UNIVERSITY OF SOUTHAMPTON

THE AVOIDANCE OF TAX ON INCOME, PROFITS AND GAINS

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CONTENTS

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ABSTRACT

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THE AVOIDANCE OF TAX ON INCOME, PROFITS AND GAINS

by Colin David Masters

This thesis deals with the various ways taxpayers have employed to avoid paying tax on income, profits and gains and the responses of the judges and legislators. Each type of avoidance is followed from its first appearance to the present day, where appropriate. The respective manoeuvres of the taxpayers, on the one hand, and the Legislature, on the other, are chartered, as is the attitude of the courts.

There are four sections. In the first, the various categories of tax avoidance arrangements that have been implemented over the years in the United Kingdom are examined. The second is concerned with international tax avoidance as seen from a United Kingdom perspective. Thirdly, the approach in the United Kingdom is compared with that of other countries, with particular reference to the United States of America, Canada and Australia. The last section analyses the role of the judges and examines the extent to which they have been prepared to look through the form of a transaction to consider the underlying substance. The role of the judges as makers of tax law is also considered.

The way in which the subject was researched was to examine each category of tax avoidance in a chronological order, beginning with the first moves by the taxpayer, and charting the ensuing battle of wits between the taxpayer and the Legislature from the standpoint of those who have had to adjudicate on the process: the judges.

INTRODUCTION

The question of how to deal with tax avoidance has been one of the biggest problems facing the Judiciary and the Legislature for many years. In fact, it is a problem that has been confronting those who make and administer the law from the end of the First World War. Initially, both the schemes used by the taxpayer, and the methods employed to combat those schemes, were relatively straightforward. As time went on, however, the picture grew ever more complex, and the problems increased dramatically in the 1960's, when high taxes coincided with a period of relative prosperity and, in the 1970's, with the property booms of that decade. During these years taxpayers had a great incentive to avoid what were sometimes substantial tax liabilities.

Legislation had to become ever more complicated to cater for the increasing complexity of the schemes implemented by taxpayers. The judges, who had to referee this perpetual game of complicated manoeuvring, had to decide to what extent they would keep to a strict literal interpretation of the law, and to what extent they could look through the form of the taxpayers transactions to examine the substance of the arrangements before them.

The picture was further complicated by the fact that different situations generated different schemes, calling for different judicial or legislative solutions. What has been built up over years, therefore, is a complex mass of legislation and case law that few can claim to understand fully.

Set out below is a detailed examination of the methods used by taxpayers to avoid paying taxes, and the judicial and legislative responses. This study has been made by going back to the "raw material" of the law, the cases and the statutes, and examining them in depth to build up a picture of how particular types of scheme have been combated. it will be seen that more attention has been given that is normal to the decisions and pronouncements of lower courts, where matters have proceeded further. This is often a neglected area. A case may go, for example, to the House of Lords, but it is not uncommon for the most incisive analysis to have been given by the judge at first instance, or the judges in the Court of Appeal. Accordingly, often a case will be examined through all of its stages in the courts so as to give as full a picture as possible.

This examination is restricted to taxes on income, profits and gains; it does not cover taxes such as Estate Duty and its successors, Stamp Duty or Value Added Tax, each being worthy of a separate study of its own.

Furthermore, this study deals over with legal tax "avoidance"; not illegal tax "evasion". In this connection, it should be noted that some judges, particularly in past years, have used these terms loosely and have spoken of "evasion" when they have undoubtedly meant "avoidance", as those terms are now understood. However, the meaning is normally clear from the context.

The first eight Chapters are each devoted to a particular category or class of avoidance arrangement. The subject matter has been divided up in this way because the type of arrangements implemented, and consequently, the responses of the judges and the legislators have depended on what the taxpayer has been trying to achieve and the taxes he has had to avoid.

The treatment of the topic in each Chapter basically follows the same pattern, namely, the subject or a particular aspect of it is considered chronologically, beginning with the first manoeuvres, and following the changes through to the present day, where appropriate, as taxpayers and the legislature found fresh ways to defeat the latest moves of the other side, with the courts constantly ruling on the success of failure of the attempts of the protagonists.

Chapter 9 deals with international matters from a United Kingdom standpoint. As communications and international trade have increased throughout this century, so new opportunities have presented themselves to taxpayers, and new problems have had to be faced by the Inland Revenue and Parliament.

Chapter 10 looks at how other countries have dealt with the same problem, with particular attention being given to three countries with common law jurisdictions not greatly dissimilar from that of the United Kingdom: the United States of America, Canada and Australia. These countries, plus the others dealt with in Chapter 10, provide interesting comparisons with the United Kingdom because each country has gone about countering tax avoidance in a different way, with different results.

Chapters 11 to 13 deal, not with particular types of scheme, but with important matters of general application. Each is concerned with the attitudes of the judges. The examination of the progress of tax avoidance in the earlier Chapters shows that the judges and their attitudes lie at the heart of the subject. Their changing approaches and views, as might be expected, have had a fundamental effect on the type of arrangement attempted by taxpayers, and the responses of the Legislature. Chapter 11 examines the question of how far judges have been prepared to look through the form of a transaction to what lies underneath. There has been no single answer to this question, attitudes have varied over the years, and from judge to judge. The whole subject took a significantly different direction in the 1980's and the reverberations are still being felt today. Chapter 12 looks at an associated matter: how far the courts will ignore the existence of companies. Chapter 13 examines the question of the extent to which judges in tax matters should make, rather than merely adjudicate on, the law.

In Chapter 14 the conclusions from the earlier Chapters are drawn, and suggestions for charting the way forward are made, based on the experiences of the past and the lessons to be learnt from abroad.

Changes in the law up to 28 February 1990 have been covered in this examination.

CHAPTER 1

THE EXTRACTION OF PROFITS FROM COMPANIES AND THE MANIPULATION OF COMPANIES AND THEIR SHARES

GENERAL INTRODUCTION

A great many tax avoidance devices have concerned the exploitation of corporate entities. The distinct legal identity of companies together with a general reluctance of the courts in this country to pierce the corporate veil have ensured that, from the days when tax rates first became high enough for taxpayers to be seriously concerned about them, many taxpayers have been seeking to use the corporate form, in one way or another, to reduce or eliminate their tax liabilities.

The legislature has naturally sought to counter these moves by the taxpayer in very many ways and with strikingly different levels of success. The judiciary, for its part, has had to adjudicate in this battle of wits. The interpretation given by the judges to the legislative provisions and their attitude towards the manoeuvres of the taxpayers have greatly influenced the type of arrangements undertaken to avoid tax and the response of the law makers.

In this Chapter, the history of the exploitation of companies for tax avoidance purposes is examined. This exploitation has taken many forms, prompting a wide range of counteracting measures. Many of these measures have proved ineffective, to a greater or lesser extent, and the approach of the legislature has altered and become more sophisticated over the years.

Part 1 of this Chapter considers the question of extracting funds from a company. This has been a problem that has been exercising the minds of taxpayers and their advisers for many years. The normal methods of extracting funds, such as by way of dividend or remuneration, have normally attracted their own tax liabilities.

Taxpayers were quick to appreciate that a straightforward method of removing funds from the corporate sector was to convert income into capital. For a number of years, the courts had to consider the efficacy of these arrangements.

Part 2 is concerned with this topic in the light of the profits tax provisions. These provisions were amended and refined until there was built up the current comprehensive code of distribution and related provisions dealt with in Part 3.

A particular breed of sophisticated avoidance devices are examined in Part 4. These schemes became widely known by the catchy titles "dividend stripping", "stock stripping" and "bond washing". The arrangements falling within these categories demonstrate clearly the difficulties the judiciary and the legislature faced when trying to cope with the ingenuity of taxpayers and their advisers.

The manipulation of shares and securities, particularly in "dividend stripping" arrangements, eventually prompted the introduction of broader-based anti-avoidance provisions. These are examined in Part 5.

Part 6 also deals with a particular type of anti-avoidance legislation. It will be seen in Chaper 10 that some other countries, such as Canada and Australia, have general anti-avoidance provisions. Although the UK has some wide and sweeping tax legislation, there is no current general provision aimed at all forms of avoidance. The nearest this country came to such general provisions were in two sections, one concerning profits tax, the other excess profits tax. Part 6 of this Chapter considers these sections and the reasons why such provisions would not be a suitable solution today.

Because of the different rules and rates applying to companies and individuals, individual taxpayers have often found it attractive to keep funds locked in their companies, rather than extract the funds and pay what was originally the resulting surtax liabilities. Some of the very earliest anti-avoidance legislation was concerned with this question and such legislation has been on the statute book in various guises, reflecting the changing circumstances in the intervening periods, ever since. This legislation is the subject of Part 7 of this Chapter.

Finally, Part 8 concerns the use of companies for the exploitation of the services of high-earning individuals, particularly entertainers and sportsmen.

The general question of "piercing the corporate veil" is dealt with in Chapter 13 and certain international aspects of the exploitation of companies are examined in Chapter 9.

PART 1

CAPITALISATION ARRANGEMENTS

Introduction

Extracting funds from a company in the form of income (principally dividends or remuneration) normally generates tax burdens; in the past, often extremely high tax burdens. On the other hand, capital gains were originally tax free and, even when such gains were specifically brought within the tax net, the burden of capital gains tax was normally much lighter than that attaching to income profits.

Accordingly, it has usually been very attractive for individuals to avoid income receipts such as distributions of income or salaries and to seek to extract company funds in the form of capital.

Eventually, there was built up a comprehensive framework of legislative provisions, which are examined below, but it took many years of judicial and legislative activity before that position was reached.

The Early Years: The Influence of Blott

In the 1920s and the early 1930s there were a number of cases involving the capitalisation of profits as the legislature experimented with ways to prevent the easy circumvention of the distribution rules in the absence of more sweeping legislation introduced many years later, such as section 28 FA 1960.[1]

A series of cases concerned arrangements which sought to exploit the rule that a company could convert its profits into capital (assuming it was authorised to do so under its articles) and that this was conclusive for tax purposes.

The most straightforward method of achieving this was through the issue of bonus shares or debentures.

The first major case on this was IRC v Blott.[2] This case was one of the major factors forcing the introduction of s 21 FA 1922.[3] The facts were very simple: the taxpayer owned shares in a company which declared a bonus out of its undivided profits and, in satisfaction of such bonus, had allotted fully paid ordinary shares to its shareholders. The taxpayer had no option to receive cash in lieu of shares.

The House of Lords, by a majority, held that the shares were capital.

The Crown had contended that the taxpayer ought to be treated as if he had received a cash distribution and then reinvested that money in the company's shares. This was rejected by the courts even though the directors' report had referred to the proposal to declare a

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1. Now section 703 ICTA 1988
2. (1921) 8 TC 101
3. See Part 7

dividend. This was "bare machinery" and could be ignored.[4] Lord Haldane set out the principle in the following passage.[5]

> "It is within the power of an ordinary joint stock company with articles such as those in the case before us to determine conclusively against the whole world whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not distribute them at all, but apply them in paying up the capital sums which shareholders electing to take up unissued shares would otherwise have to contribute. If this is done the money so applied is capital and never becomes profits in the hands of the shareholder at all. What the latter gets is, no doubt, a valuable thing. But it is a thing in the nature of an extra share certificate in the company. His new shares do not give him an immediate right to a larger amount of the existing assets. These remain where they were. The new shares simply confer a title to a larger proportion of the surplus assets if and when a general distribution takes place as in a winding up. In these assets the undistributed profits now allocated to capital will be included, profits which will be used by the company for its business but henceforth as part of its issued share capital. Such a transaction appears to me to be one purely of internal management with which...no Court can interfere."

The shares did not therefore constitute income in the taxpayer's hands and he was not liable to Super-tax in respect of them.

This case was authority at least for the proposition that bonus shares issued out of accumulated profits did not attract a sur-tax (or income tax) liability.

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4. See, for example, Viscount Cave at pp 235-6
5. pp 184-5

Not unnaturally, other taxpayers sought to take advantage of Blott's case, not always with the same sucess. Shortly after Blott there were three cases which went in the Crown's favour in the High Court: Pool v The Guardian Investment Trust Co Ltd.[6]; Roe v IRC[7]; IRC v Doncaster[8].

The facts in the Guardian Investment Trust case were somewhat different from those in Blott but the point at issue was similar.

The taxpayer company owned shares in a US company. The US company decided to distribute some of its accumulated surplus funds. The US company therefore declared an Extra Dividend to be satisfied partly in cash and partly by the distribution of stock it held in another US corporation. At the same time, the US company announced its intention to reduce the regular rate of dividend from 10% to 8%, explaining that the annual dividend from the stock in the Extra Dividend would compensate for this. The taxpayer company received its Extra Dividend and thereupon sold the stock element for cash. It claimed that the proceeds were not taxable income because the stock element of the Extra Dividend was a distribution of capital. Sankey J in the High Court, however, held, distinguishing Blott, that the Extra Dividend was a distribution, not of capital, but of taxable income.

The judge explained his conception of the distinction between capital and income by likening the former to a reservoir and the latter to an outlet stream, which was not a gain accruing to capital, but a gain derived from it. Applying this to bonus shares he said:

> "From the reservoir of capital certain proceeds were allowed to flow down the outlet stream, but these

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6. (1921) 8 TC 167
7. (1921) 8 TC 613
8. (1924) 8 TC 623

proceeds were not allowed to reach the shareholder. The company enlarged the area of the reservoir and put back the proceeds into the enlarged reservoir; in other words, the proceeds in that case never became the profit or gain or income of the shareholder, but were put back, into the capital of the company and the unissued shares issued to the shareholder in respect thereof. Now in the present case just the opposite has happened. The proceeds have been allowed to flow down the outlet stream but they have not been put back into capital. They have been allowed to reach the shareholder in the form of a cash payment and as a dividend in specie of the shares of another company,....there has been a distribution of money or money's worth."[9]

Roe and Doncaster were both decisions of Rowlatt J. In Roe, the shareholders in a company (of whom the taxpayer was one) agreed to buy out another shareholder. To give them funds to do so, it was agreed that £45,000 should be distributed out of the profits of the company by way of special dividend. The taxpayer, prior to the resolution authorising the dividend, signed a letter authorising the directors to use his dividend to buy his proportion of the outgoing shareholders shares. However, despite this letter, it was held that the arrangement was not a capitalisation of profits. The taxpayer received his dividend as income.

This decision must be right. The taxpayer received an income distribution and the fact that he was obliged to spend the money in the purchase of shares was irrelevant. This is so despite the fact that, had they not decided to buy the outgoing shareholder's shares, the dividend would not have been paid. This too must be right. The taxpayer had argued that the whole trasnaction ought to

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9. p. 179

be looked at as a whole and treated as a capitalisation of profits in £45,000 of debentures to the outgoing shareholder which he had agreed, as part of the overall plan, to acquire. This Rowlatt J refused to do. There was a declaration of a dividend regardless of the understanding that it would be used in a certain way.

Rowlatt J did not have to consider Blott in the Rose case, but it was directly in point in Doncaster and he had to distinguish it.

There were a number of director/shareholders of whom the taxpayer was one. For a number of years they set aside out of profits certain sums as a reserve fund. After a few years it was resolved that the fund be distributed to the shareholders "as a funded debt payable at the option of the directors in cash or in fully paid preference shares at par". It was in fact paid in cash and credited to the directors' loan accounts.

Rowlatt J held that the fund was receiveable as income and the taxpayer was correctly assessed to Super-tax on his receipts. The judge obviously had to deal with Blott. He noted that in Blott the nub of that case was that there was an increase in capital[10] and the undivided profits were capitalised into additional shares.

In the judge's opinion it was important that the shareholders in Blott had no choice; they could not have cash instead.[11] In Doncaster the directors decided to distribute the fund not as shares but as cash.[12]

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10. Although he thought the absence of an increase in Doncaster "immaterial".
11. See, however, the Court of Appeal in <u>IRC v Coke</u> (1926) 11 TC 81, infra.
12. p. 631

The failures of the taxpayers in the Guardian, Roe and Doncaster cases did not deter taxpayers in other cases. There followed a number of cases in which the taxpayers managed to extract distributable profits from companies without triggering a liability to tax.

A few days after Rowlatt J had heard Roe and Doncaster the Court of Appeal found for the taxpayers in IRC v Burrell.[13] Rowlatt J, who also found for the taxpayers in this case, dealt with Burrell before he heard Roe and Doncaster.

The taxpayers in Burrell were partners in a firm which held shares in a number of companies, each of which owned one ship. When a ship was sold or lost, the company which owned it went into liquidation and its surplus (including reserves set aside out of profits and its other accumulated and current profits) were distributed among the various shareholders.

Rowlatt J and the Court of Appeal both held that the undistributed profits were not received by the shareholders as income.

Counsel for the Crown had pointed out that there were profits, which had not ceased to be profits, and they found their way into the hands of the shareholders. The answer given by Rowlatt J was that, under company law, on liquidation, its assets cease to be either capital or income, they are simply assets which have to be dividend as such.[14] The Crown's argument was an attempt to invoke the economic substance approach.[15] This was rejected by Rowlatt J and by the Court of Appeal.[16]

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13. (1924) 9 TC 27
14. p. 36
15. For an analysis of this doctrine, see Chapter 11
16. See, for example, Pollock MR at pp 39-40

Rowlatt J also found for the taxpayer in Whitmore v IRC.[17] Undivided profits were appropriated for distribution among ordinary shareholders by the issue of debentures redeemable at one month's notice. The taxpayer held all of the ordinary shares and so all of the debentures were issued to him. He was assessed to Super-tax in respect of the debentures.[18]

The Special Commissioners upheld the assessment, deciding that the transaction was not a capitalisation of profits, but merely a cloak to cover the distribution of profits to the taxpayer.

Rowlatt J however, held that the debentures constituted a capital receipt in the hands of the taxpayer, and that he was not assessable to Super-tax. The approach of Rowlatt J to this transaction is discussed further in Chapter 11.

A similar case was IRC v Fisher's Executors[19], which is also analysed further in Chapter 11. Here again a company capitalised part of its undivided profits and created debenture stock which it issued to ordinary shareholders by way of bonus. The debenture stock was redeemable at the option of the company. It was held by the Court of Appeal and the House of Lords that the bonus was not a distribution of income.

However, Rowaltt J found for the Crown.[20] He was of the view that the undivided profits were in substance being put into the hands of the shareholders.

The Court of Appeal considered that the taxpyers had to receive the distrivbution in a particular form - this is

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17. (1925) 10 TC 645
18. He also received new ordinary shares but, following Blott, no assessment was issued in respect of them.
19. (1926) 10 TC 302
20. He actually heard this case before Whitmore.

the Blott line - so that they stood as a creditor of the Company, which was different form the recipeint of undivided profits.

This case in the House of Lords is interesting in the difference of approach adopted by Viscount Cave LC on the one hand and Lord Shaw of Dunfermline and Sumner on the other hand.[21]

Viscount Cave LC felt himself bound by Blott[22] and decided that the taxpayers did not receive undivided profits in an indirect way.

It was accepted by Lords Shaw and Sumner that, looking at the economics of the transactions, value representing the company's profits ended up in the hands of the shareholders, but Lords Shaw and Sumner felt themselves bound by the form of the arrangements.[23]

Lords Shaw and Sumner seemed to be dissatisfied with the decision they had to give but said that it was a matter for the legislature to change the law.

This case really underlines the fact that, as this stage of the development of the law, a company and its shareholders could ensure that profits of the company could be extracted without giving rise to an income distribution fairly easily, as long as they were careful enough.

Also, this case, and the Whitmore case, showed that funds could be extracted from a company as capital simply by issuing debenture stock which was redeemable at the option of the company or the shareholder, even if the redemption could take place within a short time.[24]

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21. See Chapter 11.
22. In which he was also a member of the House of Lords.
23. Compare the attitude of Rowlatt J.
24. The period in the Whitmore case was one month.

Compare however, the different attitude of Macnaghton J during the Second World War in the case of Aykroyd v IRC,[25] in which the judge was at pains to distinguish to Fisher's Executors case.

So, merely by using a simple capitalisation scheme, a taxpayer could end up in a very short time in the same financial position as if he had received a cash dividend, but he would have received it tax free.

Four days before the House of Lords handed down their judgments in Fisher's Executors, Rowlatt J decided in favour of the Crown (as he had done in Fisher's Executors) in IRC v Coke and IRC v Wright.[26] However, he was again overruled by the Court of Appeal.

This was another case in which a company paid a bonus out of undivided profits. The company offered as capital new ordinary shares in satisfaction of the bonus. Shareholders could take shares or cash. One of the taxpayers took partly shares and partly cash (Coke); another (Wright) took shares only.

Rowlatt J held that the bonus was income for the purposes of Super-tax in each case. As in the Doncaster case, he though that the root of the Blott case was that the taxpayers there had no choice. He thus distinguished Blott.

The taxpayer who had taken both shares and cash (Coke) did not appeal; the one who had only taken shares (Wright) did. The Court of Appeal held that his bonus was not income. They held that the case was indistinguishable from the Fisher's Executors case. The company was dominant and could choose how it dealt with its undivided profits and the company's decision could

25. (1942) 24 TC 515, infra.
26. (1926) 11 TC 181

not be overruled even though the shareholders were given an option as to how they received their share. Thus Rowlatt J's reliance on the lack of choice in Blott was misplaced. If the option was actually exercised and cash taken instead, the cash would, it appears, have been income on the basis of Coke's case which was not taken to the Court of Appeal.

Into the 1930's, and the courts were still having to consider similar indirect distribution cases, and Rowlatt J was still largely unsympathetic to them. Wilkinson v IRC[27], concerned a company which, as part of a deal under which it was taken over, assigned to its existing shareholders the shares in a subsidiary. The subsidiary's shares were declared to be capital assets by the assignor parent in excess of its liabilities.

The taxpayer, a shareholder, was assessed to Super-tax on the value of the subsidiary's shares received by him to the extent that they had been acquired by the parent out of accumulated profits.

Rowlatt J though thtat the case was identical to the Guardian Investment Trust Co. case.[28] He said that, if it had been a distribution of the company's own shares, on the capital being increased, Blott would have ruled; but this was merely a distribution of money's worth.

Also in the 1930's is Income Tax Commissioner, Bengal v Mercantile Bank of India Ltd.[29] The judgment of the Privy Council in this case is interesting in the fact that Blott and Fisher's Executors were applied and Lord Sumner's approach was approved. This treatment of Blott and Fisher's Executors is different from that of Macnaghten J in Aykroyd during the Second World War.[30]

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27. (1931) 16 TC 52
28. p. 58
29. [1936] AC 478
30. Infra.

In the Mercantile Bank of India case, a company capitalised its accumulated undistributed profits and issued bonus debentures which were subsequently redeemed. The Privy Council held that the shareholders did not receive any taxable income.

Lord Thankerton, delivering the judgment of the court, said that it was not possible to distinguish Fisher's Executors. Lord Sumner's approach was commented on with approval (see pp 495-6).

The judicial face was turned even more firmly against capitalisation schemes during the Second World War. Macnaghten J went to considerable lengths to distinguish Fisher's Executors in order to find against the taxpayer in Aykroyd v IRC.[31]

The taxpayer owned common stock in an American company. In order to avoid UK tax, he transferred the stock to two Candian companies. The American company issued debentures redeemable at the expiration of six years or at thirty days' notice given by the company. The company declared dividends on the common stock payable in debentures and the Canadian companies received dividends in the form of debentures. The Canadian companies paid dividends on their shares in cash which included the value of the debentures received from the American company.

Macnaghten J held that the debentures were income, not capital, because they were redeemable at 30 days' notice. He further held that, even if they were capital, the cash distributed by the Canadian companies was income.

The judge obviously had to address the authority posed by the House of Lords in Fisher's Executors.[32] He did

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31. (1942) 24 TC 515
32. He did not tackle the Whitmore or the Mercantile Bank of India.

this by highlighting what he considered to be a difference between Viscount Cave and Lord Shaw on the one hand and Lord Sumner on the other in their approach to Blott. He preferred his interpretation of the Cave/Shaw approach and refjected the Sumner principle.[33]

Macnaghton J thought that Viscount Cave's view had been that the distinction between Blott and Fisher's Executors was that, in Blott, the bonus was in preference shares and, in Fisher's Executors, it was debenture stock, and Blott was to be applied in Fisher's Executors because the debenture stock was not readily redeemable in normal circumstances for six years and was not likely to be redeemed at any time. He therefore distinguished Fisher's Exeuctors because, in Aykroyd, the debentures were redeemable by the company at any time on 30 days' notice.

Lord Sumner in Fisher's Executors, on the other hand was of the opinion, according to Macnaghten J, that the company was entitled to decide what form the distribution was to take, and the company's decision would be binding against the whole world. The prospect of redemption was immaterial. Macnaghten J, whilst preferring his conception of Viscount Cave's interpretation, said that, even if Lord Sumner's interpretation were right and the debentures were capital in the hands of the Canadian companies, the distributions by those companies in cash were income.

A different view of Lord Sumner's interpretation was taken by the Privy Council in the Mercantile Bank of India case. Macnaghten J did not address this point or deal with the fact that the debentures in that case were redeemable at the option of the company at three months'

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33. See Chapter 11 for another distinction in Fisher's Executors - this time between Viscount Cave on the one hand and Lords Shaw and Sumner on the other - on application of the form and substance doctrine.

notice and the debentures were held to have been received as capital.

It is difficult to see how Macnaghten J's interpretation of Lord Cave's approach can be justified on the authorities. It amounts to saying that, although an issue of bonus shares or debentures is itself a capital transaction and the actual redemption itself is a capital transaction, the fact that the two stages occur within a short period of time can change them into an income transaction.

Another case during the Second World War in which the arrangements were held to give rise to income receipts was Associated Insulation Products Ltd v Golder.[34] The taxpayer company held shares in an American corporation which declared a distribution of 7% on its capital stock, payable in the form of certificates of indebtness payable at a later date but with interest in the meantime. Macnaghten J and the Court of Appeal held that the distributions were income which arose when the certificates of indebtedness were redeemed.

There was a rather novel interection between an arrangement desigend to extract accumulated profits in a capital form with an anti-avoidance provision in Bilsland v IRC.[35]

The taxpayer held a controlling interest in a company by virtue of the votes attaching to his preference shares. He also held most of the orindary shares. The company was in a position to distribute dividends of £100,000 out of accumulated profits. In order to avoid Sur-tax, the taxpayer sold nearly all of his orindary shares to about 40 different purchasers under verbal arrangements (all made on the same day) by which he agreed to accept £75

34. (1944) 26 TC 231
35. (1936) 20 TC 446

per share and gave a promise, which he could fulfil in view of his control of the company through the peference shares, that a dividend would be paid. A week after the sale a dividend was paid in respect of one year and, in the following month, a similar dividend was paid in respect of the following year (in total £100 less tax of £25, giving £75).

The taxpayer was assessed to Sur-tax in respect of the dividend on the basis that he was still beneficially entitled to the dividend on the shares he had purported to sell, and also under section 33 FA 1927.[36]

Section 33 was a predecessor to section 30 ICTA 1970. It was aimed at bond washing and similar arrangements whereby a person would sell securities which were about to pay a dividend or interest for a capital sum. No charge arose under section 33 if the taxpayer could prove that the avoidance of tax was exceptional and not systematic.

The Special Commissioners decided that the sale of shares was effective to deny the taxpayer a beneficial interest in the dividend but that the case did fall within section 33.

However, Lawrence J held that there was no evidence to support the Commissioners' finding that the avoidance of Sur-tax was not exceptional, and he found for the taxpayer.

The Case Stated disclosed that the taxpayer had admitted that he intended to avoid Sur-tax.[37] It was also admitted that most of the purchasers (many of whom were employees of the company) could not have found the purchase money had they not been able to rely on the

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36. See Part 4, infra.
37. p. 449

promised dividends. Furthermore, the taxpayer, who had also in most cases paid the stamp duty and deducted it from the purchase price, had agreed to wait for the purchase money until the dividends had been paid. No purchaser paid the balance of the purchase price before the date of the second dividends and in most cases the dividend warrants were endorsed over to the taxpayer in payment for the shares. This was, therefore, a highly artificial, composite scheme.

Lawrence J who agreed with the Commissioners that the taxpayer was not beneficially entitled to the dividends, also Lawrence J held that section 33 did not catch this scheme, basically because it was so artificial. The judge said:

> "The more planned or devised the avoidance is, the more exceptional it is..... It seems to me impossible to say fairly that a single avoidance of tax is systematic and not exceptional."[38]

It is not usual that a scheme escapes an anti-avoidance provision because it is too "planned" or "devised"!

Since 1922, the main set of legislation concerning distributions from companies, and companies refraining from distributing profits for tax reasons, has been the apportionment legislation. The history and effect of this legislation is examined in Part 7 of this Chapter.

The interaction of a capitilisation scheme with these provisions was considered in C.H.W. (Huddersfield) Ltd v IRC.[39] The shares in the taxpayer company were held by four individuals. The company agreed to sell it business and assets (except for £25,000 cash) to two other companies in consideration of the issue of shares by those companies and bills of exchange. It further agreed to sell the consideration shares and the bills of

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38. p. 453
39. (1963) 41 TC 92

exchange to its shareholders for £279,500. The following day, the four shareholders sold their entire holdings, 90% of which were acquired by a company outside section 245, Income Tax Act 1952.[40]

In the following month, the Comany adopted accounts, for the period covering the above transactions, showing a net profit of £32,103 and writing back reserves and provisions of £129,742. It also resolved that no dividend should be paid (except on certain preference shares).

An apportionment notice was issued so, at an EGM, it was resolved to pay a dividend of £34,000 (£59,130 gross) on its ordinary shares. Subsequently a direction under section 245 was made.

The company appealed, contending that, at the date to which the accounts were made, it was controlled by a company outside section 245.

In the House of Lords it was held, by a majority, that the company's contention was correct. Their Lordships were not blind to the fact that the individuals were in control for 303 out of the 306 days of the relevant period and that they sold their shares at a price which reflected the fact that their shares were "big with dividend", to use Lord Pearce's phrase,[41] but, nevertheless, at the date for determining control, the end of the period, the individuals had sold their shares and the company was controlled by a non-245 company.[42] The apportionment aspects are considered further in Chapter 1, Part 7, infra.

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40. The apportionment provision then in force.
41. p. 126
42. See Lord Reid at p. 119 and Lord Pearce at p. 126.

The Later Years

After the Second World War taxpayers tended to fare better than during it; the trend was mirrored in most other areas of tax avoidance as will be seen below.

Take, for example, the unreported Court of Session case of In re David Bell Limited[43]

The taxpayer company reduced its share capital from £120,000 to £90,000 by returning to its shareholders 5/- of the amount paid up on each £1 share and reducing the nominal amount of each share to 15/-. The company sought confirmation of the Court for this reduction saying that the company had funds surplus to its trading requirements. Subject to the reduction being confirmed,the capital of the company was increased again to £120,000 by the creation of 40,000 shares of 15/-.

It was pointed out to the Court that the company could have made a cash distribvution of £30,000 without having to reduce its capital but that, had it done so, the company would have suffered an increase in its profits tax liability and the shareholders might have had to pay surtax. However, the Court, while accepting that this was true, did not think that it was any ground for refusing to confirm the reduction.

A later case concerned a similar exercise except that the increase in capital came before the reduction. This was IRC v Brebner[44], a case in which the taxpayer was attacked under section 28, Finance Act 1960.[45] The point at issue was whether the transactions were entered into for bona fide commercial reasons and did not have as one of their main objects the avoidance of tax.

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43. Noted in "Taxation" magazine, 10th September 1955.
44. (1967) 43 TC 705
45. Now section 703 ICTA 1988.

The facts will be considered below[46] but, for present purposes, it should be noted that it was admitted that a tax advantage had been obtained.[47] The whole exercise was implemented in order to generate funds to defeat a takeover bid which would jeopardise the company's trade. The company could have declared a dividend to give the shareholders funds, but the ensuing surtax would not have left the shareholders with enough for their purposes.

It was held by both the Court of Session and the House of Lords that the object of the transactions was a bona fide commercial one and the taxpayer did not take part with a veiw to avoiding tax.[48]

On the other hand, attempts to extract funds in a capital form by the liquidation of the company with a view to continuing the business through a new company, and the distribution of surplus funds to the shareholders, have failed by virtue of section 703 ICTA 1988: see IRC v Joiner[49] adn Addy v IRC[50] both which are considered in Chapter 1, Part 5.

Reference should also be made to the dividend stripping cases which are considered in Chapter 1, Part 4.

Many of the situations covered by the cases considered above would now fall within one or other of the various statutory provisions which are considered later in this Chapter.

For example, in Part 3, the comprehensive distribution provisions are considered. It will be seen that these

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46. See Part 5
47. p. 706
48. See p. 713 per The Lord President (Clyde) in the Court of Session and, in the House of Lords, p. 715 per Lord Pearce and pp. 718-9 per Lord Upjohn. For a similar case, with a similar result, see IRC v Goodwin (1976) 50 TC 583.
49. (1975) 50 TC 449
50. (1975) 51 TC 71. Compare IRC v Burrell, supra and IRC v Pollock & Peel Ltd (1957).

provisions normally ensure that, where a shareholder, by an indirect route, ends up in the same financial position as if he had received a dividend, he will now suffer the appropriate income tax liabilities.

Furthermore, arrangements such as that dealt with in the Fisher's Executors case would now be covered by section 703 ICTA 1988.[51]

However, it is still the case that a bonus issue of non-redeemable shares is not a distribution, although a bonus issue of redeemable shares or any securities is a distribution except to the extent to which the issue is made for "new consideration". There are also specific provisions covering bonus issues preceeding repayments of capital and bonus issues following repayments of share capital.[52]

As regards bonus issues and the provision of section 703 ICTA 1988, a bonus issue of shares by itself would not be caught unless, perhaps, to the extent that it represents the capitalization of distributable profits.[53] Similarly, a bonus issue of debentures would also usually fall outside the provisions of the section.[54]

The redemption of bonus shares or debentures would plainly be within "circumstance" D in section 704 ICTA 1988.[55]

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51. See IRC v Parker (1966) 43 TC 396 at pp. 435-6, per Lord Hodson and p. 438, per Lord Guest.
52. See Part 3.
53. See IRC v Parker, supra at pp. 438-9, per Lord Guest.
54. Ibid, p. 432, per Viscount Dilhorne and p.442, per Lord Wilberforce.
55. See Part 5.

PART 2

PROFITS TAX PROVISIONS

Profits Tax and Distributions

Until 1937 companies were subject only to income tax at a flat standard rate. In that year, however, the national defence contribution was introduced with companies being charged at a rate of 5%. This tax was renamed "profits tax" by section 44 FA 1946. It remained until it was abolished by section 46 FA 1965 and replaced by corporation tax.

In addition, companies were subject to excess profits tax between 1939 and 1946 and excess profits levy in 1952 and 1953. Taxpayers seeking to extract funds from a company had to contend with the sometimes complicated provisions relating to these taxes.

By the FA 1947, a distinction was made in charging profits between distributed profits and undistributed profits. This was achieved by having a single rate of tax subject to a measure of non-distribution relief being granted for profits retained in the business. It therefore became necessary for the legislation to provide for the allocation of distributions to specified chargeable accounting periods so that a computation could be prepared showing the division between distributed profits and those retained within the business.

Section 35 FA 1947 defined gross relevant distributions to proprietors and indicated the manner in which distributions, and dividends in particular, were to be attributed to chargeable accounting periods. Distributions were ascertained in accordance with the provisions of section 36 FA 1947. A distribution was deemed to have taken place when, inter alia, any amount was distributed directly or indirectly by way of dividend or cash bonus to any shareholder, or assets were distributed in kind to any shareholder and, where the trade was carried on by a director-controlled company, any amount was applied by way of remuneration, loans or otherwise for the benefit of a member of the company.

The very wide definitions of distribution under the corporation tax regime and the even wider provisions relating to close companies[1] contained many of the features of this early, albeit simple, approach.

In the early 1950's, the courts considered three cases in which the point at issue was whether or not a distribution or dividend made from capital should be regarded as a distribution for profits tax purposes within section 36.

The first of these cases was Lamson Paragon Supply Co Ltd v IRC.[2]

The taxpayer company decided to pay a special dividend, to be satisfied by the distribution of one 5/- share in a subsidiary company for every £1 ordinary share in the taxpayer company. The distribution represented £125,000 of the company's reserves, which had been accumulated as a result of capital transactions over a number of years. The dividend was not subject to sur-tax in the hands of the shareholders. A distribution charge was imposed in respect of the £125,000.

The taxpayer company contended (i) that the amount of tax imposed as a distribution charge was an additional tax, over and above profits tax, at a rate of 10% and (ii)

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1. See Part 3
2. (1951) 32 TC 302

that this additional tax could not apply to a sum which was paid out of a fund which was not subject to profits tax or income tax.

The first contention was based on section 30(3) FA 1947 which imposed a distribution charge where the net relevant distributions for a chargeable accounting period exceeded the chargeable profits of that period, subject to the proviso that the distribution charge could not exceed the non-distribution relief previously given.

It had been widely thought that, on a true construction of the legislation, there was no tax on distributions as such, and that a distribution charge was simply a means of withdrawing non-distribution relief granted in earlier periods.

Harman J agreed that the distribution charge imposed by subsection (3) "is expressed as if it were an additional tax" but he also commented that:

> "It is not truly that at all. It is merely a withdrawal of a privilege obtained in a year when the company was modest in its distribution."[3]

On the company's second contention, the judge said that it was clear form the words of section 36 that a dstribtuion was a "wider thing" than a dividend. Here, having regard to the company's resolution, it was clear that the £125,000 was a dividend. The reoslution stated that, being part of the capital reserve, it was to:

> "be distributed amongst the ordinary shareholders of the company by way of special dividend or bonus of 5/- per share."

The company satisfied the 5/- per share by transferring shares as a whole at par to satisfy that amount. Harman

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3. p. 308

J held that the nature of the source from which the distribution had been made (in this case, a capital reserve built up over a number of years as a result of capital transactions) was immaterial, and that there had been a distribution for profits tax purposes within the meaning of section 36.

The other two cases were both heard by Donovan J at the beginning of 1952, in January and February respectively. First there was IRC v Bell & Nicholson Ltd.[4]

In February 1947 the company paid a dividend of £5,625 to its shareholders out of profits, not from its trade, but from the realisation of certain investments. The profit was not, therefore liable to income tax or profits tax in the hands of the company, nor was it susceptible to deduction of income tax at source when distributed to the shareholders. The Inland Revenue treated the dividend as a distribution to be taken into account in considering the amount of non-distribution relief due to the company for the chargeable accounting period ended 31st December 1947.

The company claimed that, since the dividend of £5,625 was paid otherwise than out of trading profits, it could not be a distribution for profits tax purposes. The General Commissioners, in fact, decided in the company's favour, but Donovan J reversed this finding. He held that the sum in question was a distribution within the meaning of section 36. He said:

> "On the literal construction of that language [of section 36] there is no escape from such a result, and accordingly it is argued that I must have regard to some implied limitation, which prevents the Crown from reckoning this dividend as a distribution.

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4. (1952) 33 TC 130

Such a limitation, it is suggested, is to be found in the circumstance that profits from trades or businesses are alone subject to profits tax, and distributions of such profits should therefore, it is argued , alone be taken into account in assessing the tax, even though the distribution may merely be the measure of liability.

This argument would have more force than it has, if the effect of taking a distribution of capital profits into account were to impose profits tax on an amount more than the business or trading profits earned by a concern. But such is not the effect. In the present case I am told that, whether one takes this dividend into account as a distribution or not, the net relevant distributions would be less than the full trading profits in the chargeable accounting period in question liable to profits tax. The issue merely affects the amount of relief for non-distribution."[5]

Donovan J then went on to deal with the question of what would be the position if the effect of treating this sum as a distribution were to bring section 30(3) into operation, that is, if it were wholly or partly made subject to a distribution charge. On this question. Donovan J came to the same conclusion as Harman J in the Lamson Paragon case (ie, on the company's first contention in that case).

Finally, there is the case of Bourne & Hollingsworth Ltd v IRC.[6]

The taxpayer company's capital consisted of preference shares and ordinary shares. The preference shares were entitled to a dividend of 7½%, plus a quarter of any

5. p. 133
6. (1952) 33 TC 151

dividend distributed on the ordinary shares in excess of 10%, but the total preference dividend could not exceed 10%. In 1940, £20,000, representing accretion on sales of investments in previous years, was transferred to a contingencies reserve account, and on 13th February 1947, the accounting date, the sum of £9,120 14/4d, also representing such profits, was included in the credit balance in the profit and loss account. On 6th March 1947, a further accretion of £2,011 11/- on sales of investments was realised.

On 17th March 1947, at an extraorindary general meeting, it was resolved that:

> "The sum of £20,000, standing to the credit of the contingencies reserve account and the sum of £10,916 13/4d standing to the credit of the profit and loss account, both representing realized accretions of capital assets arising from the sale of investments, be divided amongst the members...."

A total sum of £30,916 13/4d was accordingly distributed to the shareholders.

The idea of a capital distribution was discussed by three brothers who, together with certain trust holdings, were the only shareholders. The profit of the accounting period ended 13th February 1947 was disappointing, and the intention was to supplement it by a capital distribution and everyone present at the EGM on 17th March 1947 knew that the £30,916 13/4d came out of the profits of earlier periods. The matter was discussed at a directors' meeting on 5th March 1947 on the footing that the capital distribution was to be for the previous accounting period. The distribution could not have been made for the period ended 13th February 1948, because certain accounting problems would have arisen.

The company contended that, as the £30,916 13/4d was a division of a capital surplus, it was not a distribution within sections 35 and 36 FA 1947. Alternatively, the company argued that the sum was expressed to be paid in respect of the chargeable accounting period ended 13th February 1947 and therefore that the case was within section 35(1)(a), which read:

> "(1).... the gross relevant distributions to proprietors for any chargeable accounting period of a body corporate, society or other body, are the total distributions to the members of the body corporate, society or other body, not being distributions allowable as deductions in computing the profits of the trade or business for any period for the purposes of the profits tax, and being either -
>
> (a) dividends declared not later than six months after the end of that period which are expressed to be paid in respect of that period or any part thereof;"

The Crown, on the other hand, argued that the £30,916 13/4d was a distribution for the purposes of profits tax, that it was not a dividend expressed to be paid in respect of the chargeable accounting period ended 13th Feburary 1947, and therefore that the case fell within section 35 (1)(6), the wording of which was, following on from paragraph (a) above:

> (b) "distributions (other than dividends which, under paragraph (a) of this subsection, are to be treated as part of the gross relevant distributions to proprietors for any previous chargeable accounting period) made in the period;"

The Special Commissioners decided in favour of the Crown on both points. On the first point, their finding was that a distribution for profits tax purposes could be made out of a capital surplus, because that did not, involve the charging of capital to profits tax, but merely affected the rate of tax on trading profits. On the second point, the Commissioners decided that the distribution had not been expressed to be in respect of the period ended 13th February 1947.

Donovan J agreed. On the first point he followed Harman J in the Lamson Paragon case and his own decision in the previous month in Bell & Nicolson. On the second point, it had been contended that everyone in the company understood that the capital dividend was to supplement the dividend declared for the period ended 13th February 1947 and Donovan J had not doubt that this was so. But what he had been asked to do was to translate the common understanding of the shareholders into an expression by the company, and this he could not do. He declared:

> "It is not surprising to find that no period was specified, because, while it is convenient - and sometimes necessary - to do that where you are declaring a dividend out of the trading profit for a particular year, there is no heed to specify such a period when what you are declaring is a dividend out of accumulations of non-taxable profits, particularly when that dividend is an isolated one."[7]

These three cases settled that, for profits tax purposes, a "distribution" was not restricted in its meaning to a distribution of trading profits which were themselves within the scope of the charge to profits tax, but also included a dividend out of capital profits.

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7. p. 157

Even following the FA 1947, the capitalization of profits and the issue of bonus shares (provided there was no option to take cash in place of shares) did not constitute a distribution for profits tax purposes, either at the time of the issue of the bonus shares, or when share capital was repaid on liquidation or when there was a capital reduction prior to a liquidation.

It was therefore necessary to consider the nature of the bonus issue. A bonus issue made out of profits that would otherwise have been available for distribution to the members of the company in the form of a dividend would fall to be included as part of the gross relevant distributions to the proprietors for profits tax purposes. On the other hand, a company could stamp the distribution as capital if it took the form of fully paid shares. Furthermore, when an issue of bonus shares was made, the company did not distribute any part of its assets to its members.

Companies soon realised that an issue of fully-paid bonus shares out of profits did not constitute a distribution within section 36.

This issue had particular significance in relation to a company in liquidation. Section 35(1)(c) FA 1947 provided that, in the case of the last chargeable accounting period in which the trade of the company was carried on, there was to be treated as a distribution all distributions to the members in excess of the nominal value of the paid-up share capital and cash premiums paid up thereon. An increase in the paid up capital in the form of a bonus issue prior to liquidation would thus have the effect of reducing the amount distributed by the liquidator which fell to be regarded as part of the gross relevant distributions to proprietors for the last chargeable accounting period of the business.

Accordingly, where a company had undistributed profits, it could, by capitalizing those profits and issuing bonus shares, reduce its overall liability to profits tax because, on liquidation, the sum returned to the shareholders would be a return of capital for profits tax purposes.

Section 31 FA 1951 was therefore introduced to stop profits tax avoidance by means of the issue of bonus shares.

It is interesting that the FA 1951 contained specific provisions against such abuses and that the Legislature did not leave the matter to be covered by the general anti-avoidance provisions in section 32 which is discussed in Chapter 1, Part 6.

Section 31 contained rules to prevent any avoidance of liability to profits tax by the issue of bonus shares and the reduction or return of capital.

Section 31(1) provided that where, after 6th April 1949, a company capitalised any distributable sum and then, after 10th April 1951, applied a sum in reducing its share capital, the sum capitalised or the capital reduction, whichever was the lesser amount, was treated as a gross relevant distribution to the members of the company taking place at the time of the capital reduction.

Section 31(2) made similar provisions where there was a reduction of capital after 10th April 1951 and, subsequently, the company capitalised any distributable sum. Here there was deemed to be a gross relevant distribution, at the time of the capitalisation of the distriutable sum, equal to the sum capitalised or the capital reduction, whichever was the lesser amount.

A "distributable sum" was defined as meaning a sum which could be used in making a distribution, as defined in section 36(1) FA 1947, to the members of the company.

"Capitalise" was defined in section 31(5) FA 1951 as capitalising by means of an issue of paid-up or partly paid-up share capital or by paying up, in whole or in part, share capital already issued, or by creating loan stock.

Reduction in capital included the repayment or return of share capital and the repayment or return of loan capital. It did not include the repayment on redemption of loan capital or redeemable preference shares issued for full consideration paid in cash to the company. Where the company acquired any business, undertaking or property for full consideration and, in or towards payment of it, issued loan capital or redeemable preferences shares, such loan capital or shares were treated as issued for full consideration paid in cash to the company.

Although a return of capital is most common in the case of liquidation, the provisions of section 31 also operated on reductions of capital without a liquidation.

A major flaw in section 31 FA 1951 was exposed in the case of IRC v Pollock & Peel Ltd..[8]

As background to this case , the following points are relevant. If the trade of a company was carried on by a liquidator, it was, for profits tax purposes, treated as if it were being carried on by the company, except that the tax was assessed on the liquidator. Therefore, if the trade of a company was carried on by the liquidator after the company was put into liquidation, there was no cessation at the date of liquidation for the purpose of computing liability to profits tax.

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8. (1957) 37 TC 240

It has been noted above that section 35(1) FA 1947 was concerned with the determination of gross relevant distributions to proprietors for the company's chargeable accounting periods and that, in the case of the last chargeable accounting period in which the trade was carried on, there was included in gross relevant distributions to proprietors so much of any distribution made after the end of that period as was not a distribution of capital. The section then stated that the distributions which were to be treated as distributions of capital should not exceed an amount equal to the nominal amount of the paid-up share capital, together with any cash premiums paid up thereon.

Therefore, all distributions by the liquidator in excess of the nominal amount of the paid-up capital, and any cash premiums paid up thereon, were treated as part of the gross relevant distributions for the final chargeable accounting period in which the trade was carried on.

It has further been noted that section 31 FA 1951 was designed to prevent avoidance of profits tax as a result of the capitalization of profits by way of bonus issue, whether a reduction of capital preceeded or succeeded the bonus issue.

For the purpose of these provisions "references to the reduction of capital shall be deemed to include references to the repayment or return of share capital."

The taxpayer company in the Pollock & Peel case succeeded in defeating section 31 FA 1951.

The paid up capital of the taxpayer company was increased from £2,004 to £30,060 by the application of sums standing to the credit of capital reserve and profit and loss appropriation accounts. The following year the company went into liquidation and a new company took over the tapayer company's business assets in consideration of the issue of shares in the new company to the shareholders in the taxpayer company. The liquidator was left with £15,030 which he distributed to the members.

This sum of £15,030 was included in the gross relevant distributions of the company for the purposes of profits tax by virtue of section 31 F.A. 1951. The company appealed, claiming that the sum in question was not applied in reducing share capital so as to bring the provision of section 31 FA 1951 into effect. It also claimed that section 31 did not override the provisions of section 35(1) FA 1947, limiting the amount of distributions made after the last chargeable accounting period, which might be treated as gross relevant distributions, to the excess over the nominal amount of the paid-up share capital.

In the High Court, Upjohn J held that the £15,030 was not a repayment or return of share capital and that it was not a gross relevant distribution. All that the liquidator was doing was distributing the company's assets among the shareholders and those assets were capital, irrespective of their source.

In any case, even if the payment of £15,030 were a return or repayment of capital within sectin 31, the taxpayer company would still have succeeded. As mentioned above, section 31 provided that, in certain circumstnaces, a reduction of capital was "to be a distribution". Upjohn J noted that section 31 did not say that it was a "gross relevant distribution" because in section 35, "gross relevant disributions" is stated not to include distributions of capital.

The Court of Appeal agreed, holding that the payment was not a repayment or return of share capital so as to be "a sum applied in reducing capital" within section 31 FA

1951, and was a distribution of capital within section 35(1) FA 1947.

Lord Evershed MR agreed with Upjohn J that, even assuming that it was possible to say that the £15,030 might be treated as a return or repayment of capital within section 31, that alone did not necessarily mean the Crown should succeed.

The Crown had argued that section 31 had to be treated as adding two additional paragraphs to section 35(1) FA 1947 so that "gross relevant distributions" would include as a separate head, and unlimited by any restrictions in section 35(1)(c), the distributions which were described in section 31.

Lord Evershed MR rejected this argument. There was no statement in section 31 of the chargeable accounting periods to which those distributions would be related and, in addition, all section 31 did was state that certain sums of money were to be treated as "distributions" for the purpose of section 35, and not all distributions constituted gross relevant distributions automatically. It was only such of the distributions as fulfilled the qualifications of section 35 that became gross relevant distributions.

The Crown had also argued that, once the company had gone into liquidation, all the distinctions between capital and income for the liquidator's purposes disappeared, and that all he held were assets, and all he could distribute were assets.

However, Lord Evershed MR though it was insescapable that the £15,030 was a "distribution of capital" in the sense that it was a distribution of something which, so far as it was relevant to consider the distinction between capital on the one hand and income on the other, was capital. If that was so, then the qualifications at the end of section 35(1) applied, namely, the distributions which were to be treated as distributions of capital were not to exceed an amount equal to the total nominal amount of the paid-up share capital. The limit ws £30,060 and therefore, on any view, if the £15,030 was a distribution of capital, it had not exceeded the limit and was therefore excluded from the gross relevant distributions under paragraph (c).

The effect of this case was that, in the case of companies in liquidation which had made bonus issues since 6th April 1949, there would be treated as distributions for the last chargeable accounting period in which the trade was carried on, only the excess of the distributions made by the liquidator over the nominal amount of the paid-up share capital including the bonus issue. In effect, therefore, a sum equal to the bonus issue was excluded from distributions for the final chargeable accounting period.

The decision in the Pollock & Peel case was effectively superseded in the following year when the FA 1958 simplified the profits tax structure. As from 1st April 1958, the profits tax distribtion provisions were repealed. In any case, as will be seen in Chapter 1, Part 6, the Inland Revenue later successfully challenged this scheme under <u>section 32 FA 1951</u>.[9]

With the FA 1958 changes, if the trade of a company came to an end on or before 31st March 1958, subsequent distributions, whether during the life of the company or in the course of its liquidation, fell to be regarded as part of the gross relevant distributions to proprietors for the last chargeable accounting period in which the trade was carried on. Where however, accounts were made up for a period that fell partly before and partly after

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9. See <u>Ackland & Pratten Ltd v IRC</u> (1960) 39 TC 649 and <u>Jarvis Robinson Transport Ltd v IRC</u> (1963) 41 TC 410

31st March 1958, the gross relevant distributions to proprietors were ascertained for the accounting period in accordance with section 37 FA 1947, and there was then an apportionment to the separate chargeable accounting periods up to and following 31st March 1958, those distributions falling into the first period affecting the company's liability to profits tax at the old rate.

The profit tax changes in the Finance Act 1958 resulted in a simplification of profits tax computations, although there were transitional provisions which posed certain problems. As from 1st April 1958, profits tax was charged on the profits arising in the chargeable accounting period from a trade at 10% on the amount of those profits, subject to abatement relief, where appropriate, in accordance with section 33 FA 1947. Whether this actually resulted in a greater charge to profits tax than any particular company had previously paid depended on the level of profits it had distributed.

The Transitional Provisions

From 1st January 1947 onwards, many companies accumulated non-distribution relief allowed in computing their liabilities to profits tax.

The Chancellor was pressed for several years to switch from the two-tier system of profits tax to a single-tier system. The Royal Commission on the Taxation of Profits and Income recommended that this should be done.[10] When this was done in the FA 1958 it was intended that the new system should produce a broadly similar yield to the old system. This inevitably lead to a change in the incidence of profits tax. Companies that had been making substantial distributions paid less under the new system; but companies that had retained resources within their businesses generally paid more tax under the new system.

There had to be transitional provisions, principallly to prevent avoidance on the change to the new system. As was common when changes of rates, or more fundamentally, changes in the principles to be applied, were made, the transitional provisions were complicated.

An example of the transitional provisions employed during the days of the two-tier system where there was a change of rate is contained in the Fourth Schedule to the FA 1956.

Section 29 FA 1956 increased the rate of profits tax from 27½% to 30% and the rate of non-distribution relief from 25% to 27%. There was, therefore, an effective increase from 2½% to 3% on undistributed profits.

The Fourth Schedule was concerned with the prevention of avoidance by the payment of late dividends which might,

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10. Cmd 9474, para 553

under the general provisions of section 35 FA 1947, be spread back to a chargeable accounting period before the change took effect (1st April 1956). These provisions were similar to those that had operated in connection with previous changes in the rate of profits tax.

By virtue of the provisions of the Fourth Schedule, on a change of rate, where an accounting period fell partly before and partly after the date on which the change took place, there were deemed to be two separete chargeable accounting periods.

As on previous changes in the rate of profits tax, the Fourth Schedule provided for the allocation of dividends to particular chargeable accounting periods so that no advantage could be obtained by declaring a late dividend which, under normal rules, would have been attributed to a period prior to that to which the change of rate applied. The Schedule provided that if, in the case of any accounting period beginning on or before 31st March 1956, but not before 31st October 1955, the total of the dividends assignable to that period exceeded the governing total, any such dividends declared after 16th Aoril 1956 were, to the extent of the excess, included as a distribution for the chargeable acounting period beginning on 1st April 1956, or for the chargeable accounting period in which they were paid, if later. The governing total with which the dividends were compared consisted of the total of the dividends assignable to the immediately preceding accounting period, after making allowances for any variation in the lengths of the two periods, and any variation in the paid-up share capital (bonus issues being ignored).

On the 1958 changes, transitional provisions were contained in the Seventh Schedule to determine the gross relevant distributions to proprietors for the final period or periods up to 1st april 1958. It was necessary to fix on a standard period, the distributions of which had to be compared with those of a final period or periods up to 1st April 1958.

For this purpose, the "standard period" was the last period of account of the company for which either the rate of dividend could not have been affected by the six months rule in section 35(1) FA 1947, by any declaration of dividends made on or after 15th April 1958, or the company in general meeting before that day finally decided the total amount of the dividends (if any).

As has been seen above, section 35(1)(a) FA 1947 was concerned with attributing distributions to particular chargeable accounting periods for the purpose of determining the gross relevant distributions to proprietors for those periods, and provided that dividends declared not later than six months after the end of that period, and which were expressed to be paid in respect of that period, were to be treated as part of the gross relevant distributions for that period.

When the standard period had been determined, it was necessary to ascertain the rate of dividend attributable to that period. This rate was then compared with the rate of dividend attributable the subsequent period or periods up to 1st April 1958. Paragraph 1 of the Seventh Schedule provided that, where the rate of dividend for any chargeable accounting period falling between the end of the standard period and 1st April 1958, was less than the rate of dividend for the standard period, the gross relevant distributions to proprietors for that chargeable accounting period was to be deemed to include an additional distribution by way of dividend computed on the amount the paid-up share capital at the end of that period. This additional distribution was computed as the difference between the two rates of dividend. By this means, the dividend for the periods following the standard periods were brought up to the rate of dividend attributable to the standard period. If there was more than one chargeable accounting period after the end of the standard period, then the average dividends attributable to those chargeable accounting periods were compared with the rate of dividend attributable to the standard period.

If the rate of dividend for these chargeable accounting periods was equal to or in excess of the rate of dividend for the standard period, no adjustment was required under the Seventh Schedule. On the other hand, if the rate of dividend for the chargeable accounting periods was less than the rate of dividend for the standard period, the appropriate additional sum had to be included for the purpose of arriving at the gross relevant distributions to proprietors for the chargeable accounting periods in question.

If a company had not paid dividnds in the past, the provisions of the Seventh Schedule did not enable the Inland Revenue to attribute dividends to the company for the chargeable accounting period ended on 31st mach 1958. Some companies, however, had to pay a dividend for the accounting period falling partly before and partly after 31st March 1958 because of the operation of section 245 ITA 1952.[11] As will be noted below,[12] the protection of the "Cripps statement" in relation to apportionment was withdrawn for accounting periods ending after 1st August 1957.

Therefore, if accounts were made up to 30th June 1958, the apportionment provisions may have required a dividend for that year if the penal effect of seciton 245 was to be avoided. But, if the dividend was declared more than six months after 30th June 1958, the dividend was not attributable to the accounting period ended on that date. Accordingly, the delayed dividend did not affect the

11. See Part 7
12. Ibid

computation of liability to profits tax whereas, if the dividend had been paid in, for example, December 1958, it would have been treated as a distribution for the accounting period ended 30th June 1958 and the proportion attributable to the nine months chargeable accounting period ended 31st March 1958 would have attracted the distribution rate of profits tax.

It seems that the anti-avoidance provisions of section 32 FA 1951 could not operate in relation to such a delay in the payment of the dividend because, as noted below,[13] section 32(5) provided that no direction could be given by the Inland Revenue under section 32 by reason only that no distributions had been made or only a smaller distribution was made than might have been made.

The situation was the same where a company that had paid dividends in the past but which wanted to pay a greater dividend for the period that overlapped 31st March 1958, deferred the declaration of the dividends until after the expiration of the six month period. The Inland Revenue then attributed to the final chargeable accounting period the same rate of dividend as was paid by the company for the standard period but the increased dividend did not affect the computation of liability to profits tax.

For example, assume that a company paid a dividend of £2,000 gross for each year up to and including the year ended 30th June 1957. In the following year, due to the withdrawal of the "Cripps statement",[14] it had to pay a dividend of £5,000 gross. If the payment of this dividend was made after 31st December 1958, it would have been taken outside the accounting period ended 30th June 1958, but there would have been attributed to the nine months chargeable accounting period ended 31st March 1958, a notional dividend of £1,500, being a dividend at the same rate as for the standard period.

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13. See Part 6
14. Discussed in Part 7

Applying the definition of "standard period" given above to this example, where the accounting period was 30th June, the rate of dividend for the year ended 30th June 1957 could not be affected by any declaration of dividends made after 15th April 1958 and, accordingly, that year would be the standard period.

On the other hand, where accounts were made up to, say, 31st December each year, the standard period would be the year ended 3st December 1956, because dividends could have been declared after 15th April 1958, which would have affected the distributions attributed to the year ended 31st December 1957.

Companies might, therefore, have been tempted to change their accounting date to obtain a more advantageous standard period. The Seventh Schedule catered for this by providing that, where the length of a period of account was less than that regularly adopted for the preceding periods of account, it was not treated as the standard period, but was disregarded unless it was shown to the satisfaction of the Inland Revenue that the length of the period was determined before 15th April 1958.

The Financial Secretary to the Treasury, when introducing these transitional provisions, said:

> "It is a once-for-all problem and we have sought to achieve reasonable fairness without too great refinement."

On the whole it appears that, alhtough inevitably there were some cases in which the provisions operated harshly, the transitional provisions did operate fairly well, although there still was some scope for planning by delaying the payment of dividends as noted above.

Once the complicated transitional provisions had worked themselves through, profits tax computations were much simpler than they were under the old system.

It will be seen later that similar transitional rules were required on the introduction of corporation tax in 1965.

Reducing Share Capital and Section 31 FA 1956

It was noted above that, by virtue of section 36(1)FA 1947, there were included in distributions any amount distributed directly or indirectly by way of dividend or cash bonus to any shareholder, or assets distributed in kind to any shareholder and, in the case of a director-controlled company, any amount applied, whether by way of remuneration loans or otherwise, for the benefit of a member of the company.

The section was therefore widely drawn in the case of such companies, and amounts applied for the benefit of members were included as distribution insofar as they were not deductible in computing profits for profits tax purposes. The section also provided however, that no sum applied in repaying a loan or in reducing the share capital of the company was treated as a distribution.

In the case of IRC v Universal Grinding Wheel Co. Ltd[15] the taxpayer company, in December 1947, redeemed its issued £1 redeemable preference shares at their nominal amount plus a premium of 7/- per share. The company made a fresh issue of preference shares for the purpose of the redemption. The premium was paid out of the company's profits which would otherwise have been available for dividend.

In the profits tax assessment for the chargeable accounting period ending 30th September 1948, the premium of 7/- per share was treated as part of the gross relevant distributions to proprietors for that period. The company claimed that it had purchased its preference shares for 27/- per share, that the full redemption price was a sum applied in reducing its share capital and that, in accordance with section 36(1) FA 1947, no part of it should be treated as a distribution.

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15. (1955) 35 TC 551

The House of Lords held that the whole amount was applied in repaying share capital and, therefore, no part was a distribution for profits tax purposes.

Section 31 FA 1956 was enacted to deal with this type of arrangement. It provided that any sum applied after 18th April 1956 was not regarded as reducing the share capital for the purposes of section 36(1) FA 1947 to the extent to which it exceeded the nominal amount of the share capital that was repaid. Similarly, section 31 provided that, in the case of a director-controlled company, any sum applied after 18th April 1956 in repaying a loan was not excluded from distributions under section 36(1) to the extent to which it exceeded the amount of the loan. Where, before 16th April 1947, the terms of issue of redeemable preference shares conferred on the company an obligation to redeem them at a premium, and the company applied a sum, on or after 18th April 1956, in redeeming the shares, section 31 FA 1956 applied as if the nominal amount of the shares was equal to the total sum which the company was under the obligation to apply in the redemption of the shares. The position was similar where a loan was made to a company before 16th April 1947 and the company was under an obligation to repay the loan subject to a premium.

If, before 16th April 1947, a company issued shares giving a right of priority as regards capital for a sum in excess of the nominal amount of the shares (not being, in the case of redeemable preference shares, a right only to a premium on redemption) and, by virtue of that right, a sum was paid in excess of the nominal amount of the shares, then, for the purposes of section 35(1) FA 1947, those shares were treated as if they had a nominal amount equal to the sum paid by the company.

The principle of the Unversal Grinding Wheel case was, therefore, set aside by section 31 FA 1956 but it was not so displaced in the case of shares issued by, and loans made to, a compnay before 16th April 1947.

Intercompany Payments

Under section 42 FA 1938, where two companies were in the relationship of parent and subsidiary, or were both subsidiaries of a third company, any annuity, interest, or other annual payment, or any rent or royalty paid by one of the companies to the other, would be disallowed in computing the profits of the paying company and excluded from the profits of the recipient, provided that the paying company was either resident in or carrying on a trade or business in the United Kingdom. This was to prevent the artificial distribution of profits in order to obtain the maximum benefits from investment income relief, abatements, pre-national defence contribution losses brought forward etc. The introduction of non--distribution relief and distribution charges in the FA 1947 provided a loophole by means of which tax could be avoided through the medium of inter-company payments, even though these payments were still respectively disallowed and excluded from profits. It was, for example, possible to arrange a transfer of profits from parent to subsidiary so that, although the payment was added back in computing the parent's profits, that company had no funds available for the payment of a dividend and could therefore only be liable to profits tax at the 10% rate. At the same time, the subsidiary was in possession of funds which were excluded from taxable profits under the 1938 provisions and which could safely be utilised for paying dividends without attracting a distribution charge. This method of avoidance was countered by section 69 FA 1948 with retrospective effect to 1st January 1947. Section 69 said:

(1) In applying section 42 FA 1938, the rent, royalty etc. was not to be excluded from the profits of the recipient if the recipient was resident in the UK. This did not apply: (a) where a notice was in force under section 22 FA 1937 to aggregate the profits of parent and subsidiary; or (b) when the paying

company was director controlled so that the disallowed payment fell to be treated as a part of the gross relevant distributions to proprietors.

(2) When a payment was disallowed but was not excluded from profits of the recipient, the profits tax payable by the latter was reduced by 10% of the amount of the payment, or by 10% of the adjusted profits of the recipient, whichever was the lower. If a notice of aggregation had been given by a third company in respect of the profits of the recipient, then the 10% reduction was applied to the profits tax payable by that third company (i.e. the parent company), and not to the liability of the recipient.

(3) An election could be made that an inter-company payment should be allowed as a deduction in computing the profits of the paying company and taxed in the hands of the recipient (in other words, that both section 42 FA 1938 and section 68 FA 1948 should not apply to the payment) if all of the following conditions were complied with:

(a) the recipient was resident in the UK;

(b) the election was made jointly by the payer and the recipient and also by the parent company, should a third company control both the payer and the recipient for profits tax purposes;

(c) the election had to specify the first payment to which it applied and had to be made in writing to the Commissioners within six months of the end of the recipient's chargeable accounting period, or such longer time as the Commissioners would allow. The election was irrevocable, applying to the specified payment and to all future inter-company payments made between the payer and the recipient.

These provisions were designed to prevent tax avoidance and, at the same time, to ensure that the paying and receiving companies together did not suffer profits tax at more than 25% on the payment concerned.

Compared with the widely drafted provisions discussed in Chapter 1, Part 6, section 42 FA 1938 and section 69 FA 1948 had a refreshing air of precision about them. It appears that they both worked fairly well although, of course, section 42 FA 1938 had to be strengthened by section 69 FA 1948, but neither section appears to have given rise to any problems in the Courts.

PART 3

THE DISTRIBUTION PROVISIONS

The Excess Dividend Provisions

Before considering the current distribution provisions, there is an interesting preliminary matter to deal with relating to the introduction of corporation tax.

Companies became liable for corporation tax on their profits under the FA 1965. For dividends paid after 5th April 1966, the income tax deducted by a company could no longer be retained by it, but had to be paid to the Revenue under section 47 FA 1965 as Schedule F income tax. There was, therefore, an important difference between the tax position on 5th April and 6th April 1966. The FA 1965 received the Royal Assent on 5th August 1965 and so companies could, for several months, see what was in store for them. Obviously, companies which had earned large profits would have been tempted to pay as much as they could by way of dividend on or before 5th April 1966, rather than after that date. In fact, companies had notice of these changes a long time before FA 1965 received the Royal Assent because the Chancellor stated his intentions as early as December 1964.

Accordingly, section 83 FA 1965 contained elaborate and complex provisions designed to prevent this method of avoidance by restricting dividends paid in 1965/66 to a particular standard.[1] It was necessary to compare the dividends paid in that year with the average of the dividends paid by the company in the three years ended 30th November 1964 ("the standard period"), subject to adjustment upwards where the profits were higher, in a twelve month period ended in the year to 31st March 1966, than the average of the three accounting years ending

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1. Compare the profits tax transitional provisions considered in Part 2, supra

prior to 30th November 1964. The standard dividends could be computed at 7½% of the company's share capital in 1965/66 (if this exceeded the dividends paid) and the standard profits of the company could be computed at 10% of the share capital in the standard period, if greater than the average profits of the period. In the case of a company not having a period of account ending before 1st December 1964, or not having commenced to carry on business three years at least before the end of the last period of account ended before 1st December 1964, the standard amount was not less than one half of the profits of the year ended 31st march 1966. In the case of a company not carrying on business earlier than December 1963, the standard amount was 7½% of the share capital of the company in the year ended 31st March 1966 or one half of the profits of the company in that year whichever was the greater.

In considering dividend policy for 1965/66, companies obviously had to take these provisions into account but they also had to consider section 245.[2] In the case of an accounting period which was not subject to corporation tax, the principles of section 245 had to be taken into account and this could involve the payment of a dividend in 1965/66, although it related to an accounting period ended before that year. If that dividend, when aggregated with other dividends paid in 1965/66, exceeded the standard dividends, the excess fell to be dealt with under Schedule F. There were cases where the Special Commissioners took action against the company for a year prior to those to which corporation tax applied where they were willing to accept the payment of a late dividend. If the late dividend was paid in 1965/66, it had to be taken into account when considering whether any excess dividend fell to be dealt with under Schedule F. If the dividend was paid on or after 6th April 1966, it had to be treated as a distribution falling to be dealt

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2. See Part 7

with under Schedule F even though it related to an accounting period ending prior to the charge to corporation tax.

The practical effect of section 83 was that if, in 1965/66, a company paid "a gross amount in dividends greater than the standard amount", then "the excess" was to be brought into account under sections 47 and 48 FA 1965 as if it were the gross amount of dividends paid on 6th April 1966. In other words, even though the excess was paid before 6th April, it was treated as having been notionally paid on 6th April and thus exposed to income tax under Schedule F.

An exception was provided by <u>section 83(11) FA 1965</u> which read:

> "Where a company has in the year 1965/66 paid a gross amount in dividends greater than the standard amount, it may, not later than two years after the end of that year, apply to the Board to be exempted from the foregoing provisions of this section, and if the company shows that it was not the company's main purpose or one of its main purposes in paying that excess to avoid or reduce a liability under section 47(3) of this Act in respect of dividends paid after that year, the Board shall certify that the company is entitled to exemption under this subsection and subsection (1) above shall then not apply to the company."

As will be seen from the following cases, it was, in fact, difficult to persuade the Board and the Courts to grant exemption under this subsection.

The operation of these provisions can be seen in <u>Bromilow and Edwards Limited v IRC.</u>[3] During its financial year ending on 31st March 1966, the taxpayer company paid two dividends amounting in all to 25% of its share capital

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3. (1969) 46 TC 128

and, on the pattern of previous years, would not have paid the next dividned until some months after the end of that year. However, on 31st March 1966, it paid a further dividend of 15%, amounting to £170,000, making 40% in all for that year. In the following year, 1966/67, it paid one dividend of 10%. The additional dividend paid on 31st March 1966 brought the gross dividends paid in the tax year 1965/66 to a sum greater than the standard amount under section 83(1) FA 1965, and the excess of £140,192 fell to be brought into account under sections 47(3) and 48 FA 1965 "as if it were the gross amount of dividends" paid on 6th April 1966, and, accordingly, subject to Schedule F.

The taxpayer company applied for a certificate under section 83(11) that it was entitled to the exemption. This was refused and the company appealed to the Special Commissioners, who found that the directors of the taxpayer company were well aware that, if they paid the £170,000 after 5th April 1966 instead of before it, it would attract around £70,000 Schedule F tax, and that it was to avoid this that they paid the dividend before that date; and that they were also aware that a dividend of that size would result in an excess for section 83 purposes, but that they did not concern themselves with that. The Special Commissioners held that the taxpayer company had failed to show that one of its main purposes was not to avoid or reduce a liability under the Act and upheld the refusal of a certificate.

In the High Court, Megarry J held that the decision of the Special Commissioners should be affirmed because, on the plain language of section 83(11), the purpose of the taxpayer company in paying the £170,000 in March 1966 was to avoid or reduce a liability under section 47(3) in respect of dividends paid after 1965/66. The Court of Appeal agreed.

The width of the provisions were shown by a later case: Waller and Hartley Limited v IRC.[4] This was not a case in which the company artificially accelerated dividends as in the Bromilow and Edwards case, but the taxpayer company was still caught by section 83.

The taxpayer company was the principal company of a group carrying on the business of manufacturing confectionery. It made up its accounts to 31st December and held its Annual General Meeting in late March or early April, and paid its final dividends before 5th April. The group's profits before taxation were £240,079 for 1962; £292,191 for 1963; £325,369 for 1964; £316,286 for 1965; £313,166 for 1966; and £311,222 for 1967. For each of the years 1962 to 1968 the company paid ordinary dividends of 3 pence per 1 shilling stock unit, and for the years 1963 to 1965 it also paid a special bonus of ½ pence per unit. Because its dividends (including bonuses) for the three years up to the beginning of December 1964 were less than 3½ pence per unit, the gross amount of the dividends paid in the year 1965/66 (namely, the dividend and bonus for 1965) exceeded the company's standard dividends for the purpose of section 83 FA 1965. When recommending these dividends the Board knew that they would produce an excess, but they thought that, if the dividend were maintained but not increased, there would be no liability to tax under Schedule F. The distributions for 1966 and 1967 amounted to 95% of the distributable profits for those years.

In the Board's Annual Report for 1964 (dated March 1965) it was stated that future dividend policy must be determined by the profits available and the incidence of taxation. The 1965 Report (dated March 1966) stated that the proposals regarding dividends had been made to obtain the maximum advantage of the provisions of FA 1965. It was stated in the 1966 Report (dated March 1967) that the halfpenny bonus paid in the past two years was only paid

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4. (1972) 48 TC 515

to give members the full benefit of the transitional provisions of the relevant Finance Act.

The company applied under section 83(11) for exemption but this was refused. On appeal, the company contended that the Board's purposes in recommending the 1965 dividends had been to distribute current profits not required to be retained for the purposes of the business, to maintain a good yield on capital and thus discourage takeover bids, to follow the pattern of previous distributions, and not to anticipate distributions which would fall to be made out of the profits of later years. The Crown contended that the company had not shown that one of its main purposes in paying the excess was not to reduce liability to tax under Schedule F, and that the statement in the 1965 Report showed that that was a main purpose.

The Special Commissioners found that the directors' motive in recommending the payment for 1961 of the same dividend as for the preceeding year was the hope and expectation that the company would obtain a certificate of exemption under section 83(11), and held that one of the main purposes in paying the excess was avoidance or reduction of tax under Schedule F.

In the High Court, Foster J found that there was ample evidence on which the Commissioners could reach their conclusion. The judge noted that the onus was on the taxpayer company to show that it was entitled to a certificate of exemption under section 83(11) and so it had "the unenviable task of proving a negative".[5]

The application of the section to these facts as applied by the Special Commissioners, whose decision was upheld by Foster J, appears quite harsh given that there was no acceleration of the payment of dividends; the dividends for the year in question were paid on almost exactly the

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5. p. 523

same date as on previous years. Furthermore, there was no increase in dividend in the year ended 31st Decmeber 1965, which was declared on 4th April 1966. It was exactly the same as for the previous two years.

The width of the provisions was further demonstrated in Halsack Developments Limited v IRC[6] where it was held that the section even applied where the liability sought to be avoided was that of a company different from the one paying the excess dividend.

A property development company, "Town & City", either by virtue of its shareholding or by written "promotions agreements" with outside shareholders, had control of the dividend policy of the taxpayer company and of 10 other partly owned companies whose appeals were heard together. All of the appeals gave rise to the same question as that in the case of the taxpayer company. In March 1966, in anticipation of the changes in FA 1965, Town & City decided to make the largest distribution it could without incurring the charge under section 83, and required a contribution by way of dividend from the taxpayer company. The dividend paid by the taxpayer company exceeded its standard calculated in accordance with section 83.

Before the Special Commissioners it was contended by the taxpayer company that its purpose in paying the excess dividend was merely to comply with the directions of Town & City and that that purpose was its only purpose. It also contended that Town & City's purpose in requiring it to pay the dividend was to fulfill Town & City's own need for income, and not to cause the taxpayer company to avoid or reduce its liability under section 47(3). It therefore submitted that the Inland Revenue had acted wrongly in refusing a certificate under section 83(11). The Special Commissioners rejected the taxpayer company's contentions and upheld the refusal of the certificate.

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6. (1976) 51 TC 543

Before Goulding J in the High Court, it was further contended that the words "avoid or reduce a liability... in respect of dividends paid after that year" in section 83(11) referred only to a liability of the company paying the excess dividend.

Goulding J, however, held that these words were satisfied by reference to a liability relating to dividends of a different company from that which paid the excess dividend. It was sufficient that the taxpayer company, by paying the excess dividend, had helped Town & City to avoid or reduce its liability in respect of Schedule F tax after 1965/66.

The reason for this finding is clear from the following passage from the judgement of Goulding J:

> "When one reads the whole section through, the words 'avoid or reduce a liability... in respect of dividends paid after that year' are in my view without straining the language, literally satisfied by reference to a liability relating to dividends of a different company. Is there anything in the scheme of the Act or in common sense that requires one to confine the language more closely? I think not. The framers of the Act were perfectly well acquainted with the existence of groups of interrelated companies. Moreover, the scheme of section 83 is to put an automatic charge on excess dividends, wherever paid, that have the effect of forestalling future liability to tax. Subsection (11) then comes in as an exempting provision for what Parliament evidently regarded as deserving cases. Under the general transitional scheme, I see no reason why Parliament should regard a subsidiary that helps its parent company to anticipate the change of law as more deserving than a company which anticipates its own liability."[7]

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7. p. 562

It can be seen from these cases that the provision was very effective in achieving its objective. This was due to the wide terms in which the section was drafted and in the wide interpretation given by the courts who were mindful of the mischief of the section.

Current Distribution Provisions

By the time corporation tax was introduced in 1965, the experience of the past enabled the Legislature to introduce a comprehensive code to cover the extraction of funds from a company. The corporation tax distribution provision were bolstered by the "transactions in securities" legislation[8] which was introduced in 1960 ostensibly to tackle dividend stripping but which have been used by the Inland Revenue and accepted by the courts as a wider anti-avoidance provision to prevent inter alia, distributable income being extracted from a company in a capital form.

These provision can be set in context by keeping in mind that, until 1988, it was almost invariably more tax efficient to avoid cash dividends and to receive the funds from the company by way of capital receipt. The alignment of the income tax and capital gains tax rates in the 1988 Budget changed the emphasis in tax planning to a considerable extent.

What is set out below is not an exhaustive analysis of the present distribution provisions- that can be found in numerous text books - instead, a number of particular points relevant to the present study are made.

Sections 209-211 ICTA 1988 effectively place transactions extracting funds from a company into five categories.

In the first place, section 209 (1) states that references to "distributions" for corporation and income tax purposes shall not apply to "distributions made in repsect of share capital in a winding-up". It will be explained later, however, that, except in "pure" liquidation situations, section 703 ICTA 1988 may be relevant.[9]

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8. See Part 5
9. Ibid.

The other four categories contain the various types of distribution for corporation and income tax purposes. They are:

1. Dividends.
2. Distributions out of assets.
3. Transfers of assets.
4. Other distributions.

The category comprising "dividends" is fairly self-explanatory although it is worth noting that capital dividends are included.[10] It can be in the form of cash or it can be a dividend in specie. Dividends made during the course of a demerger are specifically excluded from the definition of distribution (see below).

The second category is defined in <u>section 209(2)(b)</u> as:

> "any other distribution out of the assets of the company (whether in cash or otherwise) in respect of shares in the company, except so much of the distribution, if any, as represents a repayment of capital on the shares or is, when it is made, equal in amount of value to any new consideration received by the company for the distribution."

It is not just distributions directly out of the assets of a company that are caught, otherwise a company could pay a third party to put funds into the hands of the company's shareholders. Section <u>254(9) ICTA 1988</u> counters this by poviding that:

> "A distribution shall be treated.... as made.... out of the assets of a company if the cost falls on the company."

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10. Section 209(2)(a) ICTA 1988

In the above situation, the cost would clearly fall on the company even though there had been no direct distribution to shareholders.

As will be seen below, reciprocal arrangements are also covered.

The legislation also covers the situation where one group company makes a distribution out of its assets in respect of shares in another group company. Section 254(3) ICTA 1988 prevents exploitation along these lines by enacting that "distribution" includes anything distributed out of the assets of the company (whether in cash or otherwise) in repect of shares in or securities of another company in the group.

For the purpose of this provision group is a parent company and its 90% subsidiaries. A distribution to another UK resident company in the same group is not caught.[11]

It should be noted that only direct group relationships are relevant for the purposes of section 254(3). Accordingly, distributions out of the funds of a sub-subsidiary in respect of the shares in the top company would not be a "distribution" within that subsection.

As mentioned above, a distribution out of assets excludes so much as represents "a repayment of capital on the shares". This covers only the repayment of a sum equivalent to the nominal capital paid up on the company's shares. See below for the position where a repayment occurs befor or after a bonus issue.

In addition, the special rules that apply on a purchase by acompany of its own shares are dealt with below.

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11. Section 254(4) ICTA 1988

"New consideration" is defined as "consideration not provided directly or indirectly out of the assets of the company, and in particular does not include amounts retained by the company by way of capitalising a distribution."[12] Bonus shares are not made for new consideration. However, section 254(5) states that, "Where share capital has been issued at a premium representing new consideration, any part of that premium afterwards applied in paying up share capital shall be treated as new consideration" unless the premium has been taken into account so as to enable a distribution to be treated as a repayment of share capital under <u>section 211(5)</u> (see below).

The third category of distributions is dealt with in <u>section 209(4) ICTA 1988</u>. On a transfer of assets between a company and a shareholder or a transfer of liabilities to a company by a shareholder, a distribution arises equal to the amount by which the value of the benefit received by the shareholder exceeds the value of any new consideration given by him. It should be noted that only direct transfers of assets are within this subsection. Only in the case of close companies does a charge arise where assets are provided for the use of a sharholder or his associate.[13]

Under the fourth category come the other specific ways a distribution can arise. Mention was made above of a repayment of capital occurring either before or after a bonus issue. As bonus issues have been part of extraction arrangements from the early days of this entry, it is relevant to see what the present position is relating to them.

It has been seen above that an issue of non-redeemable bonus shares is not a distributon out of assets under the second category of distribution. Furthermore, it is not a transfer of assets within the third category because a

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12. Section 254(1) ibid
13. Under section 418 ibid, infra

bonus issue does not actually transfer the ownership in any property to the shareholder. The actual act of issuing bnous shares does not by itself, of course, put any of the company's assets into the hands of the shareholders; it is when the bonus issue is linked to another transaction that distribution of assets can occur. Accordingly, a simple bonus issue of non-redeemable share is not attacked by the distribution provisions, but the combination of a bonus issue with a second element to extract funds, has been the subject of anit-avoidance legislation.

The issue of bonus redeemable shares and bonus securities, however, is treated differently: section 209(2)(c). There is here a distribution equal to the nominal value of the bonus shares or securities together with any premium payable on redemption or winding-up, "or in any other circumstances"[14] except to the extent that the shares or securities are issued for new consideration, such as when they are issued in substitution for shares which were previously issued for value.

The logic of distinguishing between redeemable and non-redeemable shares in this way is not as clear as it was before 1981 when companies for the first time were allowed to purchase their own shares. Since 1981, all shares have been, in practice, redeemable but shares that are technically non-redeemable do not give rise to a distribution on issue unless they follow a repayment of capital.

Non-redeemable bonus shares do give rise to a distribution if they are subsequently purchased by the company unless the purchase qualifies for capital gains tax treatment. This is discussed below.

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14. Section 209(8) ibid

As mentioned above, a distribution arises if both a bonus issue and a repayment of capital are made, regardless of which comes first, because, by a combination of these two transactions, funds are extracted from the company.

If a repayment of capital has already occurred, the bonus issue is treated as a distribution except in so far as the amount paid up on the bonus shares exceeds the amount previously repaid.[15] It should be noted that the repayment and the bonus issue need not be part of the same arrangement or connected series of transactions and, except in the case of companies outside section 704 D ICTA 1988[16] - where there is a ten year time limit in the case of non-redeemable shares - it does not matter how long after the repayment the bonus issue is made.

It can be seen that the net is here thrown over a wide area and there does not have to be any tax avoidance motive; a distribution will automatically arise.

The above charge does not apply where the repaid share capital consists of fully paid preference shares if, either they were in existence as such on 6th April 1965 and continued as such until repayment, or they were issued wholly for new consideration.[17] If the subsection stopped there, it would be easy to circumvent the provisions by issuing fully-paid preference shares in substitution for existing ordinary shares. The subsection therefore provides that the new consideration must not be "derived from ordinary shares".

Section 211(1) deals with the opposite situation: where a repayment of capital follows a bonus issue. The shares must have been issued after 6th April 1965 or, in the case of redeemable shares, on or after 6th April 1973. If qualifying bonus shares have been issued, on a

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15. Section 210(1) ibid
16. See Part 5
17. Section 210(2) ibid

subsequent repayment in respect of those shares, the amount distributed will not be treated as a "repayment of share capital" for the purposes of sections 209 and 210 except to the extent to which the distributions exceed the amounts paid up on the bonus shares.

Once again there is no time limit as regards the period between the bonus issue and the repayment except a ten year period in the case of redeemable shares issued by companies not within section 704 D ICTA 1988.[18] Furthermore, although the sums repaid must be "in respect of shares representing" the bonus shares, it must be noted that "all shares of the same class shall be treated as representing the same share capital, and where shares are issued in respect of other shares, or are directly or indirectly converted into or exchanged for other shares, all such shares shall be treated as representing the same share capital".[19] The net is therefore again cast widely, as in the case of section 210(1).

Also within this fourth category of distribution is "any interest or other distribution out of assets of the company in respect of securities of the company (except so much, if any, of such distribution as represents the principal therby secured)": <u>section 209(2)(e)</u>. The securities must come within sub-paragrpahs (i) to (vi) of that paragraph. It is not necessary to examine these sub-paragraphs here, but one point should be made in relation to tax avoidance. The provisions could at one time be exploited as follows. A company might not be able to obtain relief for interest because its profits were not sufficient. However, if it paid interest to a second company within these provisions, that second company could use the franked investment income thereby arising. This was normally done by making a small part

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18. Section 211(2) ibid
19. Section 211(4) ibid

of the loan dependent on the result of the company's business so that the second company received the interest as franked investment income instead of profits subject to corporation tax. The first company would usually share in this benefit by agreeing a lower rate of interest. Accordingly, there were severe restrictions applied on the application of the distribution provisions to the payment of interest to companies by section 60 FA 1982.

The final point to note about the distribution provisions in general was that, originally, the provisions did not cover reciprocal arrangements whereby two or more companies come to an agreement to make distributions to each other's members. This obvious shortcoming was remedied by paragraph 9, Schedule 22 FA 1972.[20] By virtue of this paragraph, when such an arrangement is made, the distribution provisions apply as if anything done by one company had been done by the other.

There is perhaps a flaw in the drafting of the paragraph but there is no reported instance of anyone ever having exploited it.

The actual wording of the paragrph is: "Where two or more companies enter into arrangements to make distributions to each other's members...." The wording therefore quite clearly envisages two or more companies each isuing shares to the other or another company within the same arrangement. It would not appear to cover the situation where, under the agreement, only one of the companies agrees to make a distribution to the other company's members. This might arise, for example, in the following example: company A holds 75% of the shares in the company B, the other 25% being held by, say, an individual, Mr. X. Company B is about to pay a dividend. Mr. X and the two companies enter into an agreement whereby Mr. X waives his dividend in return for the

20. Now section 254(8) ICTA 1988

transfer of assets to him from company A. The respective values of the waiver and the assets transferred would have to be carefully calculated so that the increase in the value of the shares in company B held by company A is matched by the value passing out of company A to Mr. X otherwise the transfer by company A could well be ultra vires (unless the transfer is authorised by the company's memorandum of association).

As there would be no element of reciprocity of the part of company B, it would seem section 254(8) would not apply. Whether such a construction would be accepted by a court has never been tested, but the matter could be put beyond doubt if the draftsman had been just a little more careful with the wording section 254(8). It could for exmaple have been drafted along the following lines:

> "Where two or more companies enter into arrangements whereby one makes a distribution to the members of the other or others or they each make distributions to each other's members...."

A similar construction appears possible in respect of the reciprocal arrangements provision in section 418 which extends the categories of distribution in the case of close companies (see below).

Close Companies and Distributions

Close companies are subject to the general distribution rules dealt with above but, in addition, there are further matters that are specifically treated as distributions where close companies are concerned. This is, of course, because close companies, by their very nature, are more susceptible to manipulation for reasons of tax avoidance than non-close companies.

Paragraph 9, Schedule 11 FA 1965 contained provisions categorising as distributions payments made to, and other benefits provided for, participators and their associates. These provisions are now contained in section 418 ICTA 1988.

Furthermore, paragraph 4, Schedule 14 FA 1969 introduced provisions later contained in section 285 ICTA 1970, concerning interest paid to directors and their associates. These provisions were repealed by section 45 FA 1980 in relation to interest paid in accounting periods ending after 26th March 1980.

It will also be seen below that it was thought necessary to have special provisions relating to loans to participators of close companies.

Section 418 extends the general meaning of distribution by providing in subsection (2) that:

> "Where a close compny incurs expense in or in connectino with the provision for any participator of living or other accommodation, of entertainment, of domestic or other services, or of other benfits or facilities of whatever nature, the company shall be treated as making a distribution to him of an amount equal to so much of that expense as is not made good to the company by the participator".

There are certain exemptions contained in subsection (3), namely:

(1) The provision of benefits provided for a director or higher paid employee taxable under section 154 to 165 ICTA 1988.[21]

(2) The provision of living accommodation by reason of employment taxable under section 145 ibid.[21]

(3) The provision for the spouse, children or dependants, of an employee of a pension, annuity etc on his death or retirement.

Exemptions (1) and (2) are obviously aimed at preventing double taxation and (3) provides for reasonable arrangements to be made in circumstances not likely to be exploited for tax avoidance.

Furthermore, transfers of assets or liabilities between UK resident companies in a 51% group are excluded.[22]

Although it is not expressly stated to be so, it is generally accepted that payments of cash are included within "benefit". This would also cover the sale by a participator of an asset to the company at an overvalue. Where cash is involved it is a straightforward matter to quantify the amount of distribution.

In other cases, the "expense" taken into account under subsection (2) is equated with the "cash equivalent" under the Schedule E directors and higher paid employee provisions in section 154 to 165 ibid. Except in the case of motor cars and petrol for private motoring, where scale charges apply, the basic measure of the benefit is the cost to the company of providing the benefit less so much as is made good by the employee. This is a rather sloppy piece of drafting, as in mentioned below, although

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21. See Chapter 7
22. Section 418(5)(6)ibid.

there is no reported instance of it giving rise to any problems in practice.

It should be noted that it is not just benefits provided for participators that are caught because such a restriction would be open to obvious manipulation. Accordingly, subsection (8) provides that references to a participator include an associate of a participator and that a participator in a company shall also be a participator of any other company which is under the control of the first. "Associate" is defined in section 417(3) and includes relatives[23], trustees of a settlement of which he is the settlor, and certain beneficiaries in a trust of which the participator is also a beneficiary. It can therefore be seen that a distribution can arise even when a benefit is provided for someone who has no interest in the company at all.

There are two instances of what appears to be careless drafting in section 418 although, in each case, the intention of the Legislature is clear and there seem to be no published instances of any problems actually arising in practice. Neverthless, there is no excuse for such careless drafting in a provision that can have important consequences for taxpayers, and where the mischief of the section is clear and well understood.

The first instance of careless drafting is in relation to the measure of the benfit by reference to the Schedule E directors and higher paid employees provisions.

Section 418(2) states that the distribution shall be equal "to so much of that expense as <u>is not made good to the company by the participator</u>".

The amount of the expense taken into account is stated to be "the same as would under Chapter II Part V be the <u>cash</u>

23. As defined in section 417(4) ibid
24. Section 418(4) ibid

equivalent of the resultant benefit to the participator".[24]

The relevant section in Chapter II of Part V is section 156 which provides in subsection (1) that:

> "The cash equivalent of any benefit chargeable to tax.... is an amount equal to the cost of the benefit, less so much (if any) of it as is made good by the employee to those providing the benefit."

Therefore, an amount "made good" is taken into account both under section 156 and again under section 418(2).

It is probable that a court would construe these provisions so as to correspond with the obvious intention of the Legislature but, nevertheless, taxpayers have the right to expect better service than this from the Parliamentary draftsmen.

The same comment can be made of the second instance of careless drafting. This concerns the reciprocal arrangements provision in section 418 which appears to suffer from the same defect as the main distribution reciprocal arrangements provision in section 254(8) which is considered above.

The section 418 rules are contained in subsection (7) which says:

> "Where each of two or more close companies makes a payment to a person which is not a participator in that compnay, but is a particpator in another of those companies, and the companies are acting in concert or under arrangements made by any person, then each of those companies and any participator in it shall be treated as if the payment made to him had been made by that company."

This is expressed to require the same element of reciprocity as, on a strict construction, is required by section 254 (8). Whether a court would construe the subsection as demanding reciprocity in this way has not yet been tested, but it would have been easy to draft the section so as to avoid any such conjecture.

Close Companies Restrictions on Directors' Remuneration

Section 74 FA 1965 was an unsatisfactory provision which lasted only four years. It caused great difficulties and there were few people who were sorry to see it repealed by section 28 FA 1969.

Section 74 dealt with the remuneration of directors of close companies. It was uncommercial in conception and obscurely drafted. Its effect was to disallow a corporation tax deduction for revenue expenditure even though it was wholly and exclusively incurred for the purposes of the trade, so that it passed the normal tests for deductibility. Because of this section, certain remuneration was deductible in the case of non-close companies but not deductible in the case of close companies engaged in the same business. It therefore tended to distort competition.

The rationale was, no doubt, that directors of a close company were in a much better position to exploit the system by determining their level of remuneration than directors of non-close companies. Although the remuneration had to be approved by the shareholders, often, it was presumably thought, the directors and shareholders were the same people.

But what happened with section 74 was that, in stopping perceived abuses, the Legislature denied a deduction for legitimate business expenditure. It should not be forgotten that:

(a) the expenditure passed the normal tests for deductibility; and
(b) it would have been subject to tax in the hands of the directors, possibly at a higher rate than the corporation tax paid by the company.

Section 74(1) provided for a limit on the deduction that could be made for the remuneration of directors other than whole-time service directors. This limit was 15% of the company's profits (including chargeable gains) before making any deduction for the remuneration and with the addition of franked investment income.

The 15% calculation could be based on the average profits of the preceding three years, where this was beneficial to the company.[25]

There were a number of obscure areas. For example, subsection (2) provided that the provisions of subsection (1) were not to reduce the deduction for any accounting period below £4,000, nor "if there are for more than half the accounting period at least two directors to whom subsection (3) below applies, below the aggregate remuneration within the limits permitted by subsection (3) of those directors."

Subsection (3) applied to:

> "directors who are required to devote substantially the whole of their time to the service for the company in a managerial or technical capacity but are not whole-time service directors."

If a director died or retired, not having served for more than half the accounting period, he did not qualify for the purposes of subsection (3) and no allowance was obtained for his remuneration. So, if accounts were made up to 31st December, and a director, who was a full-time working director, died or retired on June 30th, he would not have qualified for the puroses of subsection (3), although he would have done so had he remained in office

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25. Provision to section 74(1) FA 1965

until 1st July. This demonstrates how arbitrary the rules were. Proper commercial remuneration would be disallowed if a director died or retired on one day but not if he did so on the next.

In the case of directors within subsection (3) the limits on the permitted deduction for their remuneration was by reference to an overall limit of £13,000, reduced to £10,000 if, for half or more of the accounting period, there were less than four qualifying directors , and to £7,000 if, for half or more of the accounting period, there were less than three qualifying directors, with a limit of £4,000 on the remuneration of the highest paid qualifying directors and £3,000 on that of any other. If the remuneration of the highest paid qualifying director was less than £4,000, an amount equal to the difference could be made up on the remuneration of another qualifying director.

The section gave no indication as to the criteria for determining whether a director devoted substantially the whole of his time to the company. The Inland Revenue appeared to take the view that 75% of a director's time was substantial, but this figure was completely arbitrary and was capable of working harshly in individual cases.

Even the interpretation of "director" was not straightforward. The word was interpreted by reference to paragraph 6, Schedule 18 FA 1965[26] but had to be subsequently clarified by paragraph 9, Schedule 11, FA 1967[27], although, in fact, paragraph 9 merely added to the artificiality of the provisions.

Accordingly, even though a person might not have been a director in law, he could be deemed to be a director if he was a manager of the company or otherwise concerned in

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26. Now section 417 (5) ICTA 1988
27. Now section 417 (6) ibid

the management of the company's trade or business and was remunerated out of the funds of that trade or business and was either, on his own, or with one or more of his assoicates, the beneficial owner of, or able directly or through the medium of other companies, or by any other

indirect means, to control 20% or more of the company's ordinary share capital.

By paragraph 9, Schedule 11, FA 1967, a person was treated as owning or, as the case may be, controlling what any associate owned or controlled, even if he did not own or control share captial on his own.

The position could have arisen, therefore, that a person owned no shares in a company but carried out full-time management duties and be deemed to be a director by virtue of the fact that his father happened to own 20% of the ordinary share capital (not, it should be noticed, even a controlling holding). The manager's remuneration therefore fell to be dealt with in accordance with the limits set out in section 74: a ridiculous position.

The limits in section 74 were not very generous compared to general remuneration levels between 1965 and 1969 considering that the person had to devote substantially the whole of his time to the service of the company.

In view of the artificiality and obscurity of section 74, there was universal relief when it was repealed by section 28 FA 1969 with effect from 31st March 1969. Section 28 contained provision designed to prevent avoidance which could operate to disallow remuneration for periods up to 31st December 1969. It is not necessary to examine these provisions in details as they were of very limited application; basically, they averaged the remuneration for the period of nine months last subject to section 74 with the period of the same length commencing on the abolition of the section.

Extraction of Funds by Way of Loan

A straightforward means of extracting value from a company, particularly in the case of a close company, is by way of interest-free loans (or, at least, loans on beneficial terms). Arrangements involving loans from companies have been used as a means of avoiding tax since avoidance became a major issue after the First World War, right up to the highly artificial schemes of today. The various uses of loans in tax avoidance are now considered.

A basic point was determined very early on in IRC v Sansom.[28] The situation here was very straightforward: a "one-man" company made "loans" to its sole shareholder. The point at issue was whether these loans constituted part of the shareholder's income for Super-tax purposes. the "loans" were interest-free and unsecured and no dividends were ever paid. Lord Sterndale MR admitted that "anybody would approach the matter wth a very considerable amount of suspicion",[29] but he and the rest of the Court of Appeal accepted the Special Commisioners' findings that the loans were real and held that the loans did not form part of the shareholder's income for Super-tax purposes.

This case turned on the finding by the Commissioners that the loans were genuine. A finding of fact the other way was also upheld by the court in Jacobs v IRC.[30] Here, again, "loans" were made to a controlling shareholder. The Special Commissioners, however, found "that the loans in question had not been made in the course of the businesses carried on by the Companies; that the appellant as shown by his conduct in the case of Alexanders [one of the companies] had no intention of repaying them; that he had treated them as his own

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28. (1921) 8 TC 20
29. (p. 28
30. (1925) 10 TC 1

moneys; and that we could not regard them as genuine loans but must treat them as his income for the purpose of Super-tax."[31]

The Court of Session held that there was ample evidence on which the Commissioners could come to their conclusion.

These two cases turned on their own facts, as found by the Commissioners, but they do show that a genuine loan could be an effective method of extracting distributable profits from a company in a tax free form.

This was underlined in Hall v IRC.[32] In this case, virtually all of the shares of a company were held by two brothers. The company's accounts showed profits of £117,000 for the three years ending December 1919, but no dividends were paid. The company granted loans of £238,000 to the brothers, against which the capital assets of the company were increased in value by £226,000 and profits drawn upon to the extent of £57,000. The actual cash lent was mainly provided by a bank overdraft.

The brothers subsequently wished to cancel these loans, so they passed a resolution purporting to cancel the debt by writing it off against the General Reserve Account into which had been transferred the increases in the values of the company's assets plus part of the profits. The brothers were assessed to Super-tax upon £283,000.

It was held that the loans were genuine, and so they gave rise to no liability to Super-tax, even if validly cancelled, except to the extent of the £57,000 taken from the profit and loss account. However, the resolutions purporting to cancel the loans were ineffective and so the brothers had not even received the undivided profits

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31. p. 9
32. (1926) 11 TC 24

and were not liable to pay Super-tax on them. The only element on which the brothers would have paid Super-tax was on the £57,000 transferred from profit and loss account but this would only have arisen, if there had been a valid release.[33]

On the established rule that loans to shareholers do not give rise to a Super-tax (or, later, surtax) liability, see also Carnarvon Estates Co v IRC.[34]

This principle established in these early cases was never seriously challenged, and so shareholders could extract funds from a company by way of loan without having to pay tax on the money in their hands. The loans could be left outstanding (unless the company became insolvent, in which case they would have to be repaid).

Given this easy method of tax avoidance, it is surprising that no counteracting measures were taken until 1965. In that year section 75 FA 1965 introduced the "loans to participators" provisions which are now contained in section 419-20 ICTA 1988. It is not necessary here to examine these provisions in detail but a number of points relevant to the matter under consideration can usefully be made.

1. Section 75, and its successors, are restricted to close companies. This is logical because relatively few loans are made by non-close companies with a view to the extraction of funds.

2. The way the mischief is tackled is effectively that the company must also make what amounts to a loan to the Inland Revenue equal to the rate of advance corporation tax on the loan for the relevant financial year. An assessment is made on the

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33. See Scrutton LJ at p. 44
34. (1935) 19 TC 643 at p. 652 per Finlay J.

company as if the relevant amount were an amount of corporation tax chargeable on it. Although the payment to the Inland Revenue is calculated by reference to the rate of ACT, it is not treated as ACT so that, for example, it cannot be set off against the company's mainstream corporation tax liability.

3. If the participator repays all or part of his loan the company will receive an appropriate repayment of all or part of the money paid over to the Inland Revenue. In fact relief is given by discharge or repayment of tax.

4. If the loan to the participator is released or written off, he is regarded by section 421 ICTA 1988 as having received income equal to the amount released, grossed-up at the basic rate of income tax, at the date the release becomes effective. If the participator is a higher rate income taxpayer, he will be treated as having paid basic rate tax and he will be assessed to higher rate tax. On the other hand, the participator cannot reclaim the notional basic rate tax if he is not liable to the full amount of basic rate tax paid.

5. The normal meaning of "loan" is extended by section 419(2) ICTA 1988 to include a case where the participator incurs a debt to the company and where a debt due from the participator to a third party is assigned to the company. This latter provision covers the situation in which payments made to a third person on behalf of the participator would not normally consitute a loan.[35] As regards the incurring of a debt, the participator is not treated as having received a loan if the debt is incurred for the supply by the company of goods or services

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35. See Potts' Executors v IRC (1950) 32 TC 211, considered in Chapter 2

in the ordinary course of its trade or business unless the credit given exceeds six months or is longer than that normally given to the company's customers.[36]

6. For the application of these provisions it normally makes no differenc whether or not the loan is made on commercial terms.

7. The loan need not be to the participator in his personal capacity so, for example, a loan to a participator in his capacity as a trustee would be caught even though he could obtain no personal benefit from the loan.

8. There are provisions to prevent the rules being circumvented by reciprocal arrangements. Thus where a close company makes a loan which would otherwise not be caught by section 419 under an arrangement by virtue of which some person other than a close company makes a payment to, or releases or satisfies a liability of, a participator, the loan is treated as if it had been made to the participator, unless the payment in question is subject to income tax in the hands of the participator under some other provisions.[37] The logic behind this provision is clear and sensible but the drafting is slightly cumbersome. It is not, for example, stipulated that the payment to the participator should equal the loan to the non-participator; in fact, it could be much less. Furthermore, as is pointed out in "Taxation of Companies and Company Reorganisations" by Bramwell, Ivory & Brannon,[38] this provision can give rise to problems in company takeovers where the target company provides financial assistance in the form of loans to the acquiring company, for example,

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36. Section 420(1) ICTA 1988
37. Such as the "settlement" provisions considered in Chapter 2
38. Butterworths, 3rd edition, (1985) pp 267-8

on a management buy-out, where the managers form a new company, to acquire the shares in the target company in return for cash and loan stock in the new company. After the take-over, cash in the target is transferred up to the new company by way of loan to enable the new company to reduce its bank borrowings. This is a common structure and entirely commercial in nature, but a charge under section 419 could arise because the target company (a close company) makes a loan to a person not within the relevant class of borrowers (the new company) and, under the same arrangement, the other person (the new company) makes a payment to persons who are within the class of relevant borrowers (the vendors of the shares in the target company) so, under section 419(5), the loan by the target company is deemed to be made to the vendors of the shares in the target company.

9. The scope of the section is also extended to catch another obvious avoidance device in subsection (7) which enacts that any participator in a company which controls another company is treated as being a participator in the controlled company. Therefore, a loan by a subsidiary to a participator in the parent is caught.

10. The section is essentially aimed at preventing the extraction of funds from the corporate sector in a tax-free form because a charge is only triggered when the loan is to an individual[39] who is himself a participator; no charge under this section is levied by a loan to a company which is an associate of a participator. The section does, however, guard against loans being made to a company as nominee for an individual and to funds going

39. Section 419(1) ICTA 1988

offshore, thus subsection (6) provides that "references to an individual shall apply also to a company receiving the loan or advance in a fiduciary or representative capacity, and to a company not resident in the United Kingdom."

11. There is an exemption for full-time directors and employees who do no have a material interest in the company and who have a loan of £15,000 or less. This is logical and sensible exemption but it is a rough-and-ready provision: if the loan is £15,001, a section 419 charge will apply to the whole amount. Furthermore, the fact that there is a section 419 charge does not preclude a charge on the interest foregone under the benefits-in-kind legislation under section 160 ICTA 1988.[40]

12. There is, however, the avoidance of a double charge where the loan generates an income tax charge on the individual under section 677 ICTA 1988.[41] The release or writing-off of a loan will not give rise to a section 421 charge except in so far as the amount released or written off exceeds the sums previously included in the total income of the individual.[42] In determining what sum has been assessed under seciton 677, only the net sum is taken into account, not the gross amount on which higher rate income tax is chargeable.

13. To a certain extent the mischief covered by section 421 is covered by section 209(4). Without section 421 it still, in most cases, would not be possible to extract funds from a company by paying tax at an effective basic rate of income tax (ie. the rate equal to the rate of ACT on the loan written off) because it would constitute a distribution under

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40. See Chapter 7
41. See Chapter 2
42. Section 421(3) ICTA 1988

section 209(4) which states:

> "Where on a transfer of assets or liabilities by a company to its members or to a company by its members, the amount or value of the benefit received by a member (taken according to its market value) exceeds the amount or value (so taken) of any new consideration given by him, the company shall.... be treated as making a distribution to him of an amount equal to the difference."

Section 209(4) would not, however, cover the situation where the individual ceased to be a participator before the company makes the waiver. A charge under section 421 would, of course, arise in these circumstances.

13. Following the introduction of what became section 419 in 1965, it soon became clear that there was scope for avoiding the section by arranging for the loan to be made, not by the close company iself, but by a company controlled by the close company which was not itself a close company. The main ways this was achieved were:

    (a) arranging for the loan to be made by a non-resident subsidiary of the close company; or
    (b) establishing a company which was a subsidiary of the close company but which was technically controlled by a non-close company. This could be arranged as follows:

        (i) To be a subsidiary for, for example, group relief purposes, the definition now contained in section 838 ICTA 1988 was used. Under section 838 a company is a subsidiary if at least 75% (or more than 50%, or at least 90%, as the case may be) of its "ordinary share captial" is owned by the parent. The term "ordinary share capital" was defined as "all the issued share capital... of the company, other than capital the holders whereof have a right to a dividend at a fixed rate, but have no other right to share in the profits of the company."[43]

(ii) A participator in a company is also a participator in another company controlled by the first company.[44] "Control", for this purpose is defined as including possession, or the entitlement to acquire the greater part of:

(a) share capital or issued share capital;
(b) voting power;
(c) income on a distribution; or
(d) assets on a winding-up.[45]

(iii) There would therefore be two classes of shares in the subsidiary: one class would be "ordinary share capital", of which the close company would have 75%; the other would be, say, fixed rate preference shares issued to the non-close company in such numbers, and with such rights that the four criteria mentioned at (ii) above were satisfied by the non-close company.

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43. See now section 832(1) ICTA 1988
44. Section 419(7) ibid
45. Section 416(2) ibid

To encounter such devices[46] section 44 FA 1976 inserted section 287A ICTA 1970.[47] The new section, in subsection (1), provides that, where a company which is controlled by a close company makes a loan which, apart from the new section, would not give rise to a charge under section 419(1) section 419 shall apply as if the loan had been made by the close company. Furthermore, to stop an obvious avoidance device, subsection (2) states that, if the non-close company makes a loan when it is not controlled by the close company, but the close company subsequently acquires control, section 419 applies as if the loan had been made by the close company immediately after the time when it acquired control.

Subsections (1) and (2) do not apply if it is shown that no person has made any arrangements (otherwise than in the ordinary course of a business carried on by him) as a result of which there is a connection between the making of the loan by the non-close company and the acquisition of control over it, or the provision by the close company of funds for, the loan.[48] The wording of subsection (2) is rather imprecise and does offer the potential for avoiding the charge imposed by that subsection. As noted above, the subsection applies "where a company which is not controlled by a close company makes a loan....and a close company subsequently acquires control of it..." Notice that it does not say "where a company which is not controlled by a particular close company makes a loan.... and that close company subsequently acquires control of it." Therefore, if close company A controls the non-close company which make a loan (perhaps on commercial terms, perhaps not) to a participator in close company B, and close company B later acquires control of the non-claose company then, as long as A and B are unconnected, it would appear that no liability under subsection (2) could.

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46. See also the "loan scheme" part of the transactions in Bird v IRC [1988] STC 312.
47. Now section 422 ICTA 1988
48. Section 422(4) ibid

arise. Admittedly, the circumstances will rarely arise, except in arrangements deliberately contrived to take advantage of this apparent loophole; but, where a provision is aimed at a narrow and specific scheme, the public should surely be able to rely on the Legislature and the Parliamentary draftsmen to use specific and accurate language which does not leave fairly obvious gaps.

Another method of extracting funds from a company by way of loan and the specific provision introduced to combat it are examined below Chapter 2.. The provisions are contained in one of the more badly drafted, but yet enduring sections, section 40 FA 1938.[49] Its companion section section 678 ICTA 1988, was introduced in 1981.[50]

The schemes at which section 677 was introduced to counter were explained by Lord Reid in IRC v Bates in the following way:

> "These provisions were first enacted in 1938. The mischief against which they were directed appears to have been that some taxpayers, intending to avoid paying surtax, transferred to trustees of settlements shares in companies controlled by them; they then borrowed money from the trustees, who used the dividends on these shaers to make the loans. In that way the settlors got possession of the income from the shares which they had settled in the form of capital payments which did not attract surtax.

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49. Now section 677 ICTA 1988
50. The main cases, which are analysed below in Chapter 2 in relation to these provisions are: Potts Executors v IRC (1951) 32 TC 211 IRC v De Vigier (1964) 42 TC 24 IRC v Bates (1966) 44 TC 225 McCrone v IRC (1967) 44 TC 142 IRC v Wachtel (1970) 46 TC 543

> and if the trustees were complacent the settlors might never repay these 'loans'. The reason why companies were brought in appears to have been that some settlors had devised rather more elaborate schemes. A settlor might form a company, controlled by him, to which he transferred assets yielding income. He would then put the whole, or the greater part, of the shares of that company in the settlement, and then he would cause that company to lend him the whole or a part of its income, thereby diminishing the dividends which would otherwise have gone to the settlement trustees. He would not repay these loans during his lifetime, and in that way he would receive and enjoy the income of the assets which he had transferred to the company without being liable to pay surtax in respect of it."[51]

It should be noted here that, when Lord Reid referred to the company lending income to the settlor, that would normally now be covered by section 419 ICTA 1988.

51. 44 TC 225 at pp 259-260

Interest Paid to Directors

Section 285 ICTA 1970[52] stated that interest paid by a close company to a director (or to an associate of his) of the company, or of any company which contolled or was controlled by the close company, where the director had a "material interest", was treated as a distribution to the extent that it exceeded a specified rate.

This provision was abolished by section 45 FA 1980 for accounting periods ending after 26th March 1980.

Interest could still constitute a distribution if it was within the provisions of section 209 ICTA 1988 of course.

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52. Originally para 4, Sch 14 FA 1969

Demergers

The provisions governing demergers and also those relating to a company purchasing its own shares which are considered below alter the normal distribution rules and both sets of provisions also have their own anti-avoidance legislation.

The demerger rules provide three ways of dividing up the activities of a trading company or group without giving rise to the distributions that would otherwise arise.

In his Budget speech in 1980 the Chancellor said:

> "I believe there are cases where businesses are grouped together inefficiently under a single company umbrella. They could in practice be run more dynamically and effectively if they could be 'demerged'.... and allowed to pursue their own separate ways under independent management."

The ensuing demerger provisions in section 117 and Schedule 18 FA 1980[53] allowed certain transactions to be carried through without generating distributions. . In each of the cases dealt with by the legislation, distributions would usually arise under the normal rules, but they are exempt distributions by virtue of the demerger rules.

There are three types of demerger catered for and, in each case, assets of a company do not leave the corporate sector and flow into the hands of individuals except to the extent that shareholders in the old company end up with shares in another company. The three types of demerger are set out in section 213 ICTA 1988 and have become know as "Type A", "Type B" and "Type C"

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53. Now sections 213-218 ICTA 1988

transactions. They are:

Type A - An existing company transfers one or more 75% subsidiaries to some or all of its shareholders.

Type B - An existing company transfers its trade or trades to another company or companies, and the transferee company or companies issue shares to the shareholders of the existing company.

Type C - An existing company transfers to another company or companies shares in one or more 75% subsidiaries, and the transferee company or companies issue shares to the shareholders of the existing company.

Naturally, the Government were determined that these provisions should not be used to take assets out of the corporate sector or to produce unintended tax advantages.

Accordingly, there are three separate anti-avoidance provisions: section 213(10)(11) and section 214.

Section 213(10) states that the distribution must be made wholly or mainly for the purpose of benefiting some or all of the trading activities of the old company. By virtue of section 213(11), the distribution must not form part of a scheme or arrangement the main purpose or one of the main purposes of which is:

(a) the avoidance of tax;
(b) the making of a chargeable payment (this brings in the third set of anti-avoidance provisions);
(c) the acquisition by outsiders of control of any of the companies involved; or
(d) the cessation or sale of a trade.

Also, in keeping with the main distribution provisions, the shares in any subsidiary transferred in Type A transactions and in any transferee company in Type B and C transactions, must not be redeemable.[54]

This is obviously to prevent the shareholders being able to obtain cash or other assets by redeeming the shares they receive. Non-redeemable shares can, of course, normally be sold back to the company but, as will be seen below, there are separate distribution provision dealing with this possibility. The legislation has been drafted in a tight and all- embracing fashion because most other methods of converting the shares into cash are either distributions under the normal provisions or chargeable payments under the rules dealt with below.

The "chargeable" payments provisions in section 214 constitute the third group of anti-avoidance rules. These provisions tax certain subsequent payments under Schedule D Case VI.

A "chargeable payment" is defined as "any payment made otherwise than for bona fide commercial reasons or forming part of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance o tax".[55]

The chargeable payment rules are aimed at ensuring that a demerger is not followed by some transaction whereby assets are put into the hands of shareholders.

Another element in the definition of a chargeable payment is that a payment includes transfers of money's worth and the assumption of liabilities.[56] The payment can be made by any company concerned in an exempt distribution (or by a company connected with any such company) and can be

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54. Section 213(6)(a) and (8)(d) ICTA 1988
55. Section 214(2) ibid
56. Section 214(6) ibid

made directly or indirectly to a member of any company concerned in the exempt distribution (or of a company connected with any such company). The payment must be "made in connection with, or with any transaction affecting" the shares of any company involved (or of any connected company). Finally, the payment must not itself be a distribution or exempt distribution or made to another group company.[57]

The definition of "member" for the above purposes is defined widely and includes any shareholder regardless of the class or type of share held.[58]

It can be seen that these chargeable payments provisions are very wide in their ambit and they are complex in their structure. Examples of some of the transactions envisaged as falling within these provisions were set out in an Inland Revenue Press Release of 20th June 1980. For example, a chargeable payment will arise where a transferee company in a Type B or Type C transaction acquires the distributing company (or vice versa) within five years of the exempt distribution; or if the distributing company or transferee company is wound up and assets are distributed to shareholders.

Regarding the demerger provisions as a whole, it is interesting to note that a number of the transactions covered by the demerger legislation could also fall within one or more of the other anti-avoidance provisions such as:

- section 703 ICTA 1988,[59]
- section 87 CGTA 1979,[60]
- sections 25 and 26 CGTA 1979,[60]
- sections 280 ICTA 1970,[60]

57. Section 214(6) ibid
58. Section 214(2) ibid
59. See Chapter 1, Part 5
60. See Chapter 8

These sections are not excluded merely because a distribution is an exempt distribution under the demerger provisions; separate consideration would have to be given to them where a demerger is contemplated. Given the strict conditions, in most cases, if a transaction qualifies as an exempt distribution, it will be outside the other anti-avoidance sections; but this is by no means guaranteed.

Purchase By a Company of Its Own Shares

The Companies Act 1981 made it possible for companies to purchase their own shares and issue redeemable shares. Companies were given the power to issue redeemable preference shares in 1929 but the 1981 Act extended this power to all classes of redeemable shares. Furthermore, unlimited companies have always had the power to purchase their own shares; the Companies Act 1981 extended this power to limited companies.

Tax law was altered by the FA 1982[61] to improve the taxation position of companies and their shareholders on such a purchase or redemption. Without the FA 1982 changes, sale proceeds would be dealt with under the provisions of section 209 ICTA 1988 (see above). The relief applies to unquoted trading companies or holding companies of trading groups.[62]

The effect of the FA 1982 changes is that the sale is treated as a capital gains tax disposal giving rise to capital gains tax on the net proceeds, rather than higher rate income tax on the grossed-up distribution (with ACT being payable by the company).

Such a relief was a sensible one to give and has had a number of beneficial effects for companies and their shareholders.

The Government were clearly concerned that, if they were not careful, the purchase of own shares legislation could be exploited to make a nonsense of the distribution provisions that had been built up over such a long period. Accordingly, the legislation contained a number of conditions aimed at ensuring that the relief is only used for proper purposes, plus an anti-avoidance

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61. See now sections 219 - 229 ICTA 1988
62. Section 219(1)(a) ibid

provision. In fact, the Inland Revenue have interpreted and administered the legislation in a reasonable and commercial way when, if they had wanted to be pedantic and technical, they could have largely frustrated the intention of the Legislature.

Among the commercial benefits produced by the changes in company law in 1981 and tax law in 1982 have been:

1. It is now generally easier for unquoted companies to raise additional equity capital, for example, under the business expansion scheme.

2. Unquoted shares are often more marketable.

3. It is easier for family control of a company to be retained, especially on the death or retirement of a family member or where a death gives rise to a large inheritance tax liability. Family control can be retained without the other family members investing further capital of their own.

4. A dissident shareholder can be bought out.

5. Further flexibility has been given to employee share schemes in that shares can be repurchased when an employee leaves.

6. Major capital reorganisations can be carried out without the need to rely on more complex arrangements such as under section 110 of the Insolvency Act 1986.

A number of features have been built into the legislation in an attempt to ensure that a purchase or redemption is not carried out for tax avoidance reasons. Apart from the actual anti-avoidance provision which is dealt with below, the main conditions aimed at ensuring commerciality are:

1. Except when the purchases/redemption is to release funds to pay an inheritance tax liability, the transaction must be for the purpose of benefiting the company's trade.

2. After the transaction, the vendor/shareholder must not be "connected" with the company.

3. There must be a "substantial" reduction in the vendor/shareholder's interest in the company.

As mentioned above, one of the occasions on which a purchase or redemption does not give rise to a distribution is when the proceeds are used to pay an inheritance tax liability arising on death where, otherwise, the tax could not be paid without "undue hardship." This is straightforward and is not considered further here.

Purchases etc for the benefit of the trade are subject to altogether more stringent conditions. The wording of the statutory provision is:

> "References in the Corporation Tax Acts to distributions of a company shall not include references to a payment made by a company on the redemption, repayment or purchase of its own shares if..... the redemption, repayment or purchase is made wholly or mainly for the purpose of benefiting a trade carried on by the company or by any of its 75 per cent subsidiaries, and does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is -

(i) to enable the owner of the shares to participate in the profits of the company without receiving a dividend, or

(ii) the avoidance of tax...."[63]

Dealing first with the benefit-of-trade condition, this could have been construed very narrowly by the Revenue, which would have made the section difficult to apply. It could have been argued, for example, that an outflow of funds necessitated by the purchase etc would, in most cases, be to the detriment of the trade.

It should be noted that this is a subjective test and a motive test in that it looks at the purpose of the transaction, not the actual result.

The section itself does not given any indication of the circumstances in which the condition might be met. This gives the Inland Revenue a large degree of discretion in practice over the operation of the section. The Inland Revenue issued a Statement of Practice (SP2/1982) on 3rd August 1982.

Paragraph 3 of the Statement runs:

> "If the problem being resolved by the transaction is a disagreement over the management of the company, the main purpose may nonetheless be to benefit a trade if, as will usually be the case with a trading company, the disagreement has or can be reasonably be expected to have an adverse effect on the running of the trade."

Paragraph 4 gives further examples of situations likely to be treated as benefiting the trade:

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63. Section 219

"More generally,.... since it will normally be unsatisfactory to retain an unwilling shareholder, it is expected that the condition will be shown to be satisfied where, after taking into account the interest of any associates, the vending shareholder is genuinely giving up his entire interest of all kinds in the company The case of a boardroom disagreement has already been mentioned; other examples where this might happen are:

(a) an outside shareholder has provided equity finance (whether or not with the expectation of redemption or sale to the company); he is now withdrawing his investment;

(b) the proprietor of a company is retiring to make way for new management;

(c) a shareholder has died leaving shares in his estate and his personal representatives or the beneficiaries do not wish to keep them."

The Inland Revenue have generally been very reasonable about this condition. If it can be shown that a situation similar to those mentioned in the Statement has arisen, they normally allow capital gains tax treatment even without direct evidence of how it has benefited the trade.

Turning to the anti-avoidance provision in section 219(1)(a), the meaning is clear although the drafting is confused. Reference to the wording of the section set out above will show that the purchase etc must be "made wholly or mainly for the purpose of benefiting a trade" and must not "form part of a scheme or arrangement the main purpose or one of the main purposes of which is - (i) to enable the owner of the shares to participate in the profits of the company without receiving a dividend, or (ii) the avoidance of tax..."

At first it appears odd that a purchase can be made wholly or mainly for the purpose of benefiting the trade and be part of an arrangement the main purpose of which is tax avoidance, as envisaged by the section. The answer is that one looks to the purpose of the purchase itself to see whether the first limb is satisfied, and to the purpose of the scheme or arrangement as a whole to see if the second limb is satisfied; although, even here, it is not easy to think of a clear example of such a situation.

This could potentially lead to difficulties in applying the section if the Revenue wished to be pedantic, but they have generally taken a sensible and commercial approach to the section.

There is another provision in the legislation relating to schemes and arrangements. This is contained in section 223(2). This paragraph covers the situation where the relevant conditions for the relief are satisfied immediately after the purchase etc, but subsequently the vendor (or any associate) changes his interest in any company so that the conditions cease to be satisfied. Such a change must be part of a "scheme or arrangement", but any transaction occurring within one year after the purchase is deemed to be part of a scheme or arrangement of which the purchase is also part.[64] This paragraph prevents a number of straightforward avoidance devices and does not appear to have given rise to any problems in practice.

As noted above two of the other conditions which are particularly aimed at ensuring that only commercial purchases qualify for the relief are:

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64. Section 223(3) ibid

1. There must be a "substantial" reduction in the vendor's interest in the company.[65]

2. Immediately after the purchase etc the vendor must not be "connected with" the company.[66]

As regards a "substantial" reduction, this test is satisfied if the fraction of the company's nominal share capital owned by the vendor is reduced by at least 25%.[67] Shares held by "associates" are taken into account. The Inland Revenue have to be convinced that there are genuine commercial reasons for the failure to sell or redeem all of the shares at once; although, again, they tend not to be unduly rigid in the application of this rule.

The second of the tests is that the vendor must not be "connected with" the company following the purchase or redemption. The rules for determining whether a person is connected with a company are contained in section 228 but broadly they prohibit a person (together with his associates) possessing, either directly or indirectly, or being entitled to acquire, more than 30% of the issued share capital of the company, its loan capital and issued share capital, its voting power, or its assets on a winding-up. By virtue of this condition, a shareholder cannot use the relief to extract funds from the company while at the same time retain a sizeable interest in the company.

Generally, as with the demerger provisions, the fact that the relief in section 219 is granted does not automatically mean that other anti-avoidance section cannot apply. Normally, as a matter of course a section 707 ICTA 1988[68] application is made at the same time as

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65. Section 221 ibid
66. Section 223(1) ibid
67. Section 223(4) ibid
68. See Part 5

an application for advance clearance under section 219[69], but a prospective purchaser (or holder of shares to be redeemed or repaid) must also consider the possible application of the "value shifting" provisions of section 25 and 26 CGTA 1979.[70]

The changes in the Finance Act 1988 to the capital gains tax regime had a curious effect in connection with these provisions in many cases.

The relief is obligatory, not discretionary; it is not something a taxpayer can claim if he wants it; he must have the "relief" even if he does not want it. Section 219 states that references to distributions "shall not include" transactions falling within the relevant categories if the conditions are fulfilled.

With capital gains tax rates being brought into line with income tax rates by the FA 1988, it is often better to be treated as receiving a distribution, than as having a CGT disposal. Assuming the company can use its ACT arising from a distribution, it will be in the same position either way, but the shareholder's tax situation is likely to be greatly different. If he qualifies for the relief, he will pay CGT at 25% or 40% (in practice, it is normally the latter) on the net proceeds, after taking into account rebasing, indexation, annual exemption and any other reliefs. With a distribution, he will pay higher rate income tax at 15% on the grossed-up distribution, normally giving an effective rate of 20% (for 1988/89 or 1989/90). This could be half the effective CGT rate (depending on the effect of rebasing etc).

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69. Using the procedure in section 225 ICTA 1988.
70. See Chapter 8

There is therefore the rather bizarre position, following the FA 1988, that some taxpayers are deliberately structuring their purchases or redemptions so that they would not qualify for the relief.

This is one example of the situation thrown up by the FA 1988 where, in many cases, it is now better to have an income receipt rather than a capital one, and the large number of anti-avoidance provisions aimed at preventing a taxpayer converging income into capital (for example, section 703 ICTA 1988), have lost much of their sting.

Stock Options

It is noted above that bonus shares do not constitute a distribution unless they are issued at the same time as or after a repayment of capital or unless they are redeemable. Another exception relates to stock options, namely, where a shareholder is given the option of receiving a dividend in cash or inshares.

Section 34 F(No2)A 1975,[71] substantially reintroducing legislation in force between 19th March 1968 and 6th Aoril 1973,[72] imposed a charge to income tax on bonus issues made after 5th April 1976 in pursuance of a stock option. The income tax charge arises when the shares are issued. The recipient is treated as having received income equal to the grossed up equivalent of the "appropriate amount of cash". This will normally be the value of the alternative cash dividend. The issue is not, however, treated as a distribution, so the company doe not have to pay advance corporation tax.

The purpose behind the stock option legislation, then, is to stop non-redeemable bonus shares being issued as an alternative to dividends. The legislation applies, not only when a shareholder is given a straight choice between dividends and shares, but also where he is offered one of them subject to a right, however expressed, to choose the other instead; and a person's abandonment of, or failure to exercise, such a right is treated as an exercise of the option.[73]

The provisions are extended to catch bonus share capital issued by a company in respect of any shares of a class which carry the right to receive bonus share capital in the company, which right was conferred by the terms on which the shares of the class were originally issued, or

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71. Now section 249 ICTA 1988
72. Section 23 FA 1968 (later section 236 ICTA 1970), repealed by para 5(2), Sch 22 FA 1972
73. Section 251 (1)(c) ICTA 1988

by those terms as subsequently extended or otherwise varied.[74] This is to impose income tax where a company divides its share capital into two classes, one class carrying dividend rights, the other class carrying rights to bonus issues equivalent to the dividend rights attaching to the other class.

To avoid double taxation, when determining whether a return of capital consitutes a "repayment" of capital", shares in respect of which income tax has been paid under these provisions are treated as having been issued as paid up by the receipt of new consideration.[75]

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74. Section 251(1)(c) ICTA 1988
75. Section 230 ibid

Conclusion

It can be seen that the distribution legislation has been built up into a comprehensive and relatively well targeted code of provisions which, in general, are specific in their drafting and, although many of them are, out of necessity, difficult to understand fully at first examination,in practice, they do tend to cover the abuses at which they were aimed without, on the one hand, levaing exploitable loopholes or, on the other hand catching innocent taxpayers carrying on commercial activities outside the mischief of the various provisions.

The success of the current distribution provisions can perhaps be measured by the fact that they have undergone few substantial changes over the past 25 years and they are generally accepted as fair and justified.

These provisions can be compared with those examined in Parts 4 and 5. Faced with widespread avoidance though "dividend stripping" and associated schemes, specific anti-avoidance legislation proved to be largely ineffective, leading to the introduction of wider legislation by Parliament and the adoption of less a restricted construction of the legislation by the courts.

It is also relevant to note that the complicated distribution legislation has given rise to surprisingly little legislation. It appears that the lessons from the cases heard in the second quarter of this century[76] were well learned.

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76. See Part 1 supra

PART 4

DIVIDEND STRIPPING, STOCK STRIPPING AND BOND WASHING

Introduction

The terms "dividend stripping", "stock stripping" and "bond washing" are catchy names for a range of avoidance devices used in various forms, particularly through the 1950's and early 1960's, although bond washing did become fairly popular in the 1930's.

The Legislature have had many attempts to stamp out these schemes and dividend stripping and bond washing are now covered by a number of specific anti-avoidance provisions as well as a wide one.[1] Stock stripping is somewhat different in character and is dealt with separately.

As far as court cases are concerned, the cases dealing with dividend stripping have constituted a story of total success for the Revenue with one solitary exception: the taxpayer won in one of the earliest dividend stripping cases[2], but the correctness of that decision, or whether courts in subsequent years would have reached the same decision is open to question as is explained below.

There have been fewer bond washing and stock stripping cases and, in those, the taxpayer has had more success.

The legislative and judicial history of these schemes is now examined.

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1. Section 703 ICTA 1988 see Part 5, infra.
2. J.P. Harrison (Watford) Ltd -v- Griffiths (1962) 40 TC 281

DIVIDEND STRIPPING

Backward Stripping

The first attempt to curb dividend stripping through legislation took place in 1955. This legislation was aimed at the basic type of dividend stripping transaction, "backward stripping"; as opposed to "forward stripping" which grew in prominence once backward stripping had come under fire in 1955.

The first legislation can be understood by considering an early case: J.P. Harrison (Watford) Ltd -v- Griffiths.[3] This was the only dividend stripping case the taxpayer won. Even here, there were dissenting judgments from powerful voices: Donovan LJ in the Court of Appeal and, in the House of Lords, Lords Reid and Denning.

The facts of this case demonstrate "backward stripping". This scheme would now be covered by circumstance A in section 704 ICTA 1988.

The scheme in outline was that a share dealing company would purchase the shares of a company which had accumulated profits. Following the acquisition, the profits would be distributed in the form of dividend. The dividend would be treated as taxed income but the acquired company would be sold (or liquidated) giving rise to a trading loss which could be set against the dividend. If the loss exceeded the grossed-up dividends, the share dealer could reclaim from the Revenue the tax deducted.

How this operated in practice can be seen from the facts of the Harrison case. The taxpayer company had been carrying on the business of merchants and had suffered losses in that business of £13,583. It then amended its memorandum of association to enable it to carry on the

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3. (1962) 40 TC 281

business of share dealing. Three months later, it purchased the shares of a company called Claiborne Ltd for £16,900. In the following month, Claiborne declared a dividend of £28,913 gross (£15,902 net) and the taxpayer company later sold the shares for only £1,000. It made no other share deals during that tax year. The net dividend therefore equalled the loss on the shares.

Assuming that the scheme worked, the relevant computations of the taxpayer company's profits from the scheme were as follows :

Loss from business of merchants		£13,583
Loss on Claiborne's shares :		
Cost	£16,900	
Proceeds	1,000	
		15,900
Total Loss		£29,485

The dividend itself was made up as follows :

Net dividend	£15,902
Tax deducted	13,011
Gross dividend	£28,913

The taxpayer company's cash account therefore looked like this :

Proceeds from Claiborne's shares	£1,000
Net dividend	15,902
Loss claim (under 341, ITA 1952)[4]	
£15,900 at 7/9d	6,161
	23,063
Less cost of Claiborne's shares	16,900
Tax-free profit	£6,163

4. See Chapter 4

The Revenue attacked the scheme by claiming that the taxpayer company was not carrying on the trade of dealing in shares and disallowed the loss on the sale of the Claiborne shares.

The Special Commissioners held that the Crown's contention was correct but the courts all held that the Commissioners' findings were not justified. In fact Danckwerts J, in the High Court, stated that he felt "the greatest difficulty in understanding how the Commissioners came to the conclusion to which they did".[5]

In the Court of Appeal, Pearce LJ acknowledged that "the object of the transaction was not to make a profit but to secure a fiscal advantage; it was a deliberate and admitted dividend- stripping operation"[6]; and, indeed, this was the ground on which the Commissioners based their decision. Pearce LJ disagreed. He was of the opinion that a commercial transaction cannot lose its commercial nature "simply because its object is to secure a financial advantage through repayment of tax" unless "it is a sham designed to produce a tax result" so that it cannot be said to be a commercial transaction at all. His conclusion was that the transaction "produced a valuable but unpraiseworthy tax benefit".[7]

It is noticeable that Pearce LJ contrasted the "commercial" transactions in the present case with shams. Later cases showed that transactions do not have to be shams to lead to a finding for the Revenue.

Upjohn LJ took the same line as Pearce LJ, contrasting the "real" transactions in this case with the case of Johnson -v- Jewitt (see below).[8] Upjohn LJ, like Pearce LJ, found that neither the tax avoidance object

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5. p. 284
6. p. 288
7. p. 289
8. p. 289

nor the unmeritorious nature of the claim robbed the transaction of its nature as a trading transaction.[9]

Donovan LJ disagreed. He was of the opinion that this was not a trading operation given the fact that it was an isolated transaction whereby the shares were deliberately bought to be sold at a loss; "the objective was the dividend; and ... the prime purpose of the whole transaction was purely a fiscal one."[10] It was this approach to dividend stripping cases, and also to other schemes which depended on the existence of a trade, that was to become the norm.[11]

There was a similar difference of opinion in the House of Lords. Viscount Simonds, like Pearce and Upjohn LJJ, contrasted this case to the "sham" in Johnson -v- Jewitt and took the same line as the majority below.[12]

Lord Morris of Borth-y-Gest and Lord Guest agreed. In particular, Lord Morris specifically discounted the point made by Donovan LJ that a loss was bound to result from this transaction.[13] Lord Morris made the point, no doubt correct as an abstract principle, that "A trade may be carried on with the knowledge that losses will result."[14]

The two dissenting judgments were given by Lords Reid and Denning. Both looked at the facts in a broader perspective, more in keeping with the attitude taken by judges in later years, particularly in the House of Lords. Their approach was similar to Donovan LJ's in that they were of the opinion that there was no trade: the object of the exercise being purely fiscal. Lord

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9. p 290
10. p 291
11. See, for example, <u>Reed -v- Nova Securities Ltd</u> (1985) STC 124
<u>Coates -v- Arndale Properties Ltd</u> (1984) STC 637
12. pp 293 - 4
13. pp 301-2
14. p. 302

Reid expressed himself as looking at the "substance of the matter" and could see no trade in that substance[15], and Lord Denning, as usual, turned a disapproving eye on the scheme, referring to its perpetrators as "prospectors digging for wealth in the subterranean passages of the Revenue, searching for tax repayments".[16]

Lord Denning, in his judgment, referred to an argument advanced by counsel for the taxpayer company that the object and result of the transaction was irrelevant and that the taxpayer company should be looked on merely as "a dealer in shares who buys shares, receives a dividend from them and then sells them again".[17] Lord Denning rejected this, saying that this would be looking at half of the transaction, but not the other half (i.e. the repayment of tax). Lord Denning's insistance at looking at the whole transaction is more in keeping with the approach taken in subsequent dividend stripping cases.

The device used in the Harrison case was countered by Section 4 and Sch 3, F(No 2)A 1955 (examined in detail below). The effect of these provisions was that, in the case of persons carrying on a trade of dealing in shares or other investments who implemented a Harrison-type scheme, to the extent that the dividend was paid out of accumulated profits, it was treated as a trading receipt. The 1955 provisions did however, leave open a number of loopholes which Parliament attempted to deal with in 1958.

The 1955 legislation operated in the following way. In the case of dividends paid after 26th October 1955, the net dividends were, as mentioned above, treated as trading receipts of the purchaser to the extent that they were paid out of profits accumulated prior to acquisition by the purchaser.[18]

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15. pp 294-5
16. p. 300
17. ibid
18. Even though they were treated as paid net after tax: section 184 ITA 1952

Certain conditions had to be present before the legislation could bite. These were :

1. The purchaser had to be a share dealer and hold at least 10% of the shares of the class in question.

2. The shares had to be other than fully-paid preference shares.

3. Dividends had to be declared within six years of the acquisition.

4. The dividends had to be paid wholly or partly out of profits accumulated prior to acquisition.[19]

The taxpayer company in the Harrison case would have been caught and its trading account and cash account would have looked as follows by virtue of section 4 :

Cost of Claiborne's shares		£16,900
Less: net dividend received		£15,902
Proceeds from sale of Clairborne's shares	1,000	
	16,902	
		(£ 2)

The loss on the Claiborne shares would have therefore been eliminated.

The 1955 anti-avoidance provisions were drafted to cover any person entitled to an income tax exemption on dividends.[20]

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19. Section 4(1) F (No 2)A 1955
20. Section 4(2) ibid

There were three main bodies of persons whose exploitation of the exemptions had caused the 1955 legislation to be introduced: pension funds, charities and Irish residents.

In the case of Collco Dealings Ltd -v- IRC[21] the argument that section 4(2) could not apply to residents of the Republic of Ireland by virtue of the double tax agreement with the UK was firmly rejected by the House of Lords.[22]

Charities had not, in fact, exploited dividend stripping to a significant extent.

Section 18, FA 1958 made certain amendments to section 4 and Sch 3, F(No 2)A 1955 to close certain loopholes left open by the earlier legislation. These loopholes are considered below.

The application of the 1955 provisions was extended by section 19 FA 1958. Whereas the 1955 provisions were restricted to share dealers, section 19 opened up the provisions to other traders.

The way section 19 worked was to say that, where a trader who was not caught by section 4(1), F(No 2)A 1955, received a dividend which, if he were within section 4(1) would have been regarded as trading income, then the grossed-up amount of the dividend and the tax deducted from it must be ignored in calculating any tax repayment. Previously, a non-share dealing trading company, which was operating at a loss, which received a dividend from accumulated profits could obtain relief under section 341, ITA 1952 by obtaining repayment of the tax deducted from those dividends.

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21. (1961) 39 TC 509
22. In any case, the matter was dealt with by legislation: section 29 FA 1959

With the early anti-dividend stripping legislation and the early success for the taxpayer in the courts, it is now necessary to examine the next series of dividend--stripping cases.

The next relevant case to consider is Johnson -v- Jewitt.[23] This case is interesting for two reasons. The first is that it will be recalled that it was referred to in the Harrison case as one in which the transactions were shams. Certainly they demonstrated a degree of artificiality which drew almost unprecedented expressions of disapproval from the judges who heard the case. Secondly, it appears that the original plans of the taxpayer were frustrated by the introduction of the 1955 anti-dividend stripping legislation and he then devised the rather bizarre scheme which was the subject of the case. Compared with the Johnson -v- Jewitt scheme, the Harrison scheme must have seemed fairly straightforward and commercial (except to the judges who gave dissenting judgments, of course).

The facts were that the taxpayer formed a partnership with a second person, and they also formed a company. It appears that they had in mind operating a straightforward dividend stripping operation of the kind stopped by the 1955 legislation; they had even gone so far as to place advertisements in "The Times" to this end. When the 1955 legislation closed this avenue of operation, the taxpayer put into effect this series of transactions.

The partnership caused a company called Business Economy Company Registrations to form a new £100 company. The partnership lent Business Economy £50,000 which it gave to the new company. The partnership bought the new company for £50,000, the consideration being set off against the £50,000 loan. The £50,000 was returned by the new company to the partnership by way of loan. The money had thus passed in a complete circle but the

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23. (1961) 40TC 231

partnership owned a company with a £50,000 reserve (represented by the loan). Using the same £50,000, the partnership repeated the operation with another 58 new companies, each of which had a reserve of £50,000. The one sum of £50,000 had therefore generated reserves of £2,950,000.

The next stage in the scheme was that each of the 59 new companies declared all or most of their reserves as dividends, the dividends being set off against the money the partnership owed the companies. No money therefore passed but the partnership purported to receive over £2,000,000 as taxed dividends. The partnership then sold the new companies, stripped of their reserves, for £10,000. The partnership then argued that the shares it had sold were acquired for almost £3,000,000, with the result that it had suffered a loss of £2,907,060.

This loss, it was claimed, was made from the trade of share dealing. The partnership then claimed that it has taxed income (the dividends) which the taxpayer claimed, because of the loss, entitled him to a repayment of tax on his share of those dividends, his share being £1,301,629.

Not surprisingly, the judges were not well disposed to this scheme, and easily dismissed of it by holding that there had been no trade (the same finding that was to be reached in many of the later dividend stripping cases).

Lord Evershed MR, like his two bretheren in the Court of Appeal was scathing in his criticism. He said:

> "I am quite unpersuaded that these transactions can properly, fairly or sensibly be called anything but fantastic to the degree almost, perhaps, of impidence. I am bound to say that were it otherwise, it would seem to me that the English law, and particularly the Companies Act, would have been made mock of; and I only, in conclusion, express great regret that the engineer of

this extraordinary scheme should be a member of the profession of solicitor."[24]

Donovan LJ thought it was :

> a cheap exercise in fiscal conjuring and book-keeping fantasy, involving a gross abuse of the Companies Act and having as its unworth object the extraction from the Exchequer of an enormous sum which the Apellant had never paid in tax and to which he has no shadow of a right whatsoever."[25]

Danckwerts LJ considered that the loss was "fictitious" and the claim was "impudent" and "dishonest".[26]

This was a straightforward case; there being no other possible conclusion than that no trade existed. The scheme had no chance of success. A number of the subsequent cases, however, were far from being as artificial and circular as Johnson -v- Jewitt and gave rise to much more detailed analysis by the judges of the existence or otherwise of a trade.

Two other cases from around the same time which concerned backward stripping and which gave rise to different points were F S Securities Ltd -v- IRC[27], and Argosam Finance Co Ltd -v- Oxby[28].

In FS Securities, the taxpayer company carried out a backward stripping operation and claimed loss relief under section 341 ITA 1952 on the basis that the dividends received should be excluded in computing its trading profit or loss for tax purposes. The transactions took place before the 1955 legislation came into operation. The relief was in fact, allowed.

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24. p 254
25. p 255
26. p ibid
27. (1964) 41 TC 666
28. (1964) 42 TC 86

Subsequently, an apportionment direction was issued, for the period in which the dividend stripping took place, on the basis that the company was an investment company.

The House of Lords held that it was in fact an investment company and they confirmed the direction.

To achieve their victory here the Crown had to argue that the method of dealing with the dividends, which had given rise to the relief under the dividend stripping scheme, had been correct (i.e. the dividends were properly left out of account in determining profits and losses under Sch. D Case 1). The Crown were not, of course making any great concession because the 1955 legislation had since been enacted. The taxpayer company were arguing that the dividends ought not to have been excluded after all.

The House of Lords agreed with the Crown and held that the dividends constituted investment income. This point is, of course , of no further relevance under the imputation system introduced in 1965, and the type of backward stripping implemented by the taxpayer company here was countered in the 1955 legislation.

The Argosam case concerned a procedural point. The taxpayer company had implemented a backward stripping transaction and it took out an originating summons for the determination of whether the dividends ought to be taken into account in calculating its trading profits and losses[29] and whether, if the dividends had to be taken into account, and the profits were less than the gross amount of the dividends, it could have a refund of the difference because they would have suffered double taxation.

These substantive issues were not decided because the Crown applied to stay the proceedings and the High Court

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29. This is the same point as that at issue in the F S Securities case.

and the Court of Appeal both held that the summons was an abuse of the process of the court; the first question ought to be determined in accordance with the procedure set out in the tax legislation; and the second question was hypothetical.

This case is therefore of no interest from the point of view of dividend stripping except that it gave Lord Denning MR another opportunity to show his disapproval of such schemes, referring to dividend stripping as a way "to extort money from the Revenue"[30]: a rather strong (and inaccurate) expression of dislike.

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30. p 102

Forward Stripping

The cases so far discussed have concerned "backward stripping". It is now necessary to deal with "forward stripping". The essential difference is that, in backward stripping, the share dealer acquires a company which has already accumulated profits; whereas, in forward stripping, the share dealer acquires a company which is expected to make profits in the future.

The normal forward strip would proceed along the following lines. The share dealer purchases the target company at a price which takes account of the anticipated dividends out of the anticipated profits over a specified number of years. As the profits arise, the dividends are declared, thus reducing the value of the shares. The share dealer does not have to bring the dividends into account in determining the profit or loss from the share dealing business, so the accounts each year show a loss represented by the revalued shares of the target company (or the target company is sold or liquidated to produce the loss). The dealer then makes a repayment claim by virtue of the loss, as under backward stripping.

Forward stripping is now covered by circumstance C of section 704 ICTA 1988[31].

Forward stripping has been the subject of a number of cases. The first to be considered by the House of Lords was Finsbury Securities Ltd -v- Bishop[32].

The taxpayer company was a share dealing company. During the years 1958, 1959 and 1960, it entered into 15 forward stripping transactions. These were of two types. In the first category, the taxpayer company would, for example, acquire specially created preference shares in a target

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31. Backward stripping falling within circumstances A and B: see Part 5 infra.
32. (1966) 43 TC 591

company which carried the normal fixed dividend plus an additional right to dividends which would absorb the whole of the profits available for distribution (after payment of the fixed dividend), subject to an agreed maximum. It was agreed that the purchase price was to be determined by reference to the amount of the net dividends and tax repayments received.

Under the second type of scheme, a typical arrangement was that the taxpayer company purchased the whole of the share capital of the target company. It was agreed that the target company would distribute the whole of its net profits in the following year. Again, the purchase price was determined by reference to the profits of the target to be stripped out and the tax repayments. Any net assets of the target left after the strip would be repurchased by the original owners of the target at the greater of cost or market value.

These schemes were attacked by the Crown in two ways. It was first submitted that the shares in the target companies were not trading stock, but capital assets. Secondly, it was said that, if they were stock, the dividends received must be taken into account in determining the trading profits or losses, so that there was no loss which could be relieved under section 341, ITA 1952.

The second submission became untenable after the F S Securities case and it was abandoned by the Crown. The Crown did, however, win in the House of Lords on the first submission after losing on it in the High Court and the Court of Appeal (Lord Denning MR dissenting).

In finding that there was no "adventure or concern in the nature of trade" and that the target companies shares were not trading stock, the Harrison case had to be distinguished.

It is interesting to note that five judges appeared in both cases, three of whom found for the taxpayer in Harrison but for the Crown in Finsbury; the other two judges found for the Crown in each case. It is instructive to compare the two cases, particularly where the same judges distinguished their earlier judgments. The Law Lords' judgment in Finsbury was in fact given by Lord Morris.

The judges who appeared in both cases were as follows. The two judges who formed the majority in favour of the taxpayer in the Court of Appeal in Harrison (Pearce and Upjohn LJJ) were part of the unanimous House of Lords who found for the Crown in Finsbury. The other judge who found for the Crown in Finsbury, having found for the taxpayer in Harrison, was Lord Morris (in the House of Lords in each case).

Lord Reid dissented in the Lords in favour of the Crown in Harrison and formed part of the unanimous Lords in favour of the Crown in Finsbury. The other dissenter in the House of Lords in Harrison, Lord Denning, having subsequently found himself back in the Court of Appeal after his appointment as Master of the Rolls, again found himself giving a dissenting judgment in favour of the Crown in Finsbury. This time, of course, he was upheld by all of the judges in the House of Lords.

On the question of whether there was a trade in respect of the target companies' shares, it was claimed that each of the 15 dividend stripping transactions was designed to produce some profit for the taxpayer company even ignoring the expected tax repayments.[33] However, the expected profits were so small, a few pounds in each case, that the judges of the House of Lords and Lord Denning MR had no difficulty in ignoring them. As Lord Denning said: "Those trifling sums were not the object

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33. p 592

of the exercise. The object was obviously to get tax repayments."[34]

The Harrison case was distinguished by the House of Lords because the Finsbury case, in their view, lacked a number of vital ingredients of trading which were present in Harrison. These were set out by Lord Morris.[35] They were as follows :

1. In Harrison, the vendors of the Claiborne shares had no interest in these once they had been sold to Harrison. The vendors had no prospect of receiving any benefit from any tax recovered. In Finsbury, on the other hand, the vendors were to share in any tax recovered in respect of the dividends.

2. The Harrison transaction was, in the view of the Law Lords, "demonstrably a share-dealing transaction": the Claiborne shares were bought, a dividend was declared, and then they were sold. In Finsbury, the shares could not be sold for a specified number of years.

3. As regards the object of the transaction and the clue it provides in determining its nature, in Harrison there was "no room for doubt as to the real and genuine nature of the transaction" despite the fact that the reason why it was entered into was the expected tax benefit: "It was not capable of being made better or worse or being altered or made different by the circumstance that the motive that inspired it was plain for all to see." In the Finsbury case the future interests of the vendors were safeguarded because they retained all of the benefits that would have resulted from their shareholdings had there been no scheme.

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34. p 612. See also Lord Morris at p 626.
35. pp 626-7

4. In Harrison, the taxpayer company could have done what it wished with the Claiborne shares; whereas, in Finsbury, it was of the essence of the scheme was that the taxpayer company should continue to hold the shares for the specified number of years agreed between the parties; it would have been a breach of the agreement for the shares to have been sold earlier.

As a result of the above, the various shares could not be regarded as stock-in-trade because they were not acquired for the purpose of dealing with them; to carry out the scheme, the shares had to be retained.

In the Court of Appeal, Lord Denning MR came to the same conclusion for the same reasons.[36] For good measure, Lord Denning also made no attempt to hide his dislike of such schemes, refering to the "so-called" loss as "artificial" and "fictitious", brought about by "artificial book entries". In his view "the Courts should do nothing to encourage" such a "discreditable" part of the taxpayer's activities which were "a device to outwit the Revenue."[37] Lord Morris, too, was critical of the arrangements. He said: "I should be sorry if any process of reasoning, or any authority, required me to denigrate share dealing by associating these arrangements with those which are ordinarily to be classed or normally to be found within such description."[38]

The majority in the Court of Appeal considered that the case was governed by the Harrison case.[39]

Before the House of Lords decision in Finsbury came the first instance decision of Pennycuick J in Johns -v- Wirsal Securities Ltd.[40]

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36. p 612
37 pp 610-1
38 p 625
39 See, for example, Davies L J at pp 614-5
40 (1965) 43 TC 629

This was a forward stripping case in which the judge followed the House of Lords in Harrison and the Court of Appeal in Finsbury on the question of whether there was a trade, which question was therefore decided in favour of the taxpayer company. The case went in favour of the Crown on another ground.

The facts were that the taxpayer company was formed to carry out the business of dealers in stocks and shares. In its first year it bought and sold only seven parcels of quoted securities, the purchase and sale prices each being in the region of £8,000. in total.

In that year, however, it also bought the share capital of another dealing company, Nadvet, for £316,000 (£100 being paid on account). This purchase price was estimated to be the true value of Nadvet. Some of the vendors of Nadvet indirectly owned the share capital of the taxpayer company.

The following year the taxpayer company bought and sold less than £1,000 of quoted securities. It also, in that year, purchased freehold and leasehold properties from Nadvet for £356,072 and wrote down its holding in Nadvet to £1.

The taxpayer company received from Nadvet £249,422 in respect of interim dividends declared as £456,200 subject to deduction of income tax. Nadvet's adjusted profit for the year before tax was £280,140 (in the previous year, its first, the adjusted net profit had been a mere £59). Nadvet's profit arose largely from the sale of the freehold and leasehold properties to the taxpayer company. At the end of the year in question, Nadvet's assets amounted to just £733 without provision for income tax.

As a result of these transactions, the profit and loss account of the taxpayer company showed a dealing loss of

£316,036 and the taxpayer company claimed repayment under section 341, ITA 1952 of £121,184, purporting to be the tax deducted from the dividends from Nadvet, in respect of an adjusted loss of £312,734.

The Special Commissioners found that the objects of the transactions were that the profits from the development and disposal of the freehold and leasehold properties should be channelled into Nadvet and that the shares in Nadvet should be acquired by the taxpayer company for the purposes of dividend stripping. They further found that the other minor transactions were entered into purely to show that a trade was being carried on. Despite this, and contrary to the submission of the Crown, the Commissioners found that the shares in Nadvet were held by the taxpayer company as trading stock. Pennycuick J held that this was a reasonable conclusion in the light of the Harrison case and the Court of Appeal decision in Finsbury. It is questionable whether the judge would have come to the same conclusion after the House of Lords decision in Finsbury. The judge was of the view that only artificial transactions such as those in Johnson -v- Jewitt did not amount to a trade. He did not think, however, that Johnson -v- Jewitt had any application to "real" dividend stripping transactions.[41] This view was based on Harrison and the Court of Appeal in Finsbury: the House of Lords, of course, subsequently reassessed the criteria and it is likely that their views would have influenced Pennycuick J.

In any case, the Crown's second submission succeeded. They contended that, where a dividend exhausted the distributable profit of the payer, there could be no deduction from any larger gross amount and, therefore, that the gross amount of the dividends paid by Nadvet was equal to the net amount.
Pennycuick J said :

"The dividend consisted in the actual distribution

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41. See pp 650-1

of the sum of £279,422, expressed and intended to be franked of tax by reference to a gross dividend of larger amount. I find it impossible to treat this distribution as representing in part a dividend of the same gross amount after deduction of tax and, as to the balance, a distribution without deduction of tax. In the result, this whole tax avoidance scheme has misfired. It is not for the Court to reform the scheme so as to make it partly effective."[42]

Finsbury was applied and Harrison distinguished in Cooper -v- Sandiford Investments Ltd,[43] in which the stripping transaction was held not to be trading.

The taxpayer company was a share dealing company. It purchased the shares of another company (Fragmap) for £17,599 as part of a larger composite scheme. The following day the vendors of Fragmap assigned a lease to Fragmap in return for the issue of shares in Fragmap, and Fragmap granted a sub-lease back for an aggregate rent of £21,000. Five days later, the taxpayer company paid the vendors the £17,599 by overdrawing its bank account and a few days subsequently, the vendors paid Fragmap the £21,000, followed a further few days later by Fragmap lending the taxpayer company £17,500.

Over the next three years the taxpayer company received dividends from Fragmap amounting to £10,000 net (£16,599 gross). In the years covered by the transaction, the taxpayer company wrote off £17,100 from the value of its shares in Fragmap and the taxpayer company claimed relief under section 341, ITA 1952 on the basis that the amounts written off were losses sustained in its share dealing trade.

The Crown contended that the Fragmap transactions were not bona fide trading transactions and that the Fragmap shares were not stock-in-trade.

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42. p 655
43 (1967) 44 TC 355

Buckley J applied Finsbury in finding that the transactions did not constitute trading. It is interesting to note that he had actually found for the taxpayer in Finsbury itself but had been overruled by the House of Lords.

In view of the Finsbury case, Buckley J's decision is not surprising. The Special Commissioners had found that the taxpayer company's "ordinary" share dealings were not very substantial and the only way it could expect to turn an apparent cash deficit on the Fragmap transaction into profit was by obtaining the expected tax repayments.[44]

Furthermore, all of the Fragmap transactions were part of a composite arrangement and not the ordinary type of business normally undertaken by a share dealer. The scheme would only be profitable to the taxpayer company if the composite arrangement were carried through to the end.[45]

As a result, Buckley J concluded that this was not an ordinary trading transaction; but was one entered into with the sole object of profiting by means of the fiscal consequences. Therefore, the Fragmap shares were not acquired by the taxpayer company in order to derive a profit from the carrying on of its dealing trade, but in order to gain from the tax advantages that were expected to accrue. It was "a transaction into which Sandiford would never have entered at all but for the hope that it would result in fiscal advantages."[46]

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44. See the Special Commissioners at P 358 and Buckley J at P 364.
45 p 364
46. p 364

Finsbury was followed, and Harrison distinguished, in each case in which the question of whether dividend stripping constituted a trade arose. After Buckley J's judgment in the Sandiford case, the House of Lords set the seal on the matter in two decisions in 1971: Lupton -v- F A & A B Ltd[47], and Thomson -v- Gurneville Securities Ltd[48] Lupton is of added interest in that, in the Court of Appeal and the House of Lords, the leading counsel for the taxpayer in this case of "a raid on the Treasury"[49] was one Templeman QC who, when elevated to the Bench, was a strong critic of artificial schemes.[50]

On the subject of personnel, four of the judges who appeared in Harrison also appeared in Lupton, and three of them were also in Gurneville.

Lord Morris, who had given judgment for the taxpayer in Harrison but for the Crown in Finsbury, also found in favour of the Crown in both Lupton and Gurneville. Another of the Law Lords who held for the taxpayer in Harrison was Lord Guest. He did not preside over Finsbury but he did over both Lupton and Gurneville, and decided in favour of the Crown in each case.

Donovan LJ gave a dissenting judgment in favour of the Crown in Harrison and, not surprisingly, he also held for the Crown when he sat in the House of Lords, in both Lupton and Gurneville.

Lord Denning MR was the other judge who had appeared in the earlier cases. Given his unconcealed dislike for dividend stripping, it would have been most surprising had he done anything else in Lupton than find for the Crown (he did not appear in Gurneville).

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47 (1971) 47 TC 580
48 (1971) 47 TC 633
49 Per Lord Donovan at p 629
50 See Chapter 11

Judicial opinion on the Harrison and Finsbury cases and their application was, however, still not totally consistent. This can be seen from the fact that Sachs L J dissented in Lupton and all three members of a strong Court of Appeal (Lord Diplock, Russell and Cross LJJ) found for the taxpayer company in Gurneville.

Dealing now with these two cases, taking Lupton first; in that case, the taxpayer company, a share dealing company, entered into five dividend-stripping transactions, mostly forward stripping, although there was an element of backward stripping. The backward stripping element had effectively been dealt with by the 1955 legislation. At the date of the transactions, forward-stripping had not been rendered ineffective; it was to be dealt such a blow very shortly afterwards by section 28 FA 1960.[51] In four of these cases, the taxpayer company acquired a specially created class of shares which were purchased with the benefit of a warranty that dividends would be paid, and the money representing the potential dividends had been lodged with a stakeholder who would release the money to the taxpayer company as and when the dividends were paid.

In the other case, the taxpayer company purchased the whole of the issued share capital of an investment company which had a trading subsidiary. The vendor undertook that the profits of the subsidiary were sufficient to declare a dividend of £800,000 net and that the taxpayer company would be entitled to recover from the Inland Revenue the tax deducted from the dividends paid to it by the investment company out of that dividend. The vendor further undertook, if the taxpayer company failed to recover any such tax, to pay the difference between half the tax recovered and £200,000. The vendors deposited £200,000 with a stakeholder as security for their undertakings.

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51. Now section 703 ICTA 1988

The Crown contended that the transactions were not entered into by the company in the course of trade and that the shares in the five companies was not stock-in-trade. The loss relief claim was therefore rejected.

All three courts applied Finsbury and distinguished Harrison although, particularly in the House of Lords, the analysis of the judges to those two cases was not entirely consistent.

In the High Court Megarry J considered Harrison to be "a narrow decision on a narrow point", namely that a transaction is not prevented from being a trading transaction because its object was to obtain a tax advantage. The transaction involved merely a purchase, a dividend and a sale; lacking were elements such as specially created shares, warranties and stakeholders.[52] He highlighted something which was also to become apparent in the later stages of the Lupton case, a difference of opinion as to the relevance of the purpose of the transaction. He pointed out that, in Harrison, Lord Morris had said that purpose was often relevant[53], whereas Lords Simonds and Guest had said that it should be disregarded. It is not clear why the judges are so reluctant to consider motive in determining whether a trade exists in dividend stripping transactions when it is often an important element in establishing a trade in normal situations.

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52. p 596
53. See Megarry J's judgment in Lupton itself, in which he expounded a similar view.

Analysing Lord Morris's approach to motive in Finsbury, where he said that if, looking at the transaction, it is clear whether it is or is not a trading transaction, motive is irrelevant, Megarry J concluded that "if, when the constituent elements of a transaction are examined, it is found that there are many elements the presence of which cannot be explained on any sensible trading ground but which are readily intelligible on fiscal grounds, then, in my judgment, the fiscal grounds may become relevant; for the fiscal element has invaded the transaction itself, moulding and explaining it, and is not merely the purpose or object for which a trading transaction is carried through."[54]

This point was also the subject of comment in the House of Lords in Lupton (see below).

Megarry J, finding that in Lupton "there is little or no explanation for the inclusion of some of the provisions other than fiscal advantage", considered that no trade existed.

In the Court of Appeal, Lord Denning MR's response was wholly predictable and Phillimore LJ, admitting that he was inexperienced in matters under discussion, and saying that he had wavered during argument, came down in favour of the Crown. Only Sachs LJ took a different view, breaking away from what was becoming a fairly standard judicial approach to dividend stripping.

Sachs LJ noted certain aspects of the respective schemes in Harrison and Lupton which, to him suggested that Lupton fell on the "right side" of the Harrison/Finsbury dividing line and, in fact, "a great deal further on that side than Harrison's case itself".[55] The aspects in question were :[56]

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54. p 597
55. pp 608-9
56. Looking at the fifth transaction in Lupton.

(i) the company in Lupton was already a share dealer; it did not have to change its nature as in Harrison;

(ii) the assets "other than the dividend pregnancy" were worth much more in Lupton (£800,000) compared to £1,000 in Harrison;

(iii) the company in Lupton was left with much more stock after the dividend strip (353,957 £1 shares backed by assets of nearly £700,000) compared with £1,000 in Harrison;

(iv) both companies obtained complete control of the target company and of the moneys paid out in dividends;

(v) neither transaction would have gone through apart from the fiscal advantages but, in Harrison, it might well have been difficult to strike a share-dealing bargain at all without the expectation of the fiscal advantages; whereas, in Lupton, prima facie, there would have been no such difficulty.

Given these factors, asked Sachs LJ, could Lupton be brought back on the "wrong" side of the Harrison/Finsbury line by the provision varying the price of the target shares by £200,000 depending on how far the tax repayment claim succeeded? He thought not. Lords Morris and Guest also charted a distinguishing line between Harrison and Finsbury but decided that the Lupton facts fell on the Finsbury side of the line rather than the Harrison side (see below). In their view, the sharing of the profit between the vendor and purchaser did take the case to the wrong side of the line.

Lord Simon's judgment was phrased in rather different terms although the overall effect of it was that he basically agreed with the approach taken by Sachs LJ although, like Lords Morris and Guest, he came to a different conclusion.

The other two Law Lords, Lord Donovan and Viscount Dilhorne were of the opinion that there was no proper distinction between Harrison and Finsbury, so the question of which side of the distinguishing line the Lupton facts came did not arise (see below).

Lord Morris dealt with the two earlier cases by saying that the Harrison transactions "were solely and unambiguously trading transactions" into which no fiscal considerations intruded; the tax reasons merely inspired one party to enter into the trading transactions.[57] There was, he said, "nothing equivocal". He referred to Lord Reid in Ismera -v- IRC who had said :

> "If, in order to get what he wants, the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. But if his acts are equivocal his purpose or object may be a very material factor when weighing the total effects of all the circumstances".[58]

Lord Morris's reliance on Lord Reid's dictum is interesting when it is recalled that Lord Reid himself cannot have so viewed the Harrison facts in the light of his own test in the same way as Lord Morris: Lord Reid gave a dissenting judgment in favour of the Crown in that case.

Lord Simon's view of the mental element involved was similar to Lord Morris's. He phrased the test in the following terms:

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57. p 619
58. [1965] 1 WLR 663 at p 668

".... if the appearance of the transaction leaves the matter in doubt, an examination of its paramount object will always be relevant and will generally be decisive."[59]

Viscount Dilhorne perhaps went even further, refering to purpose rather than object. He said:

"...if a transaction viewed as a whole is one entered into and carried out for the purpose of establishing a claim against the Revenue under section 341, I for my part would have no hesitation in holding that it does not form part of the trading activities of a dealer in stocks and shares."[60]

Returning to the judgment of Lord Morris, his Lordship then placed great weight on the fact that, in Harrison, there was just a sale and purchase of shares with a receipt of a dividend in the middle; there was no arrangement between the taxpayer company and the vendors to Harrisons, or the purchasers from them, as to whether Harrisons would make a tax repayment claim. No other person had any control over Harrisons once it had acquired the target shares. Therefore, said Lord Morris:

"If the presence of a motive of securing tax recovery does not cause a trading transaction to cease to be one, then reliance on motive must disappear."[61]

It is, however, difficult to see what relevance the existence or absence of such an arrangement has to the question of whether the dividend stripping company is carrying on a trade. This difficulty was shared by Viscount Dilhorne, who could not see how such an arrangement could make any difference. As he said: "A dealer in stocks and shares does not cease to trade in them if he agrees to share with the vendor as part of the purchase price any profit he makes."[62]

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59. p 631
60. p 628
61 p 620
62 p 628

Viscount Dilhorne could not see how the Finsbury arrangements could be said to be any more artificial than those in Harrison. He could not see how the two cases were distinguishable and, if there was no valid ground for distinguishing them, he said that he would "unhesitatingly" follow Finsbury.[63]

Lord Donovan, too, could not see why Finsbury should be treated differently from Harrison. In Harrison, of course, he had dissented in favour of the Crown in the Court of Appeal. In his view, the majority in Harrison reached its decision by examining the component parts of the transaction - the purchase, the dividend and the sale - and concluded that these things amounted to trading when done by a dealer, it being irrelevant that such trading had a tax advantage in view. Indeed, this is basically what the Lord Morris approach amounts to. The minority view in Harrison looked rather at the whole. Again, this does encapulate the Reid/Denning approach. As Lord Donovan pointed out, the transactions, when looked at as a whole, were "a device for extracting money from the Exchequer and nothing else."[64]

In Lord Donovan's view, if the component parts of the transaction in the Finsbury case had been considered in isolation then, logically, the same result would have been reached as in Harrison; but the House of Lords took "a comprehensive view of the transaction as a whole" and came to the conclusion that it was an artificial device. Lord Donovan thought that: "It is immaterial in principle that the wider view was induced by certain unusual features in Finsbury."[65] The Finsbury case, in his opinion, marked a change in approach to dividend stripping.

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63. ibid
64. p 629
65. ibid

It appears that, despite distinctions drawn by Lord Morris and others, there was a shift in judicial attitudes regarding dividend stripping and, had Harrison been heard a few years later, the courts might well have come to a different conclusion.

Lord Simon of Glaisdale thought that the Harrison case was "a very narrow decision indeed" and that "particular caution" was required in using passages from it which could not be reconciled with Finsbury.[66] After restating what he perceived to be the principles to be extracted from the Harrison and Finsbury cases, he gave his opinion of the Finsbury transactions :

> "Such trappings of the trade of dealing in shares as we have here are quite inadequate to prevent the real nature of this transaction showing through."

He concluded :

> "My Lords, this is not share-dealing within the trade of dealing in shares. It is plainly a joint venture of the (taxpayer company) and the vendors of the shares, by taking advantage of quirks of revenue and company law, to obtain money out of the public purse and share it between them. Even if the transaction were equivocal, its true nature would, in my view, be resolved by investigation of its paramount object: since, on the findings of the Special Commissioners, the transaction would produce a loss to the (taxpayer company) unless repayment of income tax were obtained, I conclude that the paramount object of the transaction was to procure such repayment of income tax: it was, in other words, a tax-recovery device."[67]

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66. p 631
67. p 632

The second of the two cases on which the House of Lords gave judgment at the same time as in the Lupton case was: Thomson -v- Gurneville Securities Ltd[68]

The scheme in this case was a fairly standard forward stripping operation which was part of a larger scheme to enable the profits of 102 property companies to be extracted by the vendors, who sold them to the taxpayer company, as capital. The actual stripping element involved the taxpayer company (a share-dealing company) writing down the value of its holding in a subsidiary which had paid the dividends, thus producing a loss in respect of which it made a repayment claim.

Again, the main question was whether or not the transactions constituted trading. In this regard, it should be noted that the transactions did produce a commercial profit apart from the expected fiscal benefits. This profit was not negligible, although it was not as large as the repayment claim arising out of the strip: the commercial profit was £90,996; whereas the claim against the Revenue was £413,706.

Lord Simon, however, was not impressed by this "commercial profit" which he thought was "of a very curious nature", it being built into the scheme from the outset. The taxpayer company, he said, was bound to make the profit which could be looked at as a reward for putting up the tax avoidance scheme or, alternatively, as an integral part of the scheme itself: "a colourable device to make a mere expedient for extracting money from the public purse appear to be a bona fide dealing in shares ...". He also noted the fact that the so-called "commercial profit" was so much less than the repayment claim.[69]

68. (1971) 47 TC 633

69. See pp 678 - 9

Similarly, Lord Donovan refused to give any weight to the so-called "commercial profit" because the realisation of this profit was merely part of the overall scheme (which he looked at as a whole) and also the profit was agreed before the scheme was set in motion, whereas, in a proper trade, it can not be estimated at the outset.[70]

At first instance; Goff J thought that the transactions were not like those in Harrison. In Harrison the transaction amounted merely to the purchase of shares, the declaration of a dividend and the subsequent resale of the shares. In the Gurneville case there was a single composite scheme involving, not only the strip, but also the other scheme for the extraction of profits in a capital form which entailed the shares not being sold until the scheme had been worked out. The whole structure was much more complicated than in Harrison.[71]

Regarding this comment, complexity per se ought not to make any difference; there have been many complicated trading transactions - Ransom -v- Higgs[72] for example - but the constraints on selling the shares do suggest, as in Finsbury, that this was not a straightforward dealing transaction.

In considering the transactions in this way, Goff J was looking at the transaction as a whole.[73]

In the Court of Appeal, the judges, without the benefit of the House of Lords speeches in Lupton, preferred the Sachs LJ dissenting line in the Court of Appeal in Lupton to the line taken by Lord Denning MR and Phillimore LJJ.[74]

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70. p 676
71. See pp 658-9
72. (1974) 50 TC 1, discussed, infra, in relation to stock stripping.
73 See Viscount Dilhorne and Lord Donovan in Lupton, supra, who also emphasised this.
74. See for example, Cross LJ at p 668

The decision of the House of Lords was wholly predictable, given the attitude of the House to dividend stripping since Harrison and the immediately preceding Lupton judgments.

The view of Lord Morris, with whom Lord Guest agreed, can be summed up in these comments from his judgment :

> "Suffice it to say that the transactions now under review were not merely inspired by fiscal considerations: the provisions in regard to fiscal matters which for mutual benefit were calculated to produce financial advantage were part of the pith and substance of the transactions themselves."[75]

He then commented - as was said in relation of Goff J's comment above - that the question of whether the transaction is usual or unusual or is simple or complicated may be of no account in determining whether there is a trading activity of share dealing.

Following the line he took in Lupton, he came to the conclusion that the transactions were not trading transactions.

Lord Donovan thought that the transactions were designed to exploit the tax system and were not trading transactions. As in Lupton, he looked at the scheme as a whole.

As far as Lord Simon was concerned, the question to be answered in Gurneville was narrower than that in Lupton. In Lupton, the question was whether the transaction was part of a share dealing trade or merely a device to secure a fiscal advantage. In Gurneville, on the other hand, he considered the question to be as follows :

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75 p 673

"looking at the transaction as a whole, was it, on the one hand, one whereby a true commercial profit was taken in a fiscally advantageous way or, on the other, one in which a "commercial profit" was merely a by-product of, or a disguise for, what was really a tax recovery device? Whichever way the question is put, I have no doubt that, judged both qualitatively and quantitatively, the transaction falls into the latter category in each case."[76]

As far as the above case law is concerned, the Harrison case, the only one the taxpayer won, has subsequently been interpreted and distinguished in such a way that it must now be viewed as a very narrow decision. The courts in the subsequent cases took a broader view of the transactions as a whole.[77]

Despite the lack of success of dividend-strippers in the courts, dividend stripping was extremely popular and extensively used. It was eventually stopped, not by judicial interpretation of the concept of trade as applied to the transactions, but by legislation; and it took several attempts to stamp out the mischief.

Had the above court cases been heard earlier, they would no doubt have had some effect in curbing dividend stripping by the courts' approach to what constituted a trade; but most of the cases were actually heard after the legislation had been introduced stopping the schemes, although the courts were, of course, concerned with tansactions implemented before the relevant legislation was passed. So, it was not the hostile attitude of the courts which finally killed dividend stripping, although it helped; it was the anti-avoidance legislation.

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76. p 679

77. See also Greenberg -v- IRC (1971) 47 TC 240 infra

Later Developments

The 1955 and 1958 legislation aimed at backward stripping has already been discussed. Now the other legislation will be dealt with.

A loophole exploiting the Double Tax Agreement between the UK and the Republic of Ireland had to be stopped in the FA 1959.

This loophole exploited the creation and use of finance companies in Eire. An amendment was made to the DTA and this was confirmed by section 29, FA 1959 which made exemption from tax under the treaty subject to the 1955 and 1958 anti-dividend stripping legislation.

This provision became section 513 ICTA 1970 and was repealed with effect from 6th April 1976.

In Collco Dealings Ltd -v- IRC[78] the House of Lords held that tl argument that the DTA overrode section 4(2),F (No 2)A 1955 was wrong, in any case.

Having attacked backward stripping in 1955 and 1958 - successfully as it turned out - and ratified the amended UK/Eir DTA in 1959, the next attempt to stamp out dividend stripping wa Section 28 FA 1960, now Section 703 ICTA 1988.

Although this section was introduced specifically to stop dividend stripping, the operation of the section has not been s restricted by the Revenue or the judiciary, despite assurances given to the House of Commons at the time of the 1960 Finance Bill's passage through Parliament that it was strictly an anti-dividend stripping measure. In fact, the assurances were given by the Attorney-General at the time, Manningham-Buller, wh later, as Viscount Dilhorne, gave the leading judgment in the House of Lords to the effect that the section was not restricte to dividend stripping.

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78. (1961)39 TC 509

In IRC -v- Parker, Viscount Dilhorne said :

> "The view was expressed in the Court of Appeal that section 28 was directed to dividend-stripping, and that the objective of the company in this case was not of this character. I think I should make it clear that, in my opinion, this is taking too narrow a view of section 28."[79]

Later, he was even more specific :

> "I do not agree that the general mischief which section 28 was designed to hit was dividend-stripping. It was, to my mind, designed to hit other forms of tax avoidance as well."[80]

Nevertheless, regardless of the fact that the House of Commons was mislead as to the true purpose of section 28, it is undeniably clear that dividend stripping was a target of the section and it is on its anti-stripping function that the preser discussion is concentrated.[81]

Of the four circumstances originally introduced in 1960 (circumstance E being added in 1966), A and B were aimed at backward stripping, superseding the earlier legislation, and C attacked, inter alia, forward stripping. This legislation was very successful in stamping out the dividend stripping devices against which it was aimed, although it was not until 1969 that all manifestations of dividend stripping were countered effectively.

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79. (1966)43 TC 396 at p 430
80 For a detailed examination of wider operation of section 703, see Part 5, infra.
81. For a detailed examination of wider operation of section 703, see Part 5, infra

Circumstance A covers the Harrison type of transaction. It catches transactions where there has been a distribution or a sale or purchase of shares or securities and a purchase/sale back of the same or other shares or securities, followed by the receipt of an abnormal amount by way of dividend by the taxpayer, and he obtains a tax advantage by reason of :

(a) a tax emption; or
(b) the availability of losses to set-off; or
(c) a subvention payment.

Alternative (c) was added in 1962 by section 25(3)(a),FA 1962

Paragraph 2(b),Schedule 11, FA 1973 added further paragraphs to circumstance A, namely :

(d) the application of franked investment income in calculating a company's liability to ACT;

(e) the application of surplus franked investment income against losses under sections 242 or 243 ICTA 1988;

(f) the computation of profits or gains out of which payments are made within sections 348 or 349 ICTA 1988 and

(g) the deduction from or set-off against income of interest under section 353 ICTA 1988.

These additional paragraphs cover other ways that dividends coul otherwise be received tax free or a tax repayment can be claimec in respect of a dividend.

As well as the Harrison type of backward strip, circumstance A also catches certain bond-washing schemes. The conditions set out above would also cover the purchase cum div and sale ex div of government stock by a charity which made a capital loss and which could claim exemption on the substantial dividend it received.[82]

This circumstance has been very successful in combating the schemes against which it was aimed. So completely has it achieved its objective that the schemes against which it was aimed are no longer implemented and there have been no reported cases on the paragraph at all.

Circumstance B catches backward stripping by share dealing companies which make a loss by buying securities with profits available for distribution, taking a dividend, and selling the devalued shares. The loss on the sale could be set against the tax deductible from the dividend.

Circumstance B was considered in the case of _IRC -v- Kleinwort Benson_[83] in which the Revenue tried unsuccessfully to apply it.

The taxpayer company, a merchant bank, was a dealer in securities. It purchased debenture stock, the interest on which was substantially in arrears. After the debentures had been acquired, the arrears of interest and capital were paid on the same day and, in fact, by a single cheque. Because the interest was left out of the company's profit and loss account for tax purposes, the account showed a loss of the transaction.

The Commissioners served a section 28(3) notice stating that adjustments were necessary in the computation of the company's profits by excluding the transaction. Cross J,

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82. For an examination of this and other bond washing schemes see below.
83. (1969) 45 TC 369

in the High Court, however, ruled that the notice must be discharged: there had been no "fall in the value of securities resulting from the payment of a dividend thereon or from any other dealing with any assets of the company" as required by the section. The stock did not fall by reason of the payment of the interest; all that had happened was that the stock merely ceased to exist. It would have been different had the interest been paid off before, even by only one day, because then the stock would have fallen in value within the section.[84] As it happens, the company also escaped under the commercial exemption, but that is not relevant to the present discussion.

Circumstance B also catches certain stock stripping transactions.[85]

Again, this circumstances has proven to be effective in preventing the schemes against which it was aimed.

Circumstance C catches the other party to the backward stripping transactions covered by A and B and also attacks forward stripping. As far as backward stripping is concerned, it is the owner of the shares in the stripped company who is caught. For example, the shareholders who sell their shares to the dividend stripper for a capital sum and buy them back after the strip at their reduced value.

The typical forward stripping transaction of the kind considered above would have been within C if it had been implemented after the section came into effect. On this point, see the Greenberg case,[86] below. In view of the attitude of the courts described above, the devices against which C was aimed would probably have failed

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84. See p 381
85. Discussed infra
86. Greenberg -v- IRC (1971) 47 TC 240, infra

anyway. As with A and B, circumstance C successfully combated the particular schemes it was brought in to fight.

Apart from the Greenberg, Tunnicliffe[87] and Green[88] cases dealt with below, circumstance C has been the subject of three cases, although, in two of them, the main thrust of the Revenue challenge was under circumstance D.

All three cases concerned highly artificial tax avoidance schemes devised by the one-time well known purveyor of such schemes Godfrey Bradman.

One of these was IRC -v- Garvin[89]. The taxpayers owned fire property companies which were referred to throughout the case as "ABCFS ". In furtherance of the tax avoidance scheme, the following steps were implemented :

1. On 3rd April 1969 the taxpayers sold their shares in ABCFS for £471,998 payable by annual instalment of £150 over 200 years, with a final stalment of £451,898 payable on 3rd April 2170, and interest at 10 1/4% on the outstanding instalments.

2. On 14th April 1969 the taxpayers sold the right to receive the instalments of the purchase price for £471,848.

3. On the same day they lent £471,848 to another of their companies, "Central", as part of the finance required to acquire the property portfolios of ABCFS for £989,095.

The company that had purchased the shares in ABCFS at step 1 was a Bradman company called Excalibur. On 8th

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87. Tunnicliffe -v- IRC ibid
88. Green -v- IRC (1975) 50 TC 688
89. (1981) 55 TC 24

April 1969, ABCFS disposed of their property portfolios on leases at premiums payable by instalments over 999 years, resulting in distributable profits of £558,000. By virtue of elections under what is now section 34(8) ICTA 1988 there was a negligible liability to corporation tax. A year later ABCFS paid dividends of £555,000 to Excalibur.

Stripped down to its bare essentials the basic elements of this scheme were that the taxpayers sold the ABCFS companies to Excalibur. ABCFS sold their stock to an unconnected party, and a year later paid a dividend to Excalibur.

The Inland Revenue issued notifications under what is now section 703(6) ICTA 1988, specifying, as the transactions they believed to be within section 703: (i) the sale of the shares in ABCFS; (ii) the sale of the right to the instalments of the purchase price of the shares; and (iii) the payment of the abnormal dividends by ABCFS to Excalibur. Subsequently, notices under what is now section 703(3) were issued proposing adjustments resulting in income tax and surtax assessments for 1968/69 in the sums of £235,941, in respect of Garvin, and £117,971 in respect of a fellow taxpayer, Rose.

The Crown sought to rely on circumstances C and D. Their arguments on D are dealt with below.[90] As far as C is concerned, it had to be shown, in the words of section 704C:

> "That the person in question receives, in consequence of a transaction <u>whereby</u> any other person - (a) subsequently receives, or has received, an abnormal amount by way of dividend ... a consideration which ... i) is or represents the value of, assets ... available for distribution by way of dividend, or ... (iii) is, or represents the value of, trading stock of the company."

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90. See Part 5, infra

It was held in the House of Lords that C did not apply. The scheme could only come within C if Excalibur's purpose in purchasing the shares in ABCFS was to procure the payment of an abnormal dividend by those companies and the taxpayers were aware of that purpose at the time. Here, the sale was not the means "whereby" the dividend was paid.

At first instance, Slade J distinguished between the respective approaches of the Crown and the taxpayers. The taxpayers argued that the question was : "Did some other person by that same transaction receive an abnormal amount by way of dividend?" The Crown, on the other hand, submitted that the correct question was : "Did some other person by means of that same transaction receive an abnormal amount by way of dividend?"

Slade J preferred the taxpayer's approach, stating :

> "I do not think that the language of paragraph C, however broadly interpreted, would justify the formulation of the .... question in the latter form. It would, I think, involve reading words into the paragraph which are not there and do not have to be inserted by judicial interpretation to produce a sensible result."[91]

The judge later developed this, saying:

> "however broadly the language of paragraph C is read, however, I find it impossible, in answer of [this] question, to hold that the other person involved, namely Excalibur, received the relevant dividend in 1970 by that same transaction. The Special Commissioners accepted Mr Bradman's evidence that it was not known with any certainty until about one year after the transaction of sale and purchase, even on Excalibur's side, that any such dividends

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91. p 48

would be paid. They further expressly found that there was no scheme or undertaking to which the taxpayer or their agents were parties involving the payments of such dividends, or indeed any knowledge by them that this might happen. In these circumstances, to suggest that Excalibur received the relevant dividends by the transaction of sale and purchase would seem to me to involve a complete distortion of language."[92]

Slade J would allow no extension of the words of the section by virtue of any vague concept of preordination. He said :

"I would not think that it could properly be said an abnormal dividend has been received by a sale and purchase transaction consisting of the sale and purchase of shares, within paragraph C, merely because the vendor knew that the purchaser intended to arrange for the payment of such dividend. Still less would I conclude that the relevant dividend had been received by the transaction of sale and purchase where, as in the present case, the vendor merely knew or believed that the purchaser would carry out some tax avoidance scheme, but had no knowledge of the details. In short, to construe the word 'whereby' in the context of paragraph C as meaning 'by means of which' would, in my judgment, involve an unjustified extension of statutory language by judicial interpretation."[93]

This is not dissimilar to his approach when in the Court of Appeal in Craven -v- White.[94]

The general approach of Salde J was followed in the Court of Apeal by Buckley and Donaldson LJJ but, not

92. p 49
93. ibid
94. [1987] STC 297, see Chapter 11

surprisingly, Templeman LJ saw things rather differently. He viewed the whole of this scheme as a "pantomine".[95]

His views on the application of paragraph C are in stark contrast to those of Slade J. His reasons for considering that paragraph C did apply are vividly apparent from this passage from his judgment which deserves to be set out in full:

> "On behalf of the taxpayers, Mr Beattie submitted that the sale by the taxpayers on 3 April 1969 of the shares of ABCFS to Excalibur was not a transaction 'whereby' Excalibur received a dividend on 13 April 1970. He argued that paragraph C only applies where a dividend is bound to be declared or is intended to be declared. If Mr Bradman had agreed with the taxpayers that a dividend would be declared, or if Mr Bradman intended that a dividend would be declared, then the sale of the shares would be a transaction 'whereby' the dividend was declared. There was no such agreement or intention. I cannot reconcile the words of paragraph C with Mr Beattie's contention that there must be an agreement or intention with regard to the declaration of a dividend. Legislation which counteracts tax advantages must be based on facts and not oblige the Revenue to prove a particular 'agreement' or 'intention' because, as I have previously had occasion to comment, many tax avoidance schemes generate the suppression of agreements and intentions. In the present case, for example, it is inconceivable that the taxpayers would have parted with their shares in ABCFS for a debt payable in 2169 by Excalibur in the absence of an agreement

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95. p 76. For an analysis of Lord Templeman's approach to tax avoidance, see Chapter 11.

by Mr Bradman to procure that the ABCFS assets would be conveyed back to the taxpayers by way of Central. The taxpayers purchased a scheme which was on offer to clients generally and which admittedly included the conveyance to Central and was fully implemented in eleven days. And yet the Special Commissioners allowed themselves to be persuaded that the directors of Excalibur and the taxpayers only 'hoped and expected' that the taxpayers 'would reacquire the properties but there was no agreement to that effect'.

Failure to declare a dividend sometimes leads to disadvantageous tax consequences. However, that may be, Mr Bradman obligingly told the Special Commissioners that he did not form the intention of declaring a dividend in April 1969. History does not relate whether, and how, Mr Bradman resists the temptation to form an early and fatal intention in every production of every scheme which he sells. The taxpayers were not told, did not ask, and were careful not to guess. The Commissioners duly found there was no intention. On the view which I have formed of paragraph C the Commissioners' negative findings with regard to 'agreement' and 'intention' are not material, but they illustrate the reasons why the circumstances prescribed by paragraph C do not depend on the oral testimony of the parties seeking to frustrate anti-tax avoidance legislation.

In considering whether the sale of shares of ABCFS to Excalibur was a transaction whereby Excalibur received an abnormal dividend from ABCFS, I find that the relevant facts are four in number. Firstly, Excalibur bought 100% of the shares of ABCFS and were immediately able to secure the declaration of a dividend by ABCFS. Secondly, at the date of purchase ABCFS held profits and property available for payment of an abnormal dividend.

Thirdly, the purchase price for the shares reflected the value of the profits and properties available for payment of an abnormal dividend. Fourthly, and 'subsequently', Excalibur procured the payment of an abnormal dividend out of those profits and by converting those profits into cash. In my judgment, it follows from these facts that the purchase of the shares in ABCFS was a transaction whereby Excalibur received the abnormal dividend from ABCFS. A purchase of a controlling interest in shares of a company pregnant with dividend is a transaction whereby the dividend is subsequently delivered and received. No other construction of paragraph C is consistent with the express words and object of the paragraph."[96]

The House of Lords delivered their judgments in this case just two months after their decision in the Ramsay case.[97] Yet despite this, the Law Lords could not go with Templeman LJ. Three of the Garvin Law Lords, Lords Wilberforce, Russell and Bridge had also presided over Ramsay and another, Lord Scarman, was no lover of tax schemes, but their rejection of the Crown's appeal was unanimous.

Lord Wilberforce, for example, accepted the finding of the Special Commissioners that, in April 1969, the directors of Excalibur had not decided to procure the payment of a dividend by ABCFS. He did not take such a jaundiced view of the involvement of Bradman. He said :

> "Mr Bradman and his associates had, no doubt, their own preoccupations as regards tax, and it is clear from an examination of the intervening transactions from April 1969 to 13th April 1970, which were numerous, that a number of decisions had to be made and inter-company adjustments effected before the

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96. pp 77-4
97. <u>WT Ramsay Ltd -v- IRC</u> (1981) 54 TC 101, see Chapter 11

distribution was ultimately made. From these I feel forced to the conclusion that there is not sufficient connection between either of the events of April 1969 and the declaration of the dividends to satisfy the words 'a transaction whereby' even giving a wide meaning to 'whereby'. I would add that if I had found it possible to decide that the sale of the shares in ABCFS or the realisation of their properties was such a transaction, I should not find much difficulty in reaching the conclusion that the taxpayer received his consideration ..... in consequence of that transaction, but, on the view which I take, this becomes immaterial."[98]

Lord Wilberforce considered that the word "transaction" in the phrase "transaction whereby any other person ..... receives ..... an abnormal amount by way of dividend" could not be limited to the immediate cause of the dividend being received, namely, the declaration of the dividend by ABCFS. The word, in his opinion, "must be capable of including some anterior step in the scheme which led to the declaration being made".

He considered that "whereby" must be equivalent to "by which" and must connote some causal connection, although this could be of a fairly loose character. Even construing the word widely, there was not a sufficiently close link to bring the taxpayers within paragraph C here.

The difference, as regards paragraph C, between Garvin and the next case was that, in the latter, it was certain that the abnormal dividend would follow once the scheme had been commenced, and consequently, the Crown won. The case in question was Emery -v- IRC[99] which also concerned a Bradman scheme.

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98. pp 85-6. See also Lord Bridge at p90.
99. (1980) 54 TC 607

Nourse J held that the phrase "a transaction whereby any other person subsequently received an abnormal amount by way of dividend" must be given a wide meaning, both as a whole and as regards its individual components. The House of Lords in Garvin later agreed that the phrase should have a wide meaning, but the difference in the results of the two cases can be attributed to the degree of certainty that the dividend would follow the initial transaction. The House of Lords in Garvin, however, did not use the extended meaning of "transaction", contrary to Nourse J here who held that all of the share transactions constituted one "transaction".

This case concerned a complicated circular and artificial tax avoidance scheme typical of those devised by Godfrey Bradman in the pre-Ramsay days. This aspect of the scheme prompted this comment from Nourse J :

> "Like others of their kind [these transactions] were excessively complex and essentially circular. It appeared to the Special Commissioners that Mr Emery did not fully understand the complicated series of manoeuvres which they involved. That does not surprise me in the least; and I must assume that even Mr Faber [one of the tax consultants involved] did not appreciate all their implications. I say that because Mr Beattie, who appears for Mr Emery, has pointed out (and I agree with him) that it is at least possible that the circularity involved a contravention of section 54 of the Companies Act 1948.[100] That is a section which has consequences both in criminal and in company law. That point in no way arises in these proceedings. I mention it because it shows that those who play with this sort

100. This section related to companies providing financial assistance for the purchase of their own shares.

of fire may get their toes burned, even if not their fingers."[101]

The facts were that the taxpayer controlled a property company called Mersey Industrial Estates Ltd which owned valuable properties ripe for development. He entered into two artificial tax avoidance schemes ("the property transactions" and the "share transactions") designed to facilitate the dispersal of the properties without paying the normal tax liabilities inherent in such a disposal.

The object of the property transactions was to enable Mersey to sell the properties in such a way as to avoid corporation tax. The share transactions, which are the ones of relevance to the present discussion, were very similar to the Garvin arrangements. They commenced with the taxpayer selling his shares in Mersey on 25th March 1971 to Tishmear Investment Co Ltd, a Bradman/Faber company. The total consideration was £233,409, payable by annual instalments of £100 over 98 years, with the balance payable in three equal instalments on the 99th, 100th and 101st anniversaries of the sale.

On 29th March, the taxpayer sold to another Bradman/Faber company, Kopley Investment Co Ltd, the right to receive the instalments of the purchase price for £233,409. Mersey lent Kopley the purchase price. It was here that the company law problem of providing financial assistance for the purchase of the company's own shares arose.

On 30th March, Mersey paid an "abnormal" dividend (which it paid gross, having made an election under section 256 ICTA 1970 [102]) of £233,409 to Tishmear. Tishmear then

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101. p 624
102. Now section 247 ICTA 1988

lent an identical sum to Kopley which, in turn, repaid the loan of £233,409 to Mersey.

The basic structure of this scheme, therefore, was that the taxpayer sold Mersey to Tishmear and Mersey then declared an abnormal dividend to Tishmear.

The Revenue issued a notice under section 460(3) ICTA 1970[103] specifying as transactions giving rise to the tax advantage the scale of the shares in Mersey and the subsequent payment of the dividend.

The Special Commissioners found that all the share transactions formed part of the same scheme. They also found that the taxpayer had not been told whether or not it was Mersey's intention to declare the abnormal dividend, but that his solicitor had understood that such a dividend would be declared. This understanding could be imputed to the taxpayer. However, before Nourse J, the argument, by agreement, proceeded on the basis that, on 29th March 1971, neither the taxpayer nor his solicitor knew that an abnormal dividend was going to be declared by Mersey.

Nourse J held that paragraph C was satisfied. The "transaction" was the whole series of operations down to and including the payment of the abnormal dividend by Mersey and the two other steps taken on 30th March.[104] There was a sufficient causal link between the transactions and the subsequent receipt by Tishmear of the abnormal dividend to satisfy the requirements of the word "whereby". He said :

> "The position was that Mr Emery would never have embarked on the property scheme unless he had

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103. Now section 703(3) ICTA 1988
104. pp 631-2

intended to proceed with his part of the extraction scheme (i.e. the share transactions). Mr Faber would never have embarked on the two schemes unless Mr Emery had intended to proceed with his part of the extraction scheme, because if Mr Emery had not done that, he, Mr Faber would not have been able to procure the declaration by Mersey of the abnormal dividend, which to him was an essential part of the schemes. The die was cast when Mr Emery and Mr Faber together embarked on the property scheme on 18 March. From that moment onwards, it was as certain as night follows day that Mersey would in due course declare the abnormal dividend. I do not see how an arrangement of that kind can cease to be one transaction, or, if it should be put the other way round, can become more than one transaction at the stage when one of the participants has no further part to play."[105]

The most recent of the circumstance C cases involved yet another Bradman scheme: Bird -v- IRC. Whether circumstance C applied was a live issue before Vinelott J,[106], and the Court of Appeal [107], but, by the time the case reached the House of Lords,[108], the taxpayers had conceded that circumstance C applied and the main argument there was based on whether there was a "tax advantage" and, if so, what were the correct counteracting assessments.[109]

The scheme used in this case was highly complex and similar, in many respects, to that used in Williams.[110] In fact, the Bird scheme was not just one scheme but four separate schemes incorporated together.

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105. p 632
106. [1985] STC 584
107. [1987] STC 168
108. [1988] STC 312
109. See Part 5, infra
110. Williams -v- IRC (1980) 54 TC 257, infra

The taxpayers owned a company called Ilmarish Investments Ltd which owned 70% of the share capital in Croydon Centre Development Ltd ("CCD"). The other 30% was owned

by another company which in turn was owned by the Church Commissioners. CCD owned a valuable property in Croydon which it expected to sell for £10 Million.

The complicated scheme, purchased from the Bradman organisation for £300,000, was aimed at selling the property and placing 70% of the proceeds into the taxpayers' hands with as little tax as possible. The complexity of the scheme was accounted for by the fact that there were several taxes that had to be avoided.

1. When CCD sold the property it would have to pay corporation tax on the capital gain it would make.

2. When Ilmarish realised its 70% holding in CCD, it too would have to pay corporation tax on its capital gain.

3. When the net proceeds were put into the hands of the taxpayers, further liabilities would arise in one of two ways:

    (a) the taxpayers could realise their Ilmarish shares by sale or liquidation, giving rise to CGT in their hands; or

    (b) by Ilmarish making a loan to them with its accompanying tax charge under section 286 ICTA 1970[111] (which was then income tax).

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111. Now section 419 ICTA 1988

To minimise these taxes, there were four separate schemes implemented :

1. The property scheme.
2. The share scheme.
3. The extraction scheme.
4. The loan scheme.

The "property scheme" was implemented to avoid corporation tax in CCD's hands on the sale of the property. It involved CCD granting a 250 year lease of the property, terminable in the 49th year, to a Bradman company for a premium of £9,926,500 payable in instalments of £1,000 p.a. with interest, the balance being payable in the last three years of the lease. On the same day, CCD sold the freehold reversion to another Bradman company for £10,000. Two days later the lease was transferred to the second Bradman company, thereby merging the lease with the freehold. The object of this scheme was to ensure that the bulk of the corporation tax was payable only in year 250.

No major point arose about this part of the overall arrangement; the Inland Revenue did not attack the scheme as such because <u>section 81 FA 1972</u> rendered it ineffective because the total tax in respect of all of the instalments thereby became payable immediately.

The "share scheme" was in fact the share swap arrangement used in cases such as Furniss -v- Dawson.[112] Ilmarish exchanged its shares in CCD for shares in a new company, Jergil Investment Co Ltd; Jergil then sold the CCD shares to another Bradman company, Tishmear.

The Inland Revenue assessed Ilmarish, which appealed, and the Inland Revenue kept the appeal open for years until Furniss -v- Dawson was decided in their favour by the House of Lords. Following Furniss -v- Dawson, the

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112. (1984) 55 TC 324, see Chapter 11

taxpayers accepted that the share scheme had failed and that Ilmarish was liable for corporation tax in respect of its disposal of its holding in CCD.

The "extraction scheme" was carried out a year later and was implemented entirely between Bradman companies; the taxpayers were not parties to it or even aware of it. Basically, what happened was that CCD, which was now, of course, a Bradman company, sold its rights to receive the deferred instalments for cash and paid a dividend to its Bradman company shareholder, Tishmear Investment Co Ltd., equal to all of its reserves. As will be seen below, this was the "abnormal" dividend on which the Revenue relied under circumstance C.

The "loan scheme" was implemented to put cash into the hands of the taxpayers. This had to be done in such a way that no liability arose under section 286 ICTA 1970.[113] Accordingly, the Bradman organisation incorporated another company, Interlude Investment Co Ltd. Interlude borrowed funds, which it lent, interest free, to the taxpayers in the same proportions as their shareholdings in Ilmarish. Jergil then purchased all of the shares in Interlude so that Interlude was then owned by a subsidiary (Jergil) of a company owned by the taxpayers (Ilmarish). The loan agreements were in the same form as those used in the Williams case.[114] They were settled by Raymond Walton QC, later Walton J.

The loan scheme was in fact stopped as regards loans made, or debts incurred or assigned, after 15th April 1976 by section 44(2)(4)FA 1976 which inserted section 287A ICTA 1970.[115] This legislative amendment did not, however, affect the loan scheme here which was implemented in 1972, and section 286 ICTA 1970 did not catch the transactions, so the Revenue mounted their

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113. Now section 419 ICTA 1988
114. Williams -v- IRC (1980) 54 TC 257, see Part 5, infra
115. Now section 422 ICTA 1988

attack under section 460. Notices under section 460(3) and consequential assessments were issued to the taxpayers on the grounds that, by the combined effect of the transfer of the CCD

shares to Jergil, the transfer of those shares by Jergil to Tishmear, the payment of the dividend by CCD to Tishmear, the loans, and the acquisition by Jergil of the Interlude shares, the taxpayers had obtained a tax advantage within circumstance C.

Before the Special Commissioners it was common ground that the dividend paid by CCD was abnormal and that the taxpayers had received the loans in such a way that they did not pay or bear tax on them as income. However, the taxpayers contended :

(1) that circumstance C was not satisfied because the loan transactions were not part of the scheme which was completed on the sale of the property to the ultimate purchaser and so it was impossible to say that the loan transactions were transactions "whereby" Tishmear had received an abnormal amount by way of dividend six months earlier;

(2) that when the CCD shares were sold by Jergil to Tishmear, they were not aware that an abnormal dividend would be paid;

(3) that the moneys derived from the sale of the shares in CCD by Ilmarish through Jergil constituted an outright sale to the Bradman organisation and that the proceeds of sale were not traceable through transactions entirely within the Bradman organisation; and

(4) that, should the taxpayers be charged with tax on the whole amount of the loans as well

as having to bear corporation tax on the distributable profits of CCD, then the income tax and surtax charged would exceed anything which the taxpayers obtained from the scheme or could have obtained by any other means.

The Special Commissioners held that circumstance C did apply and that the taxpayers had obtained a tax advantage. They further held that the quantum of the assessments should be the sums which reflected the loans received by the taxpayers from Interlude.

Here the circumstance C point will be discussed. The "tax advantage" and quantum aspects of the case are examined below, as is the question raised only in the High Court, namely, whether circumstance D applied.[116]

It was common ground that the dividend paid by CCD to Tishmear was abnormal and that the taxpayers received the loans in such a way that they did not pay or bear tax on them as income. There were, therefore, two outstanding issues to be determined in deciding whether circumstance C applied :

1. Did the taxpayers receive the loans in consequence of a transaction "whereby" Tishmear received the abnormal dividend?
2. Were the loans a consideration which represented the value of assets of CCD which would have been available for distribution by way of dividend?

On the first of these questions, Vinelott J analysed the Garvin and Emery decisions. He then asked the question whether the sale of the CCD shares and the payment of the dividend were conceived as part of a single design leading to a pre-arranged end. To this he answered :

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116 See Part 5 Infra.

"To my mind, there can be only one answer to that question. As the Commissioners point out, the sale of the .... shares of CCD by Ilmarish through Jergil to Tishmear was not completed until the Croydon property had been sold. Until then substantially the whole of the purchase price had to be deposited with FNFC [a finance house], both as collateral security for the sum borrowed by Aromeg [a Bradman company] from Cassell Arenz [a subsidiary of FNFC] and as the fund from which any adjustment following a shortfall in the net proceeds of the sale of the Croydon property would be deducted. The declaration of a dividend was the means by which the proceeds of sale (converted by the property scheme into a right to a premium payable by instalments and then transmuted back into cash) would be extracted from CCD and circulated within the Bradman and Faber organisation in such a way as to enable the adjusted purchase price (or the part deposited with FNFC) to be released to the vendor of the shares."[117]

The point then to be addressed was whether the Crown also had to show that the taxpayers knew that it was part of the overall scheme that the available assets would be extracted from CCD by way of dividend.

It will be recalled that in neither Garvin nor Emery was the taxpayer aware that an abnormal dividend was going to be declared but, in Emery, unlike the position in Garvin, the relevant conditions of circumstance C were held to be satisfied. The difference between the two was that, within the Bradman organisation, it was certain that the abnormal dividend would be paid in Emery, but this was found not to be the case in Garvin.

However, in Garvin, Lord Bridge had observed that :

117. p 635

"to establish that the sale of shares [in X] by A and B to Y was a transaction "whereby" Y subsequently received an abnormal dividend, it would be necessary, in my opinion, to show that Y's purposes, or one of Y's purposes, in purchasing the shares was to procure in due course the payment of an abnormal dividend by X to Y, and that A and B were, at the time of the sale, aware of this purpose."[118]

This opinion is incompatible with the decision of Nourse J in Emery. Vinelott J in Bird pointed out[119] that Lord Bridge in Garvin expressed no doubt as to the reasoning or conclusion of Nourse J and, furthermore, Lord Wilberforce, with whom Lords Keith and Scarman agreed, indicated that he did not think knowledge on the part of the taxpayer or his adviser was necessary. Having said that, he found the question whether there was a sufficient causal link between the sale of the shares and the declaration of the dividend a difficult one, Lord Wilberforce fastened on the Commissioners' finding that the question whether to procure the payment of a dividend remained an open question for about a year as founding his conclusion that there was no sufficient causal connection. In the opinion of Vinelott J, if Lord Wilberforce had thought that knowledge on the part of the taxpayers or their advisers of the intention to declare a dividend was an essential ingredient he would have said so.

This analysis is sound and Vinelott J was correct in not considering himself bound by Lord Bridge's observation. He then applied this analysis to the facts in Bird. He said :

118. (1981) 55 TC 24 at p 90

119. at pp 635-6

"In the instant appeals (as in Emery) the taxpayers bought a scheme consisting of a number of related and (save for the loan scheme) closely interlocking steps. Indeed, they paid £300,000 for it. The scheme was designed and sold to them as one which would avoid all taxation on the commercial profit to be made from the sale of the Croydon property, including corporation tax on the profit realised by CCD. I cannot see that the taxpayers' liability to a counteracting assessment under section.460 can depend on whether they troubled to investigate every part of the scheme to see how that end would be achieved. The causal link between the sale of the shares and the declaration of the dividend is to be found in the purpose and design of those who throughout controlled the operation of the scheme, calling on the taxpayers only to play such part as it was necessary for them to play. Lastly, on this question counsel for the taxpayers submitted that there is no foundation for the finding by the Commissioners that the declaration of the dividend by CCD was an essential part of the scheme as conceived by the Bradman and Faber organisation. I doubt whether this finding was necessary to found the conclusion that the transaction was one 'whereby' the dividend was received by Tishmear. It seems to me sufficient to say that the declaration of the dividend was the way in which, under a scheme designed before the shares of CCD were sold by Ilmarish through Jergil to Tishmear, the surplus assets of CCD were to be extracted. But I think that the Commissioners were in any event justified in finding that it was an essential part of the scheme. It was essential to the operation of the scheme that the assets of CCD, or the greater part of them, should be extracted in some way. The Bradman and Faber organisation stood to make a serious loss if, following a change in the law giving rise to an immediate liability to corporation

> tax on the commercial profit realised by CCD on the sale of the Croydon property, the Revenue were able to recover the tax. It is, I think permissable to infer that even in March 1971, there were those in the Bradman and Faber organisation who foresaw this risk and thought of ways of defeating the claim (not, I would stress, avoiding the liability) by putting the assets of CCD beyond the reach of the Revenue".[120]

The reason for the dividend was no doubt the one specified by Vinelott J but, in reality, it had nothing whatsoever to do with the taxpayers or the sums they received, apart from the fact that they had bought a scheme of which it was part. The courts appear to have moved somewhat towards Templeman LJ's position in the Court of Appeal in Garvin.[121]

The second question for Vinelott J to consider in the context of circumstance C was whether the loans were a consideration which represented the value of assets of CCD which would have been available for distribution by way of dividend. Counsel for the taxpayers submitted that the loans represented moneys derived from the sale of the CCD shares by Ilmarish through Jergil and nothing else; that it was an outright sale to the Bradman organisation; and that the proceeds of sale could not be traced through transactions which took place solely within the Bradman organisation without the knowledge of the taxpayers identified with the proceeds of sale of the Croydon property. Vinelott J found this "an impossible submission".[122] His conclusion on this point was :

> "To my mind, it is clear, for the reason given by the Commissioners, that the loans represented moneys which could have been distributed by way of dividend

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120. p 636
121. See (1981) 55 TC 24 at pp 73-4
122 p 637

by CCD to Ilmarish (and by Ilmarish to the taxpayers) if CCD had sold the Croydon property to the ultimate purchaser and had done so (as it in fact did) in a way which indefinitely postponed liability to corporation tax on the commercial profits realised by CCD and made possible the declaration of the dividend which was in fact declared."

The reasoning of Vinelott J was accepted and followed by the Court of Appeal.[123] The taxpayers did not feel able to challenge these findings before the House of Lords which, accordingly, expressed no view on the matter.

The scope of the first three circumstances was fairly clear in that they were aimed at specific schemes. Circumstance D is rather wider in its terms but it was, nevertheless, widely supposed to be no more than an anti-dividend stripping provision. This supposition was quickly proved wrong and D now acts as a "sweeping-up" provision covering any form of extraction of funds which would otherwise be available for distribution in a way which gives rise to a tax advantage.

Considering the wide scope of D, it is interesting that it received very little consideration in Parliament. The assurances given by the Attorney-General have already been mentioned. Another noteable feature in this respect is the fact that the specifically targeted circumstances A, B and C were introduced at the Committee Stage of the 1960 Finance Bill on 25th May 1960; whereas D was not introduced until a late stage in the Bill's passage, the Report Stage on 6th July 1960. The structure of section 460 is considered in a wider context than dividend stripping in Part 5 of this Chapter.

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123. See [1987] STC 168 at pp 175-6, per Sir Nicholas Browne-Wilkinson VC and p 182 per Balcombe L J.

Having considered section 703 et seq., insofar as those provisions affect dividend stripping, three further cases are now considered: all forward stripping cases within circumstance C.

In the cases of Greenberg -v- IRC and Tunnicliffe -v- IRC[124], the taxpayer had entered into forward stripping transactions which were undeniably within the terms of circumstance C. Section 28 FA 1960 did not, however operate in connection with transactions carried out before 5th April 1960. The issue in each case was whether the respective transactions were caught given that, in each case, the contract with the share dealers for the sale of the shares were entered into before 5th April 1960. However, in Greenberg's case, the purchase price was paid by instalments as and when dividends were paid on the shares transferred, and most of the dividends were paid after 4th April 1960. In Tunnicliffe's case, on the other hand, the whole of the purchase price was paid immediately, but Tunnicliffe had to deposit a sum equal to the purchase price with a bank. This sum was released to him by instalments as and when dividends were paid. All of the dividends were paid after 4th April 1960.

The question in each case was, had the transaction in securities taken place before 5th April 1960? The House of Lords found for the Crown in each case on the basis that each declaration of a dividend and each payment of purchase price constituted a separate transaction in securities, and section 28 applied to all instalments of the purchase price paid on or after 5th April 1960.

Furthermore, it was held by a majority that, even if each payment of the purchase price could not be considered as a separate transaction, and that the agreement for the sale of the shares was the relevant transaction, it had

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124. Which were heard together at (1971) 47 TC 240

not been "carried out" before 5th April 1960, on the basis that "carried out" meant "implemented" or "fulfilled". The agreement could not be said to be "carried out", in this sense, until the whole purchase price had been paid.

The Law Lords were here giving a wide construction to "transaction", as they have consistently done in construing section 703 and similar wide anti-avoidance provisions in recent years. This is particularly the case where, as here, the transaction was such that it prompted Lord Morris to remark :

> "Counsel's reflection that the transaction had the features of a 'pantomine' was not uncharitable."[125]

Forward stripping within the ambit of circumstance C was also the subject of Green -v- IRC[126], but this case is of little interest now; the only point arising out of it is that, in determining the assets available for distribution, sums representing depreciation of plant and depletion of land values could not be deducted. This subject is considered further below in relation to circumstance D.[127]

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125. p 278
126. (1975) 50 TC 688
127. See Part 5, infra

Other Anti-Dividend Stripping Legislation

As well as the various forms of "backward" and "forward" stripping already considered, dividend stripping manifested itself in various other guises and was combated by a number of other provisions.

It will be seen how the dividend stripping legislation was re-cast with the coming of corporation tax in 1965. The dividend stripping provisions were then contained in Section 65 and Schedule 17, FA 1965. These provisions brought within the framework of 1965 legislation, rules similar to those contained in section 4 F(No 2)A 1955 (as amended).

This legislation was replaced in 1969 and two new provisions were introduced. These new provisions applied only to companies, whereas the 1965 legislation affected individuals as well. The 1969 provisions, which are still in operation today, were paragraph 21, Schedule 19, FA 1969[128] and paragraph 10, ibid[129].

Paragraph 21 was introduced to prevent a capital loss being created by the payment of a dividend by one company to another.

The section applies where one company holds 10% or more of a class of shares in another company and the first company is not a dealing company in relation to the shares; in other words, they are not held as trading stock.[130]. The distribution by the second company to the first must "materially" reduce the first company's holding.[131]

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128. Now section 281 ICTA 1970
129. Now section 736 ICTA 1988
130. Now section 281(1)(a)(b) ICTA 1970
131. Section 281(6)(b) ibid

It is not possible to circumvent this provision by splitting shares among connected persons so that no one holds 10% of the second company because holdings of connected persons are aggregated.[132]

No definition is given of "materially" but clearly not every reduction in value is caught by the section. There is, as yet, no concrete guidance on this point.

A distribution will not be a depreciatory transaction to the extent that the payment is taken into account in computing a chargeable gain or allowable loss of the company making the ultimate disposal.[133]

Without the section, a company could pay up its accumulated profits by way of dividend and the value of the shares in the payor company would thereby be reduced. If the reduction produces a capital loss, that loss would be disallowed. The machinery by which the counteraction operates is to provide that the dividend gives rise to a depreciatory transaction under <u>section 280 ICTA 1970</u> whether the two companies are members of a group or not.

An example of the kind of device section 281 was designed to stop is where company A buys company B for £500,000. Company B then pays an inter-group dividend of £200,000. If A then sells B, or B is liquidated, A could suffer a loss of £200,000 on B's shares. Section 281 will cause the loss of £200,000 to be disallowed.

The section has been successful so far as losses are concerned. However, it does not cover the situation where gains are merely reduced but losses are not produced. The section would not catch the situation, which is not uncommon in practice, of a company which is about to sell a subsidiary, causing the subsidiary to pay

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132. Section 281(6)(b) ibid
133. Proviso to section 281(2) ibid

up a dividend prior to sale so that the parent's gain is thereby reduced.

A similar provision to this is paragraph 10, Sch 19 FA 1969[134] which is concerned with share dealing companies, in whose case a dividend by a company in which it had a holding would produce a trading loss. Section 736 cancels the loss which could otherwise be set against the dividend received.

The section applies where a dealing company holds 10% or more of the shares in another company as trading stock and, as a result of a distribution, the value of the holding is "materially" reduced below the value of the shares when they were acquired.

As a result of this provision, a loss cannot be created by the dealing company stripping out profits of the other company which were earned prior to acquisition by the dealing company.

As with section 281, there is a provision preventing the section being avoided by the splitting of the holding between connected persons.[135]

The avoidance is counteracted by an amount equal to the reduction in value of the shares attributable to the distribution being added to the value of the shares for the purposes of any valuation and being treated as a trading receipt on a sale or appropriation from trading stock.[136] Accordingly, the value of the shares cannot be written down and no loss can arise on realisation.

Section 736 in fact is not often used in practice, not because the section is defective, but because the Revenue prefer to use the more sweeping provisions of section 703.

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134. Now Section 736 ICTA 1988

135. Section 736(4) ibid

136. Section 736(2) ibid.

A different type of provision was section 22, Finance Act 1973[137] This was aimed at charities and other exempt funds (such as pension funds) who indulged in dividend stripping. The section operates in such a way that the exemption is not available when a distribution is made out of profits made before acquisition. Exemption is available in respect of profits arising after acquisition.

So like circumstance A of section 704, section 235 prevents the use of a tax credit which would otherwise be recoverable.

The section applies where the exempt fund holds at least 10% of the class of shares giving rise to the distribution.

Where the section applies the exemption from tax does not extend to the income represented by the distribution. Furthermore, it is treated as not brought into charge to income tax for the purpose of covering an annual payment under section 348 ICTA 1988 and no interest can be deducted from or set off against it under section 353, ibid.[138] What is more, the person entitled to the income shall be liable to tax at a rate equal to the additional rate in force when the distribution is made.[139]

In deciding whether the 10% test is satisfied "associated holdings" are aggregated.[140] Two or more holdings are associated if they were acquired by persons acting in concert or under arrangements.[141]

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137. Now section 235 ibid
138. Section 235(3) ibid
139. Section 235(4) ibid
140. Section 235(1) ibid
141. Section 236(2) ibid

Another section restricting the use of a tax credit was section 23 FA 1973.[142] This section has effect where a person receives a distribution by virtue of sections 209(3), 210 or 211(1) ICTA 1988.[143]

If the person is entitled to recover tax in respect of the distriibution by virtue of any exemption from tax or the availability of losses to set against profits, then he cannot take the distribution or the tax credit into account for the purposes of that recovery except to the extent that the distribution would represent no more than a commercial return of his investment.

He will also suffer tax at the additional rate on the distribution and it will not constitute franked investment income. Furthermore, the tax credit cannot be used to cover any annual payment under section 348 and no interest under section 353 can be set off against it.

142. Now section 237 ibid
143. See Part 3, supra

Privy Council Decisions on Overseas Legislation

It is instructive to consider the 1958 Privy Council case of Newton -v- Federal Commissioner of Taxation[144] because it shows how a dividend stripping operation was defeated by the Australian "blanket" anti-avoidance provision which was then contained in section 260 of the Commonwealth Income Tax and Social Services Contribution Assessment Act, 1936-1951.[145] This section ran as follows:

> "Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly - (a) altering the incidence of any income tax; (b) relieving any person from liability to pay income tax or make any return; (c) defeating, evading or avoiding any duty or liability imposed on any person by this Act; or (d) preventing the operation of this Act in any respect, be absolutely void, as against the commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

This general anti-avoidance provision defeated the following dividend stripping arrangement.

The taxpayers controlled three companies which dealt in motor cars. Each company entered into similar transactions of which the steps set out below - implemented by one of them - were typical.

The motor dealing company had made large profits in its accounting period ended 31st December 1949. The company

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144. [1958] AC 450
145. See Chapter 10, Part 3

amended its articles in December 1949 so as to give special dividend rights to the holders of its 80,000 ordinary shares who thereby became entitled to a total of £460,000 as a special dividend. Thereafter, the shares would only carry a fixed dividend of 5%.

The taxpayers sold their shares to a share dealing company, Pactolus Ltd. for £460,999 and Pactolus received the special dividend. Pactolus then subscribed for 400,000 preference shares in the motor dealing company for £400,000. These preference shares were sold to the taxpayers for £400,000. The cheques involved in these transactions were banked simultaneously.

Pactolus sold the 80,000 ordinary shares to a subsidiary for their value at that time, £80,000. As Pactolus was a share dealing company, it could set the £380,999 loss it had made on the ordinary shares against the special dividend, giving a taxable profit of £80,000.

The Commissioner sought to apply section 260, and his claim was upheld by the Privy Council. Lord Denning delivered the opinion of the Board. He said that the taxpayers were within the words "avoiding any ... liability imposed on any person" because those words meant taking steps to avoid a liability about to arise, which the taxpayers had done.

Examining the opening words of the section, Lord Denning said that they showed that the section was not concerned with the taxpayers' motives. The section was not concerned with their desire to avoid tax, but only with the means they used to do it. In other words, the court had to look at the effect of the arrangement. So far as the purpose or effect of the arrangement was to avoid tax, it was void as against the Commissioner.

A fuller examination of both the section and the decision can be found in Chapter 10, Part 3.

A similar result was reached by the Privy Council in 1976 when they ruled that a general anti-avoidance provision in Jamaica succeeded in defeating a dividend stripping transaction. The case in question was Seramco Ltd Superannuation Fund Trustees -v- Income Tax Commissioner[146]

The scheme in question was a backward stripping operation. The law of Jamaica at the time did not contain any specific anti-dividend stripping legislation so the scheme was attacked under section 10(1) of the Income Tax Law 1954, which provided :

> "Where the Commissioner is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious, or that full effect has not in fact been given to any disposition, the Commissioner may disregard any such transaction or disposition, and the persons concerned shall be assessable accordingly."

Lord Diplock, giving the judgment of the Board, said that, the fact that the agreement between the parties provided for dividend stripping, was not of itself sufficient to bring it within the above provision; the transaction had to be "artificial" or "fictitious".[147]

It is obvious, then, that Lord Diplock did not regard all dividend stripping operations as artificial. He said that whether it could be so regarded would depend on the terms of the particular transaction and the circumstances in which it was carried out.[148]

"Fictitious" was considered to be applicable basically to a sham transaction. This description did not apply to

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146. [1976] STC 100
147. p 107
148. Ibid

this scheme. As for "artificial", the Privy Council were of the opinion that the transaction in question could be so described for the following reasons.

The shares were sold to, and reacquired from, a superannuation fund which was then exempt from tax under Jamaican law and thus a suitable vehicle to carry out the stripping. Under a proper fund - which the Privy Council accepted that it was - the trustees had to invest the fund's money in income-earning assets. At the time of the agreement to purchase the shares it had virtually no money and none of the money they did have was actually used to buy the shares. Furthermore, they were prevented by the terms of the agreement from using the shares as security for raising money from outside sources. The instalments of the purchase price could, in practice, only come from the proposed dividends.

The agreement did, however, safeguard the fund from making any loss if the trustees defaulted. The original shareholders of the company to be stripped, on the other hand, did stand to lose if the trustees defaulted. As Lord Diplock put it:

> "... from the point of view of [the shareholders] it was a most improvident agreement for them to enter into unless they had a tacit understanding with the trustees that after the accumulated profits of [the company] had been distributed by way of dividend the trustees would not default on any of the first four instalments of the purchase price ..."[149]

In the circumstances, the Privy Council came to the view that it was never contemplated by the parties that the shares would not be retransferred to the original shareholders once the instalments had been paid. They therefore concluded that :

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149. p 108

"... it is impossible to regard the transaction for which the shares agreement on its face provided either as a genuine exercise by the trustees of the powers of investment of moneys standing to the credit of the superannuation fund under which they purported to act; or as a genuine sale by the [shareholders] of their shares in [the company] for a price payable by instalments accompanied by what was no more than an 'option' to repurchase them. Their Lordships agree with the Court of Appeal [of Jamaica] that the cumulative effect of all those features of the transaction to which they have drawn attention, is that the transaction within the meaning of section 10(1). It would be difficult to find a more apt description for it."[150]

Having found that the transaction was artificial, the Privy Council then had to consider the effect of so treating it.

They came to the conclusion that the section allowed the Commissioner to treat the transaction as if it had never been entered into for tax purposes although, as between the parties themselves, the section did not alter any legal rights or liabilities the transaction gave rise to.

As the Commissioner could disregard the transaction for tax purposes, he could treat the shares as having remained with the original shareholders and the trustees as not having received the dividends. The trustees were not therefore entitled to any refund in respect of the dividends purported to have been received by them.

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150. Ibid

STOCK STRIPPING

Introduction

Stock stripping devices came in various guises but they were based on one underlying concept: a company would own an asset which had either already increased in value or had the potential for substantial increases in the future. The realisation of the increase, once accrued, would give rise to an income tax liability (because, for example, the company was a dealer in the type of asset in question).

The stock stripping schemes were concerned with ways of enabling the profit to be enjoyed without incurring the income tax charge.

The stock stripping schemes were concerned with ways of enabling the profit to be enjoyed without incuring the income tax charge.
The Finance Act 1960, which contained a number of important anti-avoidance provisions, introduced six anti-stock stripping sections, with two more being added in 1962. These sections have all now been repealed apart from one subsection which is now section 774 ICTA 1988. The rest of the ground is now largely covered by sections 703[151] and 776[152], ICTA 1988.

The original provisions were contained in sections 21 to 26 FA 1960 and sections 23 and 24, FA 1962.

151. See Chapter 1, Part 5
152. See Chapter 3

Sales of Shares in a Trading Company When the Buyer Had or Obtained Control

The first of these provisions to mention is section 21 FA 1960. This section was concerned with the sale of shares in a company which carried on either :

(a) a trade of dealing in securities, or land or buildings, or of developing land; or

(b) any other trade such that the value of any one object representing or forming part of the trading stock of the company at the time of the sale amounts to one-fifth or more of the value of the company's net assets.

If the sale was to someone who already had or obtained control of the company after the sale, and the receipt by the vendor was not of an income nature, the section applied so the Inspector could issue a certificate to the Commissioners that the above conditions for the operation of the section existed. It was then up to the vendor to satisfy the Commissioners that all of the trading stock of the company at the time of the sale had been or would be disposed of either in the course of its trade or to a person carrying on a trade which was such that the stock would be trading stock in his hands.

If the vendor failed to satisfy the Commissioners accordingly, the consideration for the sale of the shares, or an appropriate part of the consideration, was treated as the vendor's income and subject to income tax under Sch. D, Case VI.

On the other hand, if the vendor was successful in convincing the Commissioners, but the company still held any of its trading stock six years after the sale, the company would then be charged to tax in respect of the retained stock unless it had by then ceased to carry on the relevant trade, or it could establish a bona fide reason for retaining the stock.

The main charge to income tax on the vendor was calculated by charging him to tax on a sum which was equal to the taxable profits which the company itself would have made if it had sold its capital assets (less liabilities) for the same sum as the vendor received for his shares. If the vendor had not sold all of the shares, the tax charge was scaled down accordingly. The amount on which the vendor was charged to tax could be greater than the amount brought into charge had the company sold its assets. For example, if the company had sold the assets it would have suffered a balancing charge on cost less written down value but, under section 21, the charge would be based on the full value of those assets.

This was really just a result of the rather involved method of computation written into the section; rather than through any desire on the part of the Legislature to be penal. In other respects, the section is drafted so as to deal with the mischief of the section rather than to increase tax liabilities. For example, if a charge was levied on the vendor under section 21, the company itself was exempt from tax on any future actual disposal of the assets.

However, the section could easily have caught innocent taxpayers. The key to the section was not the size of the vendor's holding, but control by the purchaser after the sale; a matter on which the vendor might have been ignorant, particularly when the provisions of sections 23 and 24(4) are considered (see below). A vendor could therefore have incurred a liability under section 21 without being aware of the fact.

There was a procedure under the section for obtaining clearance in advance from the Revenue for any proposed sale.

Sales of Shares in a Building Company When the Buyer Had Control

The next section, section 22, FA 1960, was introduced to cover stock stripping in the case of non-trading building companies.

The type of scheme the section was aimed at involved an attempt by a builder to take part of his profit from the construction and sale of a building as capital (then tax-free) rather than as a normal trading receipt. This was done by ensuring that the construction was done by a non-trading company, the shares in which were sold to the purchaser.

This normally took the form of the formation by the builder of a company which was expressly prohibited by its memorandum of association from dealing in land; it was strictly an investment company and no more.

The builder then procured the company to employ him to erect the building in return for his normal fees (Any attempt to construct the building at less than the market rates could have given rise to problems under section 459, ITA 1952.[153]

Once the building had been completed the company itself would be sold and the profit that the company would have made would be reflected in the consideration received by the builder for his shares. This tax-free profit element could be particularly substantial if the value of the land and buildings was enhanced either by general factors (for example, increases in all land values), or by more specific ones (for example, a scarcity of the type of land or building in question).

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153. Now section 770 ICTA 1988, although this section is now only used against international transactions: see Chapter 9.

Section 22 came into operation if shares in the company were sold before the expiry of six years following the completion of the building to a person who had, or acquired by the sale, control of the company. Furthermore, at the date of the sale, the company had to have an interest in the building whose value (taking into account other buildings caught by the section) amounted to at least one-fifth of the net assets of the company.

Where these conditions were satisfied, the company was deemed to be a trading company and the interest in the building was treated as trading stock. Section 21 was then applied, thereby imposing a tax liability on the builder.

The section was also drafted to catch some of the more obvious methods of circumventing the main provisions.[154] For example, the building might be constructed on land owned by an associated company: this was covered by imposing an income tax liability on the vendor of the associated company's shares.[155]

Also caught were variations whereby, before the company's shares were sold, the company :

(a) sold its interest in any of the relevant buildings to the purchaser; or

(b) created an interest in any of the relevant buildings in favour of the purchaser; or

(c) sold or created such an interest to or in favour of any person and the purchaser acquired the interest, either before the sale of the shares or afterwards, in pursuance of an arrangement made before the sale.[156]

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154. Sections 23 and 24 FA 1960 infra, covered others
155. Section 22(3) ibid
156. Section 22(2) ibid

The section did not however, apply if the building was used for the bona fide trade of the company, except for the trade of dealing in securities or land or buildings or of developing land.[157]

Subsection 22(4) covered a particular form of the avoidance device attacked by the section: the shares in the investment company were not sold, but the company was put into liquidation and the assets distributed in specie to the shareholders. Alternatively, the liquidator might sell the assets.

This subsection applied if the activities of the company consisted of the erection of a building and the company was wound up within six years following its completion. If the interest of the company in the building immediately before liquidation amounted to at least one-fifth of its net assets, the company was treated as having received a profit taxable under Case VI equal to the amount of the profits that would have arisen on a sale of the interest in the open market.

If however, the non-trading company was wholly owned by another company, that other company could elect that the charge under the sub-section should not be imposed. No charge would then arise unless the parent company subsequently sold the interest.

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157. Section 22(5) ibid

Variations Involving Holding Companies and Associated Parcels of Shares

Without provisions to cover them, sections 21 and 22 could be avoided by various devices involving holding companies and transfers of a number of associated parcels of shares. Sections 23 and 24 FA 1960 attempted to combat these variations.

Section 23 prevented sections 21 and 22 being circumvented by using a holding company. If shares in a holding company, which was not caught by the main sections, were sold so that the purchaser controlled it and, through that holding company, he controlled a subsidiary which would be caught by the main sections, the sale would be treated as falling within the main sections.

Transfers of associated parcels of shares were attacked by section 24. Without this section, the non-trading company could have been transferred in a large number of separate parcels and the main charging sections would only have applied to the last purchase or purchases which actually gave the purchaser control. Alternatively, shares could have been spread among relations or partners of the purchaser or the trustees of settlements he had set up. Furthermore, shares might have been transferred to a company controlled by the purchaser, or to a nominee of his.

All of these devices were covered by section 24. Where there was a transfer by a series of separate sales, all of the sales were treated as taking place at the date of the last of them, unless they all took place in pursuance of an earlier agreement, in which case it was the date of the agreement that was taken. Sales made to relations etc. of the purchaser were treated as made to the purchaser himself.

Transactions Between a Dealing Company and an Associated Non-Dealing Company

The transactions to be considered here were countered by section 25, FA 1960. Like the other stock stripping sections introduced by the 1960 Finance Act, it was repealed in 1969, apart from subsection 25(4) which survives to this day as section 774, ICTA 1988.

Section 25 was brought in to counter transactions between a dealing company and an associated non-dealing company. A "dealing company" for this purpose was a company dealing in shares and securities or land or buildings, including a company whose profit on the sale of those assets was part of its trading profits.

The schemes against which this section was aimed involved two (or more) associated companies; one of which was a dealing company as defined above, and one which was not. It was obviously to the advantage of the companies' owners that, if there was an asset owned by the dealing company on which a profit was to be made, the profit should be made by the non-dealing company so that it would be capital in nature. Conversely, if the non-dealing company had an asset on which a loss was to be made, it was to the companies' owners' advantage if the dealing company made the loss, so that it would be revenue in nature and deductible for income tax purposes.

By the time section 25 was introduced, it was no longer possible merely to transfer the asset in the first case at an undervalue and in the second case at an overvalue. Such straightforward expedients were caught by section 37, FA 1951.[158] Section 37 allowed the Revenue to make the necessary adjustments to treat the transactions for tax purposes as if they had taken place at market value.

158. Now 770 ICTA 1988 which, as noted above, is now used exclusively as a weapon against multinational transfer pricing devices.

But, if it was anticipated that an asset held by the dealing company was to rise sharply in value, it could have been transferred at market value to the non-dealing company which would subsequently make the capital profit on that anticipated increase. Similarly, if the non-dealing company owned an asset, the value of which was expected to drop sharply, a market-value transfer to the dealing company would have ensured that the dealing company made the anticipated revenue loss.

Subsection (4) which, as mentioned above, was the only stock stripping provision not repealed in 1969, is concerned with the situation where a dealing company becomes entitled to a deduction in respect of the depreciation of any right subsisting against an associated non-dealing company, or where the dealing company makes a payment to the non-dealing company, being a payment in respect of which the dealing company is entitled to a deduction in computing its profits and which the non- dealing company is not required to bring into account in computing its profits.

The subsection would catch the situation, for example, where a non-dealing company took a loan from a dealing company and the dealing company subsequently waived the loan. Prior to section 25, the dealing company might obtain tax relief for the loan and the non-dealing company would not be subject to tax on the money it retained by virtue of the waiver.

Section 25 countered these schemes by deeming any profit made by the non-dealing company to be income chargeable under Sch. D, Case VI. In a subsection (4) situation, the non-dealing company was deemed to have received income equal to the dealing company's deduction and that income is chargeable under Case VI[159], although, if the non-dealing company also

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159. Such a charge would now arise under section 774 ICTA 1988.

carries on the trade, it can elect to have the deemed receipt treated as trading income.

For a straightforward case involving a liability to tax under section 25, see Atherma Investments Ltd -v- Tomlinson[160].

Alherma was a non-dealing company. It was a wholly-owned subsidiary of a company which was held to be a dealing company. Securities from the dealing parent's portfolio were transferred to Alherma at market value in consideration of the issue of Alherma shares to the parent. Subsequently, Alherma sold the securities at a profit. The profit was assessed under section 25 and the court upheld the assessments.

160. (1970)48 TC 81

Sales of Shares in an Investment Company to an Associated Dealing Company

Without further provisions, section 25 could have been avoided by the owner of the shares in the non-dealing company selling them to the dealing company. Section 26 FA 1960 was brought in to deal with this variation.

This section applied when a person who controlled an investment company sold its shares to a dealing company which he also controlled. The effect of the section was that the consideration was deemed to be income chargeable under Case VI. There was, however, a limit on this charge, namely, the profit the investment company would have made if it had sold to the dealing company a proportion of its profits, the proportion being determined by the proportion of its shares actually sold. Alternatively, the seller could elect to be taxed on the consideration he actually received for the shares less any consideration he actually paid for them.

If the investment company shares were sold to a person other than a dealing company but the shares were subsequently acquired by a dealing company and the two sales were part of one arrangement, the sale was treated as one made to the dealing company.

Sales of Building Land by Persons Associated with a Builder

Moving from the F.A. 1960 provisions to those contained in the 1962 Act, there are two stock stripping sections to consider here. The first in section 23, FA 1962.

The mischief against which the section was aimed can be seen from the following extract from that year's Budget Speech:

> "I propose also to deal with a device which is being used to avoid tax on building operations. Two connected persons divide between them what is in reality a single operation. One of these acquires the freehold of a building site and contracts to grant a lease to the purchaser of a building to be erected on it. The other puts up the building.
>
> Any building profit is subject to tax; but any premium paid for the lease, and any receipt on a subsequent sale of the reversion, go free of tax in the hands of the one who bought the land. In this way, what are in reality some or all of the profits of the enterprise are converted into non-taxable form. The Bill will impose an appropriate charge on the person owning the land where this or similar devices are employed".

As well as the straightforward scheme outlined by the Chancellor, there might have been an agreement that the builder's taxable profit would be reduced and the land owners' non-taxable profit increased, by a reduction in the normal price of the building work, with a corresponding increase in the price of the land.

The charge was to income tax under Case VI and was based on the difference between the cost of the land and the proceeds of sale, account being taken of any interest in the land retained by the owner. In the case of a company subject to profits tax, liability to profits tax arose as it would have arisen to income tax.

No liability arose where the owner of the land was carrying on a trade of dealing in or developing land because, then, the proceeds from the sale of the land would have been subject to income tax (under Case 1) anyway.

Sales of Land by Land-Owning Companies

The purpose of section 24 FA 1962 can again be seen from an extract of that year's Budget Speech. The Chancellor said:

> "I propose to include within Case VI of Schedule D certain transactions in land and property which are cloaked in a form that escapes liability under the present law - for example, the dealer in property who, alone or with associates, escapes tax liability in the following way.
>
> He forms a chain of companies with suitably framed articles, through each of which he puts one transaction so as to avoid the implication that he is trading. If, regarding all the activities of these companies as though they were the activities of one person, they amounted to the carrying on of a trade, a gain on a particular sale by one of the companies would be taxable. I propose to make this the law".

The Chancellor was here highlighting a scheme which was, at the time, very popular with land speculators.

The whole point of the scheme was that, if one person implemented a number of sales and purchases of land, he would probably have been treated as a trader. However, a single sale and purchase would probably not have branded him a trader, thus the requirement in this scheme for a number of companies.

When the Chancellor referred to "suitably framed articles" he meant that the companies were empowered to invest in, but not to trade in, land.

Section 24 imposed a charge under Case VI on any profit made by one of these land-owning companies if:

(i) a person who carried on the activities of that company, together with any related activities, would have been regarded as carrying on a trade of dealing in or developing land; and

(ii) the consideration for the disposal of the land in question would have been regarded as a trading receipt of his trade;

The related activities referred to above were:

(i) activities, with respect to land, of any person with whom the company was connected at the time of the disposal; and

(ii) activities, with respect to land, of a company not within (i), being activities at a time when the company was under such control as would have brought it within (i) if it had not ceased to be under that control, or ceased to exist, or both.

But regard was not had to activities of a person while he carried on a trade of dealing or developing land.

A "land-owning company" was a company not carrying on a trade of dealing in or developing land but which was entitled to land to a value equal to or exceeding one-fifth of the net value of its assets.

Looking at section 24 in general, it can be seen that the intention of the section was to look at the activities of all the companies in question together for the purpose of deciding whether they were activities in the nature of trade, regardless of the nature of each separate company's disposal.

The Effect of the Stock Stripping Legislation

Each of the stock stripping sections dealt with above was introduced to combat a specific scheme or type of scheme. Insofar as those specific schemes were concerned, the sections were successful, but they were too narrow in their application. The sections proved unsatisfactory and insufficient to prevent dealers, particularly in land, circumventing the provisions. Transactions using the medium of trusts or partnerships, rather than companies, were implemented to get round these provisions.

As a result, sections 21 to 26 were swept away in 1969 and replaced by section 32, FA 1969 [161] which introduced a much wider attack on land-based schemes. The only provision from the 1960 and 1962 stock stripping sections to survive was subsection 25(4) which is now section 774, ICTA 1988.

An example of the type of scheme not caught by the earlier, more narrowly targeted stock-stripping provisions, but which would have fallen within the ambit of section 32, can be seen in Ransom v. Higgs [162].

This case involved five related appeals arising out of two complex schemes. The point of the case was that the taxpayer in the main case owned a company which owned land. The taxpayer procured that the company took part in the arrangements by which the land was developed and the profits of the development found their way into a trust.

The Revenue, not being able to apply any of the anti-avoidance provisions, attacked the taxpayer by claiming that he had engaged in the trade of developing

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161. Now section 776 ICTA 1988, see Chapter 3
162. (1974) 50 TC 1

the land by procuring the company to carry out the trading operations. This argument was rejected by the House of Lords: merely by procuring other parties to enter into a scheme which involved trading, did not mean that the taxpayer himself was trading.

The taxpayer would have been caught by Section 776, but it had not been enacted when the transactions were implemented.

Section 703 ICTA 1988 also covers one stock-stripping transaction. Circumstance B catches the arrangement in which shares in a company owning trading stock, whose value exceeds its book value, are acquired by a share dealing company. The share dealing company extracts the trading stock at a low price and sells it on at its market value. The company thereby makes a trading profit which is matched by a trading loss which it makes on a disposal of the acquired company's shares. Section 704B effectively put a stop to this sort of transaction. However, just as in the dividend stripping cases, where the courts adopted a restricted approach to trading to defeat the schemes, the courts in connection with this type of arrangement appeared to adopt a narrower view of what constituted trading.

This trend is suggested in Petrotim Securities Ltd. v. Ayres.[163] The taxpayer company carried on the trade of dealers in securities. It sold investments forming part of its trading stock for £205,000 to Ridge Securities Ltd., a company which very recently had acquired control of Petrotim. The investments had a market value of over £835,000 at the time of their sale to Ridge. These transactions were called the "X transactions". Shortly afterwards, the "Y transactions" were implemented. Petrotim acquired War Loan stock for £104,000, sold it to

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163. (1963) 41 TC 389

Blackheath Credit Co. Ltd., which was indirectly a wholly-owned subsidiary of Ridge, for £10,000, its market value at that time being £105,000. Shortly after the completion of the Y transactions, Petrotim ceased to trade.

Petrotim claimed relief in respect of a trading loss arrived at by including the X and Y transactions on the basis of the prices realised.

The Crown contended that the sales in the X transactions were not trading transactions and that, on the principle of Sharkey v. Wernher [164], the market value of the investments at the relevant dates should be substituted for the actual sale price. As regards the Y transactions, the Crown contended that neither the purchase nor the sale of the War Loan was a trading transaction and the figures should be eliminated from the computation of Petrotim's tax liabilities.

The company failed before the Special Commissioners, the High Court and the Court of Appeal. The transactions were held not to be trading transactions, and Sharkey v. Wernher was applied.

In the Court of Appeal, Lord Denning MR who, during the same period, was taking a dim view of forward and backward dividend stripping schemes, was equally unimpressed with these transactions.

Similarly, Russell LJ:

> "The transactions here, in the form of sales, appear to be designed to confer enormous bounty on companies whose close association with the parent company at once gives every encouragement to

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164.(1955) 36 TC 275

uncommercial bounty and, at the same time, no ground for trading generosity. I cannot see how it is possible to interfere with the view of the Commissioners that these transactions were not in the course of trade".[165]

It is not only circumstance B of section 704 that can be used against stock stripping; the wider provisions, particularly of circumstance D, can catch many stock stripping arrangements.

Consider, for example, the arrangement in point in IRC v. Wiggins[166].

The two taxpayers owned, either personally or as trustees of family trusts, the shares in Arnold Wiggins & Sons Ltd. They were also the directors.

The company's main business was the acquisition and sale of antique picture frames and, to a lesser extent, pictures. The two taxpayers also owned, and were directors of, Arnold Wiggins & Sons (Carvers) Ltd. Carvers made and repaired picture frames.

Wiggins bought a frame for a small sum and discovered that it contained a very valuable picture by Poussin. A third party, M. Knoedler & Co. Ltd. wished to buy the Poussin. The following scheme was implemented with the object of stripping the assets out of Wiggins (apart from the Poussin) and selling the company to Knoedler.

Wiggins transferred its non-trading assets to Carvers at their book value, and Wiggins' staff were also switched to Carvers. The taxpayers then sold their shares in Wiggins to Knoedler for £44,447, of which £42,500 was attributed to the Poussin. Carvers subsequently carried

165. P.490 - see also Ridge Securities Ltd. v. IRC (1963) 44 TC 373
166. (1978) 53 TC 639.

on the businesses previously carried on by Wiggins and Carvers.

This fell within section 703. The tax advantage arose because Wiggins could have sold the Poussin and distributed the proceeds by way of dividend. Circumstance D applied to this arrangement. There was a distribution of profits on either of two alternative bases:

(a) indirectly as part of the scheme under which Knoedler paid the taxpayers; or

(b) on the asset strip from Wiggins to Carvers;

and the taxpayers received a consideration which represented the value of trading stock.[167]

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167. See section 704 C(1)(iii). See also Anysz v. IRC (1977) 3 TC 601, in which the "Deferred Premium" scheme was defeated by circumstance D: see Part 5.

BOND WASHING

Introduction

The term "bond washing" has been used to describe a series of specific schemes aimed at obtaining the benefit of interest and dividends without incurring the attendant income tax liabilities.

The legislature have been combating such schemes since 1927 and, each time, taxpayers and their advisers would think up a new way around the legislation, prompting in turn the introduction of more provisions, so that there is now a series of provisions with their origins over 60 years ago and culminating in the "accrued income" scheme in the FA 1985.

Bond washing schemes all relied for their efficacy on the principle that interest and dividends on shares only became taxable income once it became payable. If the shares were sold, or alternatively the right to the interest or dividends was sold, before it became payable, the vendor would receive a sum representing the interest or dividends in a capital form.[168] Often the purchaser would be someone paying a lower rate of tax than the vendor would have done and, in other cases, would be some entity exempt from tax altogether, such as a pension fund or a charity.

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168. See, for example, Wigmore v. Summerson & Sons Ltd. (1926) 9 TC 577 per Rowlatt J at p. 581.

Sales Cum Dividend

The most straightforward manifestation of bond washing involved an individual selling securities which were about to pay interest or a dividend for a capital sum. He might also buy them back ex div.

Legislation was introduced to counter this device: section 33 FA 1927. This because section 30 ICTA 1970 which was repealed with effect from 6th April 1986, having been replaced by the accrued income scheme.

This section was very restricted in its operation: it applied only to individuals and to certain types of security. Furthermore, it contained two quantitative limitations: the avoidance had to be systematic and not exceptional, and the taxpayer had to avoid more than 10% of his excess liability before the section would operate.

The restriction on the section by the first of the quantitative limitations can be seen from the case of Bilsland v. IRC [168a], the facts of which have already been given. [169] It will be recalled that the taxpayer was assessed to tax on two grounds, one of which was that section 33 applied. The Special Commissioners held that the taxpayer's scheme did fall within section 33 because he had not proved that the avoidance of Sur-tax was exceptional and not systematic. Accordingly, the income from the shares ought to be apportioned to the taxpayer. Lawrence J, however, found in favour of the taxpayer, because there was no evidence for the Commissioners' finding that the avoidance was not exceptional.

The Case Stated disclosed that the taxpayer admitted that he had intended to avoid Sur-tax. [170] It was also admitted that most of the purchasers could not have found the purchase money had they not been able to rely on the

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168a. (1936) 20 TC 446
169. See Part 1
170. p.449

dividends, and that the taxpayer, who had in most cases paid the stamp duty, deducting it from the purchase price, had agreed to wait for the purchase moneys until the dividends had been paid. No purchaser paid the balance of the purchase price before the date of the second dividend and in most cases the dividend warrants were endorsed over to the taxpayer in payment for the shares. As has been seen above, Lawrence J. despite these factors, held that section 33 did not apply.[171]

This shows a major flaw in section 33. The taxpayer carried out an artificial scheme, admittedly to avoid Sur-tax by the very means against which the section was aimed, and he succeeded because his avoidance was so planned and devised as to be exceptional.

Where the section did operate, an income tax liability was imposed on the taxpayer of the amount that would have been his excess liability if the income from the securities had accrued from day to day and had been apportioned to him as part of his total income.

The second quantitative limitation was that the taxpayer had to avoid more than 10% of the amount that would have been his excess liability for a year if the apportionment referred to in the previous paragraph had been made. "Excess liability" meant the excess of liability to income tax over what it would have been if all income tax were charged at the basic rate to the exclusion of any higher or additional rate.

In McCarney v. Freilich [172], the Inland Revenue sought to say that, on the replacement of surtax by the system of unified taxation in 1971, section 30 charged "tax" on the taxpayer's total income and that "tax" included basic rate as well as higher rate income tax.

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171. p. 453
172. (1980) 53 TC 575

Goulding J rejected this contention, holding that "tax" meant "tax in excess of the basic rule". A new burden of tax, which is what the Revenue's argument would have amounted to, would have required clearer evidence of legislative intention than the amendments made on the introduction of the unified systems of income tax.

Not only was the section limited by the two quantitative restrictions just considered, it only applied to certain securities: basically, fixed interest securities, government securities, company debentures and non-quoted shares. Given the various restrictions, the section operated only in cases of large-scale avoidance by individuals, and had no operation at all in connection with avoidance by persons other than individuals.

The section was repealed with effect from 6th April 1986. Its replacement, the much wider accrued income scheme, is dealt with below.

Sale and Repurchase of Securities

On the introduction of the 1927 legislation, bond washing developed a stage further. Two of the new devices were attacked by section 12, FA 1973.[173]

The first of these schemes involved an owner of securities, on which a dividend or interest was about to be paid, selling those securities to a party paying a lower rate of tax (or no tax at all, such as a charity or pension fund), with an agreement (or an option) to buy them (or similar securities) back once the dividend or interest had been paid. The sale and repurchase consideration were agreed at such amounts that the tax-free profit the vendor made on the shares was worth more to him than the after-tax dividend or interest foregone; and the lower rate or exempt purchaser would value the dividend or interest greater than the loss on the shares.

Section 12 countered this arrangement by deeming the interest on the securities to be income of the vendor. In the case of securities not paid under deduction of tax, the vendor was assessed under Sch D. Case VI.

Where the original owner is any individual, he is entitled to credit for any tax which the income is shown to have borne, but this does not apply if the original owner is a company.[174] It is hard to see why credit is denied in the case of a company.

The second type of arrangement hit by section 12 involved a share dealer who purchased securities on which a dividend or interest was subsequently paid, with an agreement or an option to re-sell them (or similar securities). After the payment the shares would be sold.

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173. Now section 729 ICTA 1988.
174. Section 729(1)(ii), (2), ibid.

The share dealer would thereby make a loss which he would set against the dividend or interest received, thereby enabling him to reclaim the appropriate amount of the tax deducted at source.

This device was countered by section 12 providing that the transaction was to be ignored for the purpose of computing the share dealer's trading profits.

An example of a scheme which succeeded but which would have been caught, had section 12 been on the statute books at the relevant time, was the arrangement in Thompson v. The Trust and Loan Company of Canada.[175]

In this case the taxpayer company carried on the business of a loan and finance company, assessable under Schedule D Case I on its profits, including profits from dealing in investments. The dispute which was the subject of the case related to 5½% Treasury Bonds 1930 which the company bought and sold. During the years in question, the company entered into a number of transations on the Stock Exchange, buying the bond cum coupon and selling ex coupon. The purchases and sales were matched so that, when a contract to buy bonds was made, on the same day a contract was also made to sell bonds of the same nominal value. The matched purchases and sales were through the same broker.

The date for settlement of the bargains (the same date for each of the matched buying and selling contracts) was fixed by the company as near as possible to the date on which the coupon to be detached from the bond bought by the company was due for encashment. The settlement day was always on a date before the due date of the payment of the interest. Each purchase was completed by the broker delivering to the company the bonds with coupons

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175. (1932) 16 TC 394

attached. The coupons next due to be paid were detached by the company and the sale was completed by the company handing back the bonds to the broker with the coupons for subsequent interest still attached. The company then encashed the detached coupons and retained the proceeds, being a half year's interest on the bonds less the income tax deducted from them under Schedule C.

The Revenue sought to bring the net coupon into charge under Sch D Case 1. This was rejected both by Rowlatt J in the High Court and by the Court of Appeal.

The courts refused to take any account of the fact that the matched purchases and sales took place with only a very small time gap[176] and also the fact that financially (from the point of view of economic substance[177]) the transactions were equivalent to buying a money order for the amount of the net interest, as contended by Counsel for the Crown.[178]

It had been argued by the Crown that the interest was not the company's interest at all, because it had not had its money invested in the bonds during the period over which it had accrued. This contention was quickly rejected, it being held that the person who cashes the coupon is the person who is entitled to the income, the interest becoming taxable at the moment of its payment.

The Crown's contention came down to the fact that they could tax the same sum twice, once under Sch C and again under Sch D. This rested on the assumption that the subject of each matched sale and purchase was the coupon only; in other words, that the company was dealing in coupons. The courts held that this did not accord with

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176. See Rowlatt J at p400 and Lord Hanworth MR at p402.
177. See Chapter II.
178. See Rowlatt J. at p400

the facts and, in any case, as was pointed out by Lord Hanworth MR, such dealing in coupons was forbidden by the rules of the Stock Exchange.[179]

Such a scheme as the one in this case would have been caught by section 12 following the enactment of the section in 1937.

The term "securities", for the purpose of the section, includes stocks and shares. The definition was not as restricted as that in section 33 FA 1927. Section 12 did, however, leave some large gaps which were quickly exploited by taxpayers. Some of these gaps were filled, but there were some surprisingly obvious opportunities left open to circumvent the legislation.

The following year (1938), legislation had to be brought in to deal with the situation where the vendor sold, not the securities themselves, but only the right to the income.[180]

The F.A. 1959 contained further remedial legislation covering schemes under which the resale was to someone other than the original owner and where taxpayers other than traders were concerned.[181]

However, there was nothing to stop a person connected with the original owner agreeing to repurchase the securities. Furthermore, there had to be an agreement to repurchase the share or acquire the option. If there was no binding agreement, but something less - perhaps an understanding or expectation - the section did not appear to be capable of operation.

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179. p.402
180. See section 24 FA 1938, infra
181. Infra

These provisions do not, however, apply where securities with accrued interest are transferred after 27th February 1986.[182]

It can be seen that these anti-bondwashing provisions were all aimed at specific schemes; the central principle was not addressed until the comprehensive provisions of the accrued income scheme were introduced in 1985, almost 60 years after the first anti-bondwashing section found its way onto the statute books.

What the accrued income scheme worked on was the fact that interest accrues from day-to-day, regardless of the date it is actually paid. It is therefore capable of being apportioned between successive owners.

The scheme also catered for the fact that bondwashing took advantage of the fact that the price received by the seller of securities with accrued interest could not, under common law, be dissected into principal and interest.[183] As a result, the vendor's right to the income was capitalised, and the purchaser was subject to income tax on all of the accrued interest.[184]

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182. Para 41, Sch 23 FA 1985
183. Wigmore v. Thomas Summerson & Sons Ltd. (1926) 9 TC 577
184. Schaffer v. Cattermole [1980] STC 650

Transfers of Income Arising from Securities

The legislation filling the first of the gaps in section 12 was contained in Section 24, FA, 1938.[185] This gap arose out of the fact that rights to interest and dividends could be sold separately from the securities, and the vendor's consideration would be in return for selling that right, and would not be interest or dividend, even though the date for payment had already passed.[186]

Section 24 stopped this gap by deeming the income from the securities to be income of the owner of the securities for the year in which the right to the income was transferred. Where the income was not subject to deduction at source, the owner was assessed under Sch D. Case VI. The section was introduced with retrospective effect, section 24(6) stating that "the provisions of this section shall be deemed always to have had effect".

185. Now section 730 ICTA 1988.
186. See IRC v. Paget (1938) 21 TC 677.

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185. Now section 730 ICTA 1988.
186. See IRC v. Paget (1938) 21 TC 677.

Bondwashing by Purchase and Resale of Securities

Further gaps in section 12 of the Finance Act 1937 were closed by Sections 23 to 26, F.A. 1959.[187] These sections covered a much wider area; three categories of taxpayer being targeted:

(1) finance houses and dealers in securities;[188]

(2) charities and superannuation funds exempt from income tax;[189] and

(3) ordinary traders with losses available for relief which could be set against the tax deducted from the interest and dividends.[190]

The Chancellor, Mr. Heathcoat Amery, introducing these measures in his Budget Speech, said that "certain dealers in securities and exempt institutions are making a quick and illegitimate profit at the expense of the Revenue by purchases of securities cum dividend and their sale ex dividend".

The schemes the FA 1959 provisions were aimed at were, in effect, the reverse of the traditional bondwashing schemes which involved sales cum div and purchases ex div. The schemes attacked by the 1959 sections basically concerned the recipient of the interest or dividends reclaiming the tax deducted. In fact, even prior to the 1959 provisions, moves had been made outside Parliament to curb the worst excesses of those bondwashing transactions that had not been stopped by the 1927, 1937 or 1938 legislation.

The Stock Exchange Council had been alarmed at the severe losses to the Exchequer caused by bondwashing,

187. Now sections 731-735 ICTA 1988
188. Section 24 FA 1959
189. Section 25 ibid
190. Section 26 ibid

particularly through those schemes involving an almost simultaneous buy-and-sell arrangement. Originally, Stock Exchange Rule 165 (2) (c) provided that no bargain could be made ex dividend before, or cum dividend after, the stock was officially quoted ex dividend. Until 1956, however, this rule applied only to War 3½% Stock. Bondwashers tended, therefore, to use short-dated issues (those having a currency of five years or less) with impunity. In 1956 such short-dated stocks were brought within the rule.

The following year, a new Rule 165(a) was introduced. This stated that, where there was an ex dividend sale of stock, not covered by Rule 165(2)(c) within the permitted three weeks before the ex dividend date, a certificate had to be provided to show that the principal had been the beneficial owner of it for at least a month, or had bought it within the permitted three week period. Where there was an ex dividend purchase within the three week period, evidence had to be produced that it did not reverse a cum dividend short sale already effected or that the ex dividend counterpart was not of a planned cum dividend sale.

This rule was effective in dealing with the straightforward sale cum dividend, and purchase ex dividend. The use of borrowed stock was also disallowed.

The Stock Exchange Rules did not, however, prevent all manifestations of bondwashing. Finance companies and dealers in securities were able to buy securities cum dividend and sell them virtually simultaneously ex dividend, the capital loss then being set off against the tax payable on the interest received. As a result, the 1959 provisions were introduced.

The Financial Secretary to the Treasury stated that he was confident that the 1959 rules would close all of the known loopholes exploited by bond washers. His confidence was misplaced; as will be seen, the very next year a further anti-bond washing provision had to be enacted, with further schemes being covered in 1973, 1974 and the accrued income scheme in 1985.

Nevertheless, the 1959 provisions were largely successful and filled some of the glaring gaps in the earlier anti-bond washing sections. The most obvious shortcomings of the 1937 legislation were:

(i) it did not stop arrangements in which, at the time of the sale, there was no agreement to repurchase;[191]

(ii) it did not stop arrangements where a person bought from different vendors and sold to different purchasers.

Sections 23 to 26 of the 1959 FA were introduced to correct these and other shortcomings. Section 23 contained some general provisions relevant to the next three sections in which the three main devices were attacked. Section 23 contained, as section 731 ICTA 1988 still does, the concept of "the first buyer". He is the person who buys the securities and subsequently sells them, with the dividend or interest being received by him in the meantime. Section 23 also stated that the 1959 provisions did not apply to the first buyer where the time elapsing between his purchase of the securities and his taking steps to dispose of them exceeded six months or where the time gap exceeded one month, and it was

191. In practice, no such agreement was required: the two sides to the transaction could normally be expected to complete the required steps without any formal agreement to do so.

proved that the purchase and the sale were each effected at the current market price, and that the sale was not effected in pursuance of an agreement or arrangement made before or at the time of the purchase.

The three anti-bond washing sections which were supported by section 23 were as follows.

Dealers in Securities

The provisions now under consideration were contained in Section 24, FA 1959 and can now be found in Section 732, ICTA 1988.

This section was aimed at finance companies and dealers in securities. Transactions carried out by members of a discount house or by Stock Exchange dealers are excluded provided such transactions take place in the ordinary course of business.

Where the section applies, in computing the profits or losses of the dealer, the price paid for the securities in question is reduced by the element in the purchase price which represents accrued interest or dividends. For this purpose, accrued interest or dividends is calculated on a day-to-day basis to the date of purchase. Because of this rule, a dealer could not use "washed" interest to absorb tax losses.

Bond Washing by Exempt Persons

The next provision, Section 25 FA 1959 [192], stated that, where the first buyer was exempt from tax, such as a charity or superannuation fund, its exemption did not extend to a grossed-up amount of the element in the purchase price representing accrued interest or dividend and any annual payment made out of the interest or dividend was treated as not having been paid out of profits chargeable to tax.

In other words, the tax exemption did not extend to that part of the interest or dividend which had already accrued when the security was purchased.

192. Now section 733 ICTA 1988.

Persons other than Dealers in Securities

The situation where the first buyer carried on a trade which did not consist of dealing in securities was covered by section 26 FA 1959.[193] The section applied to such traders when they acquired securities in order to recover income tax on the interest or dividend by making a section 341 ICTA 1952 loss claim[194], or when they sought to take such income into account for the purpose of making subvention payments, or in order to cover annual charges. This provision deals with such devices by stating that, in computing the loss relief available, a grossed-up amount (calculated as for section 25) is left out of the income of the trader available for a loss relief claim. So, again, the interest or dividend accruing before acquisition is left out of account in determining the size of the loss relief claims.

193. Now section 734 ICTA 1988.
194. See Chapter 4

Manufactured Dividends

The following year another provision was introduced to stop a bond washing scheme, a scheme described by Sir Edward Boyle in the House of Commons as something "which the ordinary layman could fairly describe as a swindle at the expense of the honest taxpayer - not a criminal conspiracy but a racket".[195]

The epithets "swindle" and "racket", suggesting evasion rather than avoidance, are not appropriate to describe the scheme the 1960 provisions were introduced to prevent, even though it was undeniably artificial. Basically, the scheme in question involved a dealer on the Stock Exchange selling securities cum dividend before he had acquired them, followed by a purchase of the same type of securities ex dividend. The person who sold the ex dividend securities to the dealer was entitled to the dividend, and the purchaser of the cum dividend securities from the dealer was entitled to a sum equal to the dividend (less tax). The dealer therefore paid a sum equal to the net dividend to the cum dividend purchaser. The dealer made an overall profit if his profit on the buy-and-sell transaction exceeded the amount of the net dividend he had to pay to the cum dividend purchaser. Furthermore, if both the cum dividend purchaser and the ex dividend vendor were exempt from tax, a tax relief for a dividend would have been created out of nothing. This was because the ex dividend vendor would have the actual dividend voucher he could use for tax relief purposes; but the cum dividend purchaser was entitled to another dividend voucher, under the rules of the Stock Exchange, when he settled with his broker.

This principle can be seen in operation in Multipar Syndicate v. Devitt.[196]

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195. Hansard, vol 624, col 451

196. (1945) 26 TC 359

This scheme was countered by Section 27 FA 1960[197]. Under these provisions, the seller must pay any tax deducted to the Revenue unless he has a voucher showing him to be entitled to the taxed dividend as a registered holder when he sold the securities. The provisions have, in recent years, been extended in two respects. By Section 59, FA 1982, it was extended to cover certain building society securities.

More recently, a change was effected by para 5, Sch 18, FA 1986 whereby the provision now covers the varient in which it is the purchaser who accounts to the vendor, and the dividend is manufactured by the purchaser and not the vendor. Also, in the 1960 FA was section 28 which, as has been noted above, was aimed at dividend stripping and other transactions in securities. Circumstance A also caught one form of bond washing (see above).

197. Now section 737 ICTA 1988

Transactions in Certificates of Deposit

Until 1973 certificates of deposit were widely used in a form of bond washing.

A certificate of deposit is defined, for this purpose, as:

> "a document relating to money, in any currency, which has been deposited with the issuer or some other person, being a document which recognises an obligation to pay a stated amount to bearer or to order, with or without interest and being a document by the delivery of which, with or without endorsement, the right to receive that stated amount, with or without interest is transferable".[198]

As with securities, the accrued interest on such certificates is not chargeable to tax until it becomes payable. Consequently, a person would buy certificates of deposit and, shortly before the interest became payable, would sell them at a price reflecting the accrued interest.

Not only did he not pay income tax on the accrued interest, capital gains tax was not payable because the certificate was not "a debt on a security".

To prevent these schemes section 26, FA 1973[199] was introduced. Under this section, any gain arising from the disposal or exercise of a right to receive an amount stated in a certificate of deposit is charged to income tax under Sch D Case VI, unless it constitutes a trading receipt taxable under Case I. Pension funds and charities are specifically excluded from this charge.[200]

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198. Section 56(5) ICTA 1988.
199. Now section 56, ICTA 1988.
200. Section 56(3)(b)(c) ibid

Transactions in Deposits Without Certificates Or In Debts

The following year section 26 had to be supplemented to stop further schemes which were not caught by the earlier legislation. Section 30, FA 1974[201] extended the section 26 charge to transactions in which there was no certificate of deposit and no security was issued, but an amount became payable with interest, and the person liable to pay it was a bank or similar institution or a person regularly engaging in similar transactions. On the disposal or exercise of the right to receive the amount, the gain was made chargeable under Case VI, unless it was a trading receipt under Case I.

201. Now also part of section 56 ibid

The Accrued Income Scheme

Despite the line of anti-bond washing legislation stretching back to 1927, bond washing flourished to such an extent that in 1985 the Inland Revenue estimated that about £300 million a year was being lost to the Exchequer through bond washing.[202] Consequently, the accrued income scheme, a much wider and all-embracing set of provisions, was introduced as from 28th February 1986, with transitional provisions effective from 28th February the previous year. These provisions effectively superseded the original 1927 provisions[203], which were repealed with effect from 6th April 1986.

It took the Government a long time to bring in such a comprehensive system of anti-bond washing; the last legislation had been in 1959 and 1960, apart from the certificates of deposit and similar legislation in 1973 and 1974. It was not that the Government was unaware of the schemes which fell outside the existing provisions or the extent of the lost revenue. Perhaps the Government was nervous about restricting their sale of gilts. By 1985, however, the loss of revenue was so great that it was felt that action had to be taken and what resulted were the provisions of <u>sections 73 to 77 and Schedules 22 and 23, FA, 1985</u>, a weighty and complex price of legislation.[204]

The legislation applies to "securities". This term is widely defined as including any loan stock, whether at a fixed or variable rate of interst and whether secured or unsecured, in whatever currency, whether issued by any government, any public or local authority, any company or other body. Excluded are ordinary and preference shares, national savings certificates, war savings certificates, bills of exchange and other bills and certificates of deposit.

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202. Inland Revenue Press Release, 28 Feb 1985
203. Then contained in section 30 ICTA 1970
204. Now sections 710-728 ICTA 1988.

The way the rules operate is to treat interest (which includes dividends and any other return - except a premium on redemption over the same price) as accruing from day to day. This applies to securities disposed of on or after 28th February 1986.

Because the interest accrues from day to day, the interest accrued up to and including the sale exchange or giving of the security is treated as the income of the vendor or transferor, with the purchaser or transferee being granted a corresponding relief.

The rules operate by reference to an "interest period". This normally runs from the day after the last interest payment (or from the issue of the stock) and ends on the next payment day. A period cannot, however, exceed 12 months.

On a disposal of a security cum dividend, the transferor is treated as being entitled to the interest already accrued on a daily basis unless the transferee agrees to account to the transferor for interest payable after the date of disposal, in which case the appropriate adjustments will be made.

If the transfer is ex dividend, the transferor is entitled to relief on the "rebate amount", which is effectively the converse of the accrued amount on a cum dividend disposal. On an ex dividend disposal the transferee is treated as being entitled to the "rebate amount".

If the legislation imposes a charge, the chargeable income is treated as being received on the last day of the interest period. Tax is charged under Sch D Case VI.

There are a number of exceptions from the provisions:

1. The rules do not apply where the transferor is a trader and the transfer is taken into account in computing his profits.

2. If the transferor is an individual and, at no time in the year of assessment in which the interest period ends, does he hold securities with a nominal value of more than £5,000, the scheme does not apply. This exception also applies to personal representatives of a deceased person and trustees of a disabled person's trust.

3. Certain non-resident and non-domiciled persons are outside the scheme.

4. Stock lending transactions are not covered.

The transitional provisions are rather complex but their aim was to impose a charge on bond washing operations in the year beginning 28th February 1985, if the tax avoided by the bond washing in that period was more than the average tax avoided by similar operations in the previous three years.

It can be seen that the accrued income scheme is a much wider and comprehensive scheme than the narrower provisions which, in any case applied only to individuals, contained in section 30 ICTA 1970.

An order has been made by the Inland Revenue under section 729(12) ICTA 1988 that, with effect from 9th June 1988, section 729 (see above) only applies to securities which are not within the accrued income scheme. Because of the comprehensive provisions of the scheme, the section 729 rules are no longer required for securities within the ambit of the scheme.

After 60 years, Parliament eventually found an effective, although necessarily complicated, system for countering nearly all remaining opportunities for bond washing.

PART 5

TRANSACTIONS IN SECURITIES

Introduction

Perhaps the most important anti-avoidance provisions currently on the statute books are now considered. sections 703-9 ICTA 1988, "Cancellation of Tax Advantages from Certain Transactions in Securities".

The genesis of these provisions in the days of dividend stripping has been examined in Part 4. It has been noted that, although section 28 FA 1960 was, on its introduction in Parliament, explained to be an anti-dividend stripping section, it soon became clear that the Inland Revenue were not going to restrict its use in this way.

Circumstances A, B and C in section 704 have already been dealt with specifically in relation to dividend stripping etc. Here section 703 is examined in its wider context and among the subjects, dealt with are the wide circumstances, D and E.

Various aspects of the wording of section 703 and its accompanying sections have come in for close examination by the courts so it is important to note the precise drafting of the section.

The main thrust of the section is in subsection (1) which reads:

"(1) Where -

(a) in any such circumstances as are mentioned in section 704; and

(b) in consequence of a transaction in securities or the combined effect of two or more such transactions, a person is in a position to obtain, or has obtained, a tax advantage, then unless he shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained, this section shall apply to him in respect of that transaction or those transactions".

From this wording, four main elements can be isolated, all of which must exist before a liability can arise. They are:

(1) there must be a "transaction in securities";

(2) in consequence of which a "tax advantage" is obtained;

(3) in one of the five circumstances specified in section 461; and

(4) the taxpayer must fail the mental element test.

Each of these elements will be examined in turn.

Transaction in Securities

There is a partial definition of this term in section 709 (2) which provides that it:

> "includes transactions, of whatever description, relating to securities and in particuar :
>
> (i) the purchase, sale or exchange of securities;
>
> (ii) the issuing or securing the issue of, or applying or subscribing for, new securities;
>
> (iii) the altering, or securing the alteration of, the rights attached to securities".

Furthermore, "securities" is defined in the same subsection, which states that it:

> "(a) includes shares and stock, and
>
> (b) in relation to a company not limited by shares (whether or not it has a share capital) includes also a reference to the interest of a member of the company, whatever the form of that interest".

The phase "transaction in securities" was first considered in detail in IRC v. Parker[1] . Three points arose for judicial discussion in this case:

(i) the meaing of "transaction in securities";

(ii) the meaning of "tax advantage"[2]; and

(iii) whether section 28 FA 1960 was restricted to dividend stripping[3].

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1. (1966) 43 TC 396
2. Infra
3. See Part 4 supra

The facts were that a company implemented a scheme that had been used for over 40 years for avoiding surtax.[4]

In May 1953, the company capitalized £35,002 standing to the credit of its profit and loss account and applied that sum in issuing bonus debentures to the members in proportion to the amounts paid up on their shares. The debentures did not confer any charge on the company's assets and bore no interest. One of the conditions of the issue was that the company might, at any time after the death of the holder, or after seven years from the date of issue, whichever was the earlier, pay off the debentures. On 19th January 1961, the company redeemed the debentures. The Inland Revenue gave notice to the taxpayers (members of the company) under section 28(3) FA 1960[5] that the adjustment requisite to counteract the tax advantage obtained by the capitalisation and the issue and redemption of the debentures was that their liability to surtax for 1960/61 should be computed on the basis of treating the redemption moneys as the net amount of a dividend payable under deduction of tax at the date of receipt.

The taxpayers contended, inter alia, (1) that the debentures were not securities within the meaning of the section , (2) that the language of section 28 was inappropriate to make the section apply to the transactions, and (3) that the redemption of the debentures was not a transaction in securities.

The Special Commissioners accepted the first and second contentions (and certain others mentioned later) and cancelled the notices. The House of Lords, however, by a majority, held that the notices should be confirmed.

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4. See IRC v. Fisher's Executors (1926) 10 TC 302, discussed in Part 1, supra
5. Now section 703(3) ICTA 1988

The Special Commissioners made an interesting finding regarding the ambit of the section in the light of the apportionment provisons.[6] Ungoed - Thomas J, at first instance, and the House of Lords came to a different conclusion on this fundamental point.

The Special Commissioners, in paragraph 21(a) of the Case Stated said[7]:

> "We ..... were of the opinion that the terms of section 28 Finance Act 1960 .... were inappropriate to deal with the circumstances with which we were faced in this appeal. The device of capitalising profits and utilising them to issue debentures which could be subsequently redeemed had been dealt with in legislation dating from 1936. Section 246 of the Income Tax Act 1952, which re-enacts s.19(4) of the Finance Act 1936, specifically provides for disregard of this device in considering whether a reasonable part of the company's income had been distributed in a taxable form for the purposes of s.245.[8] Even by straining the language of s.28 of the Finance Act 1960, it did not seem to us possible to bring within its ambit circumstances such as are to be found in this appeal".

More specifically, they also held that the debentures were not "securities" within the normal meaning of that word or as extended by the section. They said:

> "The term 'securities', in our view, must be interpreted as obligations secured on property or a fund. The debentures issued by the company carried no interest and were not secured in any way".[9]

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6. See Part 7, infra
7. p.401
8. These provisions are discussed in Part 7, infra
9. Ibid

The Special Commissioners' general finding was based on a basic flaw in their analysis which was correctly exposed by Ungoed - Thomas J.

The judge noted that the taxpayers had submitted that section 28 was not directed to avoidance through redemption of debentures at all, but only through capitalisation, because sections 245 and 246 ITA 1952 had already dealt with avoidance through redemption.[10] In other words, claimed the taxpayers, section 28, on the one hand, and sections 245 and 246, on the other hand, dealt with two entirely separate operations. The judge's conclusion on this was:

> "It seems to me that sections 245 and 246, on the one hand, and section 28, on the other hand, are directed to different objectives: the first to inadequate distribution of a company's income, and the second to tax advantages obtained on distribution of a company's assets".[11]

This view was clearly right and has been recognised ever since.

On the specific point, Ungoed-Thomas J. again differed from the Commissioners. In his view, "securities" included a secured debt and also a document acknowledging personal liability without a charge being created on property.[12]

The Court of Appeal, however, came to the opposite conclusion, reading the section in a much narrower way. Dealing with the question of whether the redemption of the debenture was a transaction in securities, Lord Denning MR stated:

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10. See Part 7, infra
11. p.413
12. p.408

"If it were permissible to take the ordinary meaning of a 'transaction in securities', I would think of a sale or purchase of shares or debentures. I would not myself describe the payment off of a debenture as a transaction in securities. But the definition extends the ordinary meaning so as to include 'transactions, of whatever description, relating to securities'. It is said that the repayment of a debenture is a transaction relating to securities. I think that is giving this definition far too wide an interpretation. I think that those opening wide words should be read together with the particular instances (1), (ii) and (iii) so as to show the nature of the transactions which the Legislature had in mind. The Legislature had in mind such transactions as the transfer and sale and issue of securities. It is plain to me that the phrase cannot be extended so as to include dividends paid on shares, nor money which is paid out on liquidation of a company, or a reduction of capital. It does not include the payment off of a debenture. I am confirmed in this view by looking at the general mischief which this section is designed to hit. It is designed to hit dividend-stripping and not the redemption of debentures."[13]

It will be seen from this passage that Lord Denning MR considered that section 28 had a much narrower ambit than most of the other judges who heard the early section 28 cases. Of the other two Court of Appeal judges, Darkwerts LJ agreed with Lord Denning MR[14], whereas Diplock LJ was of the same opinion as Ungoed-Thomas J on this point[15], although he did not think the taxpayer had obtained a "tax advantage" within the section (see below).

13. pp 417-8
14. See pp 481-9
15. See p 419

In the House of Lords, Viscount Dilhorne was clearly of the view that section 28 was directed to "tax avoidance taking place in certain circumstances" and not just to dividend stripping[16]. What Viscount Dilhorne told the House of Commons when he was Attorney-General has already been noted in Part 4. In the light of this, it is interesting to consider his views in this case, namely:

> "I do not agree that the general mischief which section 28 was designed to hit was dividend-stripping. It was, to my mind, designed to hit other forms of tax avoidance as well. I do not think that one should resrtrict the general and unambiguous words of the definition in the Statute by regard to the mischief which it is thought that the section is aimed at".[17]

Viscount Dilhorne thought that both the redemption and the issue of the debentures were transactions in securities. Lord Wilberforce agreed that the ambit of the section was very wide. In his view it "mounted a massive attack against tax avoidance in many forms".[18]

The judgments of Viscount Dilhorne and Lord Wilberforce emphasised that a wide interpretation has to be given to this legislation.[19]

Lord Reid also considered the meaning of "transaction in securities" in Greenberg v. IRC[20]. He too gave it a wide meaning. He noted that "transaction" is normally used to denote some bilateral activity but it can be used to denote an activity in which only one person is engaged. He then went on to say:

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16. p 430
17. p 431
18. p 440
19. See also Lord Guest at p 437
20. (1971) 47 TC 240, see Part 4, supra.

"So on the face of it any single act done by one person alone is a transaction in securities if it one 'relating to securities'. This is a vague phrase, but I do not see how to stop short of giving to it a very wide meaning. Taking acts done in carrying out these schemes I think that declaration of a dividend and payment of dividends by the taxpayer's company to the finance company were acts relating to shares. Certainly declaration of a dividend is an act done relating to the company's shares and if that is so I do not see how to draw a line and say that the actual payment of dividends is not also an act relating to the shares. Then what about a sale of shares? Clearly the sale is a transaction in securities. Can it then be said that payments at later dates of instalments of the price are not acts relating to the sale? And if they are acts relating to the sale why are they not 'transactions' relating to the sale and therefore transactions relating to the shares? I must confess that I do not like being forced step by step to a conclusion of this kind. At first sight to call each payment of one instalment of the price of a share a separate transacting relating to securities seems far-fetched".[21]

The width of the interpretation given by Lord Reid to the phrase can clearly be seen from the above passage. Lord Morris agreed that each payment was a transaction relating to securities[22] as did Lord Simon[23].

One of the major uncertain areas in relation to the meaning of "transaction in securities" was whether it covered a liquidation. The plain wording of subsection 703(2) would suggest that it is not a "transaction in securities" because that subsection states that a tax

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21. pp 271-2
22. p272
23. p285

advantage is deemed to be obtained by a person in consequence of the combined effect of two or more transactions in securities "if it is obtained or obtainable in consequence of the combined effect of the transaction or transactions and of the liquidation of a company". Accordingly, if a liquidation was itself a transaction in securities, this provision would not have been required.

Section 28 FA 1960, as originally drafted, did not refer to company liquidations. A tribunal set up under the section 28 provisions[24] had held that a tax advantage obtained in consequence of the combined effect of a transaction in securities and the liquidation of a company did not fall within section 28(1) [25].

Section 28(1) was accordingly amended by section 25(5) FA 1962, but this amendment did not clarify the position of a liquidation on its own.

Considering that "transaction in securities" is defined in section 709(2) ICTA 1988 as including a transaction "altering, or securing the alteration of, the rights attached to shares", that would suggest that a liquidation on its own was not included, at least in that particular part of the definition, because a liquidation does not alter the rights attaching to shares. This corresponds with what the Attorney-General said about liquidations in the House of Commons in 1960[26].

Despite this reasoning, the width that had been used in the construction of the section meant that the position was not entirely clear. This was clearly demonstrated by IRC v. Joiner[27] in which this point was decided. In his

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24. Under what is now section 706 ICTA 1988
25. See the arguments of Patrick Medd QC before the House of Lords in the Appeal Cases report of the Greenberg case: [1972] AC 109 at p132
26. See the discussion of the Joiner case, infra
27. (1975) 50 TC 449

arguments before the House of Lords, leading Counsel for the Crown, Browne-Wilkinson QC, noted that, before the Special Commissioners, the Inland Revenue conceded that a liquidation was not a transaction in securities but, during the Commissioner's hearing, the House of Lords gave judgment in the Greenberg case and, in the light of the judgments in that case, the Revenue thought it should take the point.[28]

Before Goulding J gave his decision at first instance in the Joiner case, Treasury Minister of State, John Nott told the House of Commons that "the Inland Revenue has not sought and will not seek to apply the provisions of section 460 to ordinary liquidations".[29] As will be seen, however, the Revenue and the courts took a very narrow view of what constituted an "ordinary" liquidation.

The facts were that the issued share capital of A.G. Joiner & Son Ltd., which was a trading company, was owned as to three-quarters by the taxpayer and one-quarter by the trustees of a family settlement. On 10th April 1964, the taxpayer, the trustees and a prospective liquidator entered into an agreement, which they immediately implemented, for the voluntary winding-up of the Joiner company, the sale of its business and certain assets to The Auto-Components and Engineering Co. Ltd. ("Auto") (a dormant company controlled by the taxpayer), and the distribution of surplus assets to the shareholders.

The liquidation agreement laid down a particular method of calculation of the assets of the Joiner company for the purposes of the sale and liquidation, and also provided that the taxpayer should take a freehold property and certain specified investments, with

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28. p.473
29. H.C.Deb.March 21, 1973, cols 136-7

consequential adjustments between himself and the trustees. By another agreement on the same day, the Joiner company sold its business and the relevant assets to Auto, which commenced trading on the following day. Shortly afterwards, Auto took over the name of the Joiner company. The value of the assets distributed to the taxpayer in the winding-up exceeded three-quarters of the balance of the profit and loss account of the Joiner company at 10th April 1964 (together with a relatively small amount previously capitalised out of the profit and loss account).

It should also be noted that the articles of association were amended as part of the liquidation agreement so that surplus assets could be distributed to the taxpayer.

The Revenue gave notice to the taxpayer under section 460(3) that the resulting tax advantage had been obtained either, (a) from the scheme of reconstruction, on the footing that the scheme as a whole should be treated as a transaction in securities, or (b) from the combined effect of the liquidation and the liquidation and sale agreements, or either of them. The requisite adjustment was the computation of the taxpayer's surtax liability for 1964/65 on the basis of treating three-quarters of the sum of the profit and loss account balance and the capitalised profits, less an allowance for the net equivalent of the income of the Joiner company for its final accounting period which had already been apportioned to him (£137,116), as a net dividend payable under deduction of tax at the date of receipt. Goulding J expressed no opinion on whether a distribution of assets on a winding up was itself a transaction in securities.[30]

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30. p 467

Neither did he decide whether the reconstruction scheme as a whole constituted a transaction in securities, although he did not think that "transaction" should be interpreted as widely as the Crown had argued.[31] He decided in favour of the Crown because the tax advantage was obtained in consequence of the liquidation agreement and, since that agreement altered the rights attached to the shares in the Joiner company by substituting agreed valuations and a conventional mode of distribution for the unmodified effect of the memorandum and articles and the statutory provisions governing a voluntary winding-up, it was a transaction in securities.[32]

Goulding J gave his judgment on 22nd March 1973. On 19th April that year John Nott once again was asked to explain the Inland Revenue's view on liquidations and what was then section 460 ICTA 1970. He said that, until such time as there is guidasnce from the courts[33], the Revenue would treat a distribution to a shareholder in a liquidation as a transaction in securities. He continued:

> "It [i.e. the Revenue] does not propose any change of practice in relation to an ordinary liquidation, that is to say, the bona fide winding up of a business as a distinct entity, whether the business with its concomitant goodwill then comes to an end or is taken over by some other concern which is under substantially different control. On the other hand, the Inland Revenue would not regard as 'ordinary' a liquidation which is part of a scheme of reconstruction which enables the old business to be carried on as before with substantially the same shareholders, directly or indirectly, in control".[34]

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31. P466
32. Ibid
33. Goulding J not having expressed a view on the point.
34. H.C. Deb. April 19, 1973, cols 159-60

Eighteen months later, the taxpayer's appeal was heard by the Court of Appeal in the Joiner case. It was held that the distribution of surplus assets to shareholders in the course of the liquidation was a transaction in securities.[35]

The Court of Appeal would also have agreed with Goulding J but they did not think it was necessary to go so far because they held that a distribution by a liquidator to shareholders gave effect to the rights attaching to shares and it therefore "related" to the shares.

The House of Lords decided in favour of the Crown on the same grounds as Goulding J. namely, that the taxpayer obtained a tax advantage as the result of the combined effect of a transaction in securities (i.e., the liquidation agreement), and of the liquidation of the Joiner company. The Law Lords did not find it necessary to decide on the wider point favoured by the Court of Appeal, namely, that the liquidation alone was a transaction in securities.

Lord Wilberforce noted the wide interpretation given to the section in the Parker and Greenberg case[36] and concluded that "we must continue to give to 'transactions in securities' and 'transactions relating to securities' the widest meaning: we can neither confine these expressions to the instances given in section.467(1), nor can we deduce from that enumeration any limitation upon their scope".[37]

On the question of whether a pure liquidation was caught by the section, Viscount Dilhorne was clear that it was not. Having been Attorney General when section 28 was originally introduced into the Finance Bill in 1960 he was, of course, in a very good position to know whether a

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35. See p471
36. This aspect of these decisions is discussed infra
37. p.480

liquidation was intended to be caught. He had then said: "An ordinary liquidation is not caught. The reason is that liquidation is not a transaction in securities any more than is the payment of a dividend on shares. It represents the operation of giving effect to the rights attaching to the securities in the circumstances that have arisen.[38]

In the Joiner case, in his judicial capacity, he stated:

"If Parliament in 1963[39] had thought that the liquidation was itself a transaction relating to securities, it is inconceivable that that section would then have been enacted. Parliament may of course have been wrong and it is not permissible for us to see what Parliament was led to suppose to be the effect and scope of section 28 of the Act 1960 by referring to reports of proceedings in Parliament. The device of obtaining the accumulated profits of a company without payment of tax by means of the liquidation of the company and distribution of the assets and, at the same time, securing that the business of the company liquidated continued to be carried on, was well known in 1960: see Commissioners of Inland Revenue v. Pollock & Peel Ltd. [1957] 1 WLR 822[40]. If it had been the intention of Parliament when section.28 was enacted that the liquidation should itself be treated as a transaction relating to securities I would have expected that to have been made clear by express words in that section. It certainly was not".[41]

Lord Diplock agreed that a liquidation on its own could not be a transaction in securities.[42] The other three Law Lords did not commit themselves on this point.

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38. H.C. Deb, May 25th, 1960
39. When what was then section 25(5) FA 1962 introduced a reference to liquidations.
40. See Part 2. supra
41. p483
42. pp487-8

The case of Addy v. IRC[43] was heard by Goff J after the Court of Appeal decision in Joiner, but before it had been considered by the House of Lords.

This case is considered below when circumstance D and the mental element defences are examined. From the facts there set out, it will be seen that arrangements were implemented which involved the liquidation of a family company, referred to in the case as "Oldco", with a view to the continuation of Oldco's business through a new company ("Newco") and the distribution of surplus cash to the shareholders of Oldco.

Goff J said that he was bound by the Court of Appeal decision in Joiner that a liquidation is by itself a transaction in securities.[44] However, it is clear from the facts that the judge would have found that there was a transaction in securities even if he had had the benefit of the Law Lords' views. Goff J. refused to speculate on the wider question of whether there would be a transaction in securities if a liquidation on its own did not count but, as in Joiner, the liquidation was only part of a larger arrangement which undoubtedly have been a transaction in securities.

Paragraph 10(d) of the Case Stated discloses the Special Commissioners' finding that:

> "The liquidation of Oldco and the continuation of its undertaking by Newco with the same directors and shareholders were, we find, inter-related parts of a single comprehensive scheme which it would be unrealistic to divide into two parts. The arrangements for the liquidation of Oldco would never have gone forward without the simultaneous arrangements to transfer its undertaking to Newco,

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43. (1975) 51 TC 71
44. p79

which was simply a reincarnation of the Oldco bereft of its liquid assets".[45]

The final case that needs to be mentioned in connection with the meaning of "transaction in securities" is Williams v. IRC.[46]. This was another case concerning a Bredman scheme. It was a scheme of considerable complexity comprising three sets of transactions: "the property transactions", "the share transactions" and "the loan transactions".

It is not, thankfully, necessary to set out the details of this scheme at length at this stage. The essence of it was that five taxpayers transferred the shares in one company which was awash with cash to a second company (which they also owned). The taxpayers obtained interest-free loans from a third company (with which they had no connection). The first company paid an abnormal dividend to the second company and the second company bought the third. The property transactions and the share transactions were basically the same as those used in the Anysz case.[47]

It was held in the House of Lords that the making of the interest-free loans constituted transactions in securities. In fact, this had also been the finding of the Court of Appeal. The House of Lords decided that tax advantages had been obtained in consequence of the combined effect of the many transactions in securities entered into in implementing the scheme, even though one or more links in the chain of operations may not themselves have been transactions in securities. However, Viscount Dilhorne, with whom the other Law Lords agreed, said that, while he preferred to base his conclusion on this wider ground, he was was "far from saying that the Court of Appeal's decision cannot be sustained on the narrower one".[48]

45. pp76-7
46. (1980) 54 TC 257
47. Anysz v. IRC (1977) 53 TC 601, infra
48. p309

Tax Advantage

The term "tax advantage" is defined in Section 709 ICTA 1988 as:

> "a relief or increased relief from, or repayment or increased repayment of, tax, or the avoidance or reduction of a charge to tax or an assessment to tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is effected by receipts accruing in such a way that the recipient does not pay or bear tax on them, or by a deduction in computing profits or gains".

As to the definition of "tax", it is necessary to refer to section 832(3) ibid which states that "'tax', where neither income tax nor corporation tax is specified, means either of those taxes". Accordingly, "tax advantage" can only refer to an advantage as regards income tax or corporation tax and not, for example, capital gains tax, inheritance tax, stamp duty or value added tax.

Section 703 is drafted in very wide terms in itself and the net is thrown even wider by section 703(1) which provides that the taxpayer only needs to be "in a position to obtain" a tax advantage; he does not necessarily have actually obtained one.

The phrase was considered by the courts first in IRC v. Parkes.[49]

In the Court of Appeal all three judges considered that the taxpayer had not obtained a tax advantage within what was then section 43(4)(g) FA 1960.

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49. (1966) 43 TC 396. This case has already been considered in connection with the meaning of "transactions in securities".

Lord Denning MR held that there was no possibility of the taxpayer being assessed to income tax and surtax in January 1961 when the debenture was paid off. He could not, in Lord Denning's view, be taxed on that capital receipt. The Master of the Rolls considered that the only transaction to give the taxpayer a tax advantage was the issue of a debenture to him rather than the distribution of a dividend, but that took place in 1953, long before section 28 came into operation (6th April 1960)[50]. Danckwerts LJ agreed with this.[51] Diplock LJ would have held that there was a tax advantage if the phrase had been used in its ordinary sense rather than what Diplock LJ considered was "the restricted sense" given to it by the section. He said:

> "I should have said that undoubtedly Mr. Parker had obtained a tax advantage. He had got some £20,000 out of the profits of the company without paying any tax on it".[52]

The judge pointed to the fact that "tax advantage" here meant "the avoidance of a possible assessment to income tax" where the avoidance "is effected by receipts accruing in such a way that the recipient does not pay or bear tax on them". Diplock LJ pointed out that the taxpayer did obtain receipts in such a way that he did not pay tax on them but, in Diplock LJ's view, there was no assessment to tax which was avoided. He pointed out that, for example, an apportionment assessment could have been made on the company under sections 245 and 246 ITA 1952[53], in respect of the undistributed income of the company, including Mr. Parker's £20,000 and that, if such a notice had been given, the taxpayer would have been assessed to surtax. That assessment could have been made in 1953 or any of the subsequent six years (when the Revenue could have reopened the 1953 assessment). But

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50. p418
51. p419
52. ibid
53. see Part 7, infra

once it was too late to reopen the 1953 assessment, the undistributed profits were capitalised and Diplock LJ could see no room for a possible assessment on them. Therefore, when section 28 came into force and the second stage of the transaction took place, under which the taxpayer obtained the £20,000 surtax relief, no assessment to income tax was avoided by this second transaction. The judge commented:

> "It is only when it is by a combination of the two transactions that an assessment was avoided, that the case comes within s.28(1)".

The exemption for transactions before 5th April 1960, in Diplock LJ's view, protected the taxpayer here.[54] Lord Wilberforce took a different view.

The difference in approach between the Court of Appeal and the House of Lords to the interpretation of "tax advantage" is striking. The Law Lords' approach was epitomised by Lord Wilberforce. He rejected the notion that any advantage was obtained in 1953. In his view, the taxpayer received a tax-free sum in 1961 through "combined transactions which included the capitalisation of the company's profits". He continued.

> "Had it not been for this combination of transactions, the sum would have been taxable in [the taxpayer's] hands. I cannot see that it is an answer to this to show that, had the current of transactions been stopped midway, after the issues of the debentures in 1953, he would also, at that point, have been found to have obtained a tax advantage .... For even if he did obtain a tax advantage in 1953, that was not the advantage that he obtained in 1961: the one was a promise to pay in the future when the company should decide to make

54. pp 419-420

payment; the other was an actual sum of money. The receipt of 1961 was not merely the automatic fruition of something he had already gained in 1953: it was received as the result of a fresh transaction in that year".[55]

However, regardless of this "combined transactions" approach, Lord Wilberforce was of the opinion that the Crown would have succeeded anyway. It was the test propounded here that has subsequently been used as the appropriate criterion in connection with section 703.

Here, Lord Wilberforce considered whether the taxpayer did receive a tax advantage in 1953. Referring to the definition of "tax advantage" in section 43(4)(g) FA 1960 he said:

> "The paragraph, as I understand it, presupposes a situation in which an assessment to tax, or increased tax, either is made or may possibly be made, that the taxpayer is in a position to resist the assessment by saying that <u>the way in which he received what it is sought to tax</u> prevents him from being taxed on it, and that the Crown is in a position to reply that if he had received what is sought to tax <u>in another way</u> he would have had to bear tax. In other words, there must be a contrast as regards the 'receipts' between the actual case where these accrue in a non-taxable way with a possible accruer in a taxable way, and unless this contrast exists the existence of the advantage is not established".[56]

Lord Wilberforce considered that the definition, as analysed by him, could not apply to the debentures.

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55. p 441
56. ibid

As Lord Wilberforce's analysis has been adopted in subsequent cases as the correct approach to the meaning of "tax advantage", it is instructive to see how he applied that test to the facts of this case.

He considered first the 1961 receipt. He was of the view that there was "no difficulty". Having established a connection with the distribution of profits - which has to be done to show the existence of the appropriate circumstance (D in this case) - he said that:

> "It follows that a tax advantage has been gained through the receipt of £18,002 (representing profits which, if received by way of dividend, would be taxable) in such a way as not to be taxable. Through this the [taxpayer] has avoided an assessment or obtained a reduction in his assessment - it matters not which".[57]

Turning to the 1953 transaction, Lord Wilberforce was of the opinion that the taxpayer did not then receive profits of the company in a non-taxable form, or, in fact, in any way at all. The Blott and Fisher's Executors cases[58] showed that, by a decision of the company, the character of the divisible profits had been taken from the capitalised sums:

> "The shareholders, instead of receiving their share of those profits, received a right, enforceable at the time and in the manner defined by the resolution creating the debentures, to participate in the company's capital. Nothing (and this is I think crucial for the present case) passed from the company ... to the shareholders: they were merely given a right, a chose in action, over the company's capital assets".[59]

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57. pp 441-2
58. See Part 1, supra.
59. p 442

The definition of "tax advantage" could not, in Lord Wilberforce's view, apply to the debentures because they were untaxable because they were rights over a portion of the company's capital. The company could not issue paid-up debentures of its own in such a way as to be taxable because the issue pre-supposes a capitalisation of profits. Accordingly, there was no "tax advantage" in 1953. Instead, section 28 came into operation later when a second stage was implemented to extract profits from the company in cash. Lord Wilberforce found this result "not unsatisfactory".[60]

Lord Wilberforce rejected the findings of the Court of Appeal as follows:

> "In the Court of Appeal Lord Denning MR held that the tax advantage arose in 1953 when the debenture was issued. 'If it were not for the debenture' he said 'the company might well have declared a dividend (which could be 'receipts accruing') on which he could be taxed'. As an analysis of the facts, this is of course true; the difficulty arises when one seeks to find the statutory tax advantage: and I cannot read section.43(4)(g) as attributing a advantage to a taxpayer who receives one non-taxable thing merely because he might have received another different taxable thing. Danckwerts LJ adopted the same argument, but Diplock LJ based his decision on different reasoning, namely, that no possible assessment was avoided in 1961. I have already given the reasons why I think that an assessment, or possible assessment, was then avoided, and I would only add that I do not think that the possibility or

60. p 442

otherwise of an assessment under section.245 of the Income Tax Act 1952 (as to which the Special Commissioners made no finding) has a bearing on the issue before us. Section 28(12) of the Finance Act 1960 makes plain the independence of section.28 from all other income tax legislation".[61]

Viscount Dilhorne was of a similar opinion.[62] See also Lord Guest.[63] However, Lord Hodson, with whom Lord Morton agreed, saw the matter differently.

Lord Hodson was of the view that the tax advantage was not obtained by a combination of the 1953 and 1961 transactions, but only through the 1953 transactions. Section 28 FA 1960 therefore could not impose a tax liability. This in turn depends on the consequences of receiving the debentures in 1953. It is here that Lords Hodson and Morton differed from the majority, and this distinction throws into sharp outline the essence of Lord Wilberforce's test which is now accepted as the correct one.

Lord Hodson pointed out that the taxpayer's share of the undivided income (£18,000) could have been received in cash but, instead, he received a debenture for that amount. This is similar to the Denning/Danekwerts approach in the Court of Appeal. He thus avoided the surtax charge that would have ensued.[64] He further noted that the Crown had argued that nothing was "received"[65] until 1961 when the cash was paid out on the redemption of the debenture. Lord Hodson regarded this as "wholly unrealistic" because:

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61. pp 442-3
62. See pp 432-3
63. pp 438-9
64. p 434
65. As demanded by circumstance D, infra

"The debenture was not money, but it was money's worth and indeed capable of realisation by transfer at any time, albeit at less than its face value. The fact that the money, namely, £18,002, the exact equivalent of the money secured by the debenture, was not paid till 1961 does not make it necessary to look to 1961 for the time when the section takes effect. The section, if it had been in existence in 1953, would have taken effect then, when the tax advantage was complete, that is to say, when the profits of the company were distributed in such a way as to avoid tax by the issue of debentures instead of a cash distribution".[66]

As noted above, Lord Wilberforce's answer to this was to say that the tax advantage was achieved through the combined effect of the 1953 and 1961 transactions[67] but that, in any case, even taking the 1953 transaction on its own, the taxpayer did not receive profits of the company at all.[68] This, it is submitted, must be the better construction based on the Blott and Fisher's Executors' cases, the whole point of which was that the taxpayers in those cases did not receive profits because they had been capitalised.

Taking this a stage further, could section 43(4)(g) FA 1960 apply to the debentures[7]. Again, as explained above, Lord Wilberforce was clearly of the opinion that it could not, on the basis that it was merely "a right over a portion of the company's capital" which could not be issued in a taxable form. The tax benefit can only arise at the subsequent stage when the taxpayer obtains cash. Again, this is the better view. It is one thing to say that a person receives non-taxable debentures instead of
taxable distributions, but a debenture itself (the bundle of rights which it confers) has to be turned into cash

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66. p 435
67. p 441
68. p 442

before the taxpayer has extracted profits from the company. Lord Hodson's view of this was that:

> "The receipt was obtained when the debentures were issued, and the tax advantage was then complete, although the fruits were not enjoyed until the debentures were redeemed and the cash became available to the debenture holders".[69]

It is submitted that it is not in accordance with the correct meaning of "tax advantage", in particular, and the structure of section 703, in general, so to seek to divorce the advantage supposedly obtained and the "fruits" of that advantage.

The nub of the distinction between the approach advocated by Lord Denning LJ and Lords Hodson and Morton, on the one hand, and Lord Wilberforce, Viscount Dilhorne and Lord Guest on the other, is contained in Lord Wilberforce's comment at p 443, dealt with above in the context of his judgment as a whole, that "I cannot read section.43(4)(g) as attributing a tax advantage to a taxpayer who receives one non-taxable thing merely because he might have received another different taxable thing".

Another early case on section 28, <u>IRC v. Cleary</u>[70] which is examined below, also considered the question of the meaning of "tax advantage".

It will be seen that, in that case, the taxpayers gave full consideration, in the form of shares, for the sum they received as proceeds from the sale of those shares. Adopting Lord Wilberforce's test, the House of Lords held that the taxpayers had obtained a tax advantage because the purchasing company, which the taxpayers also owned, paid the taxpayers cash for the shares which the company could have paid to them by way of dividend.[71]

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69. p 436
70. (1967) 44 TC 399
71. See Viscount Dilhorne at p 423, Lord Upjohn at p 428 and the analysis of the case, infra.

It will be seen that there was here no stripping of the assets of the company, the value of the net assets shown on the company's balance sheet remained the same, although one particular asset (an amount of cash) was replaced by another of equal value (an investment). It was therefore established that section 703, in particular circumstance D, was not restricted to the stripping of assets, which, as will be seen below, is not what was suggested to the House of Commons when circumstance D was first introduced as a separate paragraph.

The test propounded by Lord Wilberforce was very wide but it was not clear quite how far it went. What was clear was that the notional taxable receipt did not have to arise in the same way the real non-taxable receipt had arisen, but how far could this be taken? In a case like Parker, the repayment of the debenture could be compared with the dividend that could have been paid out of distributable profits. There are situations, however, where a person can receive non-taxable consideration which represents an amount he could have received in a taxable form but which is a receipt which he could not actually have received in a taxable form. For example, he may have received proceeds from the sale of shares which represents distributable profits of the company sold. He could clearly have received a dividend in a taxable form, but he could not receive the proceeds in a form subject to income tax or corporation tax (unless he is a dealer in shares, of course).

This point was dealt with in two cases. The first was Anysz v. IRC.[72] This case concerned a very complicated tax avoidance scheme which was essentially the same as the first two sets of transactions in the Williams case.[73]

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72. (1977) 53 TC 601
73. Williams v. IRC (1980) 54 TC 257, infra

Basically, the taxpayers, Mr. Anysz and Mr. Manolescue, sold their shares in Kenyon Construction Co. (Northern) Ltd., which was cash-rich, to Pelkem Investment Co. Ltd. in return for shares in Pelkem. Kenyon subsequently paid a dividend to Pelkem.

The taxpayers contended, inter alia, that no tax advantage had been obtained. Browne-Wilkinson J disagreed. A tax advantage had been obtained because, although a receipt received in a non-taxable way could be contrasted only with that same receipt received in a taxable way, nevertheless, the receipt of the Pelkem shares was capable of constituting a tax advantage because, if Kenyon had used its assets to purchase the Pelkem shares and had then distributed those shares in specie to the taxpayers, the receipt of the Pelkem shares (which the taxpayers had received in a non-taxable form) could be contrasted with a receipt of those shares in a taxable form.

Browne-Wilkinson J, however, rejected a broader argument put forward by the Crown that the taxpayers had obtained a tax advantage because the object of the share exchange and the payment of the dividend was to strip Kenyon of its assets, and the tax-free method in which this had been achieved could be compared with a taxable method of achieving the same objective. This argument was not in accordance with the majority view in the House of Lords in Parker. The judge rejected the notion that it was possible to compare the tax-free receipt of the Pelkem shares with a notional taxable transaction not involving the receipt of those shares, such as the payment of a dividend by Kenyon. He said:

> "If, as the Crown contend, the tax advantage was obtained by the receipt of the Pelkem shares then, in my judgment, the question of whether or not a tax advantage was obtained has to be decided according to Lord Wilberforce's test [in Parker] by

> contrasting the actual and the hypothetical receipt of those shares; it is not legitimate to contrast actual and hypothetical means of achieving an 'end result' (being an end result different from the receipt of the shares) and then seek to quantify the tax advantage by contrasting the actual receipt accruing to the taxpayer with another way in which he could have achieved the same end result. To put it another way, if the Crown were to have alleged (as against Kenyon) that the relevant tax advantage was the stripping of Kenyon of its assets, then the relevant comparison would have been between the actual method adopted to strip Kenyon and other possible methods of achieving that result. But as the Crown are alleging a tax advantage to the taxpayer arising from the receipt of the Pelken shares, they must, in my judgment, show another way in which that receipt could have accrued in a taxable way, and it is not permissible to look to some wider 'end result' aimed at".[74]

Even looking at the test from the point of view of the Crown's "narrower" argument, it can be seen how widely the phrase "tax advantage" was being construed by the courts.

Another point on the meaning of "tax advantage" is that the taxpayers here were held to have received such an advantage even though they received only the Pelkem shares rather than cash.

Browne-Wilkinson J. referred to the introduction of circumstance E by the Finance Act 1966 which covers the situation where two companies are involved and the taxpayer receives "share capital or any security" issued by a company. He noted:

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74. p 627

> "Paragraph E(2) provides that, in relation to share capital, other than redeemable share capital, circumstance E is not to apply unless and except to the extent that the share capital is repaid. The Crown are not relying on circumstance E in this case, but its relevance for present purposes is that, as Mr. Beattie [Counsel for the taxpayer] conceded, the provision is drafted on the basis that the mere receipt of irredeemable share capital would constitute the receipt of a tax advantage were it not for the provisions of subpara (2), and that the receipt of redeemable share capital does constitute a tax advantage even before redemption".[75]

The judge did not think it was unreasonable for the taxpayers to be held to have received a tax advantage in these circumstances.

He commented:

> "The taxpayers have received a new item of property (the Pelkem shares) capable of being sold. Moreover, by establishing a share premium account in Pelkem the share exchange may (I say no more) have prevented any shortfall assessments being made on Pelkem in respect of the same funds which, if they had remained as undistributed profits in Kenyon, would have been vulnerable. I am concerned that the counteraction seems to be excessive in that the taxpayers, who are no more than shareholders in Pelkem and are probably unable to obtain spendable cash without incurring further tax liability, are to be taxed as though they had received freely spendable cash by way of dividend; but I think this is the unfortunate consequence which may be suffered by those who indulge in deliberately artificial devices of great complexity which have tax avoidance as their sole objective".[76]

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75. p 629
76. Ibid

It is not difficult to have sympathy with this view in a case such as the present one where the taxpayers have been willing participants in highly artificial avoidance transactions. A similar attitude is slightly less palatable when, for example, in a different situation, the sisters in the Cleary case[77] were faced in theory, if not necessarily in practice, with the prospect of double taxation.

Just under a year later Walton J decided the case of IRC v. Wiggins.[78] The facts of this case have already been given.

Walton J. held that the taxpayers had received a tax advantage in that the tax-free receipt of the proceeds of the sale of the share capital of Wiggins which the taxpayers had received from Knoedler could be contrasted with a sale of the Poussin by Wiggins, followed by a distribution of the resultant profit. In contrasting the actual, non-taxable receipt with an alternative hypothetical receipt in a taxable way, it was not necessary that the paymaster should be the same. The judge said:

> "I have .... come to the clear conclusion that the Special Commissioners were in error when they sought, as a comparable within Lord Wilberforce's method of procedure [in Parker], another payment made by Knoedler. What they should have looked for was another possible way in which the profits of the company might have reached the hands of its shareholders, and such a way was readily to hand via a sale of the Poussin and distribution of the resultant profit, which would indeed be the most natural way in the world to proceed".[79]

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77. IRC v. Cleary (1967) 44 TC 399, infra.
78. (1978) 53 TC 639
79. p 660

Wiggins, then, decided that the non-taxable receipt did not have to be received from the same person as the notional taxable receipt.[80]

Comparing the tests of Walton J. in Wiggins and Browne-Wilkinson J in Anysz, Walton J's was a wider and less restricted test than Browne-Wilkinson J's which demanded that the non-taxable receipt had to be contrasted only with that same receipt received in a taxable way. Walton J, on the other hand, considered that one has to see if there is another way in which the profits might have reached the hands of the shareholder. Of the two tests, Walton J's appears to more closely represent current judicial thinking, although it was moving away from the precise terms of Lord Wilberforce's judgment in Parker.

The Walton J line is supported by the decision in Williams v. IRC[81]. In this case, Bridge LJ, in the Court of Appeal, held that there had been a "tax advantage" obtained by the taxpayers when they received loans from Dolerin.[82] It was not necessary to compare like with like and money paid as a loan could be compared to money paid to shareholders as a dividend. The taxpayer had submitted that a loan could not be so compared because it was liable to be repaid. Bridge LJ rejected this. He said:

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80. Reference here, and elsewhere in this Part, to non-taxable receipts means, of course, not subject to income tax or corporation tax.
81. (1980) 54 TC 257. This case is examined in relation to circumstances D and E, infra, where the relevant facts are set out in full.
82. See the details of the scheme, set out infra.

"The reality, of course, of the matter is that Gristrim and Dolerin, being under the full control of the taxpayers ...., are companies which do not, and never have, carried on any business and which never existed for any other purpose than for the purpose of carrying through the avoidance scheme; the practical likelihood of these debts being called in is negligible".[83]

The taxpayers also claimed that they received no tax advantage because they remained technically liable to tax under other provisions. In fact, Gristrim had actually been the subject of shortfall assessments under what was then section 289 ICTA 1970 and the taxpayers had been issued with consequential surtax assessments under sections 296 and 297 ibid. The Crown had given undertakings that they would not proceed with these assessments if the section 460 assessments were upheld. Following Viscount Dilhorne in the Cleary case[84] and Lord Wilberforce in the Parker case[85], Bridge LJ rejected this argument. A possibility of double taxation did not exclude the application of a tax advantage.[86]

Finally, the taxpayers argued that there could be no tax advantage because, having received their loans from Dolerin, they lent that money to another of their companies, "Developments".

Bridge LJ rejected this contention as well:

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83. p 299
84. (1967) 44 TC 399 at p 424
85. (1966) 43 TC 396 at p 443
86. See the decision of the House of Lords in Bird v IRC [1988] STC 312 where this point is considered further. This case is analysed infra. There, Lord Keith, with whom the other Law Lords agreed, stated that if the Revenue in Williams had insisted in pursuing both claims, "much closer consideration would have had to be given to the question whether they were entitled to do so" (p 324). From Lord Keith's judgment, it appears that he would have held that they were not so entitled.

"The taxpayers ..... were under no legal obligation to make those loans to Developments. True it was commercially desirable that they should do so, but it might indeed have been commercially desirable that they should use the money in a hundred ways, and the fact that they chose to use the funds they had received in this way seems to me entirely irrelevant to their liability".[87]

Orr and Cumming-Bruce LJJ agreed with Bridge LJ's analysis throughout.

All that the House of Lords had to say on the point was:

"The taxpayers each received £84,216 without paying or bearing tax thereon. That was the object of the scheme. By the operations in which they engaged they avoided a possible assessment thereon and it is clear beyond all doubt that they obtained or, by virtue of these transaction, were in a position to obtain a tax advantage".[88]

This finding must have been based on the fact that it was not necessary to compare like with like and that the loans could be compared to the payment of a dividend.

The Court of Appeal in IRC v. Garvin[89] considered the meaning of "tax advantage". The House of Lords, in that case, did not go into the question, merely agreeing with the Court of Appeal.[90]

In the Court of Appeal, all three judges had something to say on the matter. Buckley LJ, after considering the cases, was clear that "tax advantage" does not require that the advantage must accrue from the fact that

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87. p 301
88. p 308, per Viscount Dilhorne, with whom the other Law Lords agreed.
89. (1981) 55 TC 24, supra
90. See, for example, Lord Wilberforce at p 86.

receipts have come from any particular source. Buckley LJ identified four features common to all the cases on "tax advantage". These were:

> "(a) that a taxpayer owning shares in a company replete with profit so arranged his affairs, either on his own or in co-operation with others, that he received something in such a way that the receipt did not attract income tax; (b) that the value of what he received, was at least in part attributable to the accumulated profits of the company; (c) that he would have so arranged matters that he received the same subject-matter from the company by means of a distribution in cash or in kind of its accumulated profits which would have attracted income tax; and (d) that, consequently, the way in which he arranged his affairs was advantageous to him as regards income tax".[91]

Furthermore, noting the Parker case, he said that it was "not a decision that what is received by the taxpayer must have come from the company which has accumulated profits". On the authorities, this is now clearly the case.

Templemen LJ took a typically robust line which came down to the same approach as Buckley LJ's[92]. Donaldson LJ also took the same line.[93]

Another Bradman scheme caused the court to consider the question of "tax advantage" in Emery v. IRC.[94] Counsel for the taxpayer argued that this case was different from previous cases that had considered the meaning of "tax advantage" because here there were not just two options available (either to take a non-taxable receipt or to

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91. pp 70-1
92. See pp 75-6
93. p 80
94 (1980) 54 TC 607, considered in relation to circumstances C, supra, and D. infra.
The facts are set out, supra

take it in a taxable way), but a third option which was also non-taxable.

Not surprisingly, Nourse J did not spend much time rejecting this argument. After quoting Lord Wilberforce's explanation of the meaning of tax advantage, he said:

> "That seems clearly to require that I should look at the way in which Mr. Emery received the £233,409 free of tax and then see whether he would have received it in another way which would have resulted in its being subject to tax. Taking those words at their face value, I would have thought that Lord Wilberforce was saying that if the taxpayer could have received what is sought to tax in <u>any</u> other way which would have resulted in it being subject to tax, then that was enough for him to have obtained a tax advantage. And, speaking for myself, I would have thought that a taxpayer did obtain the avoidance of a possible assessment to tax if he received something in one non-taxable form even though he might equally have received it in some other non-taxable form, provided always that he could have received it in some third way which would have resulted in its being subject to tax".[95]

Counsel for the taxpayer also tried a second argument which was that the taxpayer merely sold the Mersey shares to Tishmear and that he was simply a vendor selling a capital asset for a sum of money, and that he could not be regarded as thereby avoiding an assessment to income tax. This argument could not stand up in the face of Nourse J's finding, which has already been discussed in connection with circumstance C, that the whole series of operations down to and including the payment of the

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95. p 172
96. (1968) 44 TC 619, a circumstance D case. The facts are given infra.

abnormal dividend by Mersey were all part of the one "transaction". Nourse J referred to Buckley LJ's analysis of the "common features" in Garvin (a case involving a similar scheme), and Nourse J considered that all four features were satisfied in the present case. Given the similarity between the schemes in Garvin and Emery, the judge could not possibly have come to any other conclusion.

An interesting question regarding "tax advantage" arose in the case of Hague v. IRC.[96]

Mr. and Mrs. Hague were not separately assessed to surtax. By virtue of certain transactions in securities explained later, sums were paid both to Mr. and Mrs. Hague. It was held that Mr. Hague had obtained a tax advantage which was correctly counteracted under Section 28. Mrs. Hague had carried out the same transactions as her husband but it was argued on her behalf that she had no personal tax liability because no application had been made for her to be separately assessed. Accordingly, as she had never been liable to tax, the transactions could not have conferred any tax advantage on her.

It should be noted that the Inland Revenue did not seek to rely on section 359 ITA 1952[97] whereby, if a husband does not pay tax assessed on him but which was attributable to his wife's income, the tax can be collected from the wife. Section 359 was concerned solely with collection rather than assessment.

The Court of Appeal decided that section 28 did not apply to the amount paid to Mrs. Hague because she had not obtained a tax advantage and her husband had not received the payment, so circumstance D could not impose a liability on him in respect of it.

Salmon LJ noted that Counsel for the Crown had argued

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97. Now section 285 ICTA 1988.

that, if the taxpayer was correct, it was a most anomalous and absurd state of affairs. Salmon LJ agreed, but said that circumstance D had been "grafted on" to section 28 without sufficient thought being given to the consequences. The position where, as here, a wife's income was deemed to be her husband's upon which she could not be separately assessed had been entirely overlooked. Salmon LJ said, that of course, that the court had no power to call such a provision into existence. He pointed out that Parliament had, since the transactions in the Hague case had been implemented, attempted to fill the gap by section 25(4) FA 1962[98]. The effect of this subsection is that both the husband and the wife can be assessed in respect of sums received by the wife.

The most recent case in which the meaning of "tax advantage" has been considered is Bird v. IRC[99] In the High Court,[100] Vinelott J held that the amount of the tax advantage that had been obtained fell to be ascertained by contrasting the receipt which in fact accrued in a non-taxable way with a similar receipt which might have accrued in some other taxable way. This was clearly right based on the authorities considered above. He also held that, in making this contrast, account must be taken of other tax liabilities which fell directly or indirectly on the taxpayers in consequence of the transactions which they in fact carried out. This part of Vinelott J's decision is examined in detail below.[101]

Another point raised in the judgment of Vinelott J was the possible interaction of section 703 and the "new

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98. Now section 703(7) ICTA 1988.

99. [1988] STC 312. The facts of this case are set out supra. Certain aspects of the tax advantage question are examined infra in connection with double taxation.

100. [1985] STC 584.

101. see "The Question of Double Taxation" later in this Part.

approach" of the courts to tax avoidance. Counsel for the taxpayers submitted that it was now clear that, in the light of the House of Lords' decision in Ramsay[102] and Furniss & Dawson[103], the loan scheme was ineffective to avoid liability under what was then section 286 ICTA 1970[104]. It was argued that, if the intermediate steps inserted for purely fiscal purposes were disregarded, it could be seen that the taxpayers were participators in Interlude when the loans were made. Alternatively, the loans must be treated as having been made by Ilmarish, Consequently, it was claimed, there was no "tax advantage".

Vinelott J was unimpressed by this argument, pointing out that the court was being invited by the taxpayers to treat as fiscally ineffective steps taken by them to achieve a result they were now seeking to say the scheme failed to achieve.[105]

This contention was also rejected in the Court of Appeal.[106]

Sir Nicolas Browne-Wilkinson V.C. propounded three reasons why this contention was fallacious:

1. The taxpayers put forward the whole scheme as a series of real transactions on the basis of which tax should be assessed. Therefore, said the judge, it does not then lie in their mouths to claim to disregard what they had done. The judge commented:

   > "The steps taken by the taxpayers in this case were not in any sense shams: they were real steps. If the effect of those steps was to give rise to a tax liability under s.460,

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102. W.T. Ramsay v. IRC (1981) 54 TC 101
103. (1954) 55 TC 324
104. Now section 419 ICTA 1988
105. p 646
106. [1989] STC 168

the taxpayer is hoist with his own petard: he cannot now be heard to say that they fall to be disregarded for that would be for him to put forward two inconsistent cases".

2. The "new approach" was a principle of statutory construction.[107] The doctrine does not treat the steps to be disregarded as shams; it accept that they occurred but requires that for tax purposes they are to be disregarded. The relevant part of ICTA 1970 (Part XVII) was headed "Tax Avoidance" and Chapter 1 (which contained section 460) was headed "Cancellation of Tax Advantages from Certain Transactions in Securities". To apply the doctrine so as to disregard the very transactions which Chapter 1 required to be considered in meticulous detail, in the judge's view:

> "files in the face of all rules of construction. Parliament has required those transactions to be looked at in detail, not to be disregarded".

3. Referring to the definition of "tax advantage" in section 709, the judge commented that, even if the taxpayers were right in saying that under the "new approach" the loan scheme was ineffective to avoid tax, what was done

> what was done certainly avoided a "possible assessment" to tax and probably avoided an actual assessment.[108] As it was then too late to make any such assessment, the requirements of section 709 had been satisfied.[109]

107. This was confirmed by three of the Law Lords in <u>Craven v. White et al</u> [1988] STC 476, see Chapter 11.
109. p 177
110. [1988] STC 312

When the case reached the House of Lords, [110] the only matters in dispute were whether there was a tax advantage (including the question of whether there was any double taxation) and, if so, whether the assessments were correct in amount.

The taxpayers took the opportunity of their appearance before the House of Lords to challenge a number of fundamental points decided or touched on in earlier cases. Leading Counsel for the taxpayers in Bird, C.N. Beattie QC, also appeared for the taxpayers in three of the earlier section 703 cases considered by the House of Lords: Garvin, Williams and Anysz.[111] His challenge on these fundamental points were to no avail.

The taxpayers advanced five arguments challenging the validity of the section 703 assessments and all of them failed. They did, however, succeed in getting the assessments reduced in amount, as Vinelott J. had ruled.

The first four arguments are considered here; the fifth (which related to the double taxation point) and the question of the amounts of the assessments are dealt with below.[112]

It should be noted that the only judgment of any substance was delivered by Lord Keith; the other Law Lords merely agreed with him.

The first argument put forward by the taxpayers was that no tax advantage can be obtained unless the consideration actually received is of the same nature as that which might be received in a taxable form. It was argued that it was not proper to compare receipt of a dividend which

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111. All of these cases have been considered, supra
112. See "The Question of Double Taxation" later in this Part

was freely available for spending with receipt of a loan which was liable to be repaid.

Lord Keith noted that, as has been explained above, such an argument was accepted by Pennycuick J in Cleary[113], but rejected by the Court of Appeal and House of Lords. Accordingly, it was hardly surprising that Lord Keith rejected this argument: he was not persuaded that there was any doubt about the Cleary decision and he also observed that the taxpayers' first argument would also entail departing from the decision in Williams[114] where, as has been seen, section 703 was held to apply in circumstances where the taxpayers received their payments in the form of interest-free loans.[115]

The taxpayers' second argument was one of those dealt with by the lower courts in Bird. They argued that they had in fact failed to obtain any tax advantage because, on an application of the "new approach", they must be treated as having been participators in Interlude at the time of the loans so that a charge to tax on the grossed-up amount of the loans fell upon Interlude under section 419 ICTA 1988. They claimed that the fact that the Revenue had not chosen to raise an assessment under section 419, and that it was then too late to do so, was irrelevant.

Lord Keith, not surprisingly, declared this argument to be unsound. He pointed out that the circumstance that the Revenue might have raised a section 419 assessment did not detract from the situation that the taxpayers were the beneficiaries of receipts accruing in such a way that they did not bear tax on them. Furthermore, Lord Keith could see no reason why the Revenue should not have deliberately chosen to refrain from making a section 419

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113. <u>IRC v. Cleary</u> (1967) 44 TC 399
114. <u>Williams v. IRC</u> (1980) 54 TC 257
115. pp 316-7
116. pp 317-8

assessment, but rather have proceeded against the taxpayers under section 116.

The third argument was that section 703 permitted counteraction of tax advantages only in relation to potential distributions of an income nature, not those of a capital nature. Geoff J in Addy[117] had rejected this contention and Lord Keith thought this conclusion was "plainly correct".[118]

The taxpayers' fourth argument was that the hypothetical transaction with which the loans by Interlude should be contrasted was the lending of money by Ilmarish to the taxpayers. Accordingly, Ilmarish should be treated as having obtained the tax advantage and assessed under Section 703 to the amount of tax it would have paid under section 419 had it been the direct lender. Section 703 would not, however, have been capable of application to Ilmarish in relation to avoidance of liability to tax under section 419. The taxpayers also argued that it was wrong for the Crown to pick on a hypothetical capital dividend from Ilmarish as the transaction to be contrasted with the loan arrangement because such a dividend was never in contemplation and would not have been paid in any circumstances. As Lord Keith pointed out (ibid), and as explained above, the House of Lords rejected a similar contention in Garvin.[119] Lord Keith also rejected it.[120]

Because of the rejection of these four argument and the fifth dealt with below, the House of Lords held that the taxpayers had obtained a tax advantage by receiving the loans in a non-taxable form which they could have received in a taxable way, namely, by means of capital dividends declared by Ilmarish. Given the state of the authorities, it was almost inconceivable that the House of Lords would reach any other conclusion.

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118. p 318
119. IRC v. Garvin (1981) 55 TC 24
120. p 318

The Wider Circumstances - Circumstance D

Circumstances A, B and C in section 704 ICTA 1988 have already been considered.[121] They are aimed at specific schemes in the divided stripping, bond washing and stock stripping areas. Circumstance D has turned out to be much wider and is now the circumstance most commonly met in practice. Circumstance E is, in effect, an extension of D.

Circumstance D has become a wide sweeping-up provision covering most forms of distribution of a company's assets, which might otherwise be used to pay dividends, in a non-taxable form.

It is symptomatic of the way Parliament was misled over the structure and operation of section 28 FA 1960 that circumstance D, the widest and most used of all of the circumstances, received virtually no consideration in the House of Commons. The first three circumstances were introduced at Committee Stage on 25th May 1960. It was not until the Report Stage on 6th July 1960 that circumstance D was given a separate existence; it was originally just a limb of circumstance C. At Report Stage it was split from C because, in the words of the Attorney General: "it would assist in the comprehension of these provisions if we made provision by a separate paragraph for the stripping of the assets simpliciter".[122] There was no indication, and the Commons were certainly not made aware, that circumstance D would become such a general anti-avoidance tool.

As circumstance D is so important it is appropriate to set out most of it here:

> "D - (1) That in connection with the distribution of profits of a company to which this paragraph

121. See Part 4, supra
122. H.C. Deb. 6th June 1960, col. 604

applies, the person in question so receives as is mentioned in paragraph C (1) above such a consideration as is therein mentioned.

(2) - The companies to which this paragraph applies are:

(a) any company under the control of not more than five persons, and

(b) any other company which does not satisfy the condition that its shares or stocks or some class thereof (disregarding debenture stock, preferred shares or preferred stock), are authorised to be dealt in on the Stock Exchange, are so dealt in (regularly or from time to time), so, however, that this paragraph does not apply to a company under the control of one or more companies to which this paragraph does not apply".

Circumstance D therefore only applies to certain companies, as specified in (b) above. In this way, it is narrower than circumstance C but, to those companies to which it does apply, it is much wider because, unlike C, no abnormal dividend is required (Compare paragraph C (1) (a)) and no deduction in computing profits or gains is necessary (compare paragraph C (a) (b)).

The first case on section 28 FA 1960 to be decided by the courts was IRC v. Parker[123], a case that has already been examined in connection with the meaning of "tax advantage". This was a case on circumstance D and the question that immediately arose was whether section 28 in general, and circumstance D in particular, could be applied beyond the confines of dividend stripping.

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123. (1966) 43 TC 396

This point has already been touched on in the examination of dividend stripping. There it was noted that Parliament was assured that this was an anti-dividend stripping provision but that, once it was on the statute books, the Inland Revenue sought to use it in a much wider way.

The Parker case disclosed that, originally, judicial opinion was far from consistent on this point.

In the Court of Appeal, Lord Denning MR and Danckwerts LJ took a narrow view of the section.[124] Lord Denning MR commented:

> "This appeal concerns s.28 of the Finance Act 1960, which was no doubt passed by Parliament at the instigation of the Board of Inland Revenue. Like the famous arrow shot into the air, it seems to have landed they know not where. The target was plain enough: it was the operation which has come to be known as "dividend stripping. The operation carried out in the present case was not of that character".[125]

As has already been noted, the House of Lords disagreed: Viscount Dilhorne, who was Attorney-General when the section was eased through Parliament, stated:

> "The view was expressed in the Court of Appeal that s. 28 was directed to dividend stripping, and that the objective of the company in this case was not of this character. I think I should make it clear that, in my opinion, this is taking too narrow a view of s.28. That section was, in my view, directed to tax avoidance taking place in certain

124. See Lord Denning MR at pp 417-8 and Danckwerts LJ at pp 418-9.
125. p 418

circumstances, and one has to consider whether, in a particular case, the circumstances specified existed. In my opinion, in this case they did".[126]

Later he said:

"I do not agree that the general mischief which section.28 was designed to hit was dividend stripping. It was, to my mind, designed to hit other forms of tax avoidance as well. I do not think that one should restrict the general and unambiguous words of the definition in the Statute by regard to the mischief which it is thought that the section is aimed at".[127]

It would be irrelevant, but nevertheless interesting, to know whether Viscount Dilhorne recalled clearly what he had said six years before when he was Attorney-General. It would not, of course, have been proper for him to have consulted Hansard to refresh his memory but, on such an important and specific point, it would be surprising if he had not retained a pretty clear picture of the assurances he had given to Parliament. In any case, Lord Wilberforce agreed that the section had to be construed widely. He also differed from the Court of Appeal's view that the section was confined to dividend stripping. He said:

"I do not find it possible to discern in this Act any indication that it was the purpose of the legislature to limit it to any specific form of tax avoidance. The scheme and drafting, not only of section.28 but of the preceding sections, is far too general to admit of the suggested restriction, and I do not think that interpretation should seek to narrow this generality".[128]

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126. p 430
127. p 431
128. p 440. Lord Wilberforce was to return to this subject later, infra.

As to the Parker case itself, the decision has been dealt with already in the discussion of "transaction in security" and "tax advantage". The scheme would now be covered by specific legislation. As noted above, the issue of redeemable shares and the redemption of shares can now both create distributions under section 209(2)(b) and (c) ICTA 1988.[129]

Another early case established another basic principle in the operation of section 28: it does not matter if the taxpayer did not have a tax avoidance motive[130] and if the transaction is implemented at market value he can still be caught.

Before examining the case, it is interesting to consider yet another assurance given to Parliament by the Attorney-General when the 1960 Finance Bill was being considered:

> "Perhaps I may reiterate that we do not want this clause to include any cases which we would all regard as legitimate transactions. We do not believe that as now drawn this wording is capable of including such cases".

Less than seven years later Viscount Dilhorne was one of the five Law Lords who decided that the innocent Cleary sisters had unwittingly been caught by the section.

In IRC v Cleary[131], the facts were that each of two sisters held half of the issued share capital in M.J. Gleeson Ltd. and half of the issued share capital of Gleeson Developments Ltd. At 31st December 1960, Gleeson Developments had an accumulation of profits of £180,840. The two sisters were in need of cash so, in July 1961,

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129. See Part 3, supra.
130. Except in relation to the mental element tests, infra
131. (1967) 44TC 399

they each sold most of their shares in M.J. Gleeson to Gleeson Developments for £60,500 in cash. The proceeds represented the market value of the shares sold. Despite this, the Inland Revenue issued a notice to each sister under section 28(3) that the adjustment requisite for counteracting the tax advantage obtained was that, in the computation of her surtax for 1961/62, the payment of £60,500 should be taken into account as if it were the net amount of a dividend payable under deduction of tax at the date of receipt.

It should not be forgotten that, if the sisters had sold their shares for the same amount to an unconnected third party, or, if Gleeson Developments had bought similar shares for the same amount from an unconnected third party, there could be no question of section 28 being applied (assuming the two transactions were not part of a larger scheme, of course).

The sisters contended (a) that they had not obtained a "tax advantage" in consequence of the sale and (b) that the proceeds were not received in connection with a transfer of assets of Gleeson Developments or otherwise "in connection with the distribution of profits" of that company within circumstance D.

Pennycuick J, at first instance, heard the case after the Court of Appeal but before the House of Lords decision in Parker.[132] He therefore was guided by the restricted interpretation given by the Court of Appeal to "tax advantage"[133]; he was not to know how the Law Lords would treat that term.

Furthermore, the judge had not the guidance of the House of Lords in Parker on how widely section 28 was to be interpreted. It will be recalled that the Court of

132. <u>IRC v. Parker</u> (1966) 43 TC 396.
133. see p 409

Appeal in Parker took a very much more restricted view of the section. In the circumstances, it is not surprising that Pennycuick J too took a narrow view of the ambit of the section. He said:

> "I was reminded by Sir John Senter, for Mrs. Cleary, of the well-established rule that one must look at the form of a transaction in order to determine tis taxable quality. Mr. Bagnall [for the Crown], on the other hand, pointed out that section.28 contains a whole series of highly artificial deeming provisions, and that its entire purpose is to go behind the form of the transaction in question. That is so, but one would still have to find clear words to justify treating a sale of shares for cash by a member to a company as a gratuitous disposition of the cash by the company so as to bring the receipt in the hands of the member within the scope of the definition in section.43(4)(g); and I can find no such words".[134]

The Court of Appeal, on the other hand, heard the Cleary case shortly after the House of Lords had given their decision in Parker. Lord Denning MR and Danckwerts LJ, who had dealt with Parker in the Court of Appeal, reappeared in the Cleary case, along with Salmon LJ. Guided by the Law Lords' judgments in Parker, the Court of Appeal judges unanimously held for the Crown. There are some indications, however, that perhaps they were not entirely happy about it. Danckwerts LJ, for example, commenced his judgment with the following passage:

> "Section 28 of the Finance Act 1960 is a highly artificial section and not at all easy to follow in its complicated language. Its objects are clear: to enable the Commissioners of Inland Revenue to

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134. ibid

> outmanoeuvre the ingenuity of wealthy taxpayers in arranging their business affairs so as to avoid or minimise tax. How delightful it must be to a taxing office to have the power to counteract 'a tax advantage' which a person is in a position to obtain or has obtained by assessments or other adjustments! The section is indeed a tax collector's dream. Gone is the old principle that a citizen was entitled to arrange his affairs so as to minimise his liability to tax."[135]

Danckwerts LJ was, of course, going too far in his last sentence although it is undoubtedly true that the wide interpretation given by the Law Lords to section 28 in Parker signalled a severe restriction in the ability of taxpayers to manipulate shares to obtain tax benefits.

In the House of Lords, the two main points considered by the Law Lords were:

1. Was circumstance D satisfied?
2. Was there a tax advantage?

In connection with the first question, the Crown had to show that the sale of shares was "in connection with the distribution of profits". In this respect, it should be kept in mind that, as far as Gleeson Developments was concerned, all that had happened was that there had been a substitution in its reserves of one form of asset for another: £121,000 cash was replaced by the shares of M.J. Gleeson which were of the same value. So the question was: could there be a distribution of the company's profits for the purposes of section 28, merely by reason of a change in the character of its assets?

The Law Lords held that there could be a distribution of profits in these circumstances. Viscount Dilhorne said:

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135. p 412

"There was a transfer by the company of profits and of assets of the company. If the company entered into a contract to purchase the shares for £60,500, there was also an application of profits and assets of the company in discharge of a liability. Acceptance of the [taxpayer's] contention that there cannot be a distribution of profits without a diminution of the amount available for distribution involves ignoring the definitions of the words 'distribution' and 'profits' and reading into the section a qualification which is not there".[136]

On the question of whether there was a tax advantage, the Law Lords were again unanimous. In connection with this question, it is relevant to note that the sisters gave full consideration for what they received. However, this fact did not help the taxpayers here. Viscount Dilhorne, giving the leading judgment, commented:

"That the [taxpayer] received £60,500 in such a way that she did not pay or bear tax on it, is not disputed. It could have been distributed to her by way of dividend and, if it had been, she would have been liable to tax. There is thus in this case the contrast to which Lord Wilberforce referred [in Parker]. It is clear that, in consequence of a transaction in securities, she avoided a possible assessment to income tax, the possible assessment being that which would have been made if she had received the sum by way of dividend. She therefore obtained a tax advantage within the meaning of the section".[137]

Lord Upjohn analysed the position in a similar way. He said:

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136. p 424. See also Lord Morris, ibid, and Lord Upjohn at pp 428-9.
137. p 423

"My Lords, this question depends upon the proper construction of the words 'avoidance of a possible assessment thereto' in section.43(4)(g). I think light is thrown upon the proper construction of these words by the words which follow:

> 'whether the avoidance or reduction is affected by receipts accruing in such a way that he recipient does not pay or bear tax on them'.

Clearly, 'avoidance of a possible assessment' was not merely directed to the reduction of the figure of profits in account available for distribution but to the reduction of physical assets for that purpose. In this case, there was a sum of cash available for payment of a dividend in cash; the result of the transaction was to remove the possibility of that sum of cash being used to declare a dividend. True, other assets might be realised in the future so as to provide money for payment of a dividend, but it seems to me quite clear that the definition is aimed at just such a transaction as this. The sisters have managed, by a perfectly fair transaction, to extract cash from the company without declaring a dividend, and thereby they avoided a possible assessment upon them which would have been made had a dividend been declared".[138]

One final point to be made about the Cleary case was that the House of Lords acknowledged that double taxation could arise if Gleeson Developments distributed the value of the shares in M.J. Gleeson it had purchased from the sisters. Viscount Dilhorne noted that there is nothing in the section to exclude double taxation in these circumstances.[139]

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138. p 428
139. p 424

Lord Denning MR, in the Court of Appeal, also acknowledged the danger of double taxation but he did not think that it was, in practice, a real danger. He commented:

> "I am sure that the Courts are well able to take care of that contingency. They would not allow the sisters to be taxed twice over in that way".[140]

The question of double taxation is considered further below.

The taxpayers in IRC v. Brown[141], argued that their situation was different from that of the Clearly sisters in a case which concerned the meaning of "assets available for distribution". It is also a useful case on the question of the mental element defences.[142]

The relevant facts were that the taxpayer and his wife owned virtually all of the shares in General Auto-Work Ltd. ("General") and five other companies. General carried on the business of light engineering, and the five other companies hired out plant and machinery to, amongst others, General. General's balance sheet at 30th April 1960 showed that current liabilities (including a proposed dividend of some £2,150) exceeded current assets by over £5,000. There were revenue reserves of £36,000.

On 9th May 1960, the taxpayer and his wife sold their shares in the five other companies to General for a consideration which included cash payments of £10,000 to the taxpayer and £15,000 to his wife.

In order to fund the purchase, General borrowed £25,000 from a bank. If General had instead wanted to pay a dividend, the tribunal appointed for the purposes of section 28 considered that "it would have been improper

140. p 412
141. (1971) 47 TC 217
142. Discussed infra.

or, at any rate, not justified for the directors to procure the company to incur a bank overdraft of £25,000 for the purposes of declaring and paying a dividend".

The Inland Revenue issued notices under section 28(3) that the adjustment requisite for counteracting the tax advantage obtained by the sale of the shares was that, in the computation of his surtax liability for 1960/61, £10,000 should be taken into account as if it were the net amount of a dividend payable under deduction of tax at the date of receipt.

Before the tribunal, the taxpayer contended, inter alia, that the consideration received by him did not represent the value of assets available for distribution by way of dividend within circumstances C and D. The tribunal decided that, in the light of the current assets and liabilities of General at 30th April 1960, and the terms on which the overdraft was granted, the taxpayer had not received a consideration representing the value of assets available for distribution by way of dividend.

Before Megarry J in the High Court, it was conceded by the taxpayer that the £10,000 constituted a consideration representing the value of assets which were legally available for distribution by way of dividend.

The tribunal had held that "available" meant commercially available or available according to sound commercial practice. The Inland Revenue, however, argued that "available" meant legally available.

Megarry J. agreed with the Revenue. The judge pointed out that, if "available" meant legally available, there was little difficulty in interpreting the Act. On the other hand, if some other criterion were used, what was the required standard? The judge asked:

"Is it that of the prudent and conservative financier, or that of the daring entrepreneur? Does one resort to the overworked word 'reasonably', and invoke the assistance of the man on the Lombard Street omnibus (if such there be)?"

He concluded that:

"the word 'available' in subsection (2)(c) and, by incorporation in subsection (2)(d), bears the meaning of 'legally available', and Mr. Bates [Counsel for the taxpayer] could not and did not contend that the £10,000 in question did not constitute a consideration which represented the value of assets which were legally available for distribution by way of dividend. I appreciate that this construction is likely to result in section.28 being very wide in its operation but, in the absence of any satisfactory alternative test, I can see no other possible result".[143]

Regarding the wide interpretation he was giving the section he commented:

"Section 28 is a wide-ranging section and, having provided reasonable safeguards for the bona fide or ordinary transaction, I do not think that the Legislature has given any indication of intending to use kid gloves in these cases".[144]

The Court of Appeal agreed, adopting Megarry J's reasoning.[145]

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143. p 235

144. Ibid

145. See p 236, per Russell LJ

Following the test of legal availability in Brown, Goff J held that "assets available for distribution" include the company's capital reserve. This was in the case of Addy v. IRC.[146]

The facts were that, on 13th February 1968, a new company was incorporated to acquire the business and assets of the old company. As both companies were called Thomas Wade & Sons Ltd., the names having been switched, the two companies were referred to throughout the case as "Newco" and "Oldco".

The consideration for the acquisition was the issue of shares in Newco and the assumption of Oldco's liabilities.

On 6th March 1968, Oldco had a capital reserve of £67,959 and revenue reserves of £23,540. On 24th April 1968, the liquidator distributed £66,150 in cash to Oldco's shareholders, including £5,499 to the taxpayer's wife. She was also allotted 3.208 shares in Newco, the nominal amount of which exceeded the amount subscribed for her shares in Oldco. The directors of Oldco desired that money should be made available to an associated company from Oldco so that the associated company could repay a debt to Oldco and have finance for its business, and also that the members of Oldco could have from that company money to spend. No consideration had been given to the payment of a dividend by Oldco instead of its liquidation, but the directors were aware that the scheme would put cash into the hands of Oldco's shareholders without their being taxed on it as income. Neither the taxpayer nor his wife was a party to the decision to liquidate.

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146. (1975) 51 TC 71

The Inland Revenue gave notice to the taxpayer under section 703(3) that the adjustment requisite for counteracting the tax advantage obtained from the above transactions was an assessment to income tax in the sum of £5,499, and the recomputation of his liability to surtax on the basis that this sum formed part of his total income.

The taxpayer argued, inter alia, that the counteraction had to be limited to the part of the cash received which represented the revenue reserves. The Special Commissioners and Goff J. held that the tax advantage extended to the whole sum of £5,499.

Goff J noted that, before 1965, section 28, as it was then, could only be used in relation to distributions out of revenue funds because capital distributions did not attract income tax, and so there was no question of anyone gaining a tax advantage by making the distribution in a non-taxable form. However, by section 47 and paragraph 1, Schedule 11, FA 1965 capital distributions were subjected to income tax and there was then a tax advantage on which section 28 could bite.[147]

Goff J. was of the opinion that the term "assets available for distribution by way of dividend" was in no way limited to distributions out of revenue funds. Brown's case decided that the terms meant legally so applicable. In the judge's view, the only assets not so available were the company's share capital, any share premium account and any capital redemption reserve fund.[148]

Goff J referred to the Hague case[149], particularly the first instance decision of Cross J. In that case distributions were made from a fund having three

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147. p 83
148. Ibid
149. Hague v. IRC (1968) 44 TC 619, infra

constituent elements: the share capital, a capital redemption reserve fund and capitalised reserves. The first two elements were not available for distribution, whereas the third was.[150]

On the question of assets available for distribution, it is useful to consider the forward dividend stripping case of Green v. IRC.[151]

The taxpayer and his wife were the sole shareholders and directors of Henry Streeter (Sunbury) Ltd. The shares in this company were sold to another company, Gensal Securities Ltd. The price was £300,000 payable as to £10,000 immediately and, as to the balance, by instalments. The instalments were funded by dividends paid by Henry Streeter to Gensal.

The notice under section 28(3) stated that the adjustments requisite for counteracting the tax advantage obtained was that the instalments should be treated for surtax purposes as if they were the net amounts of dividends payable under deduction of tax at the date of receipt. The taxpayer appealed, contending, inter alia, that the distributable profit of the company was not sufficient to provide the gross dividends declared.

The Court of Appeal, however, found that the accounts disclosed that there were sufficient distributable profits unless figurse for depreciation of plant and depletion of land values were deducted. No such deductions could be made and, accordingly, the distributable proftis were sufficient.

In Williams v. IRC [152] it was held that loans represented assets available for distribution.

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150. Ibid at p 631
151. (1975) 50 TC 688
152. (1980) 54 TC 257

This case concerned another scheme marketed by Godfrey Bradman. It had three groups of transactions, "the property transactions", "the share transactions" and "the loan transactions". The first two groups were identical to the transactions in the Anysz case.[153]

Five individuals held shares in Kithurst Park Estates Ltd. ("Kithurst") which acquired farmland on which planning permission was obtained. As a result of the property transactions, the details of which have no relevance to the present discussion, the company was left with a distributable profit of £422,255.

The share transactions included the exchange, by the individuals, of their Kithurst shares for shares in Gristrim Investment Co. ("Gristrim"), Kithurst becoming a wholly-owned subsidiary of Gristrim. An election was made under section 48 FA 1965[154] under which Kithurst paid a gross dividend of £422,000 to Gristrim.

As part of the loan transactions, Dolerin Investments ("Dolerin") was incorporated. Although Dolerin was not initially owned by the individuals, it agreed to lend £84,200 to each of them (i.e. £421,000) interest-free (apart from the first seven days). The loans were repayable on demand, but no such demand was to be made unless repayment was demanded from all the shareholders. The share capital of Dolerin was later sold to Gristim for £421,250 and the individuals became directors of Dolerin. It is a matter of passing interest that the Case Stated discloses that the loan agreements were in a form settled by Raymond Walton QC, later Walton J. The scheme itself, however, was approved by C.B. Beattie Q.C., Counsel for the taxpayers in this appeal. The

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153. Anysz v. IRC (1977) 53 TC 601, supra
154. Now section 247 ICTA 1988.

taxpayers were served with notices under section 460(3) which specified two alternative re-computations of the liability to tax:

(a) relating to the year 1969/70 (when the property and share transactions took place) on the basis of a tax advantage obtained by the receipt of the Gristrim shares;

(b) relating to the year 1970/71 (when the loan transactions took place) on the basis of a tax advantage obtained by receiving loans made by Dolerin.

The Special Commissioners upheld the notices for 1969/70 and dismissed those for 1970/71. Both sides appealed.

In the High Court, the case was heard by Browne-Wilkinson J. As the property and share transactions were the same as in the Anysz case and, as Browne-Wilkinson J. had also heard the Anysz case, he naturally reached the same decision that the case came within circumstance D for the same reasons. The 1969/70 assessments were therefore upheld.

At the beginning of Browne-Wilkinson J's judgment, the judge gave an indication of why taxpayers entered into such complex and artificial schemes as those implemented in the Williams case. The judge pointed out that the Williams' family, the individuals who held the shares in Kithurst, wanted to sell the farmland owned by Kirhurst and to use the proceeds to finance projects of other companies they owned: a sensible business approach. However, to say the tax position was prohibitive would be substantially to understate the position. Counsel for the taxpayers estimated that the effective tax rate, taking into account all of the taxes involved, wouild be between 98% and 99%. The Crown's estimate was 91 1/4%. As the judge commented:

"Not surprisingly with these rates of tax, the taxpayers took steps to see if the tax burden could not be mitigated".[156]

In the Court of Appeal, the taxpayers, in addition to the other points, argued that, even if circumstance D did apply, a counteraction of that tax advantage was precluded by paragraph E(2) unless and except to the extent that the share capital of Gristrim was repaid.[157] The Crown, in relation to the 1970/71 assessments, argued that the taxpayers had obtained tax advantages since they had received interest-free loans from Dolerin which were, in substance, the moneys available for distribution by Kithurst, and the actual receipt of these loans could be contrasted with a hypothetical receipt consisting of a dividend paid directly by Kithurst to the shareholders. The Crown contended that both circumstance C and D were satisfied.

The Court of Appeal allowed both the taxpayers' appeals and the Crown's cross-appeal. As far as the taxpayer's appeals were concerned, the Court of Appeal agreed with their curcumstance E point[158] but, on the Crown's cross-appeal they held that the taxpayers had obtained tax advantages because it was not necessary to compare like with like as regards the receipt obtained, and that circumstance C did apply.

The House of Lords dismissed the taxpayers' appeals and found it unnecessary to decide the Crown's cross-appeal on the circumstance E point. The Law Lords held that, by receiving cash in a non-taxable form from Dolerim in the form of interest-free loans, the taxpayers avoided possible assessments which could have been made had equivalent sums been received by way of dividend from Kithurst; and they thus obtained, or were in a position

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156. p286
157. This is considered infra.
158. Infra.

to obtain, tax advantages.[159] It was also held that circumstance D was present and that the tax advantages had been obtained in consequence of the combined effect of two or more transactions in securities (i.e. the various transactions in securities implemented through-the scheme) even though one or more links in the chain of operations may not themselves have been transactions in securities. Furthermore, the making of the interest-free loans were themselves transactions in securities.[160]

The Inland Revenue were therefore entitled to counteract the tax advantage by the notices they gave and the assessments they made for 1970/71.

On the circumstance D point, Viscount Dilhorne, with whom the other Law Lords agreed, was of the opinion that:

> "In connection with the distribution of profits of a company (Kithurst) to which that paragraph applies, [the taxpayers] received without paying or bearing tax a consideration which represented the value of assets which would have been available for distribution to them by way of dividend but for the steps taken by that company".[161]

The case of Hague v. IRC[162] concerned a husband and wife who owned ordinary stock in a cotton-spinning company, Hagues Textile Ltd. The Company sold two mills and, in view of the consideration received, it found itself with surplus funds. It therefore decided to pay out to the stockholders £284,235 by means of reduction of capital.[163] The company's issued share capital consisted of £284,235 ordinary stock and there was a capital redemption reserve fund of £60,000 created in respect of redeemable preference stock which had already been redeemed.

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159. This point is dealt with supra.
160. This point is also dealt with supra.
161. p.308
162. (1968) 44 TC 619
163. A dividend was not considered because of the surtax consequences.

By resolutions passed in November 1959, the issued ordinary stock was increased to £437,725 by capitalising the capital redemption reserve and £129,490 standing to the credit of the profit and loss account, the additional amounts being credited to stockholders pro rata to their existing holdings. In November 1960, it was resolved to reduce the company's capital by £284,235 by returning 12/- in the pound to the stockholders.

Both Mr. and Mrs. Hague received notices under section 28(3). For reasons dealt with above, the Court of Appeal held that section 28 did not apply to Mrs. Hague. On the other hand, it was held that the section did apply to Mr. Hague and the question was how much of the consideration received by him represented assets "available for distribution by way of dividend".

On appeal, the taxpayers argued that the sums paid to them represented a return of the sums paid by the subscribers for the stock in issue prior to November 1959. Alternatively, if this were wrong, it was argued that the sums received came out of the total post-capitalisation capital. Cross J accepted this. Mr. Hague's payment came out of capital of £473,725 consisting of £284,235 and £60,000, which were not available for distribution by way of dividend, and £129,490 which, prior to its capitalisation, was available. Therefore, he applied to the payment received by Mr. Hague the fraction 129,490 over 473,725.[164]

The Inland Revenue were not satisfied with this and they appealed successfully to the Court of Appeal. The judges of the Court of Appeal considered that the correct fraction to apply was 129,490 over 284,235, namely, the undivided profits capitalised immediately before the reduction (less the £60,000 in the capital reserve fund)

164. p.631

over the total amount paid on the reduction. In effect, therefore, the sum paid to the shareholders was allocated to the bonus issue rather than to the capital as a whole, despite the fact that the 12/- returned on the original shares could not be returned to shareholders later.

Less than two months after the Court of Appeal delivered their judgments in the Hague case, Plowman J heard IRC v. Horrocks[165], in which the order of events was reversed: in Hague the capitalisation preceded the reduction, whereas, in Horrocks, the reduction preceded the capitalisation.

Plowman J held that this reversing of the order did not help the taxpayer because the resolutions for the reduction of capital and the capitalisation of profits were parts of a single composite scheme. The judge commented:

> "Mr. Major Allen, for the taxpayer, concedes, and in my judgment rightly concedes, that if in the present case the restoration of capital had preceded the reduction then the present case would be indistinguishable from Hague. But he submits that the reduction preceded the restoration of capital and that this makes all the difference. He submits that, if Mr. Horrocks received in a non-taxable form a sum of money which he might have received in a taxable form, it is because he received it in consequence of a reduction of capital and for no other reason. He submits that either the money was never available for distribution by way of dividend or that it represented a return of money paid by subscribers on the issue of shares. He argues that, although Mr. Horrocks did not in fact receive his £692 5/- until after the capital had been restored

165. (1968) 44 TC

by a capitalisation of profits, he would still have received it if the capital had never been restored at all, and that it was, therefore, obtained on consequence of reduction of capital and nothing else. I need not pause to consider whether these arguments would be valid if the relevant transaction had been a reduction of capital and nothing else, because in my judgment it was not. It seems to me to be completely unreal to divide up a single scheme into parts in that way, and then to suggest that one part preceded another. In my judgment there was only one transaction which was a composite of all its parts and it makes no difference whether the resolution were passed in one order or another".[166]

In view of the fact that the two steps in Horrocks were undeniably part of the same scheme (the increase in capital and the bonus issue being contingent on the reduction of capital taking effect), Plowman J's decision is not surprising. The judge, as can be seen from the passage quoted above, did not consider what the position would be if the two transactions had not been part of the same scheme. It has been shown above that, for the purposes of circumstance C, there must be some causal connection between the transaction and the dividend, denoted by the use of the word "whereby": see the Garvin case.[167].

The structure of circumstance D is different. For D to apply, it must be shown that the taxpayer receives tainted consideration "in connection with" a distribution of profits. It is now clear that there does not have to be such a strong causal link in D situations (denoted by "in connection with") as in C situations (denoted by "whereby").

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166. p.656
167. IRC v. Garvin (1981) 55 TC 24., supra

This was established in two cases dealt with already on the question of "tax advantage": Anysz v. IRC[168] and Emery v. IRC[169].

In the Anysz case, Browne-Wilkinson J had little difficulty in deciding that circumstance D applied. He noted that Counsel for the taxpayers accepted that the payment of the dividend by Kenyon to Pelkem was a distribution of profits to a "D" company, and that the taxpayers received the Pelkem shares, representing assets which were available for distribution by way of dividend, in a non-taxable form. It therefore remained to decide whether the receipt of the Pelkem shares by the taxpayers was "in connection with" the payment of the dividend by Kenyon to Pelkem. On this, the finding of the Special Commissioners had been clear. They stated:

> "In short, what the transactions accomplished was the payment of £454,000 from [Kenyon] to Pelkem, leaving [Kenyon] hopelessly insolvent once it receievd its tax assessments, while enabling the [taxpayers] to retain control of the £454,000 and direct how it should be employed, without incurring the tax which would have accompanied a distribution by [Kenyon] to them. We can see no other point or meaning in the transactions and the [taxpayers] not having told us their meaning, we conclude that their real nature is to be found in what they accomplished, and we so find".[170]

On circumstance D, they found as follows:

> "The [taxpayers] so received such consideration in connection with a distribution of profits of [Kenyon] a company to which D applies. The whole meaning of the share exchange was that it enabled

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168. (1977) 53 TC 601
169. (1980) 54 TC 607.
170. p615

[Kenyon] to make the subsequent distribution, and we find there is a clear connection".[171]

In the light of these findings, Browne-Wilkinson J could not have reached any other decision than the following:

> "In my judgment, the Special Commissioners having found that the purpose of the share exchange was to enable Kenyon to be stripped of its assets by a subsequent dividend, it is impossible to differ from their conclusion that the taxpayers received the Pelkem shares 'in connection with' the payment of the dividend to Pelkem, both the share exchange and the subsequent dividend being consistuent parts of the same scheme. Accordingly, in my judgment, circumstance D was satisfied".[172]

It is clear that it is not necessary that the receipt of the consideration and the distribution of profits are "constituent parts of the same scheme". This can be seen from the findings of Nourse J in Emery v. IRC.[173] Although, as has been seen, the relevant transactions did, in fact, form part of the same scheme, the judgment of Nourse J makes it clear that "in connection with" denotes a relationship no stronger than "having to do with".

The judge first stated that "in connection with" is satisfied by a less definite causal link than that required by "whereby".[174] He then said:

> "I do not think I can do better for this purpose than refer to a definition of these words [i.e. "in connection with"] which was given by McFarlane J. in the Supreme Court of British Columbia in Re Nanaimo Community Hotel Ltd. [1944] 4 DLR 638, where he said this:

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171. ibid
172. p625
173. (1980) 54 TC 607.
174. p 632

'one of the very generally accepted meanings of 'connexion' is 'relation between things one of which is bound up with or involved in another', or, again, 'having to do with'. The words include matters occurring prior to as well as subsequent to or consequent upon so long as they are related to the principal thing. The phrase 'having to do with' perhaps gives as good a suggestion of the meaning as could be had'

..... I have found that definition a very helpful one, and it is a decisive of this point. In my judgment Mr. Emery's receipt of the £233,409 was clearly related to or had something to do with the distribution of Mersey's profits".[175]

An interesting point on circumstance D arose in IRC v. Garvin [176] a case which has already been considered in connection with circumstance C and the meaning of "tax advantage".

When the Inland Revenue appealed to the High Court, they raised circumstance D for the first time. The High Court, as well as the Court of Appeal and the House of Lords, held that circumstance D did not apply.

At first instance, Slade J was of the view that the Crown had the burden of demonstrating that the necessary conditions for the application of section 460 were present: a burden that it had not discharged.

It will be recalled that circumstance D can only be applied to companies under the control of not more than five persons and companies whose shares are not dealt with on a United Kingdom stock exchange. It does not

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175. pp 632-3
176. (1981) 55 TC 24.

apply to a company under a control of a non-D company.[177] No evidence had been laid before the Special Commissioners (before whom the circumstance D point had not been taken) to show whether, at the time their profits were distributed, the "ABCFS" companies were companies to which circumstance D applied, because they were controlled by Excalibur, as to the status of which there was no evidence.

The Court of Appeal agreed that circumstance D did not apply but the reasoning of the appeal judges was slightly different from that of Slade J.

Donaldson LJ analysed the situation in the following way. Noting the absence of evidence as to the control of the company when the profits were distributed, he said:

> "In the absence of further findings of fact, this is fatal to the Crown's claim that para. D circumstances obtained. However, I must not be taken as being of the opinion that in reaching a decision on the application of para. D the burden is always on the Crown. Such a conclusion would ignore the curious construction of D(2), which first provides that para.D shall apply to companies which meet the criteria set out at (a) and (b) and then provides that nevertheless it shall not apply to some of those companies. In other words, proof of the first state of affairs produces a prima facie applicability of the paragraph, which can be rebutted by proof of the second state of affairs. The paragraph is silent on the burden of proof. Accordingly, the ordinary rule applies that he who must allege must prove. The Crown, which alleges that the paragraph applies, need only prove facts showing prima facie applicability. It is then for

177. Section 704 D(2) ICTA 1988.

> the taxpayer to rebut that prima facie case. Applied to the facts of this appeal, it was for the Crown to prove that at the relevant time the companies were controlled by Excalibur and thus by not more than five persons. It was for the taxpayer to prove that Excalibur was itself not a D(2) company".[178]

Templeman LJ who, as has been explained above, dissented in the Court of Appeal, disagreed. He too pointed out that the ABCFS companies were within circumstance D when the taxpayers received their tainted consideration but that their status when they realised their assets was unknown. He was firmly of the opinion that it was the former date, rather than the latter, that was important in determining whether circumstance D applied to them. His reasoning is apparent from the following passage:

> "Paragraph D deals with two events which must be connected, but which do not necessarily take place on the same date or in any particular order. One date is the date when the taxpayer receives what has been called his tainted consideration in respect of a company. The other date is the date when the company distributes profits or realises its assets. Paragraph D does not apply to all companies, but only to companies of a kind which are most inclined to provide the opportunity and the temptation for the shareholders to accumulate taxable profits and to obtain the benefits of those profits in a non-taxable form. It is logical that the status of a company should be judged by its position on the date when the shareholders obtain a profit in a non-taxable form. If the company subsequently changes its status this change is irrelevant. If this were not the case, para. D would not apply if

178. p.80

the shareholders by or after obtaining a non-taxable benefit, ensured that their shares were transferred to a company to which para.D did not apply. It is impossible that Parliament intended to produce this effect. No difficulties were advanced if the paragraph is construed so as to apply to companies by reference to their status on the date when a non-taxable benefit is obtained. Faced with the choice of two dates, only one of which is consistent with the object of the legislation, I reject [the taxpayer's] submission".[179]

Templemen LJ's analysis does not appear to be borne out by the words of section 704 D (1). The words "company to which this paragraph applies" are linked to the distribution of profits rather than the receipt of consideration. This suggests that the appropriate time for judging whether a company is within D(2) is when the profits are distributed.

When the case went up to the House of Lords, it was unanimously held that the proper date is that of the distribution of profits, the Law Lords expressing similar views to that set out in the previous paragraph.[180] The Law Lords said very little on this point, obviously considering that the point was clear. As to the burden of proof, the House of Lords, although they did not discuss the point, must have taken a different view on the burden of proof from Donaldson LJ who, as mentioned above, thought that it was for the Crown to prove that the relevant companies were controlled by Excalibur, but it was for the taxpayer to prove that Excalibur was itself not a D company.

Lord Wilberforce, on the other hand, held that there was "no evidence that Excalibur was controlled by not more

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179. p 75
180. See Lord Wilberforce at pp 84-5

than five persons, and in the absence of such evidence the Crown must fail".[181] The burden of proof was assumed to be with the Crown. Similarly, Lord Russell stated that:

> "there is no evidence to show that, at the time of the declaration of dividends, ABCFS were close companies, that question depending on the 'make up' of Excalibur. The question must, in my opinion, clearly fall to be resolved in the light of the situation at the time of the distribution of profits, and the Crown adduced no evidence on the point, no doubt because the Crown before the commissioners never thought of relying on para. D. Thus the Crown fails on para.D".[182]

Again, the burden of proof was assumed to be on the Crown, as Slade J, but not Donaldson LJ, had thought.

This difference of opinion might well explain the fact that in Emery v. IRC[183] the lack of evidence on the very same point went against the taxpayer. The Special Commissioners heard the Emery appeal before the High Court stage in Garvin, and Nourse J heard Emery in the High Court after Garvin was dealt with by the Court of Appeal, but before the House of Lords had heard the case. So the Commissioners in Emery did not have Slade J's view that the onus was on the Crown, and Nourse J only had the Court of Appeal analysis that the onus on this point was on the taxpayer.

This point is given added interest when it is considered that the two cases involved similar Bradman schemes and that Counsel for the taxpayer was the same, C.N. Beattie QC. The Special Commissioners in Emery were clearly of the opinion that the burden of proving that the company

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181. p84

182. p87

183. (1980) 54 TC 607

in the same position as Excalibur in Garvin, Tishmear, was not a D company, was on the taxpayer. This is apparent from this passage from the Case Stated:

> "There was some argument as to whether Mersey, once it had become a wholly-owned subsidiary of Tishmear was a company to which paragraph D applied. It was clear from the evidence that paragraph D(2)(a) was satisfied and [Counsel for Mr. Emery] eventually conceded that the complicated cross-holdings of shares in the group of companies .. which held shares in Evidro Investment Co. Ltd., of which Tishmear was a wholly-owned subsidiary, was such that he was unable to prove that Tishmear was under the control of one or more companies to which paragraph D did apply".[184]

By the time the case came on to be heard by Nourse J in the light of the Court of Appeal's views in Garvin, presumably it did not seem to be worthwhile to try to turn the lack of evidence on the status of Tishmer against the Crown. In the end, of course, it did not matter because Nourse J held that circumstance C applied as well as circumstance D.

In the most recent case to consider the question of burden of proof, Bird v. IRC[185], Vinelott J expressly followed Donaldson LJ's line and disagreed with Slade J. As Vinelott J. had already held that the Crown won on the circumstance C point, it was not strictly necessary for him to consider the circumstance D point and the question was not dealt with by the Court of Appeal or the House of Lords, yet the views of Vinelott J are interesting in trying to

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184. pp 622-3

185. [1985] STC 584

establish the correct position. It seems that Vinelott J's opinion differs from the views expressed by Lord Wilberforce and Lord Russell in Garvin quoted above and the resolution of the question will, it appears, have to wait definitive treatment by the House of Lords at some future date. Vinelott J. did not refer to the comments of Lord Wilberforce and Russell in Garvin or to the judgment of Nourse J in Emery. The facts of Bird have been considered above in connection with circumstance C.

Vinelott J. pointed out[186] that it was common ground that the loans received by the taxpayers were received "in connection with the distribution of profits" of CCD. There were two such distributions. The first was the grant of the lease and the transfer of the freehold of the Croydon property. At that time, CCD was controlled by the Burston and Texas Bank. The second distribution was the declaration of the dividend by CCD, at which time CCD was controlled by Tishmear. The question was, then, whether the burden of proving that the Burston and Texas Bank or Tishmear was a paragraph D company rested on the Crown or on the taxpayers.

Vinelott J. considered that there was a "vital distinction" between the present case and Garvin. This was that, in Garvin, the Crown did not rely on circumstance D before the Special Commissioners. Counsel for the taxpayers did not dispute the Crown's right to rely on circumstance D, subject to the qualification that such reliance was based exclusively on findings of fact made by the Commissioners.

The judge noted[187] that in Garvin at the relevant time, the ABCFS companies were under the control of Excalibur and that there was no evidence as to the ownership of the sharse of Excalibur. He then considered the approaches

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186 p639
187. pp 639-40

of Slade J and Donaldson LJ to the problem and preferred the views expressed by Donaldson LJ. The true position, according to Vinelott J was:

> "If the Crown relies on para.D the burden of showing that the relevant company was a para D(2) company falls on the Crown. The Crown may seek to discharge that burden by showing that at the relevant date the company was under the control of another company; the burden then shifts to the taxpayer to show that that company was not a para D(2) company".[188]

He then expanded on his view that the present case could be distinguished from Garvin. He said:

> "In the instant appeals the admitted facts showed that at the relevant dates CCD was controlled either by the Burston and Texas Bank or by Tishmeasr. The Crown claimed before the commissioners that those two companies were para D(2) companies. In my judgment, the burden of proving that these two companies were not para D(2) companies then fell on the taxpayers. In Garvin it was similarly conceded that at the relevant time the ABCFS companies controlled by Excalibur. But the Crown did not rely on para D before the Special Commissioners and the taxpayers accordingly had no occasionto adduce evidence to show that Excalibur was not a para D(2) company. The Crown could not therefore rely on the taxpayers' failure to discharge that burden of proving that Excalibur was not a para D(2) company in the appeals to the High Court. As I understand it, it was on that ground that the appeal on this point was not pursued in the Court of Appeal. Of course, Counsel for the taxpayers, in that case, not surprisingly declined an invitation

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188. p 641

by the Crown that the case stated should be remitted to the Special Commissioners to hear further evidence on the point".

It is not clear whether this distinction is a supportable one. The comments of Slade J and Lords Wilberforce and Russell cannot be said to support this reasoning, although it is true that they did not have to deal with this point directly, as Vinelott J had to. Neither the Court of Appeal nor the House of Lords in Bird was called on to consider the matter, Sir Nicholas Browne-Wilkinson V.C. merely commenting that the point "turns on a question on which there is a division of judicial opinion".[190] Further judicial clarification on this important matter is awaited. There is no way of knowing to what extent, if at all, Vinelott J's sympathy for the Crown's argument on this point was influenced by the fact that he was leading Counsel for the Crown in the High Court (but not the Court of Appeal or the House of Lords) in Garvin.

189. Ibid
190 [1987] STC 168 at p176.

Circumstance E

Circumstance E was added by section 39(3) FA 1966. The wording of the paragraph is as follows:

> "E(1) That in connection with the transfer directly or indirectly of assets of a company to which paragraph D above applies to another such company, or in connection with any transaction in securities in which two or more companies to which paragraph D above applies are concerned, the person in question receives non-taxable consideration which is or represents the value of assets available for distribution by such a company, and which consists of any share capital or any security ... issued by such a company.
>
> (2) So far as sub-paragraph (1) above relates to share capital other than redeemable share capital, it shall not apply unless and except to the extent that the share capital is repaid (in a winding-up or otherwise), and where section 703 above applies to a person by virtue of sub-paragraph (1) above on the repayment of any share capital any assessment to tax under sub-section (3) of that section shall be an assessment to tax for the year in which the share capital is repaid".

In other words, circumstance E deals with the case where there is a transfer of assets (including trading stock) between two "D" companies, or where there is a transaction in securities in which two or more "D" companies are concerned, in connection with which the taxpayer receives non-taxable consideration consisting of, or representing, the value of assets available for distribution, and being in some way related to share capital or securities of the company. The paragraph does not require there to be any connection between the "D" companies involved. The ultimate form of the benefit contemplated is by way of a reduction of capital, or a repayment of capital on a winding-up, or a redemption of securities. Where the share capital of a company consists of non-redeemable share capital, the operation of circumstance E is limited to the case where there is either a reduction or repayment of capital, for example, in a winding-up. This would include a redemption of, or purchase by, the company of its shares under the "purchse of own shares" provisions.

The case of Williams v. IRC[191] which has already been examined dealt with, amongst other things, the relationship between circumstances D and E.

Circumstance E was first raised before the Court of Appeal by the taxpayers. They argued that, even if a tax advantage had been obtained within circumstance D, the words "in connection with the transfer directly or indirectly of assets of a company which paragraph D ... applies to another such company" in section 704 E(1) brought their scheme within circumstance E and, accordingly, the taxpayers were entitled to the deferment under section 704 (E)(2); in other words, paragraph E(2) precluded counteraction of the tax advantage unless and except to the extent that the share capital of Gristrim was repaid.

The Court of Appeal allowed the taxpayers' appeal on this point because, they held that, where a taxpayer receives non-taxable consideration under paragraph E(1), it must have been intended that the taxpayer should be entitled to the benefit of the deferment of liability provided for by paragraph E(2).

This finding was explained by Bridge LJ[192]. Referring to what he called the "first limb" of circumstanc E (that

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191. (1980) 54 TC 257
192. pp 296-7 - See Cumming-Bruce LJ at p303 who was of the same opinion.

part of the paragraph which speaks of a connection with the transfer of assets between two "D" companies), he noted that, of all the relevant definitions and cross-references are applied and compared to the provisions relating to the circumstances envisaged by circumstance D, it is apparent that any case falling within the first limb of circumstance E must necessarily also be a case falling within circumstance D. He continued.

> "For those reasons it seems to me perfectly clear that Parliament intended that where a person receives a non-taxable consideration under para E's first limb by virtue of a transfer of assets between companies to which para D applies, representing the value of assets available for distribution by such a company, and also consisting of share capital, notwithstanding that those circumstances fall within the wide ambit of para D, it must have been intended that the taxpayer concerned should be entitled to the benefit of the deferment of his liability to taxation which is specifically provided by sub-para (2) of para E. If it were otherwise then the first limb of para E, coupled with the exemption which sub-para (2) provides, would be totally ineffective for, in every case, it would be open to the Revenue to say: 'You may be within para E entitled to deferment under sub-para (2) of that paragraph, but we can make you immediately liable because the circumstances of the transactions in which you have engaged and in consequence of which you have obtained a tax advantage also fall within para D of section.461'.

The House of Lords did not have to deal with this point because the taxpayers' appeal on the interest-free loan point[193] failed. This meant that, on that point, the taxpayers had obtained a tax advantage by virtue of transactions which were within D but not E. It was therefore unnecessary to consider the Crown's cross-appeal against the Court of Appeal's findings on the interaction of circumstances D and E. The Court of Appeal's findings, therefore, still stand. On a proper construction of the section, it is submitted that the analysis of Bridge and Cumming-Bruce LJJ is correct.

The precise nature of the deferment provided for in paragraph E(2) has yet to be explored by the courts. It seems clear from the wording of the paragraph that it is not a liability that is deferred but only a counteracting assessment under section 703(3). That counteracting assessment, when it is eventually issued, need not be on the person who receives the proceeds. Similarly, the tax advantage the counteracting assessment seeks to nullify might not even be the repayment itself. If this is right, a person who has ceased to hold the shares before the repayment could still, in appropriate cases, be caught by circumstance E.

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193. Supra.

The Exceptions

Section 703(1) provides for three exceptions from the operation of the anti-avoidance provisions. A person who obtains a tax advantage in consequence of a transaction in securities within one of the circumstances in section 704 will be within section 703:

> "unless he shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained ..."

It will be seen that there are two limbs: a taxpayer has to show both that the transactions were carried out for bona fide commercial reasons (or in the ordinary course of making or managing investments - but this does not tend to give rise to many problems) and that none of the transactions had as a main object the obtaining of tax advantages.

The nature of the exception was examined in one of the earliest cases on what was then section 28 FA 1960. The case was IRC v. Brebner.[194]

The taxpayer was a director and shareholder of a company carrying on business as coal merchants. In 1959 a takeover bid was made for the company which, if successful, was likely to put an end to the business. The taxpayer and most of the other directors had interests in fishing companies which received favourable terms from the company and which would be in difficulties

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194. (1969) 43 TC 705

if the company ceased to operate. The taxpayer and five other directors, therefore, made a counter-offer, which was successful, at a price based, not on the company's earning capacity, but on the need to defeat the original offer. The money was advanced by a bank on condition of early repayment.

Subsequently, a scheme was prepared by the company's auditors whereby, in December 1960, the company resolved to increase its paid-up share capital from £60,000 to £135,000 by capitalizing £16,527 from capital reserve and £58,473 from revenue reserve, and then to reduce its capital to £60,000 and repay the balance to the shareholders. The reduction was confirmed by the court.

The taxpayer and the other shareholders applied the sums received by them in reducing their loans from the bank. The Inland Revenue gave notice to the taxpayer that the adjustdment requisite to counteract the tax advantage was that his liability to surtax for the year 1960/61 should be computed on the basis of treating 75,000 of the sum received by him as the net amount of a dividend payable under deduction of tax at the date of receipt.

The taxpayer admitted that there was a transaction in securities and that a tax advantage had been obtained.[195] However, the Stated Case also disclosed that the shareholders involved were mainly concerned, by the acquisition of the additional shares, to preserve the company in its existing line of business.[196]

In the circumstances, the Commissioners found that the transactions in question were entered into for bona fide commercial reasons and did not have as one of their main objects to enable tax advantages to be obtained.

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195. See para V of the Stated Case, p.706
196. See para VII of the Stated Case p.709

In the Court of Session, the Lord President (Clyde), with whom the other judges agreed, noted that the question of what was in the mind of the taxpayer was essentially a matter of fact and of inference for the Commissioners.[197] This being the case, it was no easy task for the Revenue to persuade the Court to overturn the Commissioners' finding, the general rule being, of course, that it would have to be proved that no body of Commissioners acting judicially and properly instructed could come to the same conclusion. The Revenue sought to overcome this difficulty by splitting up the transactions and isolating one of them which had as its main object the obtaining of a tax advantage. The Lord President did not accept this, saying:

> "The transaction which the argument sought to isolate from its context was a decision of the company to capitalise certain of its reserves and to apply the resulting capital sum in paying up in full ordinary shares which were allotted to the shareholders, including the [taxpayer]. There is no doubt that this transaction did result in a tax advantage to the shareholders, including the [taxpayer], but that is not the issue in this case. The material question is not what was the effect of each or all of the inter-related transactions; the question is what was the main object or objects for which any of them was adopted. Section 28(1) of the Act draws a clear distinction between effect and object. It was to this latter question that the Special Commissioners rightly directed their attention".[198]

It was also noted that the taxpayer had been content to leave the method of implementing the overall scheme to the auditor and no question of securing a tax advantage

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197. p 713
198. Ibid

was ever a factor taken into account. The object was a bona fide commercial one in which tax considerations played no part".[199]

The House of Lords unanimously dismissed the Crown's appeal.

Lord Pearce agreed that it would be wrong to try to isolate one of the transactions.[200] He also stated that the "object" to be considered was a subjective matter of intention and, following from this, he took an identical line to that adopted by The Lord President in saying that what had to be ascertained was the object, not the effect, of each interrelated transaction in its actual context, and not the isolated object of each individual part.[201]

The importance of the Commissioners' findings on this matter was emphasised when Lord Pearce noted that:

> "They could have reached a contrary conclusion, which would have been equally unassailable, had they taken a different view of the evidence. But it was they who heard the witnesses, and I see no reason to suppose that their decision was not just and sensible".[202]

On a more general matter of principle, as regards the "object" test, Lord Upjohn commented:

> "My Lords, I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out - one by paying the maximum amount of tax; the other by paying no, or much less, tax - it would be quite wrong as a <u>necessary</u> consequence to draw the

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199. Ibid
200 pp 714-5
201. p 715
202. Ibid. Lord Upjohn made the same point at p 718.

inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence".[203]

It is clear from this and the other cases in which the commercial criteria have been considered that the test is one of subjective intention.

Another early section 28 case in which the exceptions were considered was Hague v. IRC[204] which has already been dealt with in connection with the meaning of "tax advantage" and also circumstance D. This case underlines the fact that the "commercial" exception has two parts: a bona fide commercial reason test and a sole or main object test. A taxpayer must satisfy both tests.

The taxpayer argued, inter alia, that the transactions were carried out for bona fide commercial reasons and not with a view to the tax advantage.

The Special Commissioners found that one of the main objects of the transactions was the obtaining of tax advantages, and this was upheld by Cross J. and by the Court of Appeal.

Cross J. noted that the Commissioners plainly considered that the relevant transactions were carried out for bona fide commercial reasons, and that this was not challenged by the Crown in the High Court. Turning to the second limb of the test, the judge commented that it does not

203. pp 718-9
204. (1968) 44 TC 619

follow that, because a tax advantage has been obtained, it necessarily follows that the obtaining of that tax advantage was the main object, or one of the main objects, of the transaction. Nevertheless, whether the obtaining of a tax advantage was merely incidental or was one of the main objects was a question "to which different minds may easily give different answers".[205] The judge, and the Court of Appeal, felt unable to upset the findings of the Commissioners that one of the main objects was the obtaining of a tax advantage because the payment of a dividend had been rejected because of the surtax disadvantages.

A few months after the Court of Appeal decision in Hague, Cross J. heard the case of IRC v. Kleinwort, Benson Ltd.[206]. This case is unusual, in the context of the exceptions, in that the judge overturned the findings of the Special Commissioners on the sole or main object test, although the taxpayer company won both before the Special Commissioners and Cross J for reasons which have already been considered.

The Commissioners found that the transactions were carried out for bona fide commercial reasons but that, since the company could only make the profit on which it was relying by diminishing its profit for the purposes of assessment to income tax by £156,833, one of the main objects of the transactions must have been to obtain a tax advantage.

Cross J. pointed out a fact that is apparent from the way the exception is worded. Although section 28 was aimed primarily at purely artificial transactions into which no-one would think of entering but for the hope of a tax advantage, the section is framed so as to cover bona fide

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205. p630
206. (1968) 45 TC 369. This case has been dealt with in connection with circumstance B, see Part 4.

commercial transactions which are combined with a securing of a tax advantage.[207]

Cross J. noted that in Brebner and Hague the courts refused to overturn the decision of the Commissioners (and Cross J himself heard Hague at first instace). He thought that the situation here was different in that the Commissioner's decision could not possibly be justified. He explained his reasons as follows:-

> "This case, however, is quite unlike the Brebner and Hague cases. Here there was only a single indivisible transaction, and it was an ordinary commercial transaction, a simple purchase of debenture stock. As the purchaser was a dealer, he was entitled to keep the interest element out of his tax return and so was able to pay a higher price than an ordinary taxpayer would have been able to pay. Similarly, a charity, because it would have been able to reclaim the tax, would have been able to pay an equally large price and still make a profit. But it is to my mind an abuse of language to say that the object of a dealer or a charity in entering into such a transaction is to obtain a tax advantage. When a trader buys goods for £20 and swells them for £30, he intends to bring in the £20 as a deduction in computing his gross receipts for tax purposes. If you choose to describe this right to deduct the £20 (very tendentiously be it said) as a 'tax advantage', you may say that he intended from the first to secure this tax advantage. But it would be ridiculous to say that his object in entering into the transaction was to obtain this tax advantage. In the same way I do not think that you can fairly say that the object of a charity or a dealer in shares who buys a security with arrears of interest accruing on it is to obtain a tax advantage, simply because the charity or the dealer

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207. p 382

in calculating the price they are prepared to pay proceed on the footing that they will have the right which the law gives them either to recover the tax or to exclude the interest, as the case may be. One may, of course, think that it is wrong that charities and dealers should be in this privileged position. But if the Crown thinks so, it ought to deal with the matter by trying to persuade Parliament to insert provisions in a Finance Act depriving them of their privileges, not by seeking to achieve this result by a back door by invoking section.28".[208]

The situation with which Cross J was dealing was an exceptional one and in all other cases (apart from one) in which the tests have been considered, the courts have upheld the Commissioners' findings.

In the case of Hasloch v. IRC[209] Foster J emphasised how difficult it can be for the taxpayer to satisfy the relevant tests.

In October 1954, a company of which the taxpayer was a member capitalised £44,130 out of its undistributed taxed profits and applied it partly in paying up new ordinary shares and partly in paying up 14,710 new £1 redeemable cumulative preference shares, which were issued to the holders of the ordinary shares pro rata to their holdings. One of the main objects of this was to bring the share capital up to the kind of capital likely to be permanently employed in the company's trade after a projected expansion. The bonus shares were made cumulative preference shares in order to provide a regular income for shareholders not working in the company, and they were made redeemable to enable the company to get rid of the liability for the preference

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208. ibid
209. (1971) 47 TC 50

dividend if it should become onerous without having to apply to the court.

The shares were redeemed at par on 30th June 1965 and, as a result, the taxpayer received £3,400. The board had in mind, as one of their main objects, getting rid of the annual liability to pay a preference dividend in view of the corporation tax proposals in the 1965 Finance Bill. As a secondary matter, they also had in mind the elimination of the preference shares so as to facilitate a public flotation should it prove desirable. Another of their main objects was putting into the hands of the preference shareholders cash equal to the nominal value of the shares and they had a further object of reducing the liability of one of the shareholders to estate duty. The board were aware that the cash would be tax-free in the hands of the preference sharesholders. They never considered the possibility of converting the preference shares into ordinary shares.

The Inland Revenue issued a notice under section 28(3) in respect of the tax advantage obtained by the taxpayer as a result of the bonus issue and redemption of the preference shares. The taxpayer argued that the transactions were carried out for bona fide commercial reasons and that none of them had, as one of their main objects, the obtaining of tax advantages.

The Special Commissioners found that all the transactions were carried out for bona fide commercial reasons and that the fact that the preference shares were made redeemable when issued was a subsidiary object and not one of the main objects of the redemption to enable tax advantages to be obtained.

In upholding the Commissioners' decision, Foster J spelt out the difficulty facing the taxpayer:

"But the difficulty in the taxpayer's way is this, that the onus is on him to prove a negative, the negative being that he must show that the tax advantage was not the main object or one of the main objects of the transaction. It is not, therefore, necessary for the Special Commissioners in such a case as this to hold that it was, and in this particular case they have come to the conclusion that on the facts as found by them the [taxpayer] failed to discharge the onus which the section imposes on him to satisfy them that he does not come within the provisions of section.28. Further than that, I, in order to upset the findings of the Special Commissioners, really have to hold that they came to a conclusion which they could not reasonably come to upon the facts".[210]

Not only does this case, like Hague, show that the taxpayer must satisfy both limbs of the test to be excluded from the section; it also demonstrates that the sole or main object test must be satisfied in respect of all of the relevant transactions, and not just the series of transactions as a whole.

The application of the test can, therefore be far from straightforward. This fact is borne out by a comparison of the next two cases.

The first of these is a case already considered in connection with circumstance D: IRC v. Brown.[211] In this case the taxpayer stated in evidence that the reason for the sale of the shares to General Auto-Work Ltd. was that he and his wife wished to buy property for their retirement in Jersey.

The Tribunal appointed for the purposes of section 28 decided:

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210. p58
211. (81971) 47 TC 217

> "that on all the evidence, oral and written, the [taxpayer] had not shown to our satisfaction that the sale of the shares in the five companies to General Auto-Work Ltd. was carried out for bona fide commercial reasons, or in the ordinary course of managing investments".

Megarry J and the Court of Appeal held that the Tribunal were justified in deciding that the transaction had not been shown to have been carried out for bona fide commercial reasons. In the Court of Appeal,Russell LJ with whom the other two judges agreed, observed:

> "that most of the .... evidence amounts really to no more than saying that the taxpayer and his wife wanted some money and entered into the transaction in order to get it. Now it seems to me that you do not show that a transaction of sale of securities for full consideration to a company already owned by you is a transaction entered into for bona fide commercial reasons merely by saying that it is such a sale transaction and that you wanted the money".[212]

Before the second case is compared, there is one other point about the commercial exception arising from the Brown case that should be mentioned. The Crown gave evidence that the taxpayer, in managing the affairs of his companies, had taken every opportunity to minimise tax. Russell LJ saw "no reason to suppose that the Tribunal considered that past tax awareness necessarily in any case leads to a conclusion adverse to a taxpayer on this point" [i.e. on the question of the commercial exception].[213]

Returning to the first passage cited from Russell LJ's judgment, this can be compared with a later case in which the taxpayer required money and entered into transactions

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212. p239
213. Ibid

in order to get it, and in which he satisfied the commercial test.

The case was Clark v. IRC[274]. Two brothers, Robin and Colin Clark, each held 37.4% of the issued share capital of a family investment company, The Equity Trust Ltd. ("Equity"), which on 5th April 1970 had reserves on profit and loss account of £28,576 and capital reserves of £487,824. Equity held 32.6% of the issued share capital of Caledonian Associated Cinemas Ltd. ("Caledonian"), a quoted public trading company.

On 5th April 1970 the two brothers also each held half of the issued share capital of Highland and Caledonian Finance Ltd. ("Highland"), whose only substantial asset was a holding of 20% of the capital of Caledonian.

On 6th April 1970, the two brothers sold all their Highland shares to Equity for a total of £102,000 in cash, a price which reflected the value of the underlying Caledonian shares.

The Special Commissioners found that the sale of the shares owned by Robin, who was a farmer, was a transaction carried out in order to provide cash for the purchase of an adjoining farm and that there were good commercial reasons for the purchase. Robin's choice of Equity as purchaser was largely dictated by the wishes of his father who was anxious that control should remain with the family.

The Special Commissioners found that Robin's transaction did not have as a main object the obtaining of tax advantages, but that it was not carried out for bona fide commercial reasons because, in order to satisfy these provisions, the commercial reason must be connected with the vendor's interest in the companies concerned in, or affected by, the transaction.

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214. (1978) 52 TC 482

Fox J. in the High Court allowed the taxpayer's appeal on the basis that the Commissioners had misdirected themselves, having posed the wrong question: there was no such limitation on the words "bona fide commercial reason" as they had suggested.[215]

Fox J noted that it was not in dispute that the transaction was, in every respect, bona fide. The dispute was whether it was carried out for commercial reasons. This had to be decided by looking at the transaction in the context of all the circumstancs which gave rise to it. Looked at by itself, the reason for the sale of the Highland shares, from Robin's point of view, was simply to obtain money. That sale could not, however, be looked at in isolation; it had to be considered against the background of the facts which gave rise to it and, in particular, of the circumstances which set the whole matter in motion, which was Robin's intended purchase of the farm.

After referring to the Brebner case the judge continued:

> "In the present case, it seems to me the sale of the shares was merely part of a whole which was dominated by Robin's wish to acquire [the farm]. The sale of the shares had no purpose other than to finance that purchase, any more than the extraction of the money from the company in Brebner had any purpose but to pay (by discharging the debt to the bank) the purchase price of the shares in that case".[216]

Fox J cited the first of the passages of Russell LJ in Brown quoted above. Fox J said that what Russell LJ had said was "plainly correct".[217] Whether the transactions were carried out for bona fide commercial reasons

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215. p 494

216. p 495

217. p 496

depended on all the evidence, one of the pieces of which was that the taxpayer had, over the years, taken every opportunity to minimise his tax. The judge said that it was not conclusive against the taxpayer, but it was a factor that the tribunal was entitled to consider. The present case was, in his view, "a perfectly honest transaction entered into .... without the object of obtaining tax advantages" and the predominant reason for it was wholly commercial.

There was not an enormous difference between the positions of the taxpayers in Brown and Clark: both wanted money and entered into the transactions in order to get it. Although, on the facts of these two cases the reasons why one won and the other lost are readily apparent: in some cases it could well be difficult to see which side of the line they fall.

One thing is abundantly clear from Clark. Fox J's rejection of the Commissioners' reasons for holding that the taxpayer failed to satisfy the test means that the commercial reason does not have to be connected with the taxpayer's interest in the companies concerned in or affected by, the transaction.

The wish to retain family control was also one of the factors leading the Court of Appeal and the House of Lords to decide that there was a bona fide commercial reason in IRC v. Goodwin.[218] In addition, the reluctance of the courts to overturn the findings of the Commissioners as regards the commercial test was emphasised.

R. Goodwin & Sons (Engineers) Ltd. was a family company incorporated in 1935. Prior to 2nd April 1951, the issued share capital, consisting of 8,905 ordinary shares of £1 each, were held as to 30% by the taxpayer, 40% by his father and 30% by his uncle. The father and uncle

218. (1976) 50 TC 583

were not in good health and it was appreciated that if either or both of them died a considerable amount would have to be found to pay estate duty, possibly necessitating the sale of the shares by the personal representatives, leading to a break-up of the family control of the company.

To guard against this possibility, in 1951, the company capitalised a sum of £44,525 from its profit and loss account and distributed it to the shareholders by way of bonus issue in the form of 44,525 6% redeemable cumulative preference shares of £1 each. The taxpayer received 13,355 of these shares.

In 1958, in order to provide the family with funds to meet the prospective estate duty liabilities, and also with a view to obtaining a Stock Exchange quotation and so providing access to funds for a further expansion of its trade, it was decided to make a public flotation of some ordinary shares and, for that purpose, to convert half the ordinary shares into deferred shares which would be retained by the family. It was then discovered that the preference shares were not in fact redeemable because they had been created by an ordinary resolution as opposed to a special resolution as demanded by the company's articles. There having been no change of shareholdings since they were issued, in August 1958 those shares were converted into deferred shares and £44,525 was capitalized from the profit and loss account and applied in paying up 44,525 6% £1 redeemable preference shares, in order to put the shareholders into the same position as if the resolution of 1951 had not been defective. The taxpayer received 13,355 of these and, on 1st September 1958, transferred them to his wife with the object of safeguarding his family's position in the event of his death. The shares were redeemed in 1963.

The Inland Revenue gave notice to the taxpayer that the adjustment requisite for counteracting the tax advantage obtained was the recomputation of his liability to surtax for 1963/64 on the basis that the redemption moneys should be treated as net dividends payable under deduction of tax.

The taxpayer contended that the relevant transactions were carried out for bona fide commercial reasons and did not have as a main object to enable tax advantages to be obtained.

This was one of the rare occasions on which a judge, in this case Walton J, overturned the Commissioners' finding on this point. However, the Court of Appeal and the House of Lords both restored the Commissioners' findings and both emphasised that it is only in exceptional cases that a court should overturn the Commissioners on this matter. The Special Commissioners held that the main object of the 1951 bonus issue was a purely commercial one and the obtaining of tax advantages was not a main object, and that the main object of the 1958 issue was also purely commercial, being to restore the position thought to have been created in 1951. They also held that the redemption itself was carried out for bona fide commercial reasons, namely, to implement the bargain made with the public in 1958.

Walton J noted that two of the points to emerge from Brebner were that the commercial test had "to be found in the minds of those who carry out the challenged transaction in securities" and that "what is in reality all one transaction has to viewed as a whole".[219] On the

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219. p 600

authorities, these points are undeniably correct but Walton J went wrong in his application of them.

He held that the motives of those who procured the issue of redeemable preference shares in 1951 were to make provision for estate duty, and so avoid a sale of shares with the consequential loss or control. This was, in the judge's view, "obviously a prudent and intelligent thing to do" but this was a "financial", not a "commercial" motive:

> "Steps were taken to meet an expected financial impost (in the shape of estate duty) in the least expensive manner, so as to retain as much as possible of this profitable company in the family".[220]

The judge did not think the situation was materially altered by the 1958 transaction which was to restore what was thought to be the original position. There was, he thought, no independent motive of a sufficient nature to render the transaction commercial when its real object was to restore an issue of shares created for what he had ruled to be financial, and not commercial reasons.

As regards the actual redemption, which was the transaction actually conferring the tax advantage, this was, in the judge's view, "in gremio" the original issue of shares. Walton J rejected the suggestion that the redemption was effected for a commercial reason in that it implemented a bargain made with those who accepted the offer of shares on the public flotation:

> "It was not part of the bargain with such shareholders that the preference shares should be redeemed; they took their shares subject to that already existing right".[221]

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220. pp 600-1
221. p 601

The Court of Appeal took a different view of the question. They held that the retention of family control of a business was capable of being a bona fide commercial reason and accordingly that the Commissioners were justified in concluding that the object of the bonus issue in 1951 was commercial. Russell LJ delivering the judgment of the court, did not find Walton J's approach, in deciding the reason to be financial rather than commercial, to be persuasive. He said:

> "It is not unknown for the prosperity of a business to depend in part on the very fact that it is an old-established family business and continues as such under family control and management, both in the context of company-customer relationships and of the employer-employee relationship".[222]

The Court of Appeal then held that the Commissioners' similar conclusion as to the issue in 1958 was also justified, particularly as it was necessary for the success of the flotation, which was to be made with a view in part to the advantage of the company and its business.

Regarding the redemption in 1963, this was the fulfilment of the expectation of the shareholders on the basis of which the flotation went through. The redemption as a transaction, however, could not be looked at in isolation. As Walton J had said, the redemption was "in gemio" the 1958 issue and, had he taken the view that the 1958 transactions were carried out for bona fide commercial reasons, the Court of Appeal had no doubt that Walton J would have considered that label equally appropriate to the 1963 redemption.

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222. p 608

At the end of his judgment, Russell LJ emphasised the importance of the findings of the Commissioners. He said:

> "The main points for decision in this case - the objects and reasons of and for the transactions in question - are pre-eminently questions of fact (and indeed of subjective fact) for determination by the commissioners with expertise in this sort of field, and in the rarest case should a court find itself able to disagree with them".[223]

The decision of the Court of Appeal was affirmed by the House of Lords. The Law Lord's decision was unanimous, although Lord Morris was impressed with the reasoning of Walton J and it was only after hesitation that he eventually came to the view that the Courts of Appeal's reasoning was to be preferred".[224]

The importance of the findings of the commissioners emphasised by Russell LJ was stressed even more by Lord Edmund-Davies. He said that he could not help thinking that the commissioners might well have arrived at different findings of fact on the available material and that, had they done so "those different findings would have been unassailable". Furthermore, he added:

> "There are certain features of that evidence which leave me personally unconvinced that I should have arrived at the same findings of fact, subjective as well as objective, as those formed by the commissioners. But that is not the test ... I find it impossible to say that the <u>only</u> reasonable conclusion on the facts found is inconsistent with the determination come to in the instant case ..."[225]

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223 p 609
224. p 610
225. p 616

Finally, it remains to consider the case of Addy v IRC.[226] One of the taxpayer's contentions was that the transactions were carried out for bona fide commercial reasons and did not have as one of their main objects the obtaining of a tax advantage. Their findings on this were set out in paragraph 10(2) of the Case Stated:

> "The allotment of shares and the liquidation were, as we have found, parts of a single comprehensive scheme. The prime object of that scheme was to free the liquid resources of Oldco and allow the shareholders to use their proportions of these cash resources for their own purposes and at the same time to allow the undertaking of Oldco to be carried out just as it had been before, but under the aegis of Newco. The evidence adduced before us has established that the liquidation and the allotment of shares were not undertaken to advance the business or undertaking of Oldco ..... Further, we find that one of the main objects was to get the liquid assets of Oldco into the hands of its shareholders without any liability to tax on their part and to leave those shareholders with the same proportionate holdings of shares in the continuing undertaking. In these circumstances we find that the [taxpayer] has not satisfied us on either limb of the escape clause".[227]

Goff J held, first, that it was irrelevant that the taxpayer and his wife took no part in the operation of the business of Oldco or Newco, and that neither of them had been involved in the decision to liquidate Oldco

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226. (1975) 51 TC 71. This case has been dealt with in connection with the meaning of "transactions in securities" and also circumstance D, supra.
227. p 77

because what has to be applied is a subjective test of the intention of those in control. Here he cited the passage from the judgment of Lord Pearce in Brebner on this point cited above.[228] Applying this test, his conclusion was that:

> "bearing in mind that the onus lay upon the [taxpayer] I find it impossible to say that no Commissioners acting judicially and properly instructed as to the relevant law could come to the conclusion that they were not satisfied on either limb .... or that the only reasonable conclusion contradicts the determination of the Special Commissioners on this point".[229]

228. p 81
229. p 82

The Width of the Provisions

It has already been mentioned that section 28 FA 1960 was presented to Parliament as a measure aimed specifically at dividend stripping but that, in the very first case, the Parker case, the House of Lords, led by the same person who had assured Parliament that it was aimed at dividend stripping, held that it had a much wider impact. The extent of the provision is now examined.

In that first case, IRC v. Parker [230] the Special Commissioners construed the section narrowly and held that it did not cover the transactions in question[231]. In the High Court, Ungoed-Thomas J while finding for the Crown was of the view that the section was of "a penal and retroactive nature, requiring a strict approach in accordance with the presumed intention of the Legislature".[232]

Lord Denning MR in the Court of Appeal, however, was quite clear that the section was designed to deal with dividend-stripping.[233] He also refused to give the section a wide interpretation. He said:

> "The Legislature had in mind such transactions as the transfer and sale and issue of securities. It is plain to me that the phrase ["transaction in securities"] cannot be extended so as to include dividends paid on shares, nor money which is paid out on liquidation of a company, or a reduction of capital. It does not include the payment off of a debenture. I am confirmed in this view by looking at the general mischief which this section is designed to hit. It is designed to hit dividend-stripping and not the redemption of debentures".[234]

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230. (1966) 43 TC 396
231. p 401
232. p 405
233. p 417
234. pp 417-8

Danckwerts LJ was of the same mind. He put his views on the section in the following way:

> "Like the famous arrow shot into the air, it seems to have landed they know not where. The target was plain enough: it was the operation which has come to be known as 'dividend-stripping'."[235]

As has already been noted, Viscount Dilhorne (who was the Attorney-General when the original clause was presented to Parliament) held, in the House of Lords, that the section was much wider than this. In his view, saying that the section was aimed at dividend-stripping was taking too narrow a view of it. Furthermore, he did not think that what he described as "the general and unambiguous words" of the section should be restricted "by regard to the mischief which it is thought that the section is aimed at".[236]

In <u>Greenberg v. IRC</u>[237], Lord Reid emphasised the wide construction the courts must give to the section. After considering the meaning of "transaction in securities" in a passage quoted above under that heading, he continued:

> "We seem to have travelled a long way from the general and salutory rule that the subject is not to be taxed except by plain words. But I must recognise that plain words are seldom adequate to anticipate and forestall the multiplicity of ingenious schemes which are consistently being devised to evade taxation. Parliament is very properly determined to prevent this kind of tax evasion, and if the Courts find it impossible to give very wide meanings to general phrases the only alternative may be for Parliament to do as some other countries have done and introduce legislation

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235 p 481
236 pp 430-1 Lord Wilberforce agreed, p. 440
237 (1971) 47 TC 240

of a more sweeping character, which will put the ordinary well-intention person at much greater risk than is created by a wide interpretation of such provisions as those which we are now considering".[238]

Before leaving the Greenberg case, it is worth noting that Lord Reid, along with Lords Morris and Simon, held that each payment of a dividend was a separate transaction relating to securities. This should be compared with the statement of the Attorney-General to the House of Commons that a dividend was not a transaction in securities.[239]

Lord Wilberforce returned to the subject of the width of the section in IRC v. Joiner[240] where he said:

"Upon the enactment of the original section.28 of the Finance Act 1960 it was possible to contend, and it was contended that the section (and its associated sections) was directed against a particular type of tax avoidance known generally under such description as dividend- stripping, asset-stripping and bond washing and that the sections and particular expressions used in them, amongst others 'transactions in securities', should be interpreted in the light of this supposed purpose. But this line of argument became unmaintainable after the decisions of this House in [Parker] and [Greenberg]. It is clear that all the members of this House who decided those cases were of the opinion that a wide interpretation must be given to the sections and to the expressions used in them. More than this, it appeared from the opinion

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238. p 272 Examples of the sweeping anti-avoidance provisions mentioned by Lord Reid are discussed in Chapter 10.
239. H.C.Deb.25 May 1960 Col.511
240. (1975) 50 TC 449
provisions mentioned by Lord Reid are discussed in Chapter 10.

of Lord Reid in Greenberg's case that the sections called for a different method of interpretation from that traditionally used in taxing Acts. For whereas it is generally the rule that clear words are required to impose a tax, so that the taxpayer has the benefit of doubts or ambiguities, Lord Reid made it clear that the scheme of the sections, introduced as they did a wide and general attack on tax avoidance, required that expressions which might otherwise have been cut down in the interest of precision were to be given the wide meaning evidently intended, even though they led to a conclusion short of which Judges would normally desire to stop ... If we are to follow this path, and I see no other option open to us, we must continue to give to 'transactions in securities' and 'transactions relating to securities' the widest meaning: we can neither confine these expressions to the instances given in section.467(1), nor can we deduce from that numeration any limitation upon their scope".[241-2]

There are, however, limits to the width of construction judges are willing to give to these provisions. For example, Buckley LJ in <u>IRC v. Garvin</u>[243] referring to the passage from Lord Wilberforce's judgment in Joiner quoted above, commented:

"This, as I understand it, does not mean that a court should officiously strive to construe a section in its widest possible significance in order to give it the widest possible operation, but that one must look for the meaning evidently intended by

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241- 2 p. 480 See also the case of Anysz v IRC (1977 53 TC 601 supra where "tax advantage" was given a wide interpretation by Browne-Wilkinson J who held that a tax advantage had been obtained even though the taxpayers received only shares and not cash.

243. (1981) 55 TC 24

the language used bearing in mind the object of the section, and apply that section accordingly without giving either the taxpayer or the Revenue the benefit of any doubt or ambiguity".[244]

Furthermore, Lord Wilberforce himself said in IRC v. Parker:

"We must take this Act as we find it and endeavour to see what it fairly covers. But we need not be surprised if it turns out that the attack is confined to a limited sector of the front".[245]

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244. p 63
245. (1965) 43 TC 396 at p 440

The Question of Double Taxation

It was acknowledged very early on that there was the potential for double taxation in the provisions.[246] Such double taxation does not prevent the taxpayer obtaining a tax advantage. It will be recalled that in IRC v. Cleary the two sisters sold one family company to another such company and it was held that circumstance D applied. If the acquiring company subsequently made a distribution representing the value of the acquired company there would indeed be double taxation: this was confirmed by the House of Lords.

This problem of the interaction of the apportionment provisions[247] and what was then section 28 FA 1960 was addressed on the very first occasion that the section was considered by any court: Ungoed-Thomas J at first instance in IRC v. Parker.[248] He held that section 28 could not be limited by the apportionment provisions in operation at the relevant time, sections 245 and 246 ITA 1952. In the House of Lords, Lord Wilberforce agreed and drew attention to section 28(12) FA 1960[250] which states that section 28 is not limited by other provisions in the income tax legislation.

See also Bridge LJ(with whom Cumming-Bruce and Orr LJJ agreed) in Williams v. IRC[251].

These cases make it clear that a taxpayer can obtain a tax advantage even if he can suffer an apportionment in respect of the profits he had received in a non-taxable form. See, however, the decision of the House of Lords in the Bird case[252] where it was said that, if the

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246. See Viscount Dilhorne in IRC v. Cleary (1967) 44 TC 399 at p424
247. see Part 7 infra
248. (1964) 43 TC 396
249. See pp413-4
250. Now section 703(12) ICTA 1988
251. 1979 54 TC 257
252. [1988] STC 312,infra

Revenue had not given the undertaking not to pursue the shortfall assessments "much closer consideration would have had to be given to the question whether they were entitled to do so".[253]

A more serious area of possible double taxation is between these provisions and capital gains tax. This potential problem has not been sorted out despite the fact that four of the Law Lords noted the unsatisfactory nature of the law in IRC v. Garvin[254]

Lord Wilberforce noted that section 28 FA 1960 was introduced before CGT was created by the FA 1965 and so was drafted without regard to the possibility of double taxation. He continued:

> "In the present case, it is clear that a charge to capital gains tax might arise. In fact the taxpayer has been assessed for capital gains tax as regards the sale of his shares. To charge the proceeds of these shares with capital gains tax as disposals of capital assets and also with income tax under section.460 amounts to manifest double taxation - indeed, the total amount chargeable would exceed the amount which the taxpayer received. We are told that, by way of concession, if the Crown succeeded in the present appeal, it would give credit for the capital gains tax paid. This would certainly be fair, but it is not satisfactory that the matter should rest on concession. The interaction of these two taxes seems to require consideration with a view to avoiding double taxation, which should be a right and not merely a privilege".[255]

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253 p 324
254. (1981) 55 TC 24
255. p 86
256. p 88

Lord Russell, however, doubted whether such a concession could be made. As he pointed out, the CGT had been levied and paid and remained perfectly valid. He said:

> "Rather do I venture to doubt the ability of the Crown ...., having levied a tax on the basis that the transaction was a dealing in capital, then to assert that it can indirectly by counteraction be treated as giving rise to taxable income. But no argument was advanced for the taxpayers that the Crown was debarred from thus blowing hot and cold, or perhaps I should say warm and hot, and I say no more on this".[256]

It appears, however, that if such an argument had been advanced by the taxpayer, whatever Lord Russell and Lord Bridge[257] may have held, the majority may have decided that a double charge was not prohibited.

Lord Keith agreed with Lord Wilberforce's judgment. Lord Scarman expressed no view but found the figures arising out of a double charge "disturbing". He, like Lord Wilberforce, found the fact that the taxpayer might have to rely on a concession "unacceptable". He commented:

> "Those who use the services of an 'inventor and purveyor of tax avoidance schemes' (Templeman LJ's phrase) can expect no mercy: but they are entitled, like the rest of us, to justice. If the law is such that they are put at the mercy of the Crown (who, through its agent, the Board of Inland Revenue may or may not feel disposed to make a concession), they are denied justice at the hands of the court".[258]

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256. p88
257 Infra
258. p88

> Lord Scarman surmised that, when CGT was introduced in 1965, its relationship with section 28 was not fully appreciated. He concluded that: "The law requires review so that the possibility of double taxation is unambiguously excluded".[259]

Lord Bridge agreed with the other Law Lords that the position was "most unsatisfactory" that the avoidance of double taxation should depend on a concession. However, like Lord

Russell, he raised the question of whether the Revenue could validly establish a liability to both taxes. He said that:

> "if an attempt were to be made to levy both taxes in respect of a single receipt, a contingency which can I hope be regarded as remote, I can see a powerful argument being mounted to the effect that, if a receipt falls to be treated as income and taxed as such under one code it must, by necessary implication, be exempt from liability to taxation as a capital receipt under another code".[260]

The position is thus unclear, with the two Law Lords raising the possibility of the Revenue being estopped from levying tax under both codes, and three Law Lords apparently accepting that the Revenue does have the power but that it is unsatisfactory that the matter should depend on the Revenue granting relief on a concessionary basis.

It would be easy for this highly undesirable position to be dealt with by simple legislative amendment and it is a sad reflection on the complacency with which the matter is held by the Revenue that all these years after the problems were highlighted by the Law Lords, no amendments

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259. Ibid
260. pp 90-1

have been made to the provisions. This is presumably due in no small measure to the fact that, despite the reservations expressed by Lords Russell and Bridge, the general view held by the Revenue was that they did have the power to levy both taxes and they are seemingly happy with their extra-statutory power to mitigate taxes by concession. Unless such a power lands them in positive trouble as in the Vestey case[261] they are unlikely to press for legislative change.

Garvin and Williams, and the whole question of double taxation, were considered at length in the next case in which, as will be seen, the House of Lords stated that it is not open to the Revenue to subject a taxpayer to two different charges to tax in respect of the same receipts. This case was Bird v. IRC. In the High Court[262] Vinelott J held that the amount of the tax advantage fell to be ascertained by contrasting the receipt which in fact accrued in a non-taxable way with a similar receipt which might have accrued in some other taxable way. This, of course, is well settled.

The matter to which Vinelott J turned his mind was whether in making this contrast, account must be taken of other liabilities to tax that may have fallen directly or indirectly on the taxpayer in consequence of the transactions. Here, the share scheme gave rise to a liability to corporation tax on capital gains which fell to be paid by Ilmarish. The loans received by the taxpayers represented the distributable profits of CCD, ascertained without regard to any corporation tax liability which may have fallen on CCD, and the purchase price paid for the CCD shares, which was subject to corporation tax, which was derived from the same source. As the judge pointed out:

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261. Vestey v IRC (1979) 54 TC 503, see Chapter 9
262. [1985] STC 584. The facts are set out, supra.

> "If income tax and ..... surtax are charged on the full amount of the loans received the taxpayers will be exposed, not to double taxation in the narrow sense ... but to cumulative liabilities to tax which .... could exceed anything which [the taxpayers] either obtained from this scheme or could have obtained by any other means".[263]

Vinelott J reviewed the speeches of the Law Lords in Garvin and commented that the decision of Scott J in <u>Bye v Coren</u>[264] suggests that the course taken by the Crown

in Garvin was not a concession and that the taxpayer was entitled under what became sections 31 and 54,CGTA 1979 and section 49(1) TMA 1970 to have the capital gains tax assessments reopened after the section 703 assessments had been confirmed. Vinelott J noted that, in Garvin, the Law Lords were not referred to these provisions.[265]

However, in Bird, Vinelott J was in no doubt that the Crown was entitled to assess Ilmarish to corporation tax on capital gains and also to assess the taxpayers on the tax advantages they had obtained. The judge noted that, not only are the persons assessed different, the taxpayers were not the only shareholders in Ilmarish.[266]

Vinelott J thought there was a solution to the cumulative burden of taxation in respect of moneys which he pointed out, in substance, represented the purchase price of the CCD shares, which in turn was derived from the dividend declared by CCD.

He noted that, in Williams, the Crown had undertaken that it would not pursue the shortfall assessments. Accordingly, Bridge LJ thought that "the practical likelihood of the loans being called in is negligible".

263. P 642
264 [1985] STC 113
265. p 645
266 Ibid

The judge thought that, in Bird, by contrast:

> "to the extent of the liability to corporation tax which falls on Ilmarish the loans (which as a result of the application of the Ramsay principle to the share scheme must be treated as having been made out of the consideration for the shares of CCD) ought to be treated as a mere temporary accommodation which will have to be repaid to meet Ilmarish's liabilities. That temporary accommodation cannot be compared with the receipt of an equivalent sum by way of dividend. It is irrelevant I think that Ilmarish has other moneys available to meet a part, though only a small part of the capital gains tax liability. The loans were clearly made out of the proceeds of sale of the shares and should be treated as repayable to the extent necessary to pay tax on those proceeds".[267]

Despite this analysis, which produced a logical and fair result, reference to the details of the scheme shows that the loans clearly were not meant as "more temporary accommodation".

As a result of Vinelott J's analysis, he held that the tax liability of Ilmarish in respect of the share transactions fell to be taken into account when computing the taxpayer's liability.[268]

Another point touched on by the judge was whether the Crown could attack a scheme simultaneously under both the "new approach"[269] and section 703. He was of the opinion that they could not. He commented:

> "When the Crown relies on section.460 it in effect asserts that the transactions entered into by the

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267. pp 645-6 268. p647
268. p647
269. see Chapter 11

taxpayers had the effect which those transactions were designed to achieve; section.460 enables the Crown to counteract and cancel any tax advantage so obtained. When the Crown relies on the Ramsay principle the Crown asserts that at least some of the steps taken as part of a composite transaction are to be treated for fiscal purposes as if they had not been taken. It cannot in relation to the same taxpayers and in relation to the same transaction both rely on every step taken for the purposes of section.460 and disregard intermediate steps under the Ramsay principle".[270]

On the question of double taxation, the Court of Appeal[271] came to a different conclusion from Vinelott J. Basically, the judges of the Court of Appeal did not feel able, as Vinelott J. had, to distinguish Williams.

Sir Nicolas Browne-Wilkinson V-C noted the "basic approach" to counteracting the tax advantage enunciated by Lord Wilberforce in Parker.[272] He also noted that the Special Commissioners had applied Lord Wilberforce's approach by contrasting the receipt which in fact accrued without attracting tax (the loans), with a similar receipt which might have accrued in a taxable form (a distribution by Ilmarish by way of dividend). This approach entitled the Revenue to recover tax far in excess of that which would have been payable if the scheme had not been adopted: directly or indirectly, the taxpayers would have to bear tax on over £2.5 million when they received in their pockets only £2.187 million, and that was only by way of loan. As the judge pointed out:

"Although this is not strictly double taxation, since the assessments are all made on separate legal

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270. pp646-7
271. [1987] STC 168
272. p178. Lord Wilberforce's approach is set out. supra.

entities, in substance it has all the vices of double taxation".[273]

The Vice-Chancellor observed that, if he were free to do so, he would hold that a notice under section 703 producing such as result would not constitute "counteracting" a tax advantage because "counteraction" involves nullifying a tax advantage obtained; not imposing a liability to tax which would not have existed had the scheme not been undertaken.

Although the Vice-Chancellor would have liked to have agreed with Vinelott J's approach, unlike Vinelott J. he felt he could not distinguish Williams, pointing out what was undoubtedly the case that:

> "In both cases the parties expected never to have to repay the loans or only if, contrary the expectations, a tax liability accrued on the company making the loans."[274]

The taxpayers had also submitted an argument based on the remarks of the Law Lords in Garvin.[275] The Vice-Chancellor commented that only Lords Russell and Bridge thought the Crown might be estoppel from putting forward a claim to capital gains tax, having already claimed tax under section 703 on the basis that the receipt was income.

The taxpayers sought to rely on a similar estoppel here by submitting that since Ilmarish had been assessed to, and paid, corporation tax on the chargeable gain made on the sale of the CCD shares, the Crown could not seek to levy income tax and surtax on the same proceeds of sale as though they were income.

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273. Ibid
274. p180
275. These remarks are examined in detail. supra.

However, the Vice-Chancellor was not satisfied that the analogy with Garvin was sufficiently close to justify any application of estoppel here. In Garvin, the two contradictory claims to tax were made on the same taxpayer and on the same receipt, here, one claim to tax was on the taxpayers, the other was on Ilmarish and, said the Vice-Chancellor:

> "There is nothing inherently incompatible between money being received by a company as capital but, when distributed by that company, its shareholders receiving it as income."[276]

Accordingly, the Vice-Chancellor felt bound to reinstate the assessment in the full amount although he did so "with the utmost distaste as I think it is both unfair and oppressive".[277] He hoped the House of Lords might feel able to do justice by reconsidering some of its earlier decisions.

Balcombe LJ [278] and Bingham LJ [279] agreed with the Vice-Chancellor's interpretation.

It has been explained above that, in the House of Lords,[280] the taxpayers advanced five arguments for saying that there was no tax advantage. The fifth of these related to the question of double taxation and, like the other four, it failed.

The argument was the one raised in the lower courts that, since Ilmarish had been assessed to and had paid corporation tax on the proceeds of the CCD shares, and these proceeds in substance constituated the subject matter of the loans to the taxpayers, they could not properly enter into the computation of the taxpayers' liability under section 703.

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276. p181
277. Ibid
278. p182
279. p183
280. [1988] STC 312

Lord Keith, with whom the other Law Lords agreed, thought that this argument was "without substance". He said:

> "There is no question here of double taxation of these taxpayers. The liability of Ilmarish for corporation tax is quite separate from that of its shareholders for income tax. Cummulative tax liability on a company and on its shareholders can arise in a variety of circumstances, and is readily distinguishable from double taxation of an individual because separate taxpayers and separate liabilities are involved."[281]

Like the other four arguments advanced by the taxpayers on whether there was a tax advantage, this one had the air of desperation about it and it is not surprising that it was brushed aside by the House of Lords.

Lord Keith then turned to the matter on which Vinelott J, on the one hand, and the Special Commissioners and the Court of Appeal, on the other, had disagreed; whether the amounts of the assessments were correct.

The essence of the question was neatly encapsulated by Lord Keith who observed that:

> "the tax advantages obtained by the taxpayers would necessarily be reduced by the appropriate proportion of the corporation tax suffered by Imarish. The question is whether in the circumstances the amounts assessed under section.460 should be reduced accordingly."[282]

Lord Keith commented that, in the absence of any authority pointing to a contrary conclusion, he would "be

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281. p319
282. Ibid

disposed unhesitatingly to answer that question in the affirmative."[283] He noted that, if no credit for Ilmarish's corporation tax is given, the total tax liability on the taxpayers would amount to 116%. Like the Vice-Chancellor, he thought this was going far beyond counteraction. He therefore examined the relevant authorities, namely, Williams and Garvin, with also a reference to Anysz.

Having examined these cases, he expressed his view clearly and succinctly that:

> "In general, I am of opinion that it is not open to the Revenue to subject a taxpayer to two different charges in respect of the same receipts."[284]

He did not think that, contrary to what the Court of Appeal had thought, it was necessary for Parliament to intervene.

Referring to Garvin, he said:

> "I consider the correct view on the hypothetical question there discussed to be that it was necessary for the Revenue to elect between raising a charge under section 460 on the basis that the sums in question were received as income and raising a charge under the capital gains tax legislation on the basis that these sums were received as capital. I do not think that the intervention of Parliament is necessary to bring about this sensible result. It seems to me to follow from a straight forward application of principle. The two claims are incompatible. On the other hand, where transactions involving a number of corporate structures are concerned, it can well come about that successive

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283. Ibid
284. p323

charges to tax are capable of being validly levied from the different legal entities which have entered into transactions leading to liability. In the present case that charge to corporation tax on Ilmarish affected a legal entity distinct from the taxpayers, and there is no reason in principle why that should affect the liability of the latter under section.460. However, the peculiarity of the case is that (apart from the possibility of temporary borrowing, which I think it right to disregard) there is no way in which the greater part of Ilmarish's corporation tax liability can be met otherwise than through repayment of the necessary sums by the taxpayers out of monies lent to them. It would be open to the Revenue to put Ilmarish into liquidation in order to bring this about. The Revenue having taken money from the taxpayers in order to satisfy their claim to corporation tax, it would defy common sense to hold that the taxpayers are in possession of a tax advantage to the full extent of the loans which they originally received.... In the final analysis, the tax advantage obtained by the taxpayers did not extend to the full amount of the sums lent to them. It extended only to those sums less the amount requisite to be repaid in order to meet the Revenue's claim to corporation tax. This is the extent of the tax advantage which the Revenue is entitled to counteract."[285]

Referring to the shortfall assessment point dealt with by Bridge LJ [286], Lord Keith was of the opinion that this was concerned with the question whether, having regard to the liability to such assessments, the taxpayers had obtained a tax advantage at all. It has been seen that the Revenue had given an undertaking not to pursue the

285. Ibid
286. Supra

shortfall and surtax assessments if they were successful under section 703. The two claims were alternative methods of taxing the same profit in the hands of the taxpayers and Lord Keith commented:

> "If the Revenue had insisted in pursuing both claims simultaneously, much closer consideration would have had to be given to the question whether they were entitled to do so."[287]

In view of the above analysis, Lord Keith was of the opinion that Vinelott J was right in regarding Williams as not precluding him from reducing the section 703

Lord Keith did not consider this conclusion to be inconsistent with the decision of the House of Lords in Williams because, there, there was no question of the Revenue being in a postion to enforce any repayment of the loans made to the shareholders in Kithurst to satisfy the charge to betterment levy.

assessments. The assessments were therefore reduced to take into account the taxpayers' liability to repay to Ilmarish so much of their loans as is necessary to meet the company's liability to corporation tax.

It therefore seems that the robust reasoning of the House of Lords in this case has removed some of the doubt left by earlier cases and avoids the sort of injustices that the Court of Appeal reluctantly considered they were forced to produce.

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287. p324

PART 6

GENERAL EXCESS PROFITS TAX AND PROFITS TAX ANTI-AVOIDANCE PROVISIONS

Excess Profits Tax

Section 35 FA 1941 is a very important section in the history of UK anti-avoidance legislation in that it was a general anti-avoidance provision. It provided that, where the Commissioners of Inland Revenue were of the opinion that the main purpose for which any transaction or transactions was or were effected was the avoidance or reduction of liability to excess profits tax, they could, fit, direct that such adjustment should be made as respects liability to excess profits tax as they considered appropriate, so as to counteract the avoidance or reduction of liability to excess profits tax which would otherwise arise.

To be able to examine this provision properly, it is necessary to consider the background to it so that it can be seen in its proper context.

A month after the outbreak of the Second World War, on 12th October 1939 the F(No 2)A 1939 was passed. Section 12 of this Act stated:

> "(1) Where the profits arising in any chargeable accounting period from any trade or business to which this section applies exceed the standard profits, there shall, subject to the provision of this Part of this Act, be charged on the excess a tax (to be called the excess profits tax) equal to three-fifths of the excess. (2) Subject as hereafter provided, the trades and businesses to which this section applies are all trades or businesses of any description carried on in the United Kingdom, or carried on, whether personally or

through an agent, by persons ordinarily resident in the United Kingdom."

Section 13 read:

"(1) For the purposes of this Part of this Act, the standard profits of a trade or business shall, in relation to any chargeable accounting period, be taken, if the person carrying on the trade or business so elects, to be the minimum amount specified in subsection (2) of this section, and, in the absence of such an election, to be the amount of the standard profits for a full year computed in accordance with the provision of subsection (3) to (9) of this section: Provided that in relation to a chargeable accounting period which is less than twelve months, the standard profits shall be taken to be the amount in question proportionately reduced so as to correspond with the length of the period. (2) The minimum amount referred to in subsection (1) of this section is one thousand pounds, or, in the case of a trade or business carried on by a partnership or by a company the directors whereof have a controlling interest therein, such greater sum, not exceeding three thousand pounds, as is arrived at by allowing seven hundred and fifty pounds for each working proprietor in the trade or business. In this subsection-(a) the expression 'working proprietor' means a proprietor who has, during more than one-half of the chargeable accounting period in question, worked full time in the actual management or conduct of the trade or business: (b) the expression 'proprietor' means, in the case of a trade or business carried on by a partnership, a partner therein, and, in the case of a company, any director thereof owning no less than one-fifth of the share capital of the company."

Therefore, the profits of individuals or companies carrying on a trade or business could not exceed those of the standard period by more than two-fifths, and any profit greater than that was excess profit and was paid over in tax.

Within eight months, the screw had been turned even tighter. Section 26 FA 1940, which had effect from 27th June, substituted for the words "equal to three-fifths of the excess" the words "equal to the excess".

There were various exceptions to deal with cases in which the pre-war trading had shown a loss, where fresh capital had to be issued, where there was a new company or business, or where the pre-war standard was not an appropriate yardstick.

It is important that the legislation to be examined below is seen against its propert background. It will be seen that section 35 was extremely severe, to the point of being penal, but it was enacted at a time of national emergency to prevent persons making a greater profit during the war than they had made before. Even so, looking back at the matter from the comfort of a period of stability and peace, it is difficult to suppress the feeling that Parliament went too far in its attempts to block avoidance of excess profits tax.

Section 35 FA 1941, as originally erected, ran as follows:

> "(1) Where the Commissioners are of opinion that the main purpose for which any transaction or transactions was or were effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to excess profits tax, they may, if they think fit, direct that such adjustments shall be made as respects liability to excess profits tax as they consider appropriate so as to counteract the avoidance or reduction of liability to excess profits tax which would otherwise be effected by the transaction or transactions. (2)

Without prejudice to the generality of the powers conferred by subsection (1) of this section, the powers conferred thereby extend-(a) to the charging with excess profits tax of persons who, but for the adjustments, would not be chargeable with any tax, or would not be chargeable to the same extent: (b) to the charging of a greater amount of tax than would be chargeable but for the adjustments. (3) Any person aggrieved by a direction of the Commissioners under this section may appeal to the Special Commissioners, whether on the ground that the main purpose of the transaction or transactions was not to the avoidance or reduction of liability to tax or on the ground that no direction ought to have been given or that the adjustments directed to be made are inappropriate."

When section 35 came before the House of Commons, the words "main purpose" were very strongly debated and were introduced as an amendment to the original clause which would have been applicable to a transaction without regard to the nature of its <u>main</u> purpose. When the clause was first introduced into the House of Commons, it was designed to operate if any of the purposes of a transaction was the avoidance or reduction of liability to EPT. However, representations were made to cut down the section, and the section was made to apply only if the main purpose was to avoid or reduce liability to EPT. It is instructive to consider how the matter was dealt with by the House of Commons.

The provisions was introduced as clause 30 of the Finance Bill 1941 and, as mentioned above, in that clause as originally drafted, the Revenue were given the power to ignore for EPT purposes, any transaction which had as its purpose, or one of its purposes, the avoidance or reduction of liability to EPT. After the Second Reading of the Finance Bill 1941, representations were made to the Treasury to the effect that this proposal was unreasonable, and in the debate of 1st July 1941, when the Bill was re-committed to a Committee of the Whole

House, an amendment was moved with the object of making the clause apply only if the main purpose of the transaction in question was the avoidance or reduction of liability to EPT. In this debate, Mr. Patrick Spens said:

> "The question whether it is done mainly for the purpose of avoiding taxation or mainly for some purpose other than avoiding taxation opens two different spheres of inquiry. As the clause is worded at the present time, in every transaction which in fact produces excess profits tax, it is very difficult to say whether or not one of the purposes of the transaction may not have been the reduction of taxation. Supposing the Honourable Member were the adviser of a Board of Directors, and he said to them, 'This is a magnificent thing to do, it is in the national interest, it is in everybody's interest, but I would have to point out that if you do it you will, in fact, reduce your EPT by £100'. If that is mentioned to the Board, then it is postulated that one of the purposes which some of the Board may have had in mind may have been the saving of that £100 per annum. We do not want that. We want to stop tax dodging, we want to stop people from entering into a transaction mainly for the purpose of avoiding taxation."

In its original form, the clause was modelled on section 28(2) FA 1938, which inserted subsection (1)(b) into section 18 FA 1936[1]. As will be seen below, this section was aimed at a method of avoiding income tax which was then being widely used, and the artificial character of the avoidance made it quite plain that the transactions had no purposes other than the avoidance of income tax. Originally, section 18 applied if the main purpose of the transaction was avoidance of liability to taxation, but the amendment made by section 28 FA 1938

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1. See Chapter 9

caused section 18 to operate unless "the purpose of avoiding liability to taxation was not the purpose, or one of the purposes" of the transaction.[2]

In speaking of the amendment to clause 30, Sir Kingsley Wood referred to section 18 FA 1936, and the amendment which was made by section 28 FA 1938, and recalled that one of the safeguards in the latter amendment was that section 18 was not to apply if:

> "The transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation."[3]

He then said:

> "Therefore, I think it can be said that in applying the principal to the EPT area we are following along the lines laid down in the FA 1938. If a transaction is designed for the purpose of avoiding taxation, then such transaction is really one which has the avoidance of tax as its main purpose.
>
> Finally, it has to be borne in mind that the assessing authorities for EPT are the Commissioners of Inland Revenue, and while they are not likely to attempt to apply the avoidance powers of clause 30 to innocent trading transactions, they are equally not likely to allow to pass unchallenged any case in which the avoidance of taxation and not genuine business is the governing motive. I consulted my two Right Honourable and Learned Friends the Law Officers, and they did not hold that I should be justified in refusing to accept the amendment. If I find that acceptance of the amendment would destroy

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2. See now section 741(a) ICTA 1988
3. See now section 741(b) ibid

the object of the clause, I shall have to take another course. I therefore accept the amendment today with the warning that I may have to come back to the House and ask it to reverse its decision."

It was only three years later after the above words by the Chancellor (Sir Kingsley Wood) that section 35 FA 1941 had to be amended by what became section 33 FA 1944.

In his Budget speech on 25th April 1944, Sir John Anderson said that "a strengthening of the provisions of section 35 of the Finance Act 1941, dealing with the avoidance of taxation, will be required." Accordingly a Budget Resolution was moved:

> "That the extent and incidence of excess profits tax (for past and future chargeable accounting periods) shall be varied so as to give effect to amendments to section 35 of the Finance Act 1941 (which relates to the avoidance of taxation)."

During the debate on the Budget resolutions on 2nd May 1944, the Attorney General said of the above resolution:

> "What my Honourable Friend proposes is to strengthen the working of the clause by words of this kind so that it must be shown to be one of the main purposes. It is not as I say to show that it is the main purpose, but it should be shown that it was one of the main purposes, and I think provision may also be made that, if it is found that there is a substantial diminuition in the amount of EPT to be paid, that can be taken into account in deciding the question. Those are the lines which the Chancellor desires to proceed. And that is the reason why we are asking the House to pass this resolution."

During the Committee stage of the Finance Bill, a great deal of attention was devoted to the relevant clause (clause 32). Clause 32 altered section 35 FA 1941 in two respects. First, it made the section apply if one of the main purposes was avoidance or reduction of liability to EPT; and, secondly, it directed that, if the main benefit which was to be expected from the transaction during the currency of EPT was avoidance or reduction of liability, then avoidance or reduction was to be deemed to have been one of the main purposes. In other words, in considering whether section 35 applied to a given transaction, regard was to be had to the main benefit to be expected from the transaction while EPT lasted, instead of to the main purpose which the taxpayer had in mind in embarking upon the transaction.

The debate on clause 32 was concerned mainly with three topics. It began with the moving of an amendment which would have prevented the clause from having retrospective effect. It may have been that, with the climate of feeling running against tax avoidance during the war years, this amendment did not receive a great deal of sympathy. The case for the Treasury was a simple one. Section 35 had not in practice caught cases which the Inland Revenue thought it should have caught. Therefore, section 35 should be strengthened; and not only should it be amended for the future, but it should be made to catch the cases which it had failed to catch in the past; and that was right because those cases were all cases of deliberate avoidance of EPT. There appears to have been little appreciation of the difference between artificial tax avoidance and more straightforward tax planning, and it may have been that, in times other than those of national emergency, the matter of retrospection would have been given the attention it deserved.

The second point with which the House was mainly concerned was that the new clause should not apply where businesses had been amalgamated under schemes approved by the Board of Trade. This part of the debate is not relevant to the present discussion and is not considered further.

The third and most important topic the Committee had to consider was whether the test of main benefit should be used or not. Sir Waldron Smithers moved an amendment that the relevant subsection[4] should be omitted. This was the clause the provided that, if it appeared in the case of any transaction that the main benefit which might have been expected to accrue from the transaction was a saving in liability to excess profits tax, this could be deemed to have been the main purpose of the transactions. Sir Waldron Smithers asked:

> "Is it to be sufficient if the Commissions of Inland Revenue or one of their officials thinks that the main benefit which he would have expected was avoidance or reduction of liability to EPT if he had engaged in this transaction? Secondly, is the test to be whether the taxpayer ought to have expected that the main benefit to accrue to him was avoidance or reduction? Thirdly, are the Special Commissioners of Appeal to decide whether they would have expected the main benefit to be avoidance or reduction if they had been engaged in the transaction?"

In resisting the amendment, the Solicitor General repeated the statement that the test of main purpose had not fulfilled expectations. Apparently, the reason was that a number of taxpayers had satisfied the Special Commissioners that, in causing additional working proprietors to come into existence, they did not have, as their main purpose in doing so, the avoidance or

4. Subsection (3)

reduction of EPT. He said that cases were known where a person introduced into his business his son or daughter aged 16 or 17 and presented the child with 5.1% of the shares.

If this person maintained on appeal that avoidance was not the main purpose of this transaction, then section 35 could not be applied to him. The Solicitor General said:

> "We say, bluntly, that any reasonable person ought to appreciate that if he transfers 5.1% of the shares to a youth of 17 and makes that youth a director he is carrying through that extraordinary transaction with financial benefit to himself. We ought to face that position and say that where the main benefit is a financial advantage, it will be deemed to be one of the main purposes, and that hurdle will be over-come. My Honourable Friend says, 'who was to expect that that was the main benefit?' That varies at each point. In clause 3, first of all one looks at it with the mind of the person who carries through the transaction, and when it comes to the Commissioners of Inland Revenue, or the Special Commissioners, they have to decide it as a tribunal of fact. I hope I have made clear to the Committee what is our purpose in this clause."

Regardless of what the Solicitor General said, no indication was given of the mind in which the relevant expectation was to be considered to have arisen. Another point of importance was that, in sub-clause (3), the main benefit was the main benefit which might have been expected to accrue from the transaction during the currency of EPT. Accordingly, if a businessman made alterations in his organisation for the purpose of meeting what might be expected when the war ended, he would still be caught by section 32, if the main benefit from the transaction was postponed to the post-war years, and the main benefit during the EPT years was a reduction of his liability. It would not matter what his main purpose was.

As the debate on this topic proceeded, it became clear that the Inland Revenue was troubled by section 35 in its original form in two ways. First, too many working proprietors were being created and were not being caught by the section. Secondly, there were too many transfers of shares which had the effect of avoiding or reducing liability to EPT and which could not be upset under section 35. When this fact became apparent, the House pressed strongly for clause 32 to be limited to those two matters, and finally, the Solicitor General made this statement:

> "If my Honourable Friend has in mind the question of the main benefit being deemed to be the main purpose, it was not my intention to hold out any hopes of altering that. I wanted to indicate to the Committee that my Right Honourable Friend and I wanted to hit these two forms of evasion - the abuse of the working proprietor and the abuse of the transfer of shares. We are prepared to look at it from the point of view of de-limiting our missile to hit that target, but I do not want anybody to have false impression that we are prepared to go beyond that."

A little later he said:

> "We are trying to hit the abuse of the transfer of shares. If I can get some words - and my Right Honourable Friend is prepared to consider this - which will direct the clause more closely to these admitted evils, we will do our best to do so. That is quite clear to those who have listened to the debate, and that is what my Right Honourable Friend is prepared to do."

Section 33(2) FA 1944 replaced the words in section 35 FA 1941, "the main purpose for which any transaction or transactions was or were effected" with these words:

> "The main purpose or one of the main purposes for which any transaction or transactions was or were effective."

In other words the matter was put back to where it was when section 35 was first presented to Parliament. The reference to "main purposes" makes little or no difference, because the substituted words assume that there can be several main purposes to one transaction.

As with other avoidance sections that have used this formula, it can be difficult to distinguish between one of the main purposes and one of the subsidiary purposes of any given transaction, and still more difficult to say whether any given purpose is a main one or not. The problems were left to the Special Commissioners to sort out.

A person not used to dealing with tax legislation would no doubt wonder how there could be more than one main purpose attaching to any given transaction. He would say, quite reasonably, that there must for every transaction only be one main purpose, and all the other purposes (if any) must be subsidiary ones. Section 35 was a penal section, and its language ought to have been perfectly clear. If the Legislature thought that it was possible to have a number of main purposes and a number of subsidiary purposes, they should have given taxpayers some clue as to how the distinction was to be drawn.

Subsection 33(3) was even more severe. It was originally intended that this subsection would apply to all kinds of transactions, but it was limited in the passage of the Bill through Parliament to:

> "transactions one or more of which involved (a) the transfer or acquisition of shares in a company; or (b) a change or changes in the person or persons carrying on a trade or business or part of the trade or business."

As noted above, in the course of the debate in Committee on the clause, it was stated from the Treasury Bench that these two arrangements represented by far the largest part of the total number of cases under section 35. On the other hand, it was represented from several parts of the House that subsection (3) in its original form was so sweeping that it would make it virtually impossible for a transaction which was not concerned with avoidance or reduction of EPT to be taken out of its provisions. It was in response to this kind of contention that the scope of subsection (3) was limited. It appears that its limits were designed by a somewhat vague reference to the connecting and disconnecting of companies, and to increases in working proprietors with their consequential reductions of liability to EPT. Sub-section (3) then went on to provide that if:

> "the main benefit which might have been expected to accrue from the transaction of transactions during the currency of excess profits tax was avoidance or reduction of liability to the tax, the avoidance or reduction of liability to excess profits tax shall be deemed for the purposes of the said section 35 to have been the main purpose or one of the main purposes of the transaction or transactions."

In other words, the former test of main purpose was replaced by the test of main benefit. If the main benefit which might have been expected was avoidance or reduction of EPT, then avoidance or reduction was to be deemed to have been one of the main purposes of the transaction; and once a taxpayer was within these words, he was caught by subsection (2) which made section 35 apply whether one of the main purposes of the transaction was avoidance or reduction of liability or not. No indication was given as to who was to be the hypothetical or real person who might have expected the main benefit from the transaction to be avoidance or reduction. But whoever the person was whose judgement was to be decisive on this question, he had, it seems, to consider, not what the main benefit might have been expected to be from the transaction as a whole, but only what its main benefit might have been expected to be during the currency of excess profits tax.

The implementation of artificial transactions for the purpose of avoiding or reducing liability to EPT was not a matter with which many taxpayers would presumably have had much sympathy, particularly during the war years; but it was very important that proper business transactions should not be impeded by the fear of the consequences which fiscal legislation might cause to them; and it was equally important that the taxpayer should be able to demonstrate without difficulty that his transaction was a proper commercial one. This was a difficult thing to do under section 35 FA 1941, as amended by section 33 FA 1944.

There is also the point made by Mr. Spens in the debate in 1941 to the effect that, if the taxpayer formulates a proposal for an alteration in the method of conducting his business such as the introduction of a new partner, or the appointment of another director, and then goes to his accountant to find out what the tax aspect of his proposal is, he at once establishes a presumption that one of the purposes of the transaction was the avoidance or reduction of liability to EPT, and the section would then almost inevitably have been made to apply to him. A business transaction, then as now, could not be properly considered without taking its probable fiscal results into account.

It soon became apparent that the Inland Revenue took the view that, if a taxpayer stated that he did not know excess profits tax law and the effect of it when entering into a transaction, this view had to be contested before the Commissioners, and the taxpayer was treated as though he was aware of the consequences for excess profits tax in deciding what was the main benefit he expected to derive from the transaction. Furthermore, the Revenue's view was that, in deciding what was the main benefit, the saving of excess profits tax could be measured in terms of cash. This was despite the fact that the Act makes no mention of measuring the benefit in terms of cash and did not state that the main benefit must be a benefit of a financial nature. A consequence of the Revenue's view was that, if a taxpayer contended that the saving of excess profits tax was not the main benefit, then he had to show there was some other benefit greater than such a saving, again, measured in terms of cash.

The official test as to whether section 33 applied was, then, whether a reasonable man, with a proper knowledge of excess profits tax law, would have entered into the transaction with a view to saving excess profits tax, or for the purpose of some weightier benefit, measured in terms of cash.

It can be seen that a very heavy burden was placed on taxpayers if they were to keep themselves outside of section 33.

The cases on section 35 and section 33 show how difficult it was for taxpayers to succeed under these provisions.

The first case to consider is Frodingham Ironstone Mines Limited-v- IRC.[5] The facts were that the taxpayer company was formed in 1918 for the purpose of acquiring and operating certain ironstone mines. At about the same time, another company called Nostell Colliery was formed

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5. [1946] 1 All ER 168

to take over a colliery. The shares in the two companies were held by trustees. The taxpayer company made excess profits but the Nostell company sustained losses. The trustees caused the taxpayer company to acquire all the shares in the Nostell company and, as a result, the two companies became a group within section 28 FA 1940, so that the losses of the one could be used to reduce the excesses of the other.

The Inland Revenue gave a direction under section 35 FA 1941 to the effect that the acquisition of the shares of Nostell by the taxpayer company was a transaction having as its main purpose the avoidance or reduction of liability to excess profits tax, and they directed further that the liability to excess profits tax of both companies should be computed as if they had remained independent companies to which section 28 FA 1940 did not apply. On the basis of this adjustment, the sum of £19,950, which the taxpayer company had paid for the purchase of the shares in the Nostell company, was treated as an investment in relation to the taxpayer company, and there was a consequential reduction of the taxpayer company's standard profit, thereby increasing its liability to excess profits tax.

On appeal, the Special Commissioners confirmed the direction. It was contended for the taxpayer company that the adjustment was not appropriate because the effect of it was to increase the liability of the taxpayer company to excess profits tax over what would have been its liability if the two companies had not become inter-connected.

In the High Court, Macnaughten J held that the Special Commissioners' decision was correct. He said that there was no doubt that the purchase of the shares of Nostell was entered into for the purpose of reducing the liability of the taxpayer company to excess profits tax. It was argued on behalf of the taxpayer company that, since the provisions of section 35 FA 1941 enabled the Inland Revenue to give directions for adjustments to be made so as to counteract the avoidance of reduction of liability to excess profits tax, it could not be right that a direction should actually increase the liability to excess profits tax of the taxpayer company beyond the amount which it would have been if the transactions had never taken place. However, the judge said:

> "The direction seems to me to be perfectly right. Up to the time when the direction was made for the purposes of excess profits tax, the profits of each of these companies was treated as a separate subject matter of taxation. That has continued. In their assessment, the excess profits tax is to remain the liability of each company separate from the other. In ascertaining the amount, if any, of the tax to which the company is liable, all the transactions which have taken place during the accounting period must be taken into account including the transaction whereby the parent company parted with £19,950 in respect of the purchase of the shares of the colliery company. As it was in fact a purchase of an investment, it must be so treated in the accounts. That is the construction which the Special Commissioners placed upon the direction, and, in my opinion, they were right."[6]

It can therefore be seen that section 35 FA 1941 was not restricted to counteracting the perceived tax avoidance; it was a penal section which could actually increase the amount of tax payable by the taxpayer had he not entered into the transaction in the first place.

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6. p 170

In the following month, Macnaughten J heard another appeal on section 35: Cooke & Fergusson Limited and Ryecroft Electrics Limited -v- IRC.[7] "Taxation" magazine.[8] discloses the following facts. In 1938, the first taxpayer company was invited to become a sub-contractor in respect of the manufacture of aircraft for the Air Ministry, and in the following year, in response to further demands from the Ministry for a particular type of aircraft, it became necessary for the company to acquire additional factory space and for the installation of plant and machinery, and for this purpose, a disused cotton mill, called Ryecroft Mill, was purchased. It was expected at that time that the Air Ministry would provide £24,000 to meet this expense but, by March 1940, it became clear that the Ministry would not do so. It therefore became necessary to obtain the finance elsewhere.

The person in control of the company was also the chairman of an investment company which, by charging its investments, could provide £10,000. This investment company had a standard profit for the purposes of EPT of £36,000 and, as its profits had fallen to around £13,000, there was a deficiency of over £20,000.

On 12th July 1940, the second taxpayer company was incorporated, and the investment company subscribed for the whole of its issued capital. The first taxpayer company transferred its assets and liabilities in connection with Rycroft Mill, and the equipment and business carried on there, to the second taxpayer company, and guaranteed that company's overdraft. By an agreement of 30th August 1940, the first taxpayer company undertook that, if it revoked the guarantee it would, at the request of investment company, take over the company's share in the second taxpayer company. It was

7. Unreported
8. 16th February 1946 at p 309

also agreed that the first taxpayer company should guarantee a minimum dividend on the issued capital of the second taxpayer company. The investment company assigned to the first taxpayer company its right to subscribe for further shares in the second taxpayer company.

A direction was made under section 35 in respect of these transactions and the Special Commissioners confirmed the direction.

Macnaughten J held that the Special Commissioners decision was correct. The taxpayers' contended that the facts as found by the Commissioners did not justify their conclusion that the avoidance or reduction of liability to excess profits tax was one of the main purposes for which the transactions were implemented. They claimed that the facts made it plain that the main purpose of the transactions was to obtain the necessary capital for the business, and to relieve to some extent the financial embarrassment caused by the withdrawal of the Air Ministry offer to provide money for the capital requirements of the business; and that it would not have been possible to carry on the business in any other way.

Macnaughten J held that, even if that were so, there was ample evidence to support the conclusion of the Special Commissioners. He said:

> "By taking over the business, the investment company was able to make use of its EPT deficiency and bring about the avoidance or reduction of excess profits tax liability on the part of Ryecroft and it was for that very purpose that the transaction commended itself to those who effected it. When Ryecroft was registered and the [investment company] subscribed for the whole of its capital, the reduction in its liability to EPT was obviously one of the main purposes of the transaction."

It can be seen that, even if the most important "main" purpose of the transactions was to obtain the necessary capital for the business, etc., another of the "main" purposes might be the reduction of EPT. Despite this ridiculous perversion of the English language, this decision is obviously correct within the terms of section 35, as amended by section 33 FA 1944.

Another unreported decision, this time from 1946, underlines the width of the wording in section 35 FA 1941 and section 33 FA 1944, and their penal nature, going beyond mere counteraction of tax avoidance. This case was Ingham & Johnson -v- IRC, a decision of Atkinson J. The following note of this case was taken from "Taxation" magazine.[9]

In 1940, the taxpayers bought plant and premises consisting of a factory, offices and ten cottages, and also the business previously carried on there, with the intention of carrying on a similar business themselves. In June 1941, having met another person who had an invention which he wished to develop, the taxpayers caused three companies to be incorporated, namely, The Automotive Company, the Brittain Company and the Hope Company, in the first of which the other person took 50 shares. The Brittain Company was to carry on the previous business. The taxpayer let a portion of the premises and the plant and machinery to the Brittain Company for a rent of £1,125 a year, apportioned to the Hope Company for £250 a year, and another portion to the Automotive Company for £400 a year.

The Inland Revenue made a direction under section 35 and section 33, on the basis of the formation of the Brittain Company and the Hope Company, and of certain transfers of shares and of the payments of the rents, and the direction laid down that the liability to excess profits tax should be computed on the footing that the Brittain

9. 2nd November 1946, at p 65

Company was to be regarded as carrying on the business of the Hope Company in addition to its own business, and that it was also to be regarded as the owner of the business premises. The direction further laid down that the liability so computed was to be a joint and several liability of the taxpayer and the three companies. On appeal to the Special Commissioners, the direction as to joint and several liability was discharged.

On appeal to the High Court it was contended that the direction should be amended by limiting the Brittain Company's liability to the tax upon the excess profits which it had itself made.

However, Atkinson J held that there was no ground for varying the direction as confirmed by the Special Commissioners.

It was argued on behalf of the Brittain Company that they might be in a great difficulty because they might find themselves assessed and ordered to pay more than they had got, and there would be no legal power to recover it from the Hope Company. Atkinson J said that this argument did not impress him very much because it seemed to him that, if people tried to invent an elaborate scheme to avoid taxation, and a direction is made in the end which is directed to defeat the purpose of the scheme, it might very well create difficulties for them which they dislike. The Hope Company remained liable for its own excess profits tax, and this direction, if it did not touch them, left them under that liability. His view of the direction was that both companies were equally bound by it, and he would have thought that both remained equally liable for it. He was satisfied that the Hope Company remained under some liability, whether it was a liability under the direction or whether it was under a separate liability for its own proportion.

The width of the sections and the broad constructions the courts were ready to give to them is apparent from this and the other cases considered here.

On the same day that Macnaughten J delivered his judgement in the Cook & Fergusson case, he also delivered his judgement in another case on section 35 and section 33, a case which went on to the Court of Appeal: Crown Bedding Co. Limited -v- IRC.[10]

This is another case on the denial of the benefit of the grouping provisions of section 28 FA 1940. On the facts, the decision is clearly right, but the case is useful for a succinct statement by Lord Greene MR of the difference between the mental requirements of section 35, as originally drafted, and as amended by section 33. Lord Greene's analysis also underlines the difficulties facing taxpayers seeking to escape these sections. In this case, for example, the taxpayer's did not expect profits to be in excess of the standard.

The facts were that the taxpayer company, had an issued share capital of £200,000, divided into 160,000 ordinary shares of 5 shillings each, and 160,000 preference shares of £1 each. It carried on the business of bedding manufacturers. In 1929, the directors decided to open a factory in South Wales to deal with imported rags, and for this purpose a company called South Wales Flock Co. Limited was incorporated with a share capital of £5,000 divided into 5,000 shares of £1 each. The shares in this company were held as to 1,360 by three individuals who were directors of, and had a controlling interest in, the taxpayer company, and their mother; as to 2,640 shares by a wholly owned subsidiary of the taxpayer company; and as to 1,000 by the manager of the factory in South Wales.

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10. (1946) 34 TC 107

In 1940, imports of rags into South Wales ceased entirely, and, early in 1940, the factory was closed down. In June 1941, the whole of the share capital of South Wales Flock Co. Limited was acquired by the taxpayer company, with the result that deficiencies incurred by the former company could, under the provisions of section 28(1) and the fifth Schedule FA 1940, relating to inter-connected companies, be applied in reduction of the excess profits of the taxpayer company and its subsidiaries.

The Inland Revenue took the view that avoidance or reduction of liability to excess profits tax was, or as being the main benefit which might have been expected to accrue from the transaction during the currency of excess profits tax was deemed to be, the main purpose, or one of the main purposes of the acquisition by the taxpayer company of the 1,360 shares in South Wales Flock Co. Limited, previously held by its directors and their mother. The Revenue issued a direction under section 35 (as amended by section 33) that the excess profits tax liabilities of the companies should continue to be computed on the basis that South Wales Flock Co. Limited was an independent company to which the provisions of section 28(1) FA 1940 did not apply.

The taxpayers contended that, at the time of the transaction, the group of which the taxpayer company was the principal company, could not expect profits to be in excess of the standard profits, and that the main benefit which might have been expected to accrue from the transaction during the currency of excess profits tax was not avoidance or reduction of liability to the tax.

Macnaughten J held that, on the facts found by the Special Commissioners, the only benefit that could possibly accrue to anyone from the transaction was the benefit which did in fact accrue to the taxpayer company by the reduction of its liabilities to excess profits tax, which would have occurred if the Revenue had not issued the direction. He said that, in his view, this reduction of liability was, not only the sole benefit obtainable from the transactions, but was in fact the only conceivable purpose of it.

In the Court of Appeal Lord Greene MR with whom Somervell and Cohen LJJ agreed, referred to the amendments made to section 35 by section 33 and said:

> "The effect of that is this. Whereas, under the original section 35 of the 1941 Act, even with the amendments introduced by subsection (2) of section 33 of the 1944 Act, it would have been necessary in such a case as this to prove to the satisfaction of the Commissioners of Inland Revenue or, on appeal, to the satisfaction of the Special Commissioners, that the main purpose of one of the main purposes of the transaction was in fact the avoidance or reduction of tax liability, under subsection (3) in the cases there mentioned the necessity of proving the subjective element of purpose in the minds of the actors is removed. It is sufficient to prove that the main benefit which might have been expected to accrue was 'avoidance or reduction of liability to tax'. Directly that is proved, the matter of purpose is deemed to have been satisfied."[11]

On that basis, Lord Greene dealt with the argument of the taxpayers that they put the potential excess profits tax advantage out of their minds as a purpose of the transaction, because they did not expect that that benefit would ever materialise owing to the improbability of the group remaining liable to excess profits tax so that, the question of excess profits tax was not considered. To this, Lord Greene said:

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11. p115

"Taking that evidence at its face value, it goes no further than this, that the directors did not expect that they would obtain a tax benefit from this transaction. But [Counsel for the taxpayers] did not argue that the opinion of the directors was to be treated in any way as conclusive for the purposes of the subsection. In other words, when the subsection speaks of the main benefit which might have been expected, it does not mean the main benefit which was in fact expected by those carrying out the transactions, but means the main benefit, in the opinion of the tribunal which ultimately has to decide, which might have been expected by a person surveying all the facts and knowing all the law on the subject at the time. I do not mean that the views of the directors, who are familiar with the facts, would be inadmissible in evidence. All I am saying is that the fact that directors expected or did not expect a particular result can by no means be conclusive of the question although it may be evidence which the Commissioners should take into account in forming their opinion."[12]

This underlines the fact that an intention on behalf of the taxpayers to avoid excess profits tax was in no way necessary. The precise nature of the mental element required is evident from the following analysis by Lord Greene:

"The Special Commissioners, in their finding, quite clearly are finding as a fact that, in their opinion, a tax benefit was to be expected and, comparing that benefit with the alleged commercial benefit, they take the view that the tax benefit was the main benefit.

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12. pp 117-8

[Counsel for the taxpayer] attacks that finding by going straight to the construction of the section, and he says that under the section it is not open to the Special Commissioners to find that the main benefit which might be expected to accrue was avoidance or reduction of tax where avoidance or reduction of tax was not a probability but only a possibility. He says in this case the directors thought that it was so remote as to be negligible and they did not take it into account. He said on the facts as found a reasonable man, knowing all the facts and putting himself in the position in which things were at the relevant date, would have come to the conclusion that he could not expect any benefit in the way of avoidance or reduction of tax to accrue; the ground being that in order to bring the section into operation there must be expectation of a benefit by way of avoidance or reduction of tax in the sense that a reasonable man would expect such avoidance or reduction to accrue - not that he would think that it might, in certain unlikely events, accrue, but that it would, in fact, in his opinion, be likely to accrue.

In my opinion that is much too narrow a construction to put upon these words. After all, the question of probability or possibility is a matter really which can be considered as resembling a scale. At the top of the scale is certainty. At the bottom of the scale is improbability so extreme that no sensible person would ever take it into account. But subject to that, the precise point on the scale at which you can say that a thing is probably rather than possible and the precise point at which you say that a probability falls to the level of the mere possibility depends on the view taken by a hypothetical observer. It seems to me that it is quite impossible to put on the word 'expected' the sense that a hypothetical observer must have had that degree of confidence in the future as to expect that the benefit would materialise."[13]

Lord Greene said that if the Commissioners, in considering the possibility of benefit came to the conclusion that, to the mind of a reasonable man, that benefit was so remote and so unlikely as not to be worth considering, they would put it out of consideration. On the other hand, once the possibility moves up the scale towards a probability there is a wide area in which they, as judges of fact and degree, are entitled to form a conclusive opinion. Lord Greene did not go as far as Macnaughten J in saying that there was no evidence on which the Commissioners could have found for the taxpayer; but there was, in his view, ample evidence on which the Commissioners could find that, of the two benefits, the tax benefit was the main benefit.

This case shows how difficult it was for the taxpayers to satisfy the test laid down by section 35, as amended by section 33.

The sections were applied to arrangements increasing the number of "working proprietors" in Marshall Castings Limited -v- IRC.[14] In this case, Wrottesley J gave further guidance on the application of the mental element in section 35 and section 33.

The issued share capital of the taxpayer company was £8,352 dividend into ordinary shares of £1 each. The directors had a controlling interest in the company and it was entitled to claim, in respect of its own business jointly with that of its subsidiary company, Cindal Aluminium Limited, a minimum standard of one working proprietor. No shareholding qualification was prescribed

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13 p 119
14 (1946) 34 TC 122

for a director. On 1st January 1941, the taxpayer company's issued share capital was increased by the issue of 2,100 £1 6% preference shares. The new shares were acquired in equal proportions by four employees of the taxpayer company who were appointed directors and, as a result of these transactions, became qualified as "working proprietors" within the meaning of section 13(2) F(No 2)A 1939, as amended.

The issued share capital of Cindal Aluminium Limited was £252, divided into ordinary shares of £1 each, 250 of which were owned by the taxpayer company. In order to qualify as a director, it was necessary to hold one share. On 29th November 1940, the two directors of Cindal, who were also the directors of the taxpayer company, purchased from the taxpayer company the whole of its shareholding in Cindal, which then ceased to be a company to which the provisions of section 28(1) and the Fifth Schedule FA 1940 (the grouping provisions) applied and became entitled to claim a separate minimum standard under section 13(1) F(No 2)A 1939.

On 29th January 1941, the capital of Cindal was increased by the creation of £1 preference shares, 525 of which were issued. Those shares were acquired by an employee of Cindal, who was appointed a director. On 8th April 1941, 50 preference shares were allotted to each of two other employees of Cindal, who were appointed directors on the same day. As a result of these transactions. The three employees became qualified as "working proprietors" within the meaning of section 13(2) F(No 2) A 1939, as amended.

The Inland Revenue took the view that avoidance or reduction of liability to excess profits tax was, or as being the main benefit which might have been expected to accrue from the transactions during the currency of excess profits tax was deemed to be, the main purpose, or one of the main purposes, of the share transactions. They issued a direction:

a. that the four employees of the taxpayer company, and the three employees of Cindal should not be regarded as "working proprietors"; and

b. that Cindal should continue to be treated as a subsidiary of the taxpayer company within the meaning of section 28 and the Fifth Schedule FA 1940.

The taxpayers argued, inter alia, that the only object, and therefore the only benefit expected by them, was that that the businesses of the two companies would be benefited by the fulfilment of promises made to employees, the removal of any cause for discontent among them and their assurance that their services would be retained. They also argued that, since the companies and the persons instigating the transactions in question thought that the benefit referred to above was the only benefit which the companies would get from the transactions and knew nothing of any excess profits tax benefit at the time, there was no evidence upon which any tribunal could hold that the excess profits tax benefit to be expected was greater in value than the other benefits in question. As regards the mental element of section 35, as amended, the taxpayers argued that it was a penal section and that consequently the onus was on the Inland Revenue to establish beyond reasonable doubt that the main benefit which might have been expected to accrue from the transactions was avoidance or reduction of liability to excess profits tax, and that they had not discharged that onus.

The Special Commissioners confirmed the directions (except as regards one of the directors) and their decision was upheld by Wrottersley J.

The Judge noted the incentive to increase the number of working proprietors. He said that there was every inducement to those who controlled a business to take advantage of the provisions permitting minimum standard profits in order to increase the standard profit of the company by, for instance, a father taking his son into partnership, or making his son and daughter directors so as to make them working proprietors. By this means, the company would be able to keep greater profits which would not be treated as excess profits.[15]

Counsel for the taxpayer pointed out, and the judge did not disagree[16], that the powers given to the Inland Revenue were far reaching and "came perilously near exposing the subject to such taxation as the Commissioners of Inland Revenue might chose to impose." The powers granted to the Commissioners were an apparent delegation of a discretion ordinarily reserved by Parliament to itself because they enabled the Commissioners of Inland Revenue to charge with tax persons who would otherwise not be chargeable. On the other hand, he said, "these powers are confined to what is necessary in order to counteract the avoidance or reduction of liability to tax which would otherwise be effected by the transaction"[17] As can be seen from the Frodingham case,[18] this is not strictly true.

With reference to the facts of this case, the judge held that the Commissioners were right to exclude from their consideration benefits accruing, not to the company, but to the individuals. The tax avoidance which the Inland Revenue had to counteract was, he said, clearly tax avoidance by the company because the tax, if not avoided, would be assessed on and raised from the company. He continued:

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15. p 134
16. See p 135
17. Ibid
18. Frodingham Ironstone Mines Ltd v IRC [1946] 1 Auer 168, supra.

"On this side of the scales, therefore, is to be placed the benefit which might be expected by a reasonable man to accrue to the company in the form of tax avoidance flowing from the transactions. Then, in order to see whether this benefit was the main benefit to the company, it seems to me that the Commissioners must next look at the other benefits which might be expected by a reasonable man to accrue to the company during the currency of the tax upon the transaction; for instance, greater zeal in production, a greater incentive to care and economy in the use of the company's plant on the part of the employees, the retention or enlistment of a particularly skillful man who is not willing to remain a wage or salary earner merely. These are the kind of benefits to which the Commissioners are intended to have regard ... From this point of view, benefits to individuals may be taken into account, but only in so far as they are likely to advantage the company."[19]

It can therefore be seen that only benefits likely to accrue to the company itself, and not those likely to accrue to other persons, could be taken into account in considering whether avoidance or reduction of tax liability was the main benefit which might be expected to accrue from the transactions in question.

Although, as is apparent from the Marshall Castings case,[20] the non-tax benefits must be specific to the company carrying out the transaction, it is apparent from the next case that the liability to excess profits tax, the avoidance or reduction of which was a purpose of the transaction, need not be the liability of any particular person or company. To say that the dice were loaded against the taxpayer is, in the circumstances, an under-

19. P 136
20. Marshall Castings Lgd v IRC (1946) 34 TC 122

statement! The case in question was British Pacific Trust and B.M. & J. Strauss -v- IRC.[21]

British Pacific Trust Limited was, before the Second World War, engaged in a large number of financial and other ventures, and had a standard profit of £225,000. After the outbreak of war, its profits declined, and on 31st March 1942, it had a deficiency for the purpose of excess profits tax of £700,000. B.M. & J. Strauss Limited carried on the business as a wine and spirit merchant, and had a valuable stock of wines and spirits. Its standard profit was £6,000, and, during the war its profits increased and, at 31st October 1942, its liability for excess profits tax was £18,000.

In 1942, the shareholders of Strauss desired for personal reasons to sell their shares and retire. Negotiations took place with the secretary of Pacific and eventually Pacific bought the whole of the issued share capital of Strauss for £168,000. If there had been no excess profits tax, there would have been more possible purchasers of the shares, and therefore a harder bargain could have been driven. The object of Pacific in purchasing the shares of Strauss was to obtain a profitable investment and, whereas before the sale, Strauss restricted the quantity of wines and spirits it sold, after the sale, this policy was changed because Pacific considered the purchase of the shares in Strauss to be primarily the purchase of a saleable asset.

The Revenue made a direction to the effect that the liability of Strauss should be computed as if it were an independent company and not a member of the Pacific group. The Special Commissioners confirmed this direction on the footing that the prospect of a profitable investment and the chance of a resale of the shares at a good price, both rested upon the consideration that the standard profit and the deficiency

21. (1947) 202 LTJO 131

of the first company would prevent the payment of excess profits tax upon sales of wine by Strauss. Both Macnaughten J, in the High Court, and the Court of Appeal, held that the Special Commissioners decision was correct.

Lord Greene MR said that it was obvious that an investment, the result of which was going to provide a person with shares in a sound company, is all the more a profitable investment if, as a collateral result of acquiring shares, he is enabled to enjoy the benefits of his own excess profits tax deficiency position by securing for the company whose shares he was buying, larger profits than it had been allowed to make before without incurring excess profits tax liability. It is noticeable that Lord Greene referred to this as a "collateral" result and not as being in any way an important or "main" one. He noted that it had been said that, it having been realised what the excess profits tax result would be, and what the financial results of the transaction would be if carried through, the tax position was dismissed from Pacific's mind and it went ahead with what was regarded as a good commercial bargain. Lord Greene commented:

> "That is a perfectly natural thing to do; but it is a little bit difficult to suppose, if the financial benefits of a bargain are very much increased by the excess profits tax position that that is not one of the objects aimed at in the purchase. You can dismiss a thing from your mind but, once you have had it in your mind I should have thought that you could not dismiss it from your mind in the sense that you give no effect to it in your calculations. You cease to bother your head about it because you have found out what it is."

Lord Greene said that it was clear that the directors of Pacific looked at the deal from a commercial point of view and one of the elements in the commercial aspect of the transaction which "must have stood out a mile to any businessman" was the excess profits tax position.

He said that the Special Commissioners would have had the greatest difficulty drawing any conclusion other than that one of the objects of Pacific in acquiring the shares was to get the benefit of the tax position, so as to be "one of the main purposes".

He said that it was quite sufficient that the main purpose was operating upon the minds of the purchasing company alone. He said:

> "It is conceded and rightly conceded that the liability to excess profits tax, the avoidance or reduction of which was a purpose of the transaction, need not the liability of any particular person or company. If it is the avoidance or reduction of anybody's liability to excess profits tax, that will do. The word 'transaction', it appears to me, means what it says. A sale is a transaction. A purchase is a transaction, and it is in a sense the same transaction, but it depends on the side from which you are looking at it. If you are looking at it from the side of the vendor, you describe it as a sale. If you are looking at it from the side of the purchaser, you describe it as a purchase. Here there was a transaction, namely, a purchase of shares by Pacific. The effect of that (starting with effects first) was to reduce the liability to excess profits tax of the Strauss company. Question: What was the object in making that purchase? I should have thought, on the facts of this case, that the only object which it is necessary to consider is the object of the person who effected that transaction, namely, the purchaser himself. I cannot see that it is necessary to bring in the vendor as part of the 'transaction' referred to in the subsection so as to regard the

> transaction as a composite transaction of sale and purchase. It is sufficient to my mind to look at it from the point of either party. You may have a case where the main purpose of the sale would be the reduction of some excess profits tax, or you may have a case where the main objects of a purchase is the same thing. I see no necessity for saying, and I think it is against the true interpretation of the section, that there must be a main purpose in the sense of a unitary purpose of a composite transaction of purchase and sale."

A similar situation arose in another unreported case: IRC-v- -v- David Allen & Sons (Billposting) Limited.[22] The profits of the taxpayer company dropped at the outbreak of war so that its profits were insufficient to cover its overheads. In order to meet this situation, the company acquired a majority stake in a company which had a small standard profit but which was beginning to make large profits. At the time, the taxpayer company had a deficiency of £30,000. The price at which the shares in the acquired company (Torbay Trawlers Limited) were purchased was based on a valuation of the assets of that company without any reference to its capacity to earn profits.

The Special Commissioners decided that the avoidance or reduction of excess profits tax was not one of the main purposes of the transaction and that the main benefit which might have been expected to accrue from it was the obtaining of an additional source of trading income to maintain the business and solvency of the taxpayer company. Atkinson J, however, disagreed and held that the main benefit which might have been expected to accrue was the avoidance of liability to excess profits tax.

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22. A note of this case was given in "Taxation" magazine, 12th July 1947 at pp 283-3

The judge pointed out that, in the light of section 33 FA 1944, the Court merely had to examine the question whether the "main benefit which might have been expected" was avoidance or reduction of liability to excess profits tax, and that design and intention ceased to be important. He noted that the auditor of the taxpayer company advised that the best thing to do when its profits fell heavily was to seek an additional source of income.

However, it was clear that, if it had not been that the result of the purchase of the Torbay company's shares would be that the company would ceased to pay excess profits tax, the transaction would have been of no value at all.

The Special Commissioners had said:

> "So looking at the matter, we were satisfied that on a true view of the facts as a whole, avoidance or reduction of excess profits tax was neither (a) the main purpuse or one of the main purposes of the transaction in issue, nor (b) the main benefit which might have been expected to accrue from the transaction during the currency of excess profits tax, but that the sole purpose of the transaction, and also the main benefit which might have been expected, was the provision of an additional source of trading income to enable the David Allen group of companies to maintain its business and solvency during a period of exceptional difficulty."

Atkinson J said that it was a contradiction of the facts to say that the "main benefit was the provision of an additional source of trading income" without adding some such words as: "With regard to which excess profits tax had been avoided and that the avoidance was the direct result of the transaction in question". He continued:

> "I repeat that, if it had not been for the fact that tax had been avoided, there was no additional source of trading income. It was only an additional source of trading income because of the benefit accruing to David Allen & Sons Limited. It does not matter which one you regard as the recipient of the benefits. The Torbay company was the first recipient; it escaped the tax, and then David Allen & Sons Limited, as the main shareholder, got the benefit of it. But the 'main benefit' arising from the transaction - indeed the only benefit - was the getting rid of the liability to tax; and when that is the only benefit, I cannot conceive how it was possible for the Special Commissioners to find as they did."

This case shows how hard it can be on the taxpayer when intention is irrelevant.

The taxpayers also failed the benefit test in Harridges (Wholesale) Limited -v- IRC.[23] The taxpayer company carried on a retail business through five shops. A company called S. Markheim Limited, which had the same shareholders as the taxpayer company, did the buying for the taxpayer company and was paid accordingly. On 31st March 1940, five new companies were incorporated and the five shops were transferred to these companies, the taxpayer company changing its name and taking over the buying side of the business.

The decision to form the new companies, and to transfer the shops to them, was arrived at following pressure by certain trustees who held shares in Markheim and the

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23 (1947) 204 LTJO 315

taxpayer company. The beneficiaries had for many years not received a dividend from Markheim and the trustees considered that, if the business were distributed among different companies, there would be a better chance of income being available for their beneficiaries, in that a period of bad trading by one company would not affect the ability of other companies to pay dividends.

The transfers of the shops to the new companies was made for a total consideration which yielded a surplus of £5,992 to the taxpayer company, £4,898 of which was distributed to the shareholders as a capital distribution, and was at once repaid by them to the taxpayer company as consideration for the allotment of further shares. The large saving of excess profits tax occured by reason of the transfers of the shops to the new companies.

The Special Commissioners were not satisfied that the main purpose of the transaction was the avoidance or reduction of liability to excess profits tax, but they decided that the main benefit, which might have been expected to accrue from the transaction, was such avoidance or reduction. In the High Court, Atkinson J held that there was ample evidence to support the Special Commissioners decision.

Atkinson J said that it did not take much intelligence to see that what was being done would have a most material affect upon the amount of excess profits tax available. It was, he said, quite clear that each of the companies would get a separate standard, and it was apparent that a large advantage was going to be obtained, namely the reduction of liability to excess profits tax. He said:

> "That is merely how it strikes me, but the question is: how did is strike the Special Commissioners? Did it strike them in the same way? They have found as a fact that that was the main result which might have been expected to ensue; in other words, they have said that any reasonable man giving his mind fairly to the question at that time; I now, what is going to be result of this? would inevitably or almost necessarily, have come to the conclusion; well, at any rate, there is one thing you can count upon, and that is this, that if you make money you will be able to stick to it; you will avoid this taxation. They were the same shareholders in all the companies, and that that was the main benefit was the conclusion at which the Special Commissioners arrived."

The taxpayers had argued that the Commissioners, in reaching their decision of fact, had failed to consider all of the benefits which resulted from the transaction, and the taxpayers submitted a list of ten commercial benefits. But, Atkinson J said that it was for the Special Commissioners and not for him to weigh up these benefits. There was, in his view, ample evidence upon which the Commissioners could find as they did.

This, then, is another case in which a transaction carried out, not for the purpose of avoiding tax, but for a genuine commercial reason, was caught by this very wide mental element test.

The next case, <u>IRC v Earthwork & Construction Ltd.</u>, another decision of Atkinson J, is something of a rarity in that the taxpayers actually managed to satisfy the main benefit test. The case was not reported but a note of the judgement appeared in "Taxation" magazine.[24] According to "Taxation" magazine, the situation was as follows. The taxpayer company was a subsidiary and it used machinery which it had bought from its parent for the purposes of its business. Other companies doing the same kind of business as the taxpayer company also bought machinery from the parent, and it became known in the trade that the taxpayer was a subsidiary of the company from which they bought their machinery. Complaints that this position was unfair reached the American manufacturers, whose agent the parent was, and the parent was anxious to do something to avoid these complaints. The parent company was approached by a representative of a third party, and it was arranged for the third party to buy the plant and machinery of the taxpayer company for £60,000, but that the subsidiary should continue to work the plant for another year so as to complete its current contracts, and should pay a hire charge of £5,000 a month.

The subsidiary was to go into liquidation. Of the purchase price of the plant £20,000 was to be paid at once, and the remaining £40,000 to the liquidator. This latter sum was to be paid to a joint account of the liquidator and the third party, and as the hire payments came in, corresponding amounts were to be released to the liquidator.

This transactions was advantageous to the parent company in that it weakened the ground of the complaints and enabled the taxpayer company to be sure of receiving the £60,000 for the plant. Shortly after the taxpayer company went into liquidation, a new subsidiary with a different name was incorporated, and, whereas the taxpayer company's standard profit was £5,570, that of the new company was £1,000. It was found as a fact that the transaction with the third party was a genuine one. There was no evidence that the hiring charge paid to the

24. 17th July 1948, at p 301

third party did not attract liability to excess profits tax in that party's hands. The hiring charge was less than the government rates of hire, and the price of £60,000 for the plant was a reasonable one.

The Special Commissioners held that the avoidance or reduction of excess profits tax liability was neither the main purpose nor one of the main purposes of the transactions and that the main benefit which might have been expected to accrue from them was the capital receipt of £60,000 on the cessation of the subsidiary company's business.

Atkinson J held that there was ample evidence to support the Commissioners decision. He said that, in his view, the crucial fact, as found by the Special Commissioners and not challenged, was that the main transaction was a perfectly genuine one between parties at arms length and that there was no collusion of any kind. The Special Commissioners found as a fact on the evidence that the avoidance of tax was not a consideration, and was not one of the main motives for the transaction, and the judge said that it was quite impossible for him to differ from them. He said:

> "I have no doubt that when considering the offer and the conditions which formed part of it, someone would point out that it made very little difference to them whether they paid their earnings away in excess profits tax or paid a great part of them to Bowmakers for hire, but that would be merely one of the incidents of the transaction; it was not one of the actuating causes for it; it was not one of the motives."

The company was not bound to trade "for the purpose of earning excess profits tax", and was not bound to trade in a way which would result in heavy taxation, if it could trade legitimately in a different way. The judge commented:

> "A company might very well say to itself: 'Now, shall we buy plant or shall we hire? If we spend £60,000 on plant, all the profit we make except £1,000 will go in excess profits tax. Why should we spend our capital in that way? We will hire plant and retain our capital, and use the plant for the same purposes as those for which we would have used it if we had bought. We will make the same profits and instead of the profit all going in excess profits tax, a great part of it will go in hire. It makes no difference to us and we are left with our capital intact.' There is no reason in the world why a company should not say that."

This case, when compared with the Harridges case, shows how important the findings of the Special Commissioners were in relating to the benefit test.

In those circumstances, the next case is even more of a rarity in that the taxpayers won on the main benefit test despite a Special Commissioners decision against them. This case was Joseph Smith (Cleckheaton) Limited -v- IRC.[25]

The taxpayer company carried on the business of a spinner of fine yarn and worsted. In 1937, it acquired the lease of additional premises in Bradford, and there carried on the separate business of spinning yarn of a coarser quality. In 1941 these premises were closed and the business was concentrated at Cleckheaton. Part of the machinery at Bradford was sold, and part was stored in certain premises at Cleckheaton. In 1941, a company called Rawfolds was incorporated with a Memorandum of Association containing similar objects to those of the

25. [1949] 2 All ER 211

taxpayer company. Rawfolds took a lease of some other premises at Cleckheaton from a third party, and in those premises, Rawfolds carried on the business of warehouseman. A part of the unsold machinery was stored in Rawfolds premises for a about a year until the machinery was sold. The main trading receipts of Rawfolds were rent and storage charges received for storing wool for the Wool Control. Some wool was also warehoused for the taxpayer company. To an unspecified extent the taxpayer company bought some uncontrolled material, and sold it to Rawfolds, which in turn resold it. All but one of the shares of Rawfolds were allotted to the person who had the main interest in the taxpayer company.

A direction was made under section 35 and section 33 against the taxpayer company directing that the business of Rawfolds should be regarded as being carried on by the taxpayer company in addition to the taxpayer company's own business, and that the liability should be a joint a several one.

The Special Commissioners decided that it was not one of the main purposes of the transaction to avoid or reduce liability to excess profits tax, but that such avoidance or reduction of liability was the main benefit to be expected during currency of excess profits tax.

However, in the High Court, Croom-Johnson J held that the facts did not disclose either the transfer or acquisition by the taxpayer company of shares in Rawfolds, or a change in the person carrying on the taxpayer company's business and that, therefore, the Special Commissioners decision could not stand.

The judge said that it had to be inquired whether the two transactions specified in the direction brought the case within section 33(3) FA 1944, as involving either the transfer or acquisition of shares in a company, or a change in the person carrying on the trade or business. On the facts set out in the Stated Case he could not see that the allotting of shares in Rawfolds to the main shareholder in the taxpayer company (Mr. Smith) could be either a transfer or acquisition of shares by the taxpayer company, unless there was a finding that the beneficial interests in those shares belonged to the taxpayer company, in other words, that Mr. Smith held them on behalf of the company. There was, however, no suggestion that any of the transactions were illusory or colourable or otherwise than what they purported to be. Further, there was no evidence that the taxpayer company carried on business even in part as a warehouseman and, therefore, there could be no change in the person or persons carrying on that sort of business.

It seemed, therefore, that the case was not within section 33(3) at all. The judge said:

> "There was no transaction that I have been able to find in the Stated Case if it makes a difference, certainly no transaction indicated in the direction, which suggests that the [taxpayer] company had transferred any branch of its business, or any part of its trade or business. There is no suggestion that the [taxpayer] company (which is occupying the whole of the spinning mill and is apparently unable to find any more room for business in it) was transferring either a trade or a business to Rawfolds, or a part of any trade or business, which theretofore it had carried on. There is nothing to indicate that the acquisition of shares in Rawfolds was other than an acquisition by Mr. Smith in

his own right, and that he paid for them. Further, it is quite plain that the benefit which was to be expected from these transactions, is a benefit, not to Mr. Smith, but to the [taxpayer] company."[26]

Earlier in his judgement, the judge had said, because of the "far reaching" powers of the Inland Revenue under section 35 FA 1941 (as amended by section 33 FA 1944), "the Court should scrutinise the exercise of those powers with some particularity."[27]

There is a suggestion here, that, as the national emergency of the war years receded, the Courts were beginning to take a rather stricter line with the wording of these sections.

The nature of the main benefit test was also at point in the case of <u>Cumberland Coal Company (Whitehaven) Limited -v- IRC</u> (unreported). A brief report of this case was given in "Taxation" magazine[28] from it appears that a direction was made under section 35 and section 33 in consequence of the acquisition by the taxpayer company of shares in another company, whereby the acquired company became the taxpayer company's subsidiary. There was evidence that the directors of the taxpayer company recognised the advantage for the purpose of excess profits tax that would accrue to the taxpayer company by the acquisition of the shares in the other company, but that they regarded that advantage as incidental, and that it did not weigh with them in proceeding with the transaction.

The Special Commissioners found that the main benefit under section 33(3) FA 1944 was not the avoidance or reduction of liability to the tax, but they also found that it was one of the main purposes of the transaction to effect such an avoidance or reduction of liability.

26. p 215
27. p 213
28. 23rd April 1949

In the High Court it was contended that, as the Special Commissioners had decided that the main benefit to be expected was not an excess profits tax benefit, it was not open to them to find that the purpose represented by that benefit was one of the main purposes of the transaction, and that that purpose was the avoidance or reduction of liability to the tax.

Croom-Johnson J, however, held that the Special Commissioners were entitled to decide that one of the main purposes of the transaction was the avoidance or reduction of liability to excess profits tax.

The taxpayer company had argued that, once the Special Commissioners had come to the conclusion that the main benefit in question was not an excess profits tax benefit, it was impossible for them to hold that it was one of the main purposes of the transaction. To this, the judge said:

> "I pointed out, in the course of the argument, that the words are different. One of the questions which the Special Commissioners had to decide was whether the main benefit to be expected was something different from any other benefit which might arise; and the other question was as to purpose or main purpose; and it is suggested, as a sort of mental exercise for me, that if a benefit is one benefit, <u>the</u> benefit, the main benefit, making no allowances so far as tax liability is concerned for any other possible benefit, then I must not, when it comes to looking at the main purpose, come to the conclusion that this was one of many main purposes. I do not see why not. It seems to me that Parliament has used one expression in one subsection and another expression in the other two subsections and in section 35. It is not for me to edit the Special Commisioners determinations about it."

The report in "Taxation" magazine states that the appeal was allowed. In fact, this must be wrong as Croom-Johnson J upheld the findings of the Special Commissioners and, accordingly, must have dismissed the appeal.

Finally, on the question of the main benefit test, there is another unreported decision: Majestic (Derby) Limited and Star Cinema (London) Limited -v- IRC, a note of which was given in "Taxation" magazine.[29] The facts were that, on 15th February 1940, Majestic leased its cinema to Star of seven years, Star having the right to terminate the lease at the end of the fifth year, and also having the right to purchase the freehold for £23,000 within the first five years of the lease.

On 5th January 1943, the whole of the shares in Majestic were purchased as to 7,500, by Star and, as to the remainder, by the controlling shareholder of Star and his wife. The cinema had cost £30,000 and Majestic was entitled to a standard profit of £3,000 pursuant to section 13(9) F(No 2)A 1939. The cinema had been carried on at a loss up to the date of the lease.

At the date of the acquisition of the shares in Majestic that company had an overdraft of about £20,000, and the bank had required that the overdraft should be reduced at a rate of £2,000 a year. It was part of the sale transaction that the £6,000 which was paid for the shares should be paid by the vendor into the account of Majestic so as to reduce the overdraft to £14,000; and that the purchaser should give his personal guarantee, in substitution for that of the vendor, to repay the overdraft at the agreed rate.

Subsequently, attempts were made to induce the bank to consent to the overdraft being reduced by sums which Majestic could pay out of the rent that it received from

29. 26th August 1950

Star, but the bank would not agree to this. Attempts were made to borrow £14,000 but without success. It was suggested by the bank manager that, in order to enable Majestic to meet its obligation to the bank, the lease should be surrendered to Majestic, so that the profits from the cinema could be received by that company, and the repayments to the bank be made out of that profit. It was in pursuance of this arrangement that the surrender of the lease took place on 6th September 1943.

During the accounting period to 30th April 1944, the overdraft of Majestic reduced to £10,455 but, during the following period it increased to £15,178, and during this period Majestic made a loan of £10,000 to an associated company.

The Crown did not dispute the evidence that was given before the Special Commissioners to the effect that avoidance or reduction of liability to excess profits tax was not, in fact, the main purpose or one of the main purposes, for which the surrender of the lease was effected; and the only question was whether the main benefit to be expected from the surrender, during the currency of excess profits tax, was such avoidance or reduction, so that section 33(3) applied.

The Special Commissioners decided that the main benefit to be expected was an avoidance or reduction of liability and Romer J, in the High Court, held that this decision was correct. The judge said that, after the transaction concerning the lease had been completed, it was Majestic that carried on the business at the cinema from that time onwards, and this plainly involved such a change as was envisaged by section 33(3)(b).

The taxpayer company's contended that, if the surrender of the lease involved such a change, then so must the grant of the lease by Majestic to Star on 15th February

1940; and, secondly, that Majestic's standard profit of £3,000 passed as an accretion to Star's standard profit on the grant of the lease, and passed back again to Majestic when the lease was surrendered, with the result that such surrender involved no change in the excess profits tax position. Alternatively, the taxpayer companies argued that, if as a matter of law, the standard profit was not carried forward from Majestic to Star in March 1940, then some figure at least should be credited to Star's capital computation as representing the value of the lease as at 15th February 1940 which was a new asset acquired by that company; and that, accordingly, an additional amount of standard profit in respect of that asset should be allowed to them during the lease which they would and did lose when the lease was surrendered.

Romer J said that he was unable to attribute to the arguments for the companies the effect of displacing the conclusion at which the Special Commissioners had arrived. He said:

> "It is, in my opinion, clear that the profits of the cinema, which prior to the surrender of the lease had been substantially or wholly lost to the Star company by reason of excess profits tax, were, subsequently to such surrender, largely immune from such tax in the hands of the Majestic company; and that this benefit was the 'main benefit' for the purposes of section 33(3) of the Finance Act 1944."

Atkinson J considered the onus and burden of proof in relation to the main benefit test in <u>Dixon & Gaunt Limited -v- IRC</u>[30] The Inland Revenue made a direction under section 35, as amended by section 33, in respect of a transfer by James Hare Limited of 7,000 shares in the taxpayer company, being of the opinion that avoidance or reduction of liability to excess profits tax was, or as

30. (1947) 29 TC 289

being the main benefit which might have been expected to accrue during the currency of excess profits tax, was deemed to be, the main purpose, or one of the main purposes of the transaction. They directed that the excess profits tax liability of the taxpayer company should be computed on the basis of the company continuing to be treated as a subsidiary company of James Hare Limited within the meaning of section 28 and the Fifth Schedule FA 1940.

On appeal to the Special Commissioners, the taxpayers contended that the onus lay upon the Inland Revenue to justify the making of the direction and that it was accordingly for the Revenue's representative to open and establish the facts necessary for that purpose. The Special Commissioners, however, ruled that it was for the taxpayers to open in the first instance and establish on the evidence a prima facie case in support of the appeal which they had entered.

On appeal to the High Court, however, Atkinson J held that the onus lay upon the Commissioners of Inland Revenue to put before the Special Commissioners facts sufficient to justify the direction, and he remitted the case to the Special Commissioners for them to hear and determine the appeal against the direction accordingly.

Atkinson J referred[31] to the normal rule in tax appeals, then to be found in section 137(4) ITA 1918.[32] He noted that there was good reason for putting the burden on the taxpayer of proving that arrangements were wrong, because otherwise the taxpayer would only have to keep no books, no bank account, insist on being paid in Treasury Notes, and no one living could ever prove what his income was or establish any liability to income tax.

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31. p 293
32. Now substantially reproduced as section 50(6) TMA 1970.

He noted that section 21 FA 1922[33] expressly incorporated the section 137(4) procedure, but that there was no similar provision in relation to appeals under section 35 FA 1941.

He added that the Commissioners had extensive powers of obtaining the information they need. He said it was clear that the Revenue had the fullest power for demanding particulars and seeing such things as accounts and books. Therefore, they ought to be certain that they had in their possession before they make any direction sufficient information to make it appear that a direction should be made.[34]

He compared section 35 with section 21 FA 1922. He pointed out that both sections effectively started with a charge of tax avoidance. The Commissioners of Inland Revenue, he said, ought not to make those charges unless they have formed an honest opinion that they are justified. That means that they must have certain facts in their possession upon which they formed their view. There can be no difficulty in placing those facts before the Special Commissioners and the Inland Revenue are under no disadvantage if called upon to justify their claims. The judge continued:

> "On the other hand it is not intended that [the Inland Revenue] should be able to say to themselves: Well, let us draw a bow at a venture and allege that such and such a transaction is intended to evade taxation and then we will try and justify it by cross examination. That is not the intention of these sections.
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> Quite apart from authority it seems to me that a man charged with evasion[35] should be told what the facts

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33. See Part 7, infra
34. p 295
35. Throughout his judgment Atkinson J referred to "evasion" when today one would say "avoidance.

are upon which the Inland Revenue Commissioners rely, upon which they base their opinion and their charge. The question on an appeal is not whether the Commissioners of Inland Revenue had been of that opinion, but whether it appears to the Special Commissioners hearing the appeal that such and such result must be expected to follow from the transaction. It is a procedure which is intended to get the view and judgement of the Special Commissioners who are hearing the appeal. To my mind, the answer to the question asked in this case must depend upon the answer to the question: Where lies the burden of proof?"

On this question of burden of proof, the judge cited Thomas Fattorini (Lancashire) Limited -v- IRC.[36] In that case, the majority of the House of Lords were of the opinion that the burden was on the Commissioners of Inland Revenue to justify the charge of avoidance, and that, at no stage, was the burden thrown on the company.

He said, assuming that what was said in the Fattorini case applied to appeals under section 35, and he saw no reason for supposing it did not, one had to ask the question: Where are the facts stated in the case which entitled the Special Commissioners to say that the direction was well founded? As the Judge said:

"They [i.e. the Special Commissioners] knew no more about the case than the usher in this Court. There was no evidence before them, I know nothing about the facts, I am told nothing about them. Then they proceed to say the direction is a good one."[37]

Atkinson J then referred to the Crown Bedding case in which Lord Greene MR had said that it was for the Inland Revenue to prove the essential matters to the satisfaction of the Special Commissioners; and the

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36. (1942) 24 TC 328
37. p 297

Marshall Castings case in which Wrottesley J clearly treated the burden of proof as on the Commissioners.

In the circumstances, Atkinson J held that there were no facts before the Special Commissioners to justify their conclusion. He concluded:

> "One asks the question: If no evidence is given, who wins? That settles the question of the burden of proof. It seems to be, on these authorities, the answer to the question is clear, namely, if no evidence is given the [taxpayer] must win because the result of giving no evidence is that there are no facts before the Special Commissioners to enable them to form any view. In this case, there was no material before them which could justify their confirming the direction."[38]

It can be seen that section 35 FA 1941, as amended by section 33 FA 1944, was very successful in stopping avoidance of excess profits tax but that it was drafted in such wide and unyielding terms, with a main benefit test which was extremely difficult to satisfy, that many "innocent" taxpayers were caught, in that they entered into transactions with no intention of avoiding excess profits tax, but they were still caught within the relevant test in the section. Such an extreme and harsh section may have been justified in times of national emergency (although it is submitted that even that is very highly debatable) but in a normal business environment, such a sweeping section would not be appropriate.

At this point it is relevant to consider another retrospective and wide transaction aimed at excess profits tax avoidance: <u>section 24 FA 1943</u>. This section

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38. p 298

was aimed at a specific scheme but was drafted in such wide terms that it easily caught innocent taxpayers who had no intention of avoiding excess profits tax and, indeed, no knowledge that any transactions that might avoid the tax were even taking place.

Before considering the scheme at which it was aimed, it is necessary to set out the section in full in view of the extensive analysis given to it by the Ross and Coulter case[39] considered below. The section ran as follows:

(1) Where any of the stock in trade of a company is disposed of otherwise than for at least its full market value, and is so disposed of either to or directly or indirectly for the benefit or by the procurement of any persons who directly or indirectly hold, or are in a position to obtain, a controlling interest in the company, and any of the stock is disposed of by any person at a profit but in circumstances in which, apart from this section, the full tax (as hereinafter defined) is not payable or, in the opinion of the [Commissioners of Inland Revenue] is unlikely to be recovered, the Commissioners may direct - (a) that such sum as may be specified in the direction, being the sum which, in the opinion of the Commissioners, is equal to the full tax, shall be chargeable by way of excess profits tax; and (b) that that sum shall be a joint and several liability of such persons as may be specified in the direction, being the company and the persons who, in the opinion of the Commissioners, obtained (but for this section) financial benefits as a result of the transactions aforesaid and any other transactions which, in the opinion of the Commissioners, were effected in

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39. IRC v Ross & Coulter [1948] I All ER 616

connection with or in association with any of the said transactions; provided that - (i) if the Commissioners think fit, the direction may apportion the said sum among all or any of the persons who would otherwise be jointly and severally liable as aforesaid, and where a part of the said sum is apportioned to more than one of the said persons, that portion of the said sum shall be a joint and several liability of the particular persons to whom it is apportioned and not of any other persons; (ii) where any person has (apart from this section) obtained financial benefits as aforesaid but only by reason of the transfer by him of shares which he did not obtain under any such transaction as aforesaid and he has not, apart from that transaction, been concerned in any such transaction as aforesaid, the direction shall apportion the said sum so that there is apportioned to him no greater part thereof than is equal to the amount by which he is, under sub-section (4) of this section, deemed to have (apart from this section) financially benefited.

(2) In this section 'the full tax' means the excess profits tax which, if the stock, instead of being disposed of otherwise for at least its full market value, had, at the time when it was so disposed of, been sold by the company on its own behalf in the ordinary course of trade for its full market value, would have become payable by or in respect of that company for the chargeable accounting period during which the stock was so disposed of, no account being taken of any relief for deficiencies of profits.

(3) As between the persons who, by virtue of a direction under this section become jointly and severally liable for any sum, their respective liabilities

shall unless otherwise agreed between them, be proportionate to the extent to which they respectively benefited financially as a result of all the transactions in question, apart from their liability under this section.

(4) Where any such transaction as aforesaid consists of the transfer of any shares, the persons transferring the shares shall be deemed to have (apart from this section) financially benefited -

(a) if they obtained the shares under any transaction as aforesaid, to the extent by which the consideration which they obtained for the shares exceeds in value the consideration which they gave for shares;

(b) if they did not obtain the shares under any such transaction as aforesaid, to the extent by which the consideration which they obtained for the shares is greater than it might have been expected to be if the stock had been sold by the company immediately before the transfer in such circumstances that the full tax became payable by or in respect of the company."

The reason for this sweeping provision is that, in 1941 and 1942, owing to restrictions on the manufacture of whiskey, sales from existing stocks were not being replaced from the distilleries and, in view of the 100% excess profits tax, the holders of those stocks - generally distillery companies or bonded warehouse companies - tended to restrict their business to limited sales to their customers, usually blenders, at a small profit, in order to keep within their standard profit, although far below the prices then obtainable in the brokers market.

In those circumstances, recourse was had to a scheme by which the benefit of these high prices could be obtained without attracting excess profits tax. The essential ingredients of the scheme were:

(1) to secure the control of the company which owned the stock by purchase of the shares, either completely or in numbers sufficient to secure control at a price attractive to the shareholders;

(2) having thus secured control, to replace the directors by nominees of the promoters of the scheme;

(3) the disposal of the whiskey stocks at a small profit to persons not carrying on a trade or business liable to excess profits tax;

(4) the disposal by such persons of the stocks at the high prices obtainable in the brokers market, or elsewhere, and the consequence avoidance of excess profits tax.

This scheme, and the effect on it of section 24 FA 1943, was considered by the House of Lords in IRC -v- Ross and Coulter and related appeals.[40]

In the Ross and Coulter case, in apportioning the liability for the full tax on the various persons involved, the Special Commissioners rejected a contention that original shareholders, who had no knowledge of, or reason to suspect, the subsequent dealings with the company's stocks, could not lawfully be made the subjects of directions under these provisions and, having neglected or refused to hear evidence of the value of

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40. [1948] 1 All ER 616

the shares in the company as a going concern for the purposes of apportionment under proviso (ii) of sub-section (1), estimated the value of the shares without reference to such evidence, and fixed the deemed financial benefit of the original shareholders under subsection (4)(b) at the maximum figure of the difference between the value so arrived and the amount received by them from the promoters of the scheme.

The House of Lords (Lord MacDermott dissenting) held as follows:

1. It was open to the Commissioners to find as a fact that an original transferor of shares in a company obtained a financial benefit within the meaning of section 24(1)(b) as a result of transactions consisting of such a sale and resale of stocks as are mentioned in the subsection and any other transactions which in their opinion were effected in connection with or in association with any of the stock transactions, although such transferor at no time had knowledge that any such transactions were in progress or contemplated.

2. The absence of such knowledge might be of some evidential value to the Commissioners in determining whether in fact there was such connection or association, and, on the other hand, the existence of such knowledge might have evidential value in the contrary direction.

3. The word "and" in the phrase "the transactions aforesaid and any other transactions" in subsection (1)(b) should be read conjunctively.[41]

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41. The relevance of this finding is dealt with, infra.

4. Liability under the section did not depend on whether the sale of shares preceded the sale of stocks. It was enough if the stock was disposed of "to, or directly or indirectly for the benefit or by the procurement of, any persons who directly or indirectly hold, or are in a position to obtain a controlling interest in the company".

5. Subsection (4) was not merely a quantitative provision; on the natural meaning of its language, it was clearly designed to provide that something should be deemed to be a financial benefit within the meaning of the section which would not otherwise fall within the financial benefits referred to in subsection (1)(b), which involved a question of fact and not of statutory fiction; and, as the deemed financial benefit under subsection (4)(b) was a specified part of the consideration received for the shares, it must be obtained as a result of "such transactions as aforesaid", the effect of subsection (4) being to define the financial benefits referred to in subsection (1) as including these deemed benefits. Consequently, where, on proper evidence, a transaction for sale of shares by original shareholders was found as a fact to have been effected in connection with or in association with any of the stock transactions, the original shareholders obtained the deemed benefit of subsection (4)(b) as a result of the stock transaction and the connected or associated transaction under consideration and were, therefore, under the joint and several liability imposed by subsection (1), subject to the operation of the two provisos.

6. The Courts were not entitled to interfere with the exercise of the discretionary powers conferred by section 24 on the Commissioners unless either (a)

the exercise of the discretion had not complied with the conditions provided by the statute for the exercise of the discretionary power, or (b) the power had not been exercised judicially. The scheme of subsection (1), including both provisos, formed the statutory basis of the power of apportionment derived from the intention of the Legislature, express or implicit in its enactment, and in the exercise of the discretion conferred by the provisos the question of apportionment, and of the amounts to be apportioned should be approached with a view to securing, in so far as practicable, a just and equitable distribution of the full tax. Therefore, where the Special Commissioners had applied the maximum amount under subsection (4)(b) without regard to the financial benefit in fact received by the original shareholders, they had not only exercised their power unjudicially, but had not conformed to the statutory basis of the exercise of the power of apportionment. Consequently, the direction, so far as it exercised the power of apportionment, would require to be reconsidered as a whole by the Special Commissioners to determine what, if any, was a fair and just proportion of the total sum to apportion to the original shareholders. Keeping in view the statutory basis of the exercise of discretionary power, taking into consideration any evidence relevant to the value of the financial benefit, if any, in fact obtained by the original shareholders.

7. Awareness or otherwise of a scheme for disposal of stocks at a price less than the full market value, or for avoidance of excess profits tax, was a relevant matter for consideration by the Commissioners in the exercise of their power of apportionment under the proviso to subsection (1).

Lord Thankerton noted that the Crown accepted as a finding for the purposes of the appeal the statement by the Lord President (Normand):

> "It was found in proceedings under section 35 of the Finance Act 1941, that the sale of shares by the shareholders, who were the original shareholders in the sense in which I have used the expression, was a bona fide sale unconnected with any consideration of evading excess profits tax, and that they knew nothing of the persons involved in the subsequent transactions. It was agreed by Counsel that this finding was evidence in the case before us."

Lord Thankerton thought that this was a proper concession.[42]

Lord Thankerton did not think that section 24 FA 1943 was a penal provision.[43] He said:

> "Counsel are apt to use the adjective 'penal' in describing the harsh consequences of a taxing provision, but, if the meaning of the provision is reasonably clear, the Courts have no jurisdiction to mitigate such harshness. On the other hand, if the provision is reasonable capable of two alternative meanings, the Courts will prefer the meaning more favourable to the subject. If the provision is so wanting in clarity the no meaning is reasonably clear, the Courts will be unable to regard it as of any effect."[44]

Lord Thankerton then dealt with the original shareholders, who were ignorant of, and not parties to, the disposal of the whiskey stocks, but who fell with the terms of the second proviso to subsection (1)(b) because

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42. p 625
43. The original shareholders would probably have taken a different view!
44. p 625

they obtained financial benefits. He said that the question was whether the transaction for sale and transfer of their shares was one of the "other transactions" referred in subsection (1)(b). This depended on the proper construction of the word "effected".

On this question the Court of Session[45] in this appeal had come to a different conclusion from the Court of Appeal in one of the other appeals being held by the House of Lords at the same time: Holt -v- IRC.[46]

The Crown maintained that "effected" merely meant "brought about"; while the taxpayers maintained that it meant "effected by such persons", in other words, by the transferors.

In the Court of Session in the Ross and Coulter case, the Lord President (Normand) had come to the conclusion that the word "effected" in subsection (1)(b) involved the transferring shareholders who are liable and those "who had an active financial interest in the stock transactions either through their transfers alone or through their transfers and in other ways as well". This was based on the use of the phrase "concerned in any such transaction as aforesaid" in the second proviso, which he regarded as signifying an active interest rather than a passive interest, and in this context, an active financial interest, which would exclude from liability original shareholders who had no knowledge of any such arrangement for disposal of the whiskey stocks. Accordingly, the Lord President held that subsection (4)(b) only applied to a transaction, being a share transfer by an original transferor who was aware of the intended stock transactions and so was enabled to obtain an effective financial interest in them in the form of an advantageous price for his shares, and would be deemed,

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45. [1946] SC 134
46. [1947] 1 All ER 148

under subsection (4)(b) to have obtained financial benefits as a result of the transfer and the scheme.

On the other hand, in the Holt case, the Court of Appeal took a different view. Lord Greene MR said:

> "The crucial words are those towards the end of paragraph (b) of sub-section (1) viz, 'transactions which, in the opinion of the Commissioners, were effected in connection with or in association with any of the said transactions.' Speaking for myself and reading these words in what appears to me to be their natural meaning, I can find no reason for interpreting them as requiring any such subjective or financial links as were suggested to be necessary by [Counsel for the taxpayers]. They appear to me to mean exactly what they say and no more, namely, that a transaction may be treated as what I have called an associated transaction if the Commissioners find (on proper evidence of course) that it was effected in connection with or in association with any of the main transactions, and this refers to a connection or association in fact and not to some subjective link existing in the minds of the transferors or transferees or both or to some financial link between the profit obtained by the promoters and the payment of the purchase price of the shares. In the present case there can be no doubt to my mind that the sale by the taxpayer of his shares to Mr. Stewart was connected or associated in fact with the purchase by Mr. Stewart of the company's whiskey. The sale of the shares was an essential preliminary to the acquisition of control of the company by Mr. Stewart, just as the acquisition of control was an essential preliminary to the purchase of the whiskey by Mr. Stewart at an under-value and its subsequent disposal at a profit. How can this relationship of one transaction to

another be better described than by the words "connected" and "associated"? I do not know."[47]

Lord Greene had also pointed out that nowhere in the section were there to be found any express words to the effect that a transferor of shares or any other person is only to be charged with tax if he knew of the existence of a scheme, and that, if such knowledge was to be necessary, nothing would have been easier than to say so in the statute itself.

Lord Thankerton agreed with the interpretation of Lord Greene rather than that of the Lord President (Normand). He said that the opening paragraph of sub-section (1) gave an illustration of a connected or associated transaction.[48] The main transactions were those by which the whiskey was disposed of, and those concerned were persons "who directly or indirectly hold, or are in a position to obtain, a controlling interest in the company". That indicated, he said, the connection or association between control and the stock disposal transactions, and the state of mind of the shareholder who surrenders such control was quite irrelevant. He held that the word "and" in the phrase "the transactions aforesaid and any other transactions" in sub- section (1)(b) should be read conjunctively, the transactions of both sorts being treated as forming "one bundle" so that, although the direct source of the financial benefit may be a unit in the bundle, it is to be regarded as resulting from the bundle.

Accordingly, he held that it was open to the Commissioners to find as a fact that an original transferor of shares obtained a financial benefit within the meaning of section 24(1)(b) as a result of transactions consisting of such a sale and resale of stocks as were mentioned in the sub-section and any other transactions which, in their opinion, were effected in connection with, or in association with, any of these

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47. Ibid. p 158
48. p 627

transactions, although the transferor at no time had knowledge that any such transactions were in progress or contemplated. On the other hand, the absence of such knowledge may be of some evidential value to the Commissioners in determining whether, in fact, there was such a connection or association.

Lord Thankerton then went on to consider the exercise of the Commissioners' discretion. He noted that, at the close of the hearings in the appeal, the House of Lords intimated that the Special Commissioners had failed to exercise their discretion judicially in that, for the purposes of proviso (ii), they treated as irrelevant the value of the shares on the footing of the company continuing as a going concern.[49]

At this stage, it is relevant to consider a submission by the Crown which was referred to as the "tainted money" argument. This was explained by the Lord President (Noramnd) in the Court of Session as follows:

> "The construction of this section maintained by Learned Counsel for the Inland Revenue was, throughout the arguments, one of lucid simplicity. They started from the premise that the section was designed to collect the full tax on a transaction which would otherwise escape tax. Accordingly, they said, the section treated as tainted money the sum realised as profit by the resale of the stock obtained from the company at a price below the full market price by a person in a position to control the company. This 'tainted money' was they said, subject to tax to be in-gathered from every person into whose hands it could be traced. Therefore, they argued, if this tainted money could be traced

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49. p 629

through various bank accounts into the hands of persons who received it under any contract or transaction in any way associated with the transactions by which the stock had been sold by the company and resold for the profitable price, these persons became liable to a direction making them jointly and severally liable for the whole tax, subject to the Commissioners power to apportion under proviso (i) or their duty to apportion under proviso (ii) ... Moreover, Counsel for all parties agreed in submitting to us that this argument fairly represented the grounds on which the Commissioners and the Special Commissioners had proceeded ... The Special Commissioners have also treated as irrelevant to their decisions evidence that the price obtained for the shares was not more than a reasonable price for shares in the company as a going concern. The price was indeed treated as if it were in fact a financial benefit resulting from the sales of stock if it was paid out of a bank account which had been swelled by the payment into it of tainted money."[50]

Lord Thankerton said that, while it was true that these passages related primarily to questions under subsection (1)(b) and subsection (4)(b), the neglect or refusal of the Special Commissioners to hear evidence as to the value of the shares in the company as a going concern for the purposes of an apportionment under proviso (ii) of subsection (1), and their application of the maximum under subsection (4)(b) as the amount of the apportionment, appeared to be only explicable by the application of the tained money theory.[51]

In the Court of Appeal in Holt case, Lord Greene MR had said:

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50. (1946) SC 134 at pp 158-9
51. p 630

> "The profits made by others seem to me to have no bearing on the question what ought to be apportioned to the taxpayer. Whatever profits the others may have made, the taxpayer's profit is ascertained and there can be nothing unfair in apportioning to him a proportion of the tax commensurate with his profit whatever the profit made by the other persons may have been. The Commissioners, in my opinion, were entitled to act on the material that was before them."[52]

Lord Thankerton's view was that, the scheme of sub-section (1) did not depend on any tainted money theory. He said:

> "The conditions precident to a direction involved the promoters of the scheme, who by their control obtained the disposal of its stock by the company at the low price, and secured the untaxed profits on the resale of the stock. Next, the direction assesses the amount of the lost tax and places that amount as a joint and several liability of the company, the promoters, who ex-hypothesi obtained financial benefits, and any other person who has obtained a financial benefit as a result of the stock transactions and any associated transaction, but this is subject to the power of apportionment under provisos (i) and (ii). It seems clear to me that this power of apportionment was intended to enable the Commissioners to modify the liability of persons who were neither the company nor the promoters, and whose financial benefit was not dependent on the results of the stock transactions."[53]

Furthermore, he pointed out that the deemed amount under subsection (4)(b) is only relevant as a maximum, and he

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52. [1947] 1 All ER 148 at p 160
53. [1948] 1 All ER 616 at p 630

said that this necessarily implied that it was open to the shareholder to establish, either that he obtained no financial benefit at all, or what the amount of his financial benefit in fact was.[54]

He said that it was essential, to any fair and reasonable exercise of the power of apportionment under either proviso, that the Commissioners should inform themselves of the amount of the financial benefit accruing to persons other than the company and the promoters.[55]

In his view, in applying the maximum amount under sub-section (4)(b) without regard to the financial benefit in fact received by the original shareholders, the Commissioners and the Special Commissioners not only exercised their power unjudicially, but had not conformed to the statutory basis of the exercise of the power of apportionment. In this respect, he disagreed with Lord Greene whose view is set out above.

Lords Porter, Simonds and Morton gave judgements agreeing with Lord Thankerton.

Regarding the fact that innocent taxpayers would be caught by the section as construed by the majority of the House of Lords, Lord Porter said:

> "It is true that the result of such a construction may be to make shareholders, who acted within the law when they sold their shares, liable to the Revenue authorities for large sums and in particular to impose that liability upon those who were entirely ignorant of any scheme to avoid excess profits tax or who even stipulated for a continuance of the business of the company whose shares they were selling - the stipulation which, if carried out, would make the accomplishment of the scheme

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54. p 631
55. Ibid

impossible. But the Act was passed in order to make a legitimate act illegitimate in the sense that its object was to impose tax which would otherwise not be due: the only question is how far its tentacles extend and it would be odd if in the case of the same company those who sold shares were divided into two categories, the suspicious and alert who could not resist the claim of the Revenue to take away their profit and the innocent and ignorant who would escape all liability. Perhaps the best illustration of the oddity of such a result is exemplified in the case of a public company where some of the shareholders might be aware of the scheme, others suspicious of the purchaser's intentions and a third class totally unaware of anything save that a good, but possibly, in its view, no more than a fair, price, was being obtained.

Moreover, the Act nowhere in terms limits its effect to the case of those who have knowledge of the matters which impose liability and the reference in the second proviso to a person who 'obtained financial benefits but only by reason of the transfer by him of shares' points, in my view, to those who sell in ignorance of any scheme as nevertheless possibly being concerned in a connected transaction".[56]

Later in his judgement, Lord Porter referred to the Act as being "loosely drawn and vaguely phrased".[57] Lord Simonds said that he shared with the Court of Session "the repugnance that any Court of justice must feel" for the result of the construction he was favouring, but he said that a judicial exercise by the Commissioners of their discretion under the provisos to subsection (1) "will mitigate, if it cannot wholly remove, the otherwise intolerable harshness of the section."[58]

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56. pp635-6
57. p 637
58. pp 640-1

Lord MacDermott delivered a dissenting judgement. Although the opinion of the majority was probably more in keeping with the ordinary meaning of the words used in the Statute, it is submitted that the construction adopted by Lord MacDermott did not unduly strain the words of the section, and the result of his interpretation was more equitable than that of the majority.

He noted that the substance of the dispute was whether the words "and any other transactions which, in the opinion of the Commissioners, were effected in connection with in or in association with any of the said transactions" implied a degree of knowledge of the relevant stock transactions on the part of the person to be charged. Lord MacDermott basically preferred the interpretation adopted by the Court of Session. He said:

> "My Lords, at first sight the suggestion that chargeability to tax depends on anyway upon the state of mind of the person charged is strange almost to the point of being startling but so are the terms of section 24 and they must be examined without any undue regard to what is usual in taxing statutes."[59]

He said that, if it is said of a person that he effected a transaction "in connection with" another transaction, the meaning is conveyed, according to the ordinary usage of language, that that person was conscious of the other transaction. If the person effected a transaction connected in fact with another transaction of which he was altogether unaware, he said that he did not think it would occur to anyone to say that the person had effected a transaction "in connection with" that unknown transaction. He also said that the words "or in association

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59. p 646

with" carried an even stronger implication of knowledge because he thought it was the more purposeful word. The argument of the Crown, however, was that the wording of paragraph (b) was such as to avoid this implication of knowledge, and particular stress was laid on the use of the passive "were effected". The Crown claimed that these words were the equivalent of "came about". Lord MacDermott adopted the terminology used during the course of the hearing and referred to this as "the Olympian retrospect construction".[60]

Lord MacDermott said that the question remained whether the words "were effected" meant "were effected by such persons" (i.e. the persons who obtained financial benefits); or were used with the intention of leaving the determination of connection or association at large and untramelled by considerations of a subjective nature. His view was that the natural import of the words favoured the first interpretation, because the expression "were effected", in his view, was more aptly used in relation to a connection or association brought about consciously than in introducing the Olympian retrospect. He said that, had the intention been to establish the latter construction, nothing would have been simpler than to use some phrase such as "and any other transactions which, in the opinion of the Commissioners, were connected with." He said:

> "After all, the words 'were effected' are not synonymous with 'came about'. They invite the question - effected by whom? And in as much as paragraph (b) must be concerned to some extent with what those it taxes have done, it seems to me that the reasonable and natural answer suggested by the context is - by the persons it is intended to charge."[61]

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60. pp 646-7
61. p 647

He said that the interpretation which he preferred, and which would read "were effected" as meaning "were effected by the person whose liability is in question", connoted knowledge on the part of the person effecting the connecting transaction. But he said that knowledge of both stock transactions was not essential. He thought it was enough, for the purpose of the section, if the individual concerned knew that a disposal of the company's stock was in progress or contemplation.[62]

Turning to the Commissioners' discretionary powers, he said that he was quite unable to see that they were any satisfactory protection for those who, on account of their ignorance of any of the stock transactions, ought, in common fairness, to be sheltered from the full rigour of subsection (4)(b) if the Crown's view of the construction of subsection (1)(b) was correct. He said:

> "Their direction must cover the full tax and what comes off [an original shareholder's] shoulders must be borne by some one or more of the others charged whose individual merits would all have to be investigated and weighed before the discretion could be exercised in any other than an arbitrary and haphazard fashion.... If the present appeals are to be taken as fair samples of the sort of case dealt with by section 24, I must confess myself at a loss to see how the Commissioners, notwithstanding the powers conferred on them by subsection (9) as to obtaining information, could be expected to exercise such a discretion in a manner equitable to all. It goes without saying that I intend no reflection whatever on the competence and impartiality of the gentlemen. But their procedure is not apt for this purpose. They do not hear or see the parties concerned and they, in their turn, may have no

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62. p 648

> opportunity of knowing the full facts or of making informed submissions. In such circumstances the protection which, according to the Crown, the discretion would afford [the original shareholders] is, to my mind, so fraught with uncertainty and practical difficulty as to rob it of all weight in the determination of this question of construction."[63]

In conclusion, he said that, while he did not suggest that his interpretation led to an ideal distribution of the burden of the full tax, he found it less generally inequitable than the alternatives.[64]

In another of the appeals heard at the same time, relating to the same scheme, IRC v Lord Saltoun the question of four directors was raised. They lost their office as directors by reason of the transfer of shares, but received £1,225 each as compensation for loss of office. The question was whether they thereby "obtained financial benefits" within subsection (1)(b).

The House of Lords held that there was evidence on which the Special Commissioners could properly hold that the directors had obtained financial benefits. It was the duty of the Special Commissioners to consider to what extent (if at all) the financial benefit to each director represented by the sum of £1,225 was greater than the financial loss to him represented by his loss of office. To that extent only did a director obtain a financial benefit as a result of the share transaction. For example, Lord Morton said:

> "It must be borne in mind that in the case of these sums a financial benefit must be obtained in fact if the directors are to be brought within subsection (1)(b). Subsection (4) does not apply to this

63. p 650
64. p 651

particular transaction, and accordingly the directors are not '<u>deemed</u> to have financially benefited'. In my view, however, the Special Commissioners might not unreasonably come to the conclusion that part of the £1,225 represented an actual financial benefit to each director. On the other hand, it was, in my view, quite impossible for the Special Commissioners, if they had directed their minds to the real question as stated above to come to the conclusion that the whole of the £1,225 represented a financial benefit obtained by each director."[65]

Later in his judgement he said:

"I would add that, in my view, any financial benefits obtained by the directors in their capacity as directors... clearly came within subsection (1)(b). These financial benefits were received by the directors... as a result of the sale of the shares in the Longmore Company to the Stewart Group; in fact, the directors insisted, not unnaturally, that compensation paid to them... should be a term of the agreement for the sale of the Longmore Company's shares. That sale would never have taken place but for the existence of a scheme to carry out the stock transactions and was an essential step in that scheme, though the innocent shareholders, including the directors, were quite unaware of these facts. Thus the financial benefits obtained by the directors... were obtained, in my view, as a result of the stock transactions and another transaction, namely, the sale of the shares, which was effected in connection with the stock transactions."[66]

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65. p 659
66. pp 659-60

The House of Lords did come to a different conclusion in relation to the original shareholders in one of the appeals, namely: IRC v Berkeley. The questions at issue were the same as those considered in the Ross and Coulter case considered above. As the House of Lords came to the opposite conclusion, the facts, which are set out in the judgement of Lord Thankerton[67] are set out in detail.

In November 1941, the taxpayer, Mr. James Berkeley, was approached by Mr. George Berkeley, who asked whether the shares of the company could be bought. The taxpayer having consulted his co-shareholders who agreed to sell provided they received a reasonable price, had a meeting with Mr. George Berkeley, Sir Hector MacNeal, Mr. Morton and another person. Mr. George Berkeley, Sir Hector MacNeal and Mr. Morton had been concerned, along with Mr. Stewart (who was the ultimate purchaser of the shares and the whisky stocks in this case), in the transactions in the Ross and Coulter case. No offer resulted from this meeting.

On 4th December 1941, the taxpayer had a call from Dr. Oscar Rabinowicz, who had been previously introduced to him by Mr. Duncan MacLeow, and was asked whether he could buy the business of the company. Mr. MacLeow's company had been one of the joint purchasers at full market prices of the stocks in the Ross and Coulter case from Mr. Stewart. The taxpayer replied that he would require to consult his co-shareholders, but there was discussed a possible selling price of £7 a share. The shareholders agreed to sell at this price and, on 12th December 1941, an offer to sell all the shares of the company for £175,000 (at the rate of £7 each) was addressed to Dr.

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67. pp 661-2

Rabinowicz. The offer was accepted and it provided for settlement on 19th December 1941, when the purchase price was to be paid in exchange for transfers of the 25,000 shares. It was part of the arrangement that the then directors of the company would resign.

Dr. Rabinowicz gave evidence that he had purchased the shares of the company as an investment, and that he was interested in the company's business as a going concern.

On 15th December 1941, Dr. Rabinowicz received a letter from a firm of Manchester stockbrokers on behalf of Mr. Stewart asking if he was willing to sell the shares of the company, and offering to pay £8 per share for a quick deal, which they said was a top price and not subject to negotiation. Dr. Rabinowicz did not reply, but was soon approached by Mr. George Berkeley, as representative of Mr. Stewart, and he arranged to resell the shares to Mr. Stewart for £8 per share and he received a letter dated 18th December purporting to come from Mr. Stewart confirming the arrangement, completion to take place forthwith. Dr. Rabinowicz stated that he had agreed to sell the shares because he had received a good offer which gave him a quick profit of £25,000.

What Lord Thankerton referred to as "the crucial paragraph" in the Case Stated ran as follows:

> "On December 20th 1941, £175,000 was paid to Dr. Rabinowicz by Mr. George Berkeley out of £200,000 made available to him at the Commercial Bank of Scotland, Glasgow, by the Anglo-Federal Banking Corporation Limited (hereinafter called the 'Anglo-Federal Bank'). £175,000 was paid by Dr. Rabinowicz to Mr. Kidd on behalf of the original shareholders in exchange for transfers of all the

> shares in the company and resignations of the then directors. In the place of the original directors who resigned as aforesaid the said Mr. George Berkeley and Mr. Spence (a business associate of Sir Hector MacNeal) were appointed directors."

At a meeting of the new directors it was noted that the ownership of the share capital of the company had been assigned to Mr. Stewart, and a sale of the whiskey stocks of the company to Mr. Stewart, stated in a letter by him to the directors to have been already arranged, was made at the price of £25,000. There was no evidence, and no suggestion that the original directors were parties to, or knew of the previous arrangements.

Lord Thankerton said that, in his opinion, only one conclusion on the evidence was open to the Special Commissioners, namely, that the purchase of the shares by Dr. Rabinowicz from the original shareholders, and their purchase from Dr. Rabinowicz by Mr. Stewart, were separate transactions, separately completed. As noted above, there was no evidence, or suggestion, that the original shareholders at any time were aware of the scheme for disposal of the stocks. There was no evidence that Dr. Rabinowicz represented Mr. Stewart, or that he was aware of, much less a party to, these schemes. Indeed, the evidence led to a contrary inferrence, namely, that the original enquiry by Mr. George Berkeley in November and the resulting meeting led to no result. Mr. Stewart and his associates had then to approach Dr. Rabinowicz, on learning that he had forestalled any intention they had of dealing with the original shareholders. Lord Thankerton, therefore, was of the opinion that the purchase of the shares from the original shareholders by Dr. Rabinowicz was not a connected or associated transaction within the meaning of section 24(1)(b), and that the original shareholders were wrongly included in the direction. Lord Thankerton pointed out that this was clearly another case in which the Special Commissioners proceeded on the "tainted money" principle.[68]

In the circumstances of this case, this finding was undoubtedly correct.

This long and complicated series of interconnected appeals shows that section 24 FA 1943, introduced to stop a particular scheme for the avoidance of excess profits tax, was drafted in such wide and vague terms that the original shareholders, who had no knowledge of, and were not party to, the scheme, were caught and had to pay part of the excess profits tax avoided. What is more, the extent of their liability was left to the discretion of the Commissioners who, as found by the House of Lords, had not exercised their discretion in accordance with the conditions provided by the Statute, and they had not exercised their power judicially.

It is intolerable that taxpayers can have inflicted upon them such harsh, vague and widely drafted legislation as this, and the only possible justification that can be given for the introduction of such a provision was that it was introduced at a time of national emergency.

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68. p 662

Profits Tax

Section 32 FA 1951 applied similar provisions to profits tax as section 35 FA 1941 (as amended by section 33 FA 1944) enacted for excess profits tax. Again, as this is such an important section, it is necessary to set out the relevant parts of it in detail.

Subsection (1) stated:

> "Where the Commissioners are of opinion that the main purpose or one of the main purposes for which any transaction or transactions was or were effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to the profits tax, they may, if they think fit, direct that such adjustments shall be made as respects liability to the profits tax as they consider appropriate so as to counteract the avoidance or reduction of liability to the profits tax which would otherwise be effected by the transaction or transactions..."

Rather more stringent provisions applied in certain circumstances. Accordingly, subsection (3) read:

> "If it appears in the case of any transaction or transactions, being a transaction which involves, or transactions one or more of which involve - (a) the transfer or acquisition of shares in or debentures of a company; or (b) a change or changes in the person or persons carrying on a trade or business or part of a trade or business; or (c) a change or changes in the directors of a company the directors whereof have a controlling interest therein, that, having regard to the provisions of the law relating to the profits tax other than this section which

were in force at the time when the transaction or transactions was or were effected, the main benefit which might have been expected to accrue from the transaction or transactions in the three years immediately following the completion thereof was the avoidance or reduction of liability to the tax, the avoidance or reduction of liability to the profits tax shall be deemed for the purposes of this section to have been the main purpose or one of the main purposes of the transaction or transactions."

It was provided by subsection (4) that:

> "Any direction of the Commissioners under this section shall specify the transaction or transactions giving rise to the direction and the adjustments as respects liability to the profits tax which the Commissioners consider appropriate."

Subsection (5) provided that the Commissioners could not give a direction under section 32 "by reason only" that no distribution to proprietors had been made or only a smaller distribution might have been made. In the case of a company that was not one in which the directors had a controlling interest, a direction could not be made merely because there had been an issue of debentures by the company for full consideration paid in cash.

The section also provided for a clearance procedure, whereby taxpayers could seek confirmation from the Commissioners that they would take no action under the section in connection with a transaction that had already been carried out or a proposed transaction.

Section 32 applied to transactions completed after 10th April 1951.

Section 69 FA 1952 brought into operation, for the purposes of excess profits levy, the provisions of section 32 FA 1951. Section 69 also made applicable to excess profits levy the provisions of section 24 FA 1943 (the section under consideration in the Ross and Coulter case).

For the purposes of excess profits levy, the FA 1952 was to be deemed to have been in force as from the date of the introduction of the Act as a Finance Bill into the House of Commons, namely, 20th March 1952.

It has been seen above[69] that section 31 FA 1951 was designed to prevent avoidance of tax through the capitalisation of profits and that the decision in IRC v Pollock & Peele Limited[70] was in favour of the taxpayer. It will be recalled that the case was concerned with a company which made an issue of bonus shares and then went into liquidation. The nominal capital was thus increased and the gross relevant distributions to proprietors for the last chargeable accounting period during which the trade or business was carried on within the meaning of section 35(1)(c) FA 1947 were accordingly reduced. It was held that the payment by the liquidator to the members was not a repayment or return of share capital so as to be a "sum applied in reducing capital" within section 31, and was a distribution of capital within the meaning of section 35(1) FA 1947.

Following the Pollock & Peel case, the Revenue tried to obtain the result they sought in Pollock and Peal by the application of section 32.

Thus it was that, in 1960, Cross J heard the case of Ackland & Pratten Ltd v IRC.[71] The facts were that, prior to 1957, the taxpayer company had retained a

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69. See Part 2, supra
70. (1957) 37 TC 240
71. (1960) 39 TC 649

substantial part of its profits. On 24th July 1957, the company passed a Special Resolution under which it was resolved that £198,011 (being part of the amount standing to the credit of the profit and loss appropriation account) be capitalised and applied in paying up in full at par 198,011 unissued £1 ordinary shares, to be allotted to the existing shareholders in the proportion of 11 new shares for every two ordinary shares already held. These shares were duly issued and allotted to the shareholders on 21st October 1957, increasing the paid up ordinary share capital from £36,002 to £234,013. On 27th November 1957, the company went into voluntary liquidation and, by an agreement entered into on 28th November 1957, the liquidator and the taxpayer company transferred all the assets of the business, except a sum of cash and certain securities of a total value of £161,517, to a new company, the shareholders being substantially the same as those in the taxpayer company. A substantial part of the consideration for the transfer of the business was shares in the new company, the distribution of which to the members of the taxpayer company would not, by virtue of an election by the two companies on 3rd December 1957 under section 36(4) FA 1947, affect its liability to profits tax. After reserving £10,721 for taxation, the liquidator was left with £150,795 available for distribution.

Since the paid up share capital of the company, as increased by the capitalisation of the undistributed profits and the allotment of paid up shares, exceeded the amount of £150,795 available for distribution, it followed from the decision of the Court of Appeal on 24th May 1957 in the Pollock & Peel case, that the distribution of that sum by the liquidator would not be a gross relevant distribution for the purposes of section 35(1)(c) FA 1947.

On 17th January 1958, the accountants of the taxpayer company wrote to the Inspector of Taxes setting out the facts and adding:

> "The assets remaining in the hands of the liquidator are government securities and the balance of the banking account. A part of these securities has already been realised and a distribution of 5 shillings in the pound on the issued capital of £234,013 has already been made. The remaining assets will not be sufficient to repay the increased capital in full (excluding the share distribution) and we presume that under the decision in Pollock & Peel, no distribution charge will be payable."

The Case Stated shows that Inspectors were issued with notification on 14th October 1957 that the Revenue were not going to take the Pollock & Peel case to the House of Lords.[72] Faced, then, with the Pollock & Peel case with regard to section 31 FA 1951, the Revenue then turned their mind to section 32 which they had not sought to apply in Pollock & Peel.

Accordingly, on 15th August 1958, a direction under section 32 was issued that the liability of the taxpayer company to profits tax for the chargeable accounting period ended 28th November 1957 should be computed as if its paid up ordinary share capital for the purposes of section 35(1)(c) was at all relevant times £36,002. The Special Commissioners upheld the direction and, in the High Court, Cross J held that this decision was correct.

Cross J. noted that the Crown accepted that the onus was on them to establish that the conditions of section 32 FA 1951 were satisfied.[73] The Crown contended that, on the evidence, the only inferrence to be drawn was that the

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72. See para 7 of the Case Stated.
73. p 661

avoidance or reduction of liability to profits tax was the main purpose of the transactions or, alternatively, the main benefit which might have been expected to accrue from these transactions.

When the case was heard by the Special Commissioners no evidence was given on behalf of the company. Cross J said that the most likely explanation for the passing of the resolutions was that the transactions were connected and were part of a scheme. He continued:

> "If, contrary to all probability, the liquidation was not contemplated in July, and tax relief was never in the minds of the parties at all until the whole matter was completed, then the directors could have said so; and if they did not say so, they ran the risk of the Special Commissioners drawing the obvious inferrence from their failure to do so."[74]

Cross J thought that the Commissioners were justified in finding that the conditions of section 32(1) were satisfied and that the main purpose, or one of the main purposes, for which the transactions were effected was the avoidance or reduction of liability to profits tax.[75] In any case, it was not, in fact, necessary for the Special Commissioners to find this because, under subsection (3), they only had to be satisfied that the main benefit which might have been expected to accrue from the transaction or transactions in the three years immediately following the completion of the transactions was the avoidance or reduction of liability to profits tax. Cross J referred to the analysis of Lord Greene MR in the Crown Bedding case[76] and noted that the test in section 32(3) is an objective test; would a reasonable man in fact expect that the main benefit which would accrue from these transactions would be the avoidance of

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74. Ibid
75. Ibid
76. Crown Bedding Co Ltd v IRC (1946) 34 TC 107, supra

tax? Cross J said that it was manifest that this is what an independent, objective third party would think was the main benefit to be expected from the transactions. Cross J said that it was not a certainty but it was, in his opinion, more than a possibility; it was, in fact, a probability. In fact, he did not think that subsection(3) really mattered because the Commissioners were fully justified in holding that subsection (1) applied.[77]

The same scheme failed in the case of Jarvis Robinson Transport Limited v IRC.[78] In this case, unlike the Ackland and Pratten case, the taxpayers were caught by subsection (3), rather than subsection (1). It is not necessary to set out the scheme in detail as it, in essence, substantially followed that implemented in the Ackland and Pratten case.

The Case Stated shows the reasons for the company entering into this scheme.

Paragraph 8 states:

> "As a result of speeches made and resolutions passed at the Labour Party Conference in October 1957, the directors of the company formed the view that, if a Labour Government should be formed as a result of a General Election (which they thought might take place in 1958) legislation would be passed for the nationalisation of road haulage and that the company's undertaking would not escape takeover. In order to limit the risk of obtaining inadequate compensation in that event, they considered it desirable: (i) that assets of the company which were surplus to the requirements of the undertaking should be taken out of the company and passed to its

77. p 662
78. (1963) 41 TC 410

shareholders; and (ii) that the fleet should be revalued and the company's issued capital brought into line with the real value of the company's assets."

Paragraph 9(2) and(3) shows that they were advised that, following the decision of the Court of Appeal in the Pollock & Peel case, the proposed arrangements would appear to enable the company to make a distribution to its members without incurring liability to a distribution charge, but that liability to a distribution charge would not be escaped, because the Inland Revenue would make a direction under section 32. At the same time, they were advised that distribution charges would be abolished, probably in the next Finance Act (as in fact happened) and the company was advised to wait. However, the directors of the company did not take this advice; they considered that the threat of nationalisation was urgent, and they wished to achieve the objects referred to in paragraph 8 of the Case Stated before there could be a General Election.

In the circumstances, it is not surprising that the Special Commissioners held that it was not established that the avoidance or reduction of liability to profits tax was the main purpose or one of the main purposes for which the transactions were effected. They found that the directors of the company had another purpose in mind when the transactions were decided on, and that that was a main purpose.[79] However, looking at the test in section 32(3) objectively, the Special Commissioners found that the main benefit which might have been expected to accrue from the transactions was the reduction of liability to profits tax.[80]

This finding was upheld in the High Court by Pennycuick J.

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79. p 415
80. p 416

It was argued before the Special Commissioners and also before the High Court, that if there was a main benefit to avoid profits tax, it could not accrue in the three years immediately after the transaction or that it had accrued simultaneously. Both the Special Commissioners and Pennycuick J rejected this argument. As Cross J had held in the Ackland and Pratten case, the words of the subsection meant only that, during the following three years, whether or not there had been a liquidation, there would in fact have been some saving of tax. Pennycuick J agreed with these words and he said that the task of the reasonable man was to look at the facts and law as they stood when the transactions were carried out and to decide whether those transactions were likely to generate a saving in tax which would otherwise have been paid during the three years after the completion of the transactions and, if so, whether that was the main benefit likely to accrue to the company from the transaction.[81]

Section 32 FA 1951 suffered from the same defects as section 35 FA 1941 (as amended by section 33 FA 1944) in that it was drafted in such wide and imprecise language that many "innocent" taxpayers were caught. Such severe provisions appear to have prevented the avoidance devices at which they were aimed but only at the expense of clarity and equity. The same can be said of section 24 FA 1943.

Such dramatic provision may perhaps be justified in times of grave national emergency but, in 1951, which admittedly could reasonably be called a time of austerity, such a provision as section 32 FA 1951, with its wide mental element adopted from section 35 FA 1941, was, it is submitted, an unfair imposition on honest taxpayers. There comes a point where effective

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81. p 421

anti-avoidance provisions become intolerably onerous on those who do not indulge in the worst excesses, and such legislation should now have no place on the statute books.

PART 7

THE APPORTIONMENT PROVISIONS

Introduction

"This is one of the most fascinating games that has ever been played."[1]

This was the view of Sir Wilfred Greene MR of the contest between the Legislature and the Inland Revenue, on the one side, and taxpayers and their advisers, on the other, regarding the apportionment legislation. Each time the law was changed to prevent individuals avoiding tax by accumulating profits in companies, the taxpayers would find a new way of achieving the same thing.

The apportionment rules represent one of the most important series of anti-avoidance provisions this century. They are not only intrinsically interesting, but they span almost three quarters of a century and reflect the different social, political, economic and fiscal pressures throughout those years. The provisions, and the cases they generated, therefore merit particularly close study.

The history of these provisions, particularly in the early years, also demonstrates the major problem of specifically targeted anti-avoidance legislation: as soon as one scheme was stopped, a new loophole was found.

It would be useful to start this analysis with a brief summary of these manoeuvres before the provisions are examined in more detail.

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1. IRC v Kered (1938) 22 TC 354 at p 379

An Outline of the Provisions - The "Finger in the Dam" Approach

The schemes at which the legislation was aimed were based on the basic principle that companies were not liable to pay super tax. Super tax was introduced in 1909/10 at the equivalent of 2½p in the pound on incomes over £3,000. This was on top of income tax at rates of up to 6p in the pound. By 1922, however, super tax was 30p for incomes over £3,000 and income tax was at the same rate, giving a total tax rate of 60%. There was therefore by this time a strong incentive for individuals to operate their businesses through limited companies which they owned and over which they retained full control. They would then refrain from distributing a substantial portion of the profit to its shareholders.

To prevent this simple arrangement, section 21 FA 1922 was introduced. As will be seen below, this was one of a pair of major anti-avoidance provisions introduced by that act, the other being the first major anti-avoidance provision aimed at settlements.[2]

By virtue of section 21, if a company to which the section applied distributed an unreasonably small proportion of its income to its shareholders, a direction could be given whereby the whole of its income, although undistributed, was to be treated as income of the shareholders and apportioned among them according to their respective interests in the company.

The section only applied to certain companies, namely:

(1) The company had to be registered in the UK, so that it did not cover foreign companies. This was because "company" was defined as being within the definition contained in the Companies (Consolidation) Act 1908.

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2. Section 20 FA 1922, see Chapter 2

(2) The company had to be under the control of not more than five persons.

(3) The company could not be a subsidiary company.

(4) The company must not be one in which the public were substantially interested.

This section was narrow in its scope and it was easy for taxpayers to avoid being caught. The next device was based on the fact that the original section merely spoke of apportionment, so that once the notional apportionment was made, there the matter had to rest. Taxpayers therefore formed two companies, one being the subsidiary of the other, individuals owning the shares in the holding company. The subsidiary would carry on the business. Under section 21 the profits of the subsidiary could be apportioned among its members and, by virtue of the apportionment direction its income would be regarded as having been distributed to the holding company. The income of the subsidiary apportioned to the holding company could not be further apportioned through to the individual shareholders, only the actual income of the holding company could be thus apportioned.

To meet this device, section 32 FA 1927 was passed. Under this section, where the income of a company was apportioned under section 21 FA 1922 to a corporate shareholder, that income could be sub-apportioned among its own members, and this process could carry on through any number of companies.[3]

This provision, too, was easy to circumvent. The aim of the Legislature was that the process of sub-apportionment was to stop when the sub-apportioned income reached the hands of the individual shareholders who would then become liable to surtax. However, enterprising taxpayers saw to it that the income could never be sub-apportioned to them. This was done by interposing in the chain of

3. Section 32(4) FA 1922

companies a company to which the provisions of section 21 FA 1922 could not apply. The commonest way for this to be achieved was to interpose a foreign company in the structure.

Two major provisions were introduced to catch this scheme. The first was section 41(4)(a)(ii) FA 1938. By section 38(3) FA 1938 the relevant provisions were, for some reason, limited to a "settlor" who retained an interest in a "settlement", as widely defined in the Act, whereas the previous provisions had applied to the individual shareholder, whether a settlor or not.

Section 41(4)(a)(2) defined the expression "income arising out of settlement" as follows:

> "Where the amount of the income of any body corporate has been apportioned under section 21 of the Finance Act of 1922 for any year or period or could have been so apportioned if the body corporate were incorporated in a part of the United Kingdom, so much of the income of the body corporate for that year or period as is equal to the amount which has been or could have been so apportioned to the trustees of or a beneficiary under the settlement"

was to be deemed to be income arising out of a settlement.

Therefore, if a foreign company was a link in the chain, the income on apportionment could be apportioned to the individual shareholders. Unfortunately, this section only spoke of apportionment, not of sub-apportionment, so that it could not operate where there was a foreign company to which income had been sub-apportioned as distinct from being apportioned.

The legislature attempted to fill this gap by section 13(3) FA 1938. This amended section 41(4)(a)(ii) to read:

"Where the amount of the income of any body corporate has been apportioned by means of an original apportionment under section 21 of the Finance Act 1922, for any year or period, or by means of such an original apportionment together with one or more such sub-apportionments or series of sub-apportion-ments as is provided for by section 32 of the Finance Act, 1927, or could have been so apportioned if the body corporate were incorporated in any part of the United Kingdom, so much of the income of the body corporate for that year or period as is equal to the amount which has been or could have been apportioned to the trustees of or beneficiary under the settlement"

shall be regarded as income arising under the settlement.

What this provision does, when read with the other relevant provisions, is merely to render the actual income of a foreign company apportionable and sub-apportionable, and nothing more. This was because the only provisions which authorised sub-apportionment were the provisions of section 32 FA 1927 but, for the purpose of those provisions, it was essential that all companies in the chain should be UK companies, so that the chain would be broken by the interposition of a foreign company. In other words, the provisions regard the process as starting with the actual income of the foreign company. That income can be apportioned to another company and then sub-apportioned from that company to another, and so on, but this process had to stop at the first foreign company interposed in the chain because, once the notional income is <u>attributed to</u> a foreign company, the process of apportionment or sub-apportionment could not go further. There was thus a distinction between the apportionment of the income of a foreign company in the first instance, and an apportionment or sub-apportionment to a foreign company.

In the former case, the process could go on so long as the companies to which the income is apportioned or sub-apportioned were all UK companies; in the latter case the process of apportionment or sub-apportionment would come to an end once it reached a foreign company.

The case which exposed this flaw in the legislation was Lord Howard de Walden v IRC.[4] The facts were that the taxpayers father, by a deed of gift in 1923, gave to the taxpayer 25,000 shares (the whole share capital) of Dufferin Investment Co Ltd, a Canadian Company. The shares in Dufferin were held in the name of Established Investments Limited, which, after the gift, held the shares as trustee for the taxpayer. In 1934, in anticipation of his marriage, the taxpayer, by a deed of settlement, created trusts over 15,000 of the shares whereby the income was payable to himself during the joint lives of himself and his father. On the death of either either of them, his wife was to receive an annuity which was to be increased on the death of the survivor and, subject to these provisions, the trust funds and the income therefrom were to be held on trust for the children of the marriage. The taxpayer and his father were alive during the whole of the years in question and, accordingly, any income would have been payable to the taxpayer. No dividends were paid by Dufferin and no income was distributed by Established, as trustee, during those years.

The taxpayer held virtually all of the shares of Established and was able to control that company and, therefore, indirectly, to control Dufferin and six other companies incorporated in Canada or Kenya which were within the control of Dufferin. Established was also a Canadian company.

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4. (1948) 30 TC 345

Assessments to surtax were made on the taxpayer on the footing that the 1934 deed was a "settlement" within the meaning of sections 38 and 31 FA 1938,[5] in which he had an interest in the income arising under the settlement. For the purposes of the assessments, the income arising under the settlement included 15/25ths of the income of Dufferin and, similarly, 15/25ths of the income of each of the other companies under Dufferin's control. The point therefore arose for consideration as to whether the undistributed income of Established, Dufferin and the subsidiary companies was to be regarded as having been notionally distributed and as having notionally reached the hands of the trustee, namely, Established. If it could be so treated, then it would be income arising out of the settlement and as such would have formed part of the taxpayer's income on which he would have to pay surtax.

In the House of Lords it was held that the provisions of section 13(3) FA 1939 did not necessitate any enlargement of the meaning of the expression "the body corporate" in section 41(4)(a) FA 1938, and that that section did not extend to income apportioned or sub-apportioned to a foreign company and, accordingly, that the income of the six foreign companies within the control of Dufferin did not amount to income arising under the settlement.

In the High Court, commenting on the effect of section 13(3) FA 1939 on section 41(4) FA 1938, Atkinson J said:

> "There is nothing to suggest that the section is aimed at enlarging or amending section 41(4). There are no express words suggesting that its intention is to enlarge section 41(4).... It would have been very easy to have inserted words such as 'and for the purposes of all such apportionments each and every company involved shall be deemed to have been incorporated in the United Kingdom'. If that had

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5. See Chapter 2

> been really meant nothing could have been easier than to insert words of that kind... Whether Parliament intended that result I have not the faintest idea. This section is framed in a most difficult manner. But, as Rowlatt, J, has said more than once: 'In Revenue matters there is no room for intendment. Ambiguity must tell in favour of the taxpayer.' I think this section is ambiguous in the extreme."[6]

The difficulty encountered by both counsel and the judge in interpreting these sections can be seen from the following interchange between Atkinson J and Stamp (junior counsel for the Crown) when the judge said: "I hope you will go to the Court of Appeal Mr. Stamp, and see what they have to say about it" and counsel replied, "It is very much in the nature of a lottery my Lord."

The accuracy of this comment was shown by the fact that the Court of Appeal, in fact, allowed the Crown's appeal. It was clear that section 41 made the income of Dufferin taxable because its income could have been apportioned under section 21 FA 1922, but the question was whether the income of Dufferin's subsidiaries could be taxed in the taxpayer's hands. It was also clear that section 41 could not achieve this because Dufferin was not a company incorporated in any part of the United Kingdom and so, as noted above, it was impossible to sub-apportion under section 32 FA 1927, that part of the income of the subsidiaries which had been apportioned to Dufferin. The point at issue was whether section 13 FA 1939 rendered the income of the subsidiaries taxable in the hands of the taxpayer. The Special Commissioners and Atkinson J had held that section 13 did not render the taxpayer liable in respect of the income of the subsidiaries.

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6. pp 354-5

In the Court of Appeal, Cohen LJ referred to section 13 FA 1939 as "a good example of bad referential legislation".

Asquith LJ dealt at some length with the interaction of section 13 FA 1939 and section 41 FA 1938. He said:

> "In order that section 13, subsection (3), of the 1939 Act to enable section 41, subsection (4)(a)(ii), to defeat device number 4 [recourse to two or more foreign companies], it would be necessary to read the words 'the body corporate' in line 4 of the letter not as limited to the body corporate whose income is involved - the 'body corporate' in line 1 - but as including any other body or bodies corporate in whose members a sub-apportionment would notionally vest that income in part or in whole, in this case the Dufferin company.
>
> Mr. Stamp argued that this was precisely how the court ought to read the words. Section 13, subsection (3), of the 1939 Act would be entirely inoperative in relation to section 41, subsection (4)(a)(ii) of the 1938 Act , unless 'the body corporate' in line 4 were read as 'each body corporate' or 'any appropriate or relevant body corporate' or 'any bodies corporate involved'; for this last variant he invoked the provisions of the Interpretation Act to the effect that the singular includes the plural.
>
> More generally he contended that if Statute 'A' provides that a term used in a previous Statute 'B' shall receive an extended meaning, and such term cannot receive such extended meaning without minor consequential changes in its context in Statute B, Statute A implies that these changes should be made,

and made they should be rather than that the provision in Statute A should be wholly stultified.

Mr. Grant for the respondent, the taxpayer, contended inter alia that this amounted to rewriting section 41, that the argument involves reading 'body corporate' in line 1 of (ii) in one sense as meaning the Finance and Trusts Company; reading 'body corporate' in line 4 in a different sense, as meaning the finance and trusts company plus any other company or companies involved in a sub-apportionment (in this case the Dufferin company), and reverting, when body corporate is used in line 6, to the sense attributed to it in line 1. He argued that if reading the expression in all these passages in the sense which it has in line 1 stultifies section 13, subsection (3), of the 1939 Act, then so much the worse for that subsection.

I am of opinion on this issue the Crown is entitled to succeed. No doubt section 13, subsection (3), of the 1939 Act is inartistically drafted. But its intention is unmistakable and I do not think that to read 'the body corporate' in line 4 of sub-paragraph (ii) as by implication amended to 'each body corporate' or 'the bodies corporate' is to do unpardonable violence to that sub-paragraph, or to rewrite it in the sense in which rewriting is prohibited."[7]

This type of argument about legislation that had been toying with the problem for 16 years already shows how unsatisfactory was the state of the apportionment provisions at this stage in their development, particularly as the House of Lords saw matters differently and came to the opposite conclusion.

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7. pp 362-3

In the House of Lords, Lord Uthwatt said of section 41:

> "In my opinion the section, as amended, is unambiguous and its proper construction clear. In its original form the only operation to be taken into account was an original apportionment; and any such original apportionment might be made as respects income of a foreign company as well as income of a British company. In the amended form the results not only of the original apportionment but of every possible sub-apportionment that can flow from an original apportionment are to be taken into account. But otherwise no attempt has been made to alter any word contained in the section, and no attempt has been made to alter the process of sub-apportionment. The machinery of sub-apportionment is brought in sans phrase. Read without a gloss the section appears to me to be precise in expression."[8]

Lord Uthwatt could not see any line of reasoning by which references in a section to bodies whose income is apportionable can be expanded so as to embrace bodies to whom the income is apportioned.[9]

He referred to the line taken by the Court of Appeal that bringing in sub-apportionment necessarily involved giving an enlarged meaning to "body corporate", since applied to sub-apportionments the expression would otherwise be inept. Lord Uthwett said:

> "The only possible ineptitude is failure to bring within sub-apportionable income any income apportioned or sub-apportioned to a foreign body corporate. That may or may not be a casus omissus,

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8. pp 367-8
9. p 368
10. Ibid

but I am unable to see any expression of any intention that such income shall be sub-apportionable"[10]

He also referred to the remark of Asquith LJ that section 13(3) FA 1939 was inarticulately drafted but its intention unmistakable. Lord Uthwatt did not agree. He said that an exact technical description is given in section 13(3). No difficulty arose by reason of the application of section 13 to section 41 unless an assumption is made that the intention was to bring in the omitted income. Lord Uthwatt differed from Asquith LJ as to the intention. Lord Uthwatt thought that the only intention expressed is to bring in all possible sub-apportionments for what they are worth.

He further commented:

"I agree with the Court of Appeal to the extent that the introduction of new words into an existing section may alter the meaning of words already there. But no such alteration can result unless (1) the requirements of the English language demand it, or (2) those requirements permit it and the sense of the section demands it. The alteration suggested by the Court of Appeal does not, in my view, fulfill either condition..."[11]

Lord Uthwatt referred to a second contention of the Crown to the effect that, where actual income from all sources of company number one is attributed to company number two as the result of an apportionment, that attributed income forms part of the "actual income from all sources" of company number two within section 21 FA 1922. For this contention, reliance was placed on the fact that the Act, in terms, provides that the attributed income is to be deemed to be the income of company number two, and "actual income" elsewhere appears in the Income Tax Acts as descriptive of income for tax purposes. Lord Uthwatt found this contention "somewhat surprising". He

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11. p 369

commented that Atkinson J passed it over in silence and the Court of Appeal rejected it. Lord Uthwatt considered that the Court of Appeal were correct in rejecting it.[12]

In this respect, he mentioned two principles of statutory interpretation.[13] The first is that, if the Crown's contention is correct, the result would be ridiculous. This is "a pertinent matter if the relevant phrase is ambiguous". Secondly, no useful purpose to the Revenue would have been served by the enactment of section 32 FA 1927. The application of section 21 FA 1922 to companies entering into a chain would do all that was necessary. This is also relevant if the words "actual income" are ambiguous.

The loophole exposed by this case was covered by what became section 651(1)(b) ICTA 1988.

This case, and the amendments in the law resulting from it, brought to an end the first period of legislative activity in the apportionment field. As will be seen below, the next major development was not statutory.

Before this next development is examined, however, it should be noted that the Howard de Walden case demonstrated how complicated and unsatisfactory the law had become with a series of statutory provisions, one grafted upon another, and couched in such language as to cause great confusion in the minds of those attempting to interpret them. With each successive provision the law became more complicated and the structure and wording of the sections came in for considerable judicial criticism. For example, in the Aldwarke Co Limited v IRC,[14] Finlay J referred to section 21 as a "most troublesome section" and to the FA 1927, in so far as it related to apportionment, as "the very troublesome 1927 Act".[15]

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12. Ibid
13. p 370
14. (1933) 18 TC 125
15. p 132

Section 21, as amended by the FA 1927, also came in for scathing criticism in Lionel Sutcliffe Limited v IRC.[16] In this case, Rowlatt J, who perhaps knew more about tax law than anyone this century, had great difficulty with the legislation. Referring to section 31 FA 1927 he said:

> "This section 31 is a section which in five pages introduces piecemeal amendments into section 21 with the result that the latter section is made perfectly unintelligible to any layman or any lawyer who has not made a prolonged study with all his law books at his elbow, and it is a crying scandal that legislation by which the subject is taxed should appear in the statute book in that utterly unintelligible form. I am told, and rightly told, by the Attorney General - he understands it as much as anybody - that it is only in this form that legislation can be carried through at all. Then all I have to say is that the price of getting this legislation through is that the people of this country are taxed by laws which they cannot possibly understand, and I must say I think that this is the worst possible example that has ever been put on the statute book."[17]

The fact that Rowlatt J found the legislation unintelligible demonstrates probably better than anything else how unsatisfactory the legislation was. A further illustration of the disapproving attitude taken by the judiciary towards this legislation can be seen in Himley Estates Limited and Humbel Investments Limited v IRC.[18] The courts here were concerned with the interpretation of section 21 (6) FA 1922 which read as follows:

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16. (1928) 14 TC 171
17. p 187
18. (1932) 17 TC 367

> "A company shall be deemed to be under the control of any persons where the majority of the voting power or shares is in the hands of those persons or relatives or nominees of those persons, or where the control is by any other means whatever in the hands of those person."

Rowlatt J and the Court of Appeal strongly criticised this wording. Rowlatt J said:

> "I cannot leave the consideration of this clause without pointing out that it calls loudly for redrafting in the interests of precision. I venture to give one illustration of many that may have occurred to me, of its defects. Suppose a majority of shares are in the hands of six brothers. The control would appear, within the meaning of the first part of the clause, to be deemed to be in the hands of those persons. But the Revenue, I understand, deny this, contending that it is deemed to be in the hands of any five or any smaller number because the others are relatives. Why stop there? The brothers may have parents who may, it is true, have nothing to do with the company, but why is the company not under the control of the parents? The majority of the shares are in the hands of their relatives within the very words of the enactment. This is not meant and is, of course, ridiculous, but the truth is that the draftsman has not observed what he has been writing. And has construed the words in accordance with some ill defined conception floating in his own brain. Really this important clause ought not to be allowed to remain in this unscholarly and bewildering form."[19]

These words by Rowlatt J were approved by Lord Hanworth MR who said that the clause was "almost hopeless to

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19. p 375

construe."[20] Lawrence LJ said that he was quite unable to understand the words of subsection (6),[21] and Romer LJ referred to the clause as "this quite ridiculous clause."[22]

Finally, before continuing with the analysis of the provisions, it should be noted that it was made clear very early on that an intention to avoid super tax was not necessary for section 21 to apply. This was so regardless of the preamble to section 21 which stated that the section was enacted "with a view to preventing the avoidance of the payment of super tax through the withholding of distribution of income of a company which would otherwise be distributed." For example, in David Carlaw and Sons Limited v IRC[23], the Lord President (Clyde) held that the application of the section does not:

> "depend on proof of motive on the part either of the company or its shareholders, unless indeed in this sense, that the object to avoid payment of super tax is an inferential presumption from the fact that the restriction of the dividends cannot be accounted for either by the current or prospective requirement of the company, or by the maintenance or development of its business. That fact must be proved to the satisfaction of the commissioners before they can make a 'direction'; but if it is established, they have neither right nor duty to carry their investigations into matters of intention or motive any further."[24]

Lord Sands (p 121) observed that there would be cases in which the section would operate harshly but, he continued:

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20. p 376
21. p 378
22. p 380
23. (1926) 11 TC 96
24. p 119

"It may be that there will be cases where prudent and careful shareholders with an eye to the future of their business... will suffer what no doubt will be hardship under this general rule. But I think that the policy of the Legislature was to allow no holes in the net, because, if any holes were left there was no guarantee but that some of the fish that were really wanted would pass through these holes."[25]

Lord Sands obviously did not foresee the many holes that ingenious taxpayers would find in the legislation.

As regards the preamble, the court held that, as the words of the section were clear and unambiguous, the preamble could not restrict or extend the section.[26]

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25. p 121
26. See, for example, Lord Ashmore at p 122.

The Extraordinary Intervention of Cripps

Before examining the various statutory provisions in more detail, it is important to consider an extra statutory factor which had a profound effect on the operation of the apportionment provisions from 1948 onwards: a statement made by the then Chancellor, Sir Stafford Cripps. In 1948 the Government adopted a policy of moderation and restraint in connection with the payment of dividends. As this was incompatible with the provisions of section 21 FA 1922, Sir Stafford Cripps intervened. This statement was, in fact, made a short time before the House of Lords judgement in the Howard de Walden case. On 22nd July 1948, Sir Stafford Cripps made the following Parliamentary statement:

> "As my predecessor[27] explained in Finance Bill Debates on 11th June, 1947, it is not the practice in present circumstances to take action against a trading company under section 21 in a bona fide case where the rate of dividend is the same as that which was accepted by the Special Commissioners as reasonable in previous periods, even though the company's profits may have increased. It is not necessary that there should have been any formal application to, or correspondence with, the Special Commissioners about the earlier periods. If, in fact, no directions have been made for the periods ending before June, 1947, the company may assume that its action was regarded as reasonable. If, for special reasons, no dividend at all was declared in the periods before June, 1947, and directions were not made by the Special Commissioners, they will not in present circumstances challenge the continuance of the company's policy. I must emphasise that this answer deals only with bona fide cases and will not apply where there are avoidance devices, such as the withdrawal of money from the company in the guise of 'capital'.

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27. Hugh Dalton

For several years immediately following this statement, the Special Commissioners usually only instituted enquiries with a view to the application of section 21 where funds were extracted from a company by shareholders by means of, for example, loans or where the company was put into liquidation with the result that the profits of the company were paid to the shareholders.

It became unusual to find the Special Commissioners taking action in the case of an ordinary trading company which continued the dividend policy which was followed up to 1947, even though there may have been greatly increased profits since that time. This practice was, therefore capable of operating in a quite arbitrary way.

In considering whether or not a reasonable distribution had been made, it was necessary to examine the position in the light of the accounts for the period in question and to see what portion of the profits shown by the accounts could be regarded as a reasonable distribution by reasonably minded businessmen with all knowledge of the facts, and having regard to the requirements of the company in the maintenance and development of its business. If it was decided that a reasonable distribution had not been made, the section was penal in its effect in that the actual income of the company as computed for income tax purposes would be apportioned among the shareholders and charged to surtax accordingly. However, the figure of profits shown by the accounts could have been very much less than the profit as adjusted for income tax purposes. In considering whether a reasonable distribution had been made, regard was had to the profit shown by the accounts, but, once it was decided that a reasonable distribution had not been made, then the adjusted profit for income tax purposes was used in computing the surtax liability.

It is important to appreciate that the Cripps statement was made as a result of the policy of the Government regarding the limitation of dividends. It was therefore a policy superimposed upon what would otherwise have been the statutory duty of the Special Commissioners to apply the provisions of section 21. If a surtax direction was made against a company, and the company appealed, the appeal Commissioners had to determine that matter on a statutory basis. So, if the company considered that it should have had the protection afforded by the Cripps statement, they had to try to settle the matter by negotiation rather than by way of a formal appeal.

There was, therefore, the remarkable situation that there was no independent tribunal that could express an opinion as to whether a case was protected by the statement made by Sir Stafford Cripps and that, if the assessing Special Commissioners considered that the case was not protected by the statement, the matter could not be heard by the Special Commissioners sitting as an appeal tribunal.

Fortunately, in the years immediately following the statement, it appeared that the Special Commissioners were, in general, taking a reasonable view of the application of the statement. However, it was totally unsatisfactory to taxpayers, and probably to the Special Commissioners themselves, that the decision whether to apply the statement was in the hands of the same people who had a statutory duty to apply the penal provisions of the section itself. The section was hard enough to administer by itself, but when it had to be applied in the light of a Parliamentary statement that ran entirely contrary to the intentions of the provisions, the difficulties facing the Commissioners were considerable.

Around 1954 and 1955 it appeared that the Special Commissioners became more active in the application of what had become section 245 ITA 1952 (which had replaced section 21 FA 1922). Their activities increased to the sort of level they reached before the Second World War. Their comparative inactivity in the intervening years was due, firstly, to the incidence of excess profits tax which prevented companies from making distributions out of increased war time profits and, secondly, to the Cripps statement which was made in the light of the Government's dividend limitation policy.

The Special Commissioners initially tended to apply the Cripps statement fairly but, in around 1954, it seems that they were looking to set aside the Cripps statement if they were given the slightest excuse for doing so.

The arrangement most commonly challenged by the Special Commissioners was where the company made a loan to a shareholder, because the company would have dissipated some of its funds to the shareholder in the guise of capital.

The Special Commissioners also began to look with increasing interest at the position where part of the original purchase price of a business had been left on loan account to the vendor and where the loan account was being repaid. The repayments may have been made when it would have been unreasonable for the company to have made a distribution in the form of a dividend, but the Special Commissioners regarded the fact of the repayment as taking the company outside the protection of the Cripps statement so that, if circumstances improved at a later date, they would consider action for those later periods notwithstanding the fact that there was no repayment of loan in those periods.

A common example of this kind of case was where an individual transferred his trade to a company in consideration partly for shares and partly for a loan. As mentioned above, any repayment of the loan was regarded as being contrary to the principles of the Cripps statement and the provisions of section 246(2) ITA 1952 became relevant. This section provided that any sum applied out of the income of a company towards the payment of the business, undertaking or property which the company was formed to acquire, or which was the first business, undertaking or property of a substantial character in fact acquired by the company, or applied in the redemptional repayment of any share or loan capital or debt issued or incurred in or towards payment for the business, undertaking or property which the company was formed to acquire or which was the first business, undertaking or property of a substantial character acquired by the company, would be regarded as income available for distribution among the members and not as having been applied to the current requirements of the company's business, or to such other requirements as may be necessary or advisable for the maintenance and development of that business. Consequently, the company could not maintain, when seeking to avoid the effect of section 245, that it had to make provision for the repayment of the vendor's loan account before dividends could be paid.

Companies incorporated after the Cripps statement were not covered by it. For the first couple of years it was likely that they could not make a distribution to shareholders owing to the fact that they had to provide for more than one years tax until they were on the normal basis of providing for tax on the current years profits. The Special Commissioners appeared to expect the payment of a dividend on a reasonable basis once a normal year's trading had been reached and they expected this level of dividend to be maintained for future years, unless there were special circumstances that would justify a reduction in the rate of dividend. Here again, however, the Special Commissioners would be likely to make a direction under section 245 if there had been a repayment of a loan to a vendor.

It should be recalled that, if a direction was made, the effect was that the whole of the income of the company for the year the direction was made was regarded as the income of the shareholders and apportioned among them with the result that the income of the company was charged to surtax. Therefore, once it was established that a reasonable distribution had not been made, the whole of the income of the company as computed for tax purposes fell to be charged to surtax and not merely the amount that would be regarded as a reasonable distribution. However, the Special Commissioners were, in some cases, prepared to negotiate a reasonable settlement rather than exact the full penalty demanded by the section. Special considerations, however, applied to investment companies because they were dealt with specifically by section 262 ITA 1952 and an automatic direction to surtax was made in such cases except in relation to estate or trading income which was governed by the normal reasonable distribution rules.[28]

At the end of the scale, in cases of liquidation, the full penal effect of section 245 was likely to be applied for the two final periods up to the commencement of the liquidation.

In the mid 1950's the Special Commissioners also appeared to have taken the view that the Cripps statement could be

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28. Infra

set aside if the shareholder had sold an asset to the company for cash, on the basis that he was withdrawing

funds from the company in a capital form. They took this view even when there was no evidence that there was any motive to avoid tax and where the sale was at a proper commercial price. On the other hand, if a company purchased, for example, business premises from a non-shareholder, then there could be no suggestion that the Cripps statement could have been set aside. The transaction would have been at arm's length and the company had clearly expended its funds in order to meet the current requirements of the company's business within the meaning of section 246. The company would therefore have been penalised under section 245 merely because the vendor of the asset happened to be a shareholder.

In 1956 the Chancellor of the Exchequer, Harold Macmillan was specifically asked whether the Cripps statement applied to companies formed since June 1947. He replied that companies formed after May 1947, and companies formed before then but whose first accounting period ended after that date, were not regarded as being within the protection afforded by the Cripps statement. This was because the company would not have had a period ending before June 1947 which could fix the dividend policy operating before the Cripps statement had effect. The Chancellor said, however, that, in practice, the spirit of the statement was observed in dealing with new companies. In the early years of a business, regard was had to the need to plough back profits for the maintenance and development of the business.

Once a business was established on a normal basis, the Special Commissioners would expect the company to pay a reasonable dividend and that rate should then remain for later years even though the subsequent profits might increase. On the other hand, if circumstances were such that the company could not reasonably be expected to pay a dividend as high as that established for the standard, a direction under section 245 would not be taken on the payment of a lower dividend. The Special Commissioners would, however, expect the company to go back to the standard as soon as it was reasonable for the company to do so.

On the question of what was a reasonable dividend, the practice of the Special Commissioners tended to be in line with the suggestions made by the Royal Commission,[29] namely, that companies must retain some resources for normal business purposes and, therefore, the penal provisions of section 245 should be abandoned in favour of a "reasonable distribution" basis.

The Final Report of the Royal Commission[30] published in 1955 set out the conclusions of the Royal Commission on the apportionment provisions as follows:

> "1037. We were told that the theory of the section is that, if in any year there is an unreasonable retention of income by a closed corporation, the whole benefit of its incorporation ought to be withdrawn from its members for that year and they ought to be treated as if they were nothing but partners in receipt of partnership income. We found ourselves unpersuaded by the force of this. It seems to disconnect the consequence from the cause. In fact the company remains a corporation, and in some cases it could not legally be a partnership, even it wanted to be. There is nothing inconsistent with the corporate status in an excessive retention of profits: a company that is not a closed corporation could do it with impunity. Indeed one of the obstacles to applying this section to a closed corporation that has a trading business is that in recent years Your Majesty's Government has itself urged the desirability of holding back

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29. The Royal Commission on the Taxation of Profits and Income
30. Cmd 9474

distributions. If the cause which brings the Special Commissioners powers into operation is a failure to make a reasonable distribution, it seems that the natural way of correcting the defect would be to secure that, for tax purposes, a proper distribution should be treated as having been made. To treat the whole income as distributed is more like a penalty: and since the question what is or what is not a reasonable amount to distribute is largely a matter of individual judgement, we think that this is not the occasion for introducing an element of the penal.

1038. Another justification for the present scheme is that, while commissioners (or the Board of Referees on appeal) can properly enquire into and decide the question whether a reasonable amount of income has not been distributed, it would be a very difficult matter for them to decide positively what amount ought to have been distributed and to direct that amount to be treated as distributed accordingly. To do that, it was said, would be to usurp the functions of the directors. We could not see this as a valid defence. It must be very difficult to decide that a reasonable amount of a given figure has not been distributed - as is done now - without at the same time forming an opinion what the reasonable amount would have been. It is quite true that there is not necessarily one reasonable amount only to fix upon and, to that extent, to fix one is to exercise a positive discretion of the managerial kind. But, since the whole basis of the provision involves that, for tax purposes, there should be the most complete overriding of the company's management, even to the extent of distributing 100% of its income, we do not see why the special body entrusted with the enquiry should not be charged with the duty of ascertaining a particular figure as the reasonable amount for distribution.

> On the whole, therefore, we think that the objections to the proposed change are not well founded, and we recommend that in future the amount that is deemed to be distributed and apportioned accordingly should be only that amount which the Special Commissioners or the appellate body shall decide to be the amount that ought reasonably to have been distributed."

It can be seen from the above, together with the discussion below of investment companies, that, by 1957, the position has become rather complicated. Although companies fell within two main groups, namely, trading companies and investment companies, there were several sub-divisions of each group. Trading companies could be classified into:

(i) Cripps companies;
(ii) Macmillan companies; and
(iii) Other companies.

Investment companies, as will be seen below, could be split into:

(i) Automatic direction companies;
(ii) Estate or trading income companies; and
(iii) Mixed income companies.

As far as trading companies are concerned, it has been seen that, if a company is protected by the Cripps statement, no action would be taken by the Special Commissioners no matter how large its profits or how liquid its resources. To retain protection under the statement the company must have continued to declare the same dividends as those that were paid for the last accounting period prior to 30th June 1947, unless there had been a decline in profits below the level for that period. The Special Commissioners would examine those cases carefully if they showed increasing profits and liquiditiy in order to see whether there had been a transaction which offended the principles of the Cripps statement. Once the protection of the statement was lost, it could never be regained.

The Macmillan statement applied a modified Cripps protection to those companies that had no trading history before June 1947 but where there had been no extraction of funds by the shareholders. Companies incorporated and commencing trading since 1947 fell within this group and, after a period of development of three or four years, the Special Commissioners would expect to find the company paying a reasonable dividend, the amount of which need not thereafter have been increased, notwithstanding increased profits, providing there were no avoidance devices (a phrase which was given, in practice, a very wide interpretation).

In the case of all other trading companies, the Special Commissioners looked for the payment of reasonable dividends, the level of which depended on the circumstances.

The Cripps and Macmillan statements did not apply to investment companies. It will be seen from the analysis later in this Part that a distinction was made between trading and investment companies for the first time in 1936 and this distinction was emphasised to an even greater extent in 1939 by the introduction of the automatic direction provisions which applied in the case of certain investment companies.

Property companies were investment companies but were not subject to automatic directions because their income consisted of "estate or trading income". Although these companies were not covered by the Cripps and Macmillan statements, the Special Commissioners were often willing to consider a modified form of the application of those statements to property companies.

The next extra statutory development occurred on 1st August 1957 when, in answer to a Parliamentary question, the Chancellor of the Exchequer, Peter Thorneycroft, made an announcement regarding the Cripps statement, as follows:

"I have come to the conclusion that this practice, which was announced by my predecessors in June 1947 and July 1948, should now be discontinued. In dealing with accounts made up for periods ending after the date of this answer the Special Commissioners will not regard themselves as bound by these statements, but will make directions in appropriate cases by reference to the statutory test, namely, that the company has failed to distribute a reasonable part of its income from all sources having regard to the current requirements of its business and to such other requirements as may be necessary or advisable for the maintenance and development of that business."

For some time after this announcement there was a great deal of speculation as to its effect. There was, for example, no reference made to the statement made by Harold Macmillan in April 1957 concerning new companies.

There was also the profits tax legislation to consider. The object of increasing the rate of profits tax attributable to distributed profits was to limit distributions. It was therefore unreasonable for the Special Commissioners to expect a trading company to pay dividends at the level that might be expected if profits tax were not chargeable. The section 245 legislation ran contrary to the principles inherent in the two tier profits tax system.[31]

It was also unclear whether there would be a change in the practice of the Special Commissioners in their willingness to negotiate a settlement on the basis of the payment of reasonable dividends for trading companies along the lines suggested by the Royal Commission.

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31. Infra

Experience had shown that distributions of about 30% of the profits as shown by the accounts was the sort of level considered as reasonable in the case of trading companies.

These were examples of the sort of questions left unanswered by the withdrawal of the Cripps statement.

On the question of the practice of the Special Commissioners, it appeared that the Special Commissioners were aware of the fact that the section was penal in its effect and did not seek to apply its stringent provisions in the case of trading companies if those companies were willing to reach a negotiated settlement based on what was regarded as a reasonable dividend. However, as the months went by, it became clear that the Special Commissioners were beginning to take a rather more demanding approach.

The picture changed somewhat on 31st March 1958 when a company's liability to profits tax was no longer affected by the amount of distributions and, therefore, the previous heavier burden of profits tax due to the payment of a dividend was no longer a factor to be taken into account when determining whether the dividend was reasonable for the purposes of section 245. This had some effect on the attitude of the Special Commissioners to the subject of reasonable distributions and the Commissioners began to look for a distribution policy under which greater dividends were paid than under the 30% guideline mentioned above. For example, where a company had no particular need to retain resources because of capital commitments and had plenty of liquid resources, a net dividend of in the region of 45% of the net profits, after providing for taxation, was regarded as reasonable.

The logic behind this change of attitude is not readily apparent in many cases. If 30% was reasonable under the old practice, there was often little case for saying that 45% was available under the new conditions. The cost of replacing fixed assets was still high and, therefore, if the company had been depreciating its fixed assets on a historical cost basis, it needed to find substantial sums out of current profits in order to replace fixed assets. In fact, with increasing competition, it was, perhaps, even more important to maintain fixed assets in a modern and efficient state in order to maintain maximum productivity.

Under the old profits tax legislation, the distribution of 30% of the profit did leave about 30% to be ploughed back into the business after providing for income tax and profits tax. The result was similar with a flat 10% liability for profits tax which would suggest that a 30% distribution policy remained reasonable. If a distribution of 45% was imposed by the Special Commissioners there would remain a much lower figure, about 22% after providing for taxation, for retention for the purpose of the current requirements of the company's business and for its maintenance and development. In many cases, 22% was too small a figure for those companies which required continuously expanding resources to meet expanding business.

The Apportionment/Profits Tax Conflict

One of the more confusing episodes in the history of the apportionment legislation arose during the period in which the profits tax legislation, with its differential rate system, was designed to curb dividend policies of companies, providing for a higher rate of profits tax on distributed profits than on profits retained in the business. The policy behind this legislation was, of course, in direct conflict to that behind the apportionment legislation which was designed to force companies to make distributions.

The profits tax legislation differed from the apportionment provisions in that it affected all companies and not just those under the control of five or fewer persons.

The profits tax legislation was a product of economic circumstances prevalent in the country at the time in which a policy of moderation in the distribution of profits to shareholders was desirable. These provisions did not sit happily with the penal apportionment provisions.

Surtax was a charge on the incomes of individuals whereas profits tax was a charge on the profits of corporate bodies. If the whole of the income of a company was charged to surtax under section 245, then there was no charge to profits tax for the same period. Section 31(2) FA 1947 provided that the profits tax charging section should not apply. It can be seen, therefore, that, to this extent, surtax and profits tax were complimentary although the philosophies behind the two taxes were contradictory.

Companies were liable to profits tax according to the profits that they made during each chargeable accounting period. Where the company did not distribute all of its profits among its members, the company would be granted non-distribution relief in the shape of a reduction in the rate of profits tax. On the other hand, if the company distributed more than the profits of the company for the relevant period by, for example, using reserves or surpluses for past years, a penalty was imposed in the shape of a distribution charge on the amount of the excess of the sum distributed over the profit for the period.

Where a company had other companies as its shareholders, those corporate shareholders would not be liable to surtax in respect of the income apportioned to them but this apportioned income would then be treated as part of their profits for profits tax purposes. Where, therefore, a surtax direction was made against a company, the income of that company, insofar as it was apportioned to individuals, would avoid profits tax altogether; on the other hand, insofar as it was apportioned to corporate shareholders, it formed part of the profits of each such corporate shareholder and became chargeable to profits tax. To bring this about, section 31(3) FA 1947 made provision for an election to be made to have the company's trade treated as if it had been carried on by all its shareholders in partnership. Section 31(3) stated that if, for a year or period which included, or for years or periods which together included, the whole of a chargeable accounting period of a trade or business carried on by a body corporate, the actual income of the body corporate from all sources was apportioned, and if some, but not all, of the persons to whom the income was apportioned were individuals, then if by notice in writing given to the Commissioners within six months of the end of that chargeable accounting period, or such longer time as the Commissioners might allow, the body corporate and the corporate shareholders to whom the income was apportioned, jointly so elected, the trade or business was to be treated as if it had been carried on in partnership by the persons to whom the income was apportioned. In such circumstances, the section went on to provide that the body corporate against whom the direction was made was not to be chargeable to profits tax for that accounting period.

The effect, therefore, of this election was that such of the company's income as was apportioned to shareholders who were individuals would be treated as the income of those individuals for surtax purposes and the overall tax bill would be reduced. On the other hand, such of the company's income as was apportioned to corporate shareholders would be treated as part of the profit

of those companies for the purposes of profits tax. The company against whom the direction was made would avoid any liability for profits tax in respect of its own income which had thus been apportioned.

Reference should also be made to Section 68(2) FA 1952 which should be read with Section 262(2)(a) ITA 1952.[32] The effect of these provisions was that, where a surtax direction was made against a company, in determining the amount of its total income to be apportioned among its members, a deduction had to be made in respect of the grossed up amount of any profits tax "payable" by the company.

The problem was to determine how exactly these provisions interacted. If a company had profits of £X and was chargeable to profits tax in the sum of £Y, so that after payment of the profits tax the balance of the profits, namely £X-Y, was so negligible that a surtax direction on this balance would be impracticable, a surtax direction would not be made. But the question was whether this was the correct order or whether the surtax direction should be made first, without any deduction of profits tax, and thus rule out profits tax altogether.

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32. Formerly section 14 FA 1939

This conflict was considered in the case of R v Special Commissioners of Income Tax ex parte Linsleys (Established 1894) Limited.[33] The point considered by the House of Lords was whether precedence had to be given to the surtax provisions or to the provisions in FA 1952 with regard to the deductibility of profits tax payable by a company in arriving at its apportionable income.

In the lower courts, the view was taken that the deduction was not to be made in respect of profits tax in the first instance and that the question whether any profits tax would be payable could not be determined until after the company and such of its members as were also companies had an opportunity of determining whether to make the election mentioned above. The House of Lords, however, rejected this view and held that profits tax became payable immediately the profits were earned and that, upon distribution, the profits tax was payable and that it had to be deducted in determining the balance of the company's income which might be apportioned among its members.

The facts of the case were that the company had, in the past, earned profits for which it had become liable to pay profits tax. By withholding distribution of those profits, the company had obtained non-distribution relief and had accordingly avoided the liability for payment of profits tax at the higher rate. The company, however, subsequently went into liquidation as a result of which those profits which had not been distributed ultimately became distributable in the course of the winding up. If the liability for profits tax which, because of the distribution, now attracted a distribution charge was taken into account and deducted from the available income of the company, no balance was left. The Inland Revenue argued that the first step was to

33. (1958) 37 TC 677

deduct the profits tax and that, as the company, after this deduction, would have been left with no income at all, there was nothing to which a surtax direction could attach, and there was nothing which could be apportioned among its shareholders.

The company, on the other hand, argued that the profits tax was not "payable" and that it could not be said to be payable unless and until the company failed to make the election conferred on it by section 31(3) FA 1947. If profits tax was not deducted there would have been income which would have been distributable among the shareholders persuant to a surtax direction which should have been made. The company therefore brought proceedings for Mandamus directing the Special Commissioners to make a surtax direction. If the company's contention had succeeded, the company would have avoided a profits tax liability for £16,421 in exchange for a smaller surtax liability of a sum not exceeding £8,920.

The House of Lords, however, held that the profits tax was payable and that it was not deductible before arising at the balance of income which was to be distributed among the shareholders. As, after the deduction, there was a nil balance, a surtax direction could not be made.

The interaction of the profits tax and the apportionment provisions when an election under section 31(2) FA 1947 had been made was also the point at issue in Heelex Investments Limited v IRC.[34] A parent company gave notice to the Commissioners under section 22(1) FA 1937 requiring the profits or losses of a subsidiary to be treated for profits tax purposes under section 22(2) as profits or losses of the parent in its corresponding chargeable accounting period. Thereafter assessments to profits tax were made on the parent in respect of both

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34. (1955) 35 TC 532

its own and the subsidiary's profits. Subsequently, the Special Commissioners, by a notice under FA 1922, directed that the income of the parent from all sources should be deemed for surtax purposes to be the income of its shareholders, all of whom at that time were individuals. Profits tax then ceased to be chargeable on the parent by virtue of section 31(2) FA 1947 and the profits tax which it had paid for the years in question was repaid to it by the Commissioners. The Inland Revenue assessed the subsidiary to profits tax in respect of the accounting periods in question.

It was held that the assessments on the subsidiary had to be discharged since, by the giving of the notice under section 22(1) FA 1937, the profits or losses of the subsidiary were required by section 22(2) to be treated as profits or losses of the parent for the purposes of ascertaining what profits tax was payable on the profits of both companies and the parent company was exempt from charge to profits tax. Nothing in section 22(2) limited its application to cases where the income of the parent was liable to profits tax.

It can therefore be seen that, while the two-tier profits tax system lasted, it threw up some peculiar problems in its interaction with the apportionment provisions. Yet despite these problems, and other factors such as the Cripps statement, the apportionment provisions remained through all of these upheavals, and it was not until 1989, 67 years after their fist introduction that apportionment was abolished.

Before moving on, reference should be made to <u>section 30 FA 1956</u> which was aimed at nullifying the effect of the decision in the Heelex case. It did this by providing that, where for a chargeable accounting period, a grouping notice was in force but exemption from profits tax was available to the company concerned because of a direction to surtax, then for that chargeable accounting period and the corresponding chargeable accounting period of the other company to which the grouping notice related, the profits or losses of the subsidiary would not be regarded as the profits or losses of the principal company under section 22(2) FA 1937. Furthermore, section 38(1) FA 19347, which dealt with the treatment of distributions between companies for which a grouping notice had been given, would not apply. Accordingly, a company which was exempt from profits tax under the surtax direction provisions of section 31(2) FA 1947, would still not be chargeable to profits tax, but any other member of the group for which the group election had been given, would be dealt with separately for the purpose of computing its liability to profits tax and it would not escape a charge to profits tax merely because a surtac direction had been made on another company affected by the same grouping notice.

It was also provided that other payments between inter-connected companies would be considered quite independently of any grouping notice for a period for which a surtax direction was made on one of the companies affected by the notice.

The section also stated that a grouping notice could not be given by a principle company in respect of a subsidiary if either of them was not carrying on a trade or business. Furthermore, a grouping notice validly given by a principle company in respect of a subsidiary could not continue in force after either of them had ceased to carry on a trade or business, or to be resident in the United Kingdom.

Companies at Which the Apportionment Legislation was Aimed

As has been noted above, only certain companies fell within the scope of section 21 FA 1922: basically, the section applied to any company under the control of not more than five persons and which was not a subsidiary or a company in which the public were substantially interested.

Section 19(3) FA 1937 defined the term "company" for this purpose as including any body incorporated in any part of the United Kingdom under any enactment. Although the company could be a subsidiary of another for the purposes of the Company's Act 1948, it was not so regarded for the purposes of the application of section 21, if the parent company itself was outside the scope of section 21. Where the shares of the subsidiary were held by more than one company, all the holding companies had to be outside the scope of section 21 if the subsidiary was itself to be exempt from the application of the section.

A company was deemed to be a company in which the public were substantially interested, so as to give it immunity from section 21, if its equity shares carrying not less than 25% of the voting power had been allotted unconditionally to or acquired unconditionally by the public and were held beneficially by the public at the end of the accounting period under consideration. In addition, those shares must have been the subject of dealings on a stock exchange in the United Kingdom during the year in question and they must have been quoted in the official list of the stock exchange.

Very elaborate provisions were contained in section 21, as amended by section 19 FA 1936 for the purpose of determining whether or not the company was under the control of not more than five persons. The company was treated as under the control of not more than five persons if any of the following conditions were satisfied:

(1) If any five or fewer persons together exercised, or were able to exercise, or were entitled to acquire control over the company's affairs, and in particular, if any five or fewer persons together possessed, or were entitled to acquire, the greater part of the share capital or voting power of the company.

(2) If any five or fewer persons together possessed, or were entitled to acquire, either the greater part of the issued share capital of the company, or such part of that capital as would, if the whole of the income of the company were distributed to its members, entitled them to receive the greater part of the amount so distributed.

(3) If

(a) on the assumption that the company was a company to which section 21 applied;

(b) on the assumption that the company and any other company or companies were companies to which section 21 applied;

more than half the income of the company any income which had been apportioned to it, or could on either of those assumptions be apportioned to it, for the purposes of section 21) could be apportioned for those purposes among not more than five persons.

For the purpose of deciding whether the company was or was not under the control of not more than five persons, persons who were relatives of one another were treated as a single person. Similarly, nominees were treated as a single person with their principal. Persons in partnership and persons interested in any shares or obligations of the company which were subject to any trust or were part of the estate of a deceased person were also treated as a single person.

In addition, in the case of an investment company, it was deemed to be under the control of not more than five persons if any five or fewer persons would, on a winding up of the company, be entitled as members or loan creditors to receive more than one half of the assets of the company which would be available for distribution to members and loan creditors.

It can be seen that the net was widely thrown, a pattern that was continued in later manifestations of the apportionment provisions.

A structure aimed at avoiding the apportionment provisions by attempting to ensure that the taxpayer company was not one to which the legislation applied was held to be ineffective in IRC v Harton Coal Co Ltd.[35] The wide ambit of the provisions was demonstrated by the judges analysis.

Originally, the taxpayer company had carried on a colliery business but, during the years in question it was an investment company whose business consisted of collecting income and interim payments and of paying off its debentures. Its capital consisted of 963,250 "A" ordinary shares of 10 shillings each and 75,000 "B" ordinary shares of 10 shillings each. One "B" ordinary share was designated the management share and carried a number of votes equal to three times the total number of

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35. (1960) 39 TC 174

votes attaching to all the other shares of both classes. All the other shares carried one vote each. The management share and one other "B" ordinary share were held jointly and beneficially by Schroder Nominees Limited and Stephenson Clarke Limited. The name of Schroder was the first on the register.

Schroder and other companies in the Schroder group held 402,355 "A" ordinary shares and 31,249 "B" ordinary shares and so, with one of the two shares already mentioned, the Schroder Group held five twelfths of the issued shares of each class. Stephenson and other companies in the Stephenson Group held 401,355 "A" ordinary shares and 31,249 "B" ordinary shares and so, with one of the two shares mentioned above, also held five twelfths of the issued shares of each class. British Industrial Corporation Limited (BIC), through nominees, held 160,540 "A" ordinary shares and 12,500 "B" ordinary shares, and thus held two twelfths of the issued shares of each class. Schroder was admitted to be a company to which section 21 FA 1922 applied and Stephenson was admitted to be a company outside that section. The Chairman of Stephenson was also Chairman of the taxpayer company. Article 78 of the taxpayer company's Articles of Association provided for the first named of joint holders to exercise the voting rights on jointly held shares.

The Inland Revenue contended, (i) as Schroder was the first named holder of the management share, it controlled the taxpayer company; (ii) as the taxpayer company was under the control of Schroder, and as Schroder was within section 21, the taxpayer company was not a subsidiary company within section 21(6); (iii) alternatively, the taxpayer company was under the control of Schroder and BIC, both being companies under section 21.

The taxpayer company contended, (i) that, as the beneficial ownership of the management share was in Schroder and Stephenson, no control could be exercised by means of the management share unless the joint owners agreed and, therefore, the taxpayer company was not under the control of Schroder; (ii) that BIC, though under the control of not more than five persons was a company in which the public were substantially interested, and was, therefore, outside section 21; (iii) that the taxpayer company was a subsidiary because the control of it was in Stephenson and BIC, neither of which was a company within section 21.

The Special Commissioners decided that the taxpayer company was a subsidiary company and that the directions should be discharged. The Crown appealed to the High Court.

In the High Court, Pennycuick J held that the taxpayer company was a subsidiary company within section 21 (6) because it was controlled by two other companies, Stephenson and BIC, neither of which was within the section; but that, as Schroder was the first named holder of the management share, it alone controlled the company, and as Schroder was within the section, the taxpayer company was, under section 14 (1) FA 1937, deemed not to be a subsidiary company.

The judge said that the issue could be approached by asking three questions;

(1) Was the control of the taxpayer company in the hands of Stephenson and BIC by reason of their beneficial ownership of shares?

(2) Was the taxpayer company excluded from the status of a subsidiary by section 14(1) FA 1937?

(3) Was BIC a company to which section 21 applied?
For the directions to be set aside, question 1 had to be answered in the affirmative and questions 2 and 3 in the negative.[36]

Dealing with the first question, the judge said that it raised three distinct points. The first point was whether the control of the company was exclusively in the hands of Schroder for the purpose of section 21(6) by reason of its interest in the management share. That share belonged beneficially to Schroder and Stephenson jointly, and their joint beneficial ownership gave them joint control in the sense, that acting together they could, by taking the appropriate steps, have exercised majority voting rights. But Schroder had exclusive control, not by reason of its beneficial interest, but by reason of the fact that its name was first on the register of members.[37]

The second point arising out of the first question was whether the control of the taxpayer company was exclusively in the hands of Schroder and Stephenson for the purpose of section 21(6) by reason of their joint beneficial ownership of the management share. As beneficial owners of the management share, Schroder and Stephenson could together have exercised their votes so as to carry a resolution at a general meeting of the company. But Stephenson, if it had not been in agreement with Schroder, could, by taking appropriate steps as joint beneficial owner, have disefranchised the management share and, on that footing, the votes attaching to the remaining ordinary shares would alone have been effective. The beneficial owners of the management share could not be said to have exclusive control of the company.[38]

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36. p 183
37. pp183-4
38. pp184-5

The third point arising out of the first question was, disregarding the management share, whether the control of the taxpayer company was in Stephenson and BIC by reason of their respective beneficial ownership of five twelfths and two twelfths of the ordinary shares. Stephenson and BIC together could have exercised their votes so as to carry a resolution, and it followed that, if the control of the company was in the hands of Schroder together with Stephenson or BIC, it must also have been in the hands of Stephenson with BIC. That was quite a common position in that, one could find a number of permutations of members who together had majority voting rights. The requirements of section 21(6) should be treated as satisfied if, upon any one permutation, the control of the company was in the hands of two or more companies, to one of which section 21 applied.[39]

On the second question, the judge said that section 14(1) FA 1937 was an overriding provision prefaced by the words "notwithstanding anything in sub-section (6) of section 21". It was common ground that the effect of the language of section 14(1) was that a company under the control of not more than five persons was absolutely disqualified from the status of a subsidiary company, unless it was only by the inclusion of a company to which section 21 did not apply, that the company could be brought within the ambit of section 19(1). Schroder, as the first registered holder of the management share, controlled the company alone in the ordinary sense of the word and within the express terms of the deeming provision in section 19(1)(a); that is to say, Schroder was able to exercise control over the company's affairs. Schroder was a company to which section 21 applied and, accordingly, the taxpayer company fell within the ambit of paragraph (a), taking into account only a company to which section 21 applied and without having to include a company to which section 21 did not apply.[40]

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39. pp185-6
40. p185

On the third question, BIC was admittedly a company under the control of not more than five persons and was not a subsidiary company. Upon certain permutations, the public held ordinary shares in BIC carrying not less than 25% of the total voting power and, upon other permutations the public held ordinary shares carrying less than 25% of the total voting power. That being the position, the question was whether BIC fell within the definition. However, on the view taken by the judge on the other questions, it was not necessary for him to express a view on this point.[41]

It can be seen that the judge's technical and careful analysis of the question demonstrated that, what might otherwise have been a useful method of avoiding the apportionment provisions, did not succeed. This case also demonstrates clearly the complexities to which the apportionment provisions could give rise.

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41. Ibid

Questions of Reasonableness

Under section 21 FA 1922, the Special Commissioners could make a direction where a company had not, within a reasonable time after the end of any year or other period for which accounts had been made up, distributed a reasonable part of its actual income from all sources for the year or period under consideration. There were thus two questions of reasonableness:

(1) Reasonable time.
(2) Reasonable part of a company's actual income from all sources.

Regarding reasonable time, Section 31(4) FA 1927,[42] provided that, where an order had been made or a resolution passed for the winding up of a company to which Section 21 applied, the income of the company for the period from the end of the last year or other period for which accounts had been made up to the date of the order or resolution for winding up should be deemed to be income available for distribution to the members of the company. As regards that period and the preceding one, section 21 applied as if the words "within a reasonable time" were omitted. Therefore, for the final period up to the date of liquidation and the period immediately before that, no regard was had to the question of "reasonable time".

Section 31(4) was passed to close a gap in section 21 FA 1922. Section 21 did not catch profits earned in the last period of a company's life because the company, having gone into liquidation, could not lawfully have declared a dividend to distribute the profits of that period.

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42. Later section 253(1) ITA 1952

Except in cases of liquidation, it was normally necessary to have regard to the company's position at the time when the directors were considering the accounts for a particular period and when they had to take a decision as to the dividend they would recommend. So, accounts might be made up to 31st December and considered by the directors at a Board Meeting held in the following October, with a view to recommending those accounts to the shareholders for adoption at the AGM. There, the period of "reasonable time" might be regarded as having expired at the conclusion of that meeting. It was possible that "reasonable time" could expire before the date of the meeting if there was a considerable delay in holding it after the accounts had been prepared. But, where a dividend had been declared, it was likely that the declaration of the dividend would fix the final limit "reasonable time". This can be seen from the following passage from Romer LJ in Montague Burton Limited v IRC[42a] where he said:

> "The point of time that has to be considered is not the point of time at which the expenditure was incurred, but the time when the directors had to determine upon the distribution of the whole, or a part, or none, of the realised profit during the year as dividend, because, by the section, the Commissioners have to consider whether a reasonable part of the income has been distributed by way of dividend. In a case where no dividend is declared at all, that point of time (the time at which the Commissioners have to consider the question) is a reasonable time after the expiration of the financial year. Where the directors have declared a dividend, the time at which the question has to be considered by the Commissioners is the time at which the directors did declare the dividend, and then the Commissioners have to determine whether at that time

42a. (1936) 20 TC 48

they declared a reasonable dividend or not, that is to say, whether they distributed a reasonable amount of the profits or not."[43]

In considering whether the company had distributed a reasonable part of its actual income from all sources, section 21 specified certain general principles to be followed. For example, it was necessary for the Commissioners to take into account the current requirements of the company's business and such other requirements as may be necessary or advisable for the maintenance and development of that business.

What was a reasonable distribution in any particular case was a question of fact and it was necessary to have regard to all the individual circumstances of the case. For example, there may have been no liquid resources out of which a dividend could be paid, but this would be no defence if there were loan accounts made by the company to its members, which would be sufficient to cover any reasonable distribution, since a dividend could then be declared and credited to the respective loan accounts of the members without the company having to find cash to meet the payment of the dividend. On the other hand, there may be a case where there was a substantial balance in hand at the bank but where it was, nevertheless, unreasonable to pay a dividend. This might be, for example, because the company had substantial commitments to meet soon after the end of the accounting period for the maintenance and development of the business.

It might also be the case that there was a debit balance on Profit and Loss account despite a substantial profit in the accounting period under consideration. The directors might then argue that it would not be reasonable to make the distribution for that year. On the other hand, section 21, as amended by the FAs of 1927 and 1936, laid down the principle that no regard was to

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43. p72

be had to a payment which was made in or towards payment for the business, undertaking or property which the company was formed to acquire, or which was the first business, undertaking or property of a substantial character in fact acquired by the company.

The repayment of share capital or loans which were obtained for the purpose of acquiring the first business, undertaking or property would be dealt with as if they were actually paid for those purposes. In the case of investment companies, as will be seen, section 14 FA 1939 enabled the Special Commissioners to make an automatic direction to surtax without considering whether or not a company had distributed a reasonable part of its actual income from all sources. Where the investment company had estate or trading income, an automatic direction could be applied to its investment income, leaving the estate or trading income to be dealt with on normal lines and taking into account the question of whether or not the company had distributed a reasonable part of its income.

Section 31(4) FA 1927 was considered by the Court of Appeal in Collier v IRC.[44] A direction was made for the last period of the taxpayer company. The company had made an agreement selling its assets, including all its income, to a new company. The taxpayer company argued that, as it was not the owner of the income, it could not be unreasonable in not distributing it. The Crown argued that the company's income for the period between the last accounting date and the date of the resolution to wind up, was automatically within section 245 ITA 1952 without the need for the consideration by the Commissioners of any question of reasonableness. This was obviously right so far as the requirement to distribute within a reasonable time was concerned, because the section itself said so. But the question was whether the wording of the

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44. (1933) 18 TC 83

section also excluded the requirement concerning the distribution of a reasonable part of the company's income. Romer LJ based his judgement on the fact that the company had not, in fact, distributed a reasonable part of its income during the broken period and that, therefore the Commissioners direction under Section 245 was properly made.[45] But the other two judges in the Court of Appeal, Lord Hanworth, MR and Slesser LJ were of the view that the formula "income available for distribution" was equivalent to "income which ought to have been distributed", on the footing that, once the winding up resolution had been passed, the need for the Commissioners to consider the reasonableness or otherwise of any distributions, had gone.[46]

This was the accepted view of the law which persisted until section 31(4) FA 1927 was again considered in the case of A & J Mucklow Limited v IRC.[47] The taxpayer company was incorporated in 1939 and carried on the business as builders and contractors. It went into liquidation on 9th December 1953, never having paid a dividend. In the course of the liquidation, the business was transferred to a new company, but a large sum in cash was excluded from the sale and distributed to the shareholders of the old company in the liquidation. A direction to surtax was made in respect of the final period from 1st May 1943 to the date of liquidation and also in the preceding accounting period of 12 months ended 30th April 1943.

On appeal, the Special Commissioners found that, for the year ended 30th April 1943 it was not unreasonable for the company not to have declared a dividend and they discharged the direction for that year. However, they confirmed the direction for the final period up to the

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45. See p.105
46. See pp101-2 and 103-4
47. (1954) 35 TC 251

date of liquidation because they considered that this course was imperative by virtue of the wording of section 31(4) FA 1927.

In the High Court, Harman J held that section 31(4) did not require that the profit for the period up to the commencement of the liquidation must necessarily be treated as available for distribution and that the question was one of fact in each case. The case was, therefore, remitted to the Special Commissioners for them to consider this point in relation to the final period. The Commissioners found that the company did not, in fact, distribute a reasonable part of its income for that period. This was upheld by Harman J and the Court of Appeal.

In his judgement Harman J referred to the words of Finlay J in the Montague Burton case who had said of section 21:

> "I think an accurate general description of the nature of the section and of the effect of the proviso was given when it was said that it was the duty of the commissioners to see whether a reasonable part of the actual income had been distributed, and that, in doing that, they were to see to it that proper development of the business should not be penalised."[48]

As has already been noted, the section was, and was intended to be, penal in its effect, and it was established in Thomas Fattorini (Lancashire) Ltd v IRC,[49] that the burden of proving that the company had not made a reasonable distribution was on the Crown. In that case, Lord Atkin said:

> "It seems clear that the discussion must proceed ab initio on the footing that the action of the

48. p 260
49. (1942) 24 TC 328

> directors must be judged by considering what their conduct would reasonably be if no question of surtax influenced their decision. Withholding of distribution for the purpose of "avoidance of the payment of supertax" by shareholders would, if found, obviously negative the reasonableness of any part so withheld. The other general point to be observed is that, as it seems to me, what has to be found is that the company acted unreasonably in withholding some part of its income from distribution. It is not enough to show that a part could reasonably be distributed, if at the same time it could be said, as it well might, that it was equally reasonable to withhold distribution. The section is highly penal, and I feel no doubt that the onus is originally, and remains, on the Revenue to show that the company acted unreasonably in withholding part of its income from distribution. What is reasonable has consistently been held to depend upon the actual conditions known at the time for decision. In the application of this section it is what <u>these</u> directors recommend and <u>these</u> shareholders decide in <u>those</u> conditions of <u>that</u> company. There is no abstract conception of reasonableness, and the conclusion is not to be reached on a priori reasoning."[50]

In the Mucklow case,[51] the Crown argued that the words "available for distribution to the members" in section 31(4) meant that any income not distributed must be treated as having been unreasonably withheld. The Crown argued that this view was supported by the Collier case. Harman J rejected this and said:

> "I conclude, therefore, that the Commissioners misdirected themselves in holding that section 31(4) and the Collier case bound them to hold that the direction was mandatory and followed automatically

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50. p351
51. <u>A & J Mucklow Ltd v IRC</u> (1954) 35 TC 251, supra

in the circumstances. It may well be that it will usually follow, because it is hard to see what circumstances can make it reasonable to refrain when the company is on the point of expiring, having regard to the injunction to treat the profit as available for distribution and considering that the factors mentioned in the proviso to section 21 can have little weight. Nonetheless, in my judgement, it is the duty of the Commissioners to consider the matter as Finlay J indicates in the Collier case."[52]

It was, therefore, necessary to consider (a) whether the income was "available" for distribution and (b) the requirements of the company for current and future development. The requirements of the new company that took over the business of the liquidated company were considered by Harman J, quite rightly, to be "irrelevant".

The problems caused by this legislation were acknowledge by Harman J in these words, when remitting the case to the Special Commissioners :

> "With these guides, the Commissioners must seat themselves in the boardroom and consider the whole situation facing the directors at the relevant time, remembering Lord Akins' warning about onus. Unless they conclude that the directors have acted unreasonably, they must discharge the direction. I cannot feel sure that they have gone through this process, and I must say I feel great sympathy with them, for it is a hard one. It would be much simpler if the Crown were right and the result automatic, but I feel constrained to hold that it is not. Therefore, I must remit the case for a new finding, hoping, though without much confidence, that what I have tried to indicate may help them to find a way through this dark legislative jungle."[53]

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52. p263
53. p264

The Court of Appeal in the Mucklow case also held that section 31(4) FA 1927 did not create an automatic liability to a direction for the final broken period. The judges of the Court of Appeal in Mucklow were unanimously of the opinion that, if the Court of Appeal in Colliers case was saying that a direction was automatic, it was wrong. Sir Raymond Evershed MR, considered the reasoning in the judgements of Lord Hanworth MR and Slesser LJ and concluded that, on this point, those judgements were given per incuriam and that, therefore, the Court of Appeal in the Mucklow case could decide the matter without feeling constrained by the earlier decision.

Sir Raymond Evershed MR was of the view that,

> "If Parliament had intended by the amendment [in section 31(4)] to create an "automatic" liability for tax it would surely have sought - and found without difficulty... appropriately clear language".[54]

The Master of the Rolls developed this by saying that:

> "In an enactment described by Lord Atkin in Fattorini's case as penal in its effect, clear language is required to impose a liability: and I should be loathe to derive obliquely from language which, ordinarily understood, could not have so far reaching an effect, a result which I venture to think would occur to no one on a first reading and which would have the somewhat capricious consequence that those against whose companies a direction had been made would have no answer or effective means of challenge, while others would escape liability for no better reason than that, in their cases, no direction had in fact been made."[55]

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54. p273
55. Ibid

This conflict of judicial interpretation once again highlighted the difficulty the Courts were having with this legislation. Assuming that the interpretation given to the section in the Mucklow case was correct, and the actual wording of the section and the context in which it appears would suggest that it was, the incorrect Collier interpretation had prevailed for over twenty years. In fact, it is likely that this did not make any difference in most cases because the winding up of a company and the cessation of its business must, in the majority of cases, eliminate most of the grounds which, in any other period, might justify a withholding from distribution because, in a liquidation situation, the creation or maintenance of reserves and the provision for development have little relevance.

In fact, for the Commissioners to find, in any particular case, that it was reasonable to withhold distribution in a liquidation situation, they had to grapple with a conceptually difficult mental process. They would have to assume that the company was able to distribute profits earned during the last broken period, regardless of its winding up, and they would also have to assume that it may be reasonable not to distribute that income, or some part of it, as dividend, notwithstanding that the shareholders will, in any event in the course of liquidation, receive the whole of the balance of the assets. It is no answer for the company to say that the profits were to be paid to the shareholders anyway as capital. The situation during the last broken period had to be considered by the Commissioners as if it were a situation occurring during the company's normal trading life. It can thus be seen that the apportionment provisions, having been continually amended since 1922, were still, three decades later, capable of giving rise to great difficulties.

Consideration, at this stage, should be given to the case mentioned above of Thomas Fattorini (Lancashire) Ltd v IRC.[56] The taxpayer company was registered in 1919 and took over and carried on, until 1928, a business. In 1928, the company ceased to trade and invested its funds on loan at interest with three other companies (the "operative companies"). The principal shareholder in all four companies was the individual who had originally carried on the business acquired by the taxpayer company. At his death in 1934, his two sons, by their father's will, were given the option to purchase his shares in these companies. One son, Mr. Wilfred Fattorini, bought all his father's shares in the taxpayer company and, thereafter he and his wife were the only shareholders in that company.

In 1936, the taxpayer company bought all the shares held by the other son in the three operative companies and, later in the year, it brought all the shares in those companies held by Mr. Wilfred Fattorini and by the executors of his father's will. To finance the latter transaction, the taxpayer company borrowed a sum of money

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56. (1942) 24 TC 328

from a bank under an agreement which provided that, until monies advanced with interest thereon had been repaid, the taxpayer company would pay over to the bank all dividends received from its shares in the three operative companies. For the years in question, the company had no income other than the dividends from those companies and it paid no dividend itself for those years.

Directions under section 21 FA 1922 for the years in question were discharged, on appeal, by the Special Commissioners but the Board of Referees, on a rehearing of the appeal, decided that the directions should be restored.

It was held that, although the contract with the bank did not bind the company not to distribute a dividend, the evidence did not establish that the company had not distributed a reasonable part of its income and, therefore, the direction should be discharged. The question whether it was reasonable for the company to make such a contract was irrelevant. There was nothing in law to prevent a company from using an income receipt as cash in its hands to discharge a capital liability or to purchase a capital asset and subsequently pay a dividend out of other cash or borrowing for the purpose to the extent of the credit balance standing on profit loss account. The general proposition that investment companies are obliged to distribute their profits to their shareholders could not be sustained. They were entitled, if they chose, to forego their income for a time to develop or improve the undertaking.

In the High Court, Macnaghten J commented that counsel for the Crown had pointed out that if Mr. and Mrs. Fattorini had not made use of the taxpayer company for carrying out the purchase of the shares in the operative

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57. p337

companies and had carried out the transactions in their own names, there is no doubt that the dividends that they then would themselves have received from the operative companies would have to be taken into account for the purposes of assessment to surtax. He said, however, that "that fact is not material to the issue before me."[57] As Lord Atkin pointed out in the House of Lords, it might have been material if there had been a motive to avoid tax.

Notwithstanding the preamble to section 21,[58] the case of David Carlaw & Sons Limited v IRC[59] showed that it was unnecessary to find a positive design to avoid tax. But the Fattorini case demonstrated that, having regard to the preamble, the presence of a tax avoidance motive had to be given some weight when the Commissioners come to consider questions of reasonableness, just as the absence of such a motive would have had some influence the other way.

Lord Atkin said :

> "If the arrangement with the bank was in fact made as part of a plan for avoiding surtax there might very well be evidence of a failure to distribute a reasonable part of the income. But in the absence of any evidence or finding to that effect, and in view of [the Crown's] disclaimer of any attack on that agreement, it must be taken to represent a genuine business arrangement, and is a circumstance of the highest importance in estimating the reasonableness of the company's actions.[60]

It is an interesting footnote to this case - which again shows the difficulties the courts were having with this legislation - that, at each stage, the decision of the previous tribunal was reversed unanimously: the directions under section 21 were discharged by the

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58. Set out supra
59. (1926) 11 TC 96
60. p352

Special Commissioners, they were restored by the Board of Referees, this was overturned by Macnaghten J, whose decision was unanimously reversed by the Court of Appeal, who were, in turn, unanimously reversed by the House of Lords.

When a direction was made under section 21 FA 1922, the income of the company was apportioned among the shareholders in accordance with their respective shareholdings. Where there had been changes in the shareholdings during the year covered by the direction, it was necessary to consider whether the apportionment should be made among the members at the conclusion of the period or in accordance with the respective holdings during the currency of the year under consideration. Paragraph 8 of the First Schedule to FA 1922 provided that the apportionment "shall be made by the Special Commissioners in accordance with the respective interests of the members". The apportioned income was included in the shareholders total income for surtax purposes and deemed to be the highest part of that income.

This was considered in Fendoch Investment Trust Co v IRC.[61]

The taxpayer company was an investment company which, throughout the financial year 1938/39, was under the control of a Mrs. Murray, who was assessed to surtax for that year in respect of the company's income under section 21 FA 1922 and section 15 FA 1939.

The original capital of the company was £100,000 divided into 10,000 A ordinary shares, 45,000 B ordinary shares and 45,000 C ordinary shares of £1 each. All of the A and B shares had been held, since September 1937, by Mrs. Murray. On 4th April 1938, special resolutions were passed whereby the A shares were to carry rights of 10

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61. (1945) 27 TC 53

votes each, whereas the holders of B and C shares were given 1 vote for every 5 shares. Mrs. Murray thereby obtained the complete control of the company. On 8th December 1939, further resolutions were passed reorganising the capital of the company. The capital was reduced to £70,000 divided into 15,000 B shares and 55,000 C shares; the whole of the 10,000 A shares and 30,000 of the B shares being redeemed, and the remaining B and C shares being converted into ordinary shares ranking equally. Thus, for the period from 8th December 1939 to 5th April 1940, the end of the financial year, Mrs. Murray, holding 15,000 shares only, was no longer in control of the company.

The Special Commissioners apportioned the whole of the income of the company for the years of assessment 1938/39 and 1939/40 to Mrs. Murray. It was not disputed that the apportionment for 1938/39 must stand but it was contended that the facts which enable the Special Commissioners to make an apportionment must exist on the last day of the year of assessment and that, in the present case, they did not exist on 5th April 1940. Alternatively, it was intended that no apportionment could be validly made which did not recognise and give effect to the fact that from 8th December 1989 ato 5th April 1940 the position was changed so that, in any case, not the whole of the actual income of the company for the year of assessment could be properly apportioned to Mrs. Murray.

It was held that the Commissioners were entitled to make an apportionment against a person to whom it could be predicated at any time in the fiscal year that he was able to secure that income or assets of the company would be applied for his benefit to a greater extent than was represented in the value for apportionment purposes of his relevant interests in the company. As regards quantum, the power of the commissioners was to apportion to the shareholder such part of the income of the company as appeared to be appropriate. Scott LJ said:

"Paragraph 4(b) of the First Schedule to the 1922 Act provides that the Commissioners may require the company to furnish them with the names of all members and their respective interests throughout the period in question; and that return must necessarily cover transfers during the period. Paragraph 8 of the same Schedule requires the apportionment to be made in accordance with the respective interests of the members; not, be it observed, the members on the register at the expiration of the period. We fail to see any reason for the view that members could escape by selling their shares before the end of the year. As Mr. Stamp [Counsel for the Crown] said, it would have been so easy for Parliament to say that the liability was to be on "members on the last day of the year" if that had been, or could have been its intention. He put two crucial instances to demonstrate the absurdity of such a construction: (1) a transfer by la: two successive tenants for life, A and B, during the year; would A's executors escape all charge and B have to bear the whole? (2) one small controlling group of shareholders A succeeded by another, B, to whom it transfers all its shares towards the end of the year, having already received a large interim dividend.

There are two further reasons in favour of the Crown's interpretation. The 1927 Act, section 31 (2), expressly authorised deduction from the newly added surtax charge of the amount, if any, already distributed to the member and therefore, already, ex hypothesi, included in his surtax return. It is incredible that Parliament, when making that addition to the language there used, should have thought it was only necessary to protect members on the Register on the last day of the year. The second reason is that the 1939 Finance Act, section 15(2)(c), gives the Commissioners complete discretion in approtionment; and that discretion has to be exercised in the case of investment companies, with regard to various people who are not shareholders at all; for example, loan creditors (Finance Act 1935, section 20), and anybody who is able, or is likely to be able, to secure any part of the income of assets of the company. These provisions seem to us wholly inconsistent with any such abitrary imitation as was put forward on behalf of the appellant company."[62]

Therefore, regard had to be given to the respective interests of the shareholders throughout the period covered by the direction. This was important where a change of shareholders was contemplated and where the prospective purchasers had doubts as to whether a surtax direction might be made against the company for the year in which the change took place or some earlier year. The principle referred to by Scott LJ gave them some protection but it could not be overlooked that the surtax liability arising under a direction could become a joint and several liability of the company and the shareholder. A purchase of shares could, therefore, be affected by this position if the former member could not himself pay the surtax liability attributed to him. This could work unfairly against a purchaser although he could protect himself by a suitable indemnity.

However, if at the end of the relevant period an individual had no interest at all, no apportionment could be made to him, even if he held an interest for most of the period. This was a major flaw in the legislation. This principal was established in <u>CHW (Huddersfield) Limited v IRC</u>,[63] in which the individuals in question

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62. p63
63. (1963) 41 TC 92. For the facts of this case, see Part 1, supra.

took advantage of this rule to extract distributable profits from the taxpayer company in a tax-free form. Lord Reid analysed the interests the individuals held in the company's income as follows:

> "I must now try to explain the nature of the interest which Crown say the Garsides and Spencers [the individuals] had in this income. During the 303 days when they held control, the company was earning income. There is no finding to this effect, but I am willing to assume that the Commissioners were entitled to infer that 303/306 parts of the actual income for the period had been earned during those 303 days. And I shall further assume, but without expressing any opinion, that that gave them an 'interest' in that income and therefore in the 'actual income' for the period. But then, in selling their shares, they sold that interest. I have no doubt that the purchasers had a pretty shrewd idea of how much profit had been earned, and that this was reflected in the price of the shares. But, if the sellers had sold their interest, how did they still retain it at the crucial date, the end of the period? The purchasers acquired it and had it at that date; they could have declared a dividend and put the whole of the actual income in their pockets, excepting the small preference dividend already paid. What the sellers had was the price of the interest; they had sold an asset full of profit for a capital sum. There are other sections which deal with dividend stripping and the like, and the facts of this case with regard to the Garsides and Spencers seem to me to be far removed from the mischief of withholding profits from distribution.

The Crown seek to bring in this case by an ingenious adaptation of Lord Russell's questions.[64] They say that during those 303 days the Garsides and Spencers could have distributed the profit already earned to themselves, and that they avoided surtax by not doing so. That would be such a strange thing to penalise that I would require clear words to justify that result. I do not think that the words of the leading section, section 245, are capable of being so extended, and certainly such a case is not within its apparent scope. The express purpose of the section is to prevent avoidance of surtax by withholding from distribution income which would otherwise be distributed. I take it that 'otherwise' means but for the attempt to avoid surtax."[65]

Lord Pearce justified the approach of the majority in the House of Lords as follows:

"In my opinion, weight must be given to the intention expressed in the introductory words of the section. From the standpoint of sound trading, the conservation of dividends is desirable and compulsory distribution is bad. On the other hand, when the conservation is used not for sound economic reasons but for tax avoidance it is undesirable and must therefore be stopped. Thus two principles conflict. The opening words of the section were inserted, I think, to underline the fact that the operators of the section must keep in mind the object: namely, to stop avoidance by failure of a company to distribute dividends. I therefore approach with suspicion any use of the section which

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64. "They may well ask themselves the questions: (1) on whom did it depend whether or not the income should be withheld from distribution, and (2) for whose benefit was the distribution withheld or (in other words) who would avoid payment of sur-tax by the withholding?" <u>IRC v FPH Finance Trust Ltd</u>(1945) 28 TC 209 at p246, infra.

would disregard the present actual position of the company in order to catch some past owner of its shares."[66]

When the Commissioners made a direction among the shareholders of a close company, it was their duty to see that a proper apportionment was made and, to this end, they had to consider, not only the identity of the shareholders, but also the extent of their interest in the capital, income or profits of the company. These matters came up for consideration in the case of Wigram Family Settled Estates Limited v IRC.[67] The facts were that the capital structure of the taxpayer company was divided into three classes of preference shares at a fixed rate of 6% interest, one class being redeemable within 10 years, and one class of ordinary shares. All of the redeemable preference shares, consisting of 100,000 shares of £1 each, had been taken up by an insurance company which had insisted in the creation and maintenance of a redemption fund by way of security. The provisions with regard to the redemption fund were to the effect that the company should each year carry to the credit of the fund certain sums until the fund amounted to a total of £100,000 at which figure it should then be maintained. These sums were to be credited to the fund out of the company's profits which would otherwise be available for dividends. By 31st March 1949, a sum of £77,000 had been transferred out of the profits to the credit of the fund and, during the three years ending 31st March 1950, 1951 and 1952, further transfers were made of £4,000, £10,000 and £4,000.

On 30th August 1950, 80,000 of these preference shares were redeemed by applying £80,000 out of the fund for this purpose. The insurance company thereafter held the balance of 20,000 shares which were not redeemed.

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65. p119
66. pp128-9
67. (1958) 37 TC 638
68. pp660-1

As the taxpayer company was an investment company, a surtax direction was automatic[68] and the question to be decided related to the proportions in which the actual income of the company was to be notionally apportioned among the various classes of shareholders. The Commissioners apportioned to all the preference shareholders for the three years 1949/50, 1950/51 and 1951/52 sums equal to 6% (i.e. the fixed rate) of the various amounts of the shares held by each class, including the redeemable preference shareholders. The result was to throw a very substantial burden on the ordinary shareholders, in respect of the amount of the income notionally apportioned to them.

The taxpayer company appealed, arguing that the redeemable preference shareholders had an "interest" in the redemption fund, out of which £77,000 had been taken by them in the course of redemption, that regard should be had to their "interest" in this fund, and that, accordingly, a much larger proportion should be apportioned to them.

This was, in fact, a strange contention because, if it had succeeded, the preference shareholders would notionally have received a surplus, over and above the fixed rate of interest. This was rejected by the House of Lords. Viscount Simonds pointed out that the apportionment legislation was aimed at preventing the avoidance of surtax by individuals. It was therefore to be expected that any approtionment of the actual income of a company would proceed on the footing that what any member received of an apportionment would be a share, which, if it had been distributed instead of being withheld, would have the character of income in his hands and as such would be liable to surtax if he was an individual. Furthermore, it would be, in his view a fantastic result of this legislation if it increased even notionally the fixed income of a shareholder such as the preference shareholders here, who were entitled merely to

6% of their money. Moreover, if it did not have any such effect, and the apportionment beyond 6% was to be regarded as a capital payment, then the purpose of the legislation was defeated, for surtax would be neither payable nor avoided. It would not be a question of attempting to avoid payment of surtax, if the surplus was received as capital, nor would the result be that surtax would be payable for the receipt would be a capital receipt.[69]

The taxpayer company argued that the apportionment constituted a hardship to the ordinary shareholders, who could not touch the money in the redemption fund.

The House of Lords pointed out that the question of hardship was immaterial, for the section required the apportionment to be made on the basis of the respective interests of the various classes for shareholders on the income of the company.

It was acknowledged that the company was not being used as a vehicle for tax avoidance. As Lord Evershed MR said in the Court of Appeal:

> "It is, I think, right to say at once that there is in this case no question whatever of the company having withheld from distribution unreasonably or otherwise, unduly large sums. There is here, indeed, no question whatever of this company having been used, at any relevant date or at all, for the purpose against which the legislation was designed, namely, the avoidance of the payment of the surtax by individuals by keeping the funds in question in a limited company not liable for surtax. In the result, if the Crown's view is right, it must I think be conceded that this might fairly be regarded as something of a hard case."[70]

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69. pp660-1
70. p651

The reason why hardships such as this could not be taken into account was cogently explained later in his judgement:

> "Although I have said more than once that this is not a tax avoidance case, as that phrase is commonly understood, yet it is relevant to bear in mind, as Mr. Pennycuick [Counsel for the Crown] made clear to us in his very cogent argument, if he will allow me so to describe it, how in such a case as this the matter would work if the company is right. It is never to be forgotten that this is an investment company, and that therefore a direction perforce must be given with the inevitable consequence that the income of the company, that is the income available for distribution, is to be deemed to be the income of the members. Let me apply that phrase to the income with which we are concerned for the year here in question. If the income in question is so to be deemed, then prima facie it would be deemed to be their income in acccordance with their rights to receive it. The structure of the company here is in perfectly normal and ordinary form. The preference shareholders are entitled to preferential dividends and no more, subject again to the limited right of participation by one of the junior classes of preference shareholders. Subject to those rights, everything which is distributed goes to the ordinary shareholders; and they, as you would expect, are the persons eventually entitled in a winding up to the company's distributable assets after the prior classes of shareholders have been repaid the equivalent of their capital. The ordinary shareholders, therefore, if they received, let us say, this sum of £4,000, would have paid in respect of it a large sum, a very high proportion, in the way of surtax. By not distributing this sum, by keeping it in the company (albeit pursuant to a

> contractual obligation and for the purpose of providing for the redemption of the redeemable preference shares), no surtax would apart from this legislation be paid upon it. If therefore the object of this legislation is that, quoad companies of this kind, surtax should be exigible on the footing that you deem all the income distributable to be the income of the members, then the result would be, if the company is right, that so much surtax has been lost to the Revenue. Put the other way round, and from the point of view of the ordinary shareholders, it may fairly be said that instead of their having received this sum by way of dividend it has been kept in the company and upon the liquidation of the company, which has now in fact occurred, they will be able to get those sums which were kept in reserve and get them free of tax."[71]

One of the issues involved in this case was whether the redeemable preference shareholders had an "interest" in the redemption fund for the purpose of the section.

It can be seen that the financial position of the company was such as to assure the redemption of the redeemable preference shares, quite apart from the redemption fund. The fund was by way of added security, which in fact was unnecessary, and in substance the only benefit that the redeemable preference shareholders obtained from it was, as Viscount Simonds put it, peace of mind from the knowledge that the fund was there.

In fact, their interest in the fund was negligible. The real interest in the fund lay with the ordinary shareholders because, although they might not be able to withdraw from it themselves while the shares in question

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71. p654

remained unredeemed, the fund was there for their ultimate enjoyment. In other words, retaining these sums in this fund postponed the enjoyment of them by the other shareholders but did not in any substantial way add to the financial return which the insurance company (the holder of the redeemable preference shares) would receive or the probability that they would be paid in full.

In the circumstances, the Commissioners were right in finding that the insurance companies interst was represented only by its right to a dividend on the redeemable preference shares.

The question of the "respective interests of the members" for the purposes of section 21 and paragraph 8 of the First Schedule, was considered also in IRC v FPH Finance Trust Limited.[72] Here the phrase was given a wide meaning, thereby rendering ineffective an artificial arrangement designed to avoid surtax.

The taxpayer company was incorporated in the UK and was a trading company. Its capital was £10,000 in £1 shares and, early in 1936, this capital was held by a company incorporated in Southern Rhodesia, the shares in which were held by Mrs. Latilla and her two daughters, in approximately equal shares.

With a view to avoiding possible liability to surtax which might attach to the shareholders of the Rhodesian company, the following transactions were carried out:

(1) On 27th November 1936, the share capital of the taxpayer company was reconstituted and increased; the existing 10,000 £ 1 shares were converted into preference shares, carrying a 5% dividend and the right to surplus assets on a winding up, and 1,000 ordinary shares of £1

72. (1945) 28 TC 209

each were created carrying a right to sums declared by way of dividend, but with the right, on a winding up, to repayment of capital and no more. Shareholders of either class were entitled to 1 vote per share. The 1,000 ordinary shares were taken up, at the instance of the taxpayer company, by a public company to which section 21 FA 1922 did not apply. Mrs. Latilla's husband was a director of this company and had effective control in its management.

(2) In December 1936, the Rhodesian company was wound up and its holding of shares in the taxpayer company was distributed to the shareholders. The shareholders of the taxpayer company thus became Mrs. Latilla and her two daughters, holding the 10,000 preference shares in approximately equal amounts, and the public company, holding 1,000 ordinary shares.

(3) On 1st April 1938, the taxpayer company went into liquidation, the public company was paid £1,000, the amount subscribed for its holding of ordinary shares, and the balance of the assets was distributed to Mrs. Latilla and her daughters.

Up to the end of 1936, the taxpayer company had distributed no dividends and had accumulated profits exceeding £900,000. At an Annual General Meeting on 12th October 1937 accounts for the period 1st April 1935 to 31st Decmeber 1936, which showed a profit of £645,192, were adopted, and dividends were declared amounting in total to £46 in respect of the period 27th November to 31st December 1936 on the preference shares and to £100 in respect of the period to 31st Decmeber 1936 on the ordinary shares.

The Special Commissioners issued a direction under Section 21 FA 1922 for the period from 1st April 1935 to 31st December 1936 and apportioned the company's income as to £100 to the public company and, as to the balance, in approximately equal shares to Mrs. Latilla and her two daughters.

On appeal, it was contended that the apportionments were not made in accordance with paragraph 8 of the First Schedule to the FA 1922 because they were made with regard to their rights on a winding up and not by having regard only to the dividend rights of the shareholders while the company was actively trading.

It was, however, held that, in apportioning income of a company "in accordance with the respective interests of the members", there was no justification for restricting the "interests" which might be taken into consideration to rights in declared dividends. The Special Commissioners should have regard to all the different interests of the shareholders, including their rights to undistributed profits in a winding up; and, in considering these interests and apportioning the income among them, the Commissioners may properly be guided by the preamble to section 21 and endeavour to make an apportionment, appropriate to their interests, to those shareholders for whose benefit, in relation to the avoidance of surtax, the distribution of income had been obviously withheld.

The courts here took into account the understanding that existed between the public company (The National Mining Corporation Limited) and Mrs. Latilla and her daughters and held that the individuals had sufficient interests within the meaning of the Act by virtue of the arrangements that had been undertaken. For example, at first instance, Wrottesley J commented:

"There is no doubt that in that case[73] Finlay J, held that the proper way in which to give effect to section 21 and the Schedule was to apportion the undistributed income of the company among the persons who would have got it, had it been distributed during the period, that is to say, in that case the beneficiaries or life tenants. Nor is there any doubt that if the same method were adopted in the case before me, the result would be to apportion the whole of the undistributed profit to the National Mining Corporation, a company which does not pay surtax. But if the method of apportionment approved by the learned judge on the facts of that case were adopted in this case, it would completely disregard the fact that the respective interests of the members had been vitally affected by the understanding found by the Commissioners to exist between the Corporation and Mrs. Latilla and her daughters, under which any dividend on the ordinary shares was to be ludicrously incommensurate with the amount available for distribution. To say that if the income had been distributed in fact it must, under the Articles and Special Resolutions as they stood have gone to the Corporation, leaves out of account not merely the understanding on which the Corporation held these shares but also the voting power under which these ladies could have asserted their rights and diverted the whole amount into their own purses."[74]

This was echoed in the House of Lords by Lord Russell who made the additional point that, just because a person has an interest does not mean that he will suffer and apportionment because the Commissioners should have regard to the preamble to section 21 and the presence or absence of a tax avoidance motive.[75] Lord Russell said:

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73. Alexander Drew & Sons Ltd v IRC (1932) 17 TC 140
74. p229
75. This is a similar point to that made by Lord Atkin in Thomas Fattorini Lancashire) Ltd v IRC (1942) 24 TC 328, supra.

"Obviously everyone who falls within the extended definition of member is not necessarily to be included in the apportionment. In my opinion the Commissioners in apportioning the income among the members, should determine who are the persons of whom it can be said (1) that they fall within the definition, and (2) that they are the persons who, in view of all their interests in the company, are the persons really interested in the income in question and in what proportions. Further, I think that, in considering these interests and apportioning the income among members, the Commissioners may properly be guided by the preamble to section 21 and endeavour to make an apportionment appropriate to their interests to those members for whose benefit, in relation to the avoidance of payment of supertax (now surtax), the distribution of income has obviously been withheld. They may well ask themselves the questions, (1) upon whom did it depend whether or not the income should be withheld from distribution, and (2) for whose benefit was the distribution withheld or (in other words) who would avoid payment of surtax by the withholding? If the same individuals figure in each answer, those are obviously the persons who, according to their interests in the company, own the real and paramount beneficial interests in the fund in question. Other members may also have an interest therein, but to a smaller extent.

Applying this view to the facts of the present case, there should be no doubt about the broad result. Both questions admit of one answer only - namely Mrs. Latilla and her daughters whose voting power enable them (1) to prevent (before liquidation) any distribution to the ordinary shares beyond a nominal percentage, and thus to enforce the "understanding" referred to in the Case Stated; (2) to wind up the company at any moment and (subject to the payment of

£1,000 to the Corporation) get all the surplus assets (including the fund in question) for themselves or (3) if ever they wanted the income paid to them as such, to alter the Articles of Association by Special Resolution and.... thereby increase the dividends payable on the preference shares to any desired amount."[76]

Thus the realities (or substance) rather than the technicalities (or form) of the individuals interests should be considered. Lord Russell emphasised this later in his judgement:

"An apportionment which would result in attributing to Mrs. Latilla and her daughters a minute portion of the fund in question and the balance to the Corporation would be a travesty of the truty; it would be an apportionment in the inverse ratio to the actual beneficial interests in the fund in question. It would involve the Commissioners closing their eyes to the obvious fact that the persons who owned or controlled all but a nominal interest in the assets and profits of the appellant company were the Latilla ladies; and it would treat as the person overwhelmingly interested in the company's actual income from all sources for the period in question, the Corporation, whose only interest in fact therein was what the Latilla ladies allowed it to have, an amount which, according to an understanding for which the Latilla ladies had stipulated and which they had the power to enforce, was to be 'ludicrously incommensurate with the.... income available for distribution.' It would be acting upon the ridiculous footing that these ladies, in order to enjoy their income free of surtax, had made a present of it to the Corporation."[77]

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76. p 246
77. p 247

Given the stated object of the legislation, the courts were prepared to find who really had interests in the company when deciding who could suffer an apportionment direction.

In the same vein, and option to acquire shares was held to be sufficient to give an individual an interest in IRC v Tring Investments Limited.[78]

The taxpayer company was an investment company within section 20 FA 1936.[79] It appointed the Marquis of Queensbury as permanent director with wide powers and granted him an option to purchase, at par, any number of its ordinary shares. Originally, it issued only 2 preference shares and 10 deferred shares (none of which were held by the Marquis of Queensbury), but he was then allotted 10 ordinary shares. The company subsequently went into voluntary liquidation.

The Special Commissioners made a direction in respect of the income of the company and it was apportioned to the Marquis of Queensbury.

It was held that the Marquis of Queensbury was a member of the company within the definition in section 21 (7) FA 1922 and that the apportionment of its income to him was correct.

At first instance, Macnaghten J considered that by virtue of his option and his ability to control the company the Marquis of Queensbury had an "interest" in the company.[80] He was in a position to procure that virtually all of the value of the company came to him thereby giving him an interest for the purposes of section 21.[81]

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78. (1939) 22 TC 679
79. Discussed infra
80. p690
81. p691

The Court of Appeal agreed. Giving the judgement of the court, du Parcq LJ noted:

> "It is plain that the Marquis of Queensbury had, at the material time, a legal right to call upon the company to allot to him all the ordinary shares which might be issued by the company on payment of one shilling per share, and that if the company had ever manifested an intention to issue the shares to another person, he would have been entitled to an injunction restraining it from so doing. Further, if there had been a winding up on 5th April 1937[82] the Marquis of Queensbury would have been entitled to almost the whole of the assets of the company against payment of what may fairly be called a nominal sum. The alternative open to him would have been to allow the sum of approximately £11,000 provided by himself to be taken by the Crown. In these circumstances, we cannot doubt that the learned judge was right in deciding that the Marquis of Queensbury was in the year 1936/37 a person having an 'interest' in 'the capital or profits or income' of the company, and that he then had an 'interest in the assets of the company available for distribution among the members in the event of a winding up'. The word 'interest', as was said recently by Lord Russell in the House of Lords is'a word capable of wide meaning' (Tenant v Lord Advocate) and there is certainly nothing in the words of the Finance Act 1922, to encourage the courts to place a restricted meaning upon it. On the contrary, it seems to us to be plain that the Legislature, by giving an extended meaning to the word 'member', was at pains to bring within the scope of its remedial legislation such a case as

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82. Before the Marquis of Queensbury had been allotted any ordinary shares.

this, where a company has so arranged its affairs that the person who in fact and in law has the most substantial interest in its assets is nevertheless not a shareholder."[83]

Again it can be seen that the courts were determined to give the word "interest" a wide meaning for the purpose of giving effect to the object of section 27 and to hold that an attempt to circumvent the apportionment provisions failed.

An attempt to defeat the apportionment provisions by the interposition of a trust was held to be ineffective in Penang & General Investment Trust Limited and Ramsden v IRC.[84] The House of Lords held that, where shares are registered in the names of trustees, an apportionment under section 21 (1) FA 1922, as amended by section 31(1) FA 1927, could be made on them and that this could be followed up by an assessment on the beneficiary.

There were three cases heard together but it is only necessary to consider the facts of the first because the point at issue in the others was the same. The taxpayer company was a company to which section 21 FA 1922 applied and was an investment company within the meaning of section 20(1) FA 1936. Its issued share capital was divided into A, B and C shares. The B shares were entitled to the whole of the dividends declared but in the event of a liquidation, the B and C shares were entitled only to return of capital, and the A shares to the whole of the assets then remaining. All the A and B shares were issued to an individual by whom they were transferred to two bodies of trustees by deeds of settlement. It was admitted that the individual had an interest in the income arising under the settlement of the A shares within the meaning of section 38(3) FA 1938.[85]

83. pp694-5
84. (1943) 25 TC 219
85. See Chapter 2

The income of the company for 1937/38 was £82,000 but only £2,000 was distributed by the company within the year of assessment. The Commissioners issued a direction under section 21(1) FA 1922, as extended by section 14(2)(a) FA 1937. Under section 14(3) FA 1937, they apportioned the income by attributing to the shareholders interests corresponding to their interests in the assets in the event of a winding up, so that nearly all the income was apportioned to the trustees who held the A shares. The amount so apportioned to these trustees was assessed to surtax as the individuals' income by virtue of sections 38(2) and (3) and section 41(4)(a)(2) FA 1938. It was admitted that, if the direction and apportionment were upheld, this assessment was correct.

The company appealed against the direction and apportionment, contending that its income could only be distributed to the holders of the B shares who, being trustees, were not liable to surtax in respect of income received by them as such; but it was not possible for the company to distribute its income to its members "in such manner as to render the amount distributed liable to be included in the statements to be made by the members of the company of their total income for the purposes of surtax" within the meaning of section 21 FA 1922 and section 14(2)(a) FA 1937; and that the Special Commissioners were not, therefore, entitled to make the direction.

The House of Lords held that the fact that the only members of the company are trustees not liable to surtax does not preclude the Special Commissioners from making a direction under section 21 FA 1922 and that an apportionment of the company's income to trustees may validly be made.

Procedural Matters

It is convenient here to mention a number of procedural points.

An interesting point arose in another of the series of cases involving Mrs. Latilla; Latilla v IRC.[86] In this case the preference shares in a company were held by Mrs. Lotilla and here two daughters, while the ordinary shares were held by another company. A direction was made under section 21 FA 1922 under which most of the profit for the period in question was apportioned to Mrs. Lotilla and her daughters. Mr. Lotilla was not a shareholder. The assessments were made upon Mr. Lotilla and the husbands of the two daughters in respect of the amounts apportioned to their respective wives. On appeal to the Special Commissioners, it was intended that the assessment under section 21 (2) FA 1922 could be made only upon a member and not upon the husband of a member. The Special Commissioners and on appeal, Atkinson J, rejected this contention but the Court of Appeal upheld the view that the assessment must be made upon the member and not upon her husband. Singleton LJ said:

> "There is some reason for making a member of a private company responsible if the company does not pay. He or she has, or had, an interest in the company and, may be, some direction or control over its affairs. A wholly different position arises when it is sought to charge the husband of a married woman who is a member. So far as I know, he could have no right whatever to recover against the company any tax paid by him. It would require clear words to place liability on the husband, and I cannot find them anywhere. I see no reason why the word 'member' in section 19(5) of the Finance Act

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86. (1950) 32 TC 159

1936 should be read as meaning anyone other than a member. There is nothing in section 19 itself to encourage one to take a wider view. If it had been the intention of the Legislature to make the husband responsible it would have been easy to add to sub-section (5) 'provided that if the member is a married woman living with her husband the tax shall be recoverable from the husband'. This is not a case of the husband being called upon to defray tax accruing due on income received by his wife. The tax was a tax upon the company, but as it was surtax, it could not be assessed upon the company. The effect of the change made by the Finance Act 1936 is to make a debt owed by one person (the company) payable by another (the member) if the first does not discharge the debt.

In my opinion, it goes no further than that, even though the debt is, or is described as, tax, it is still a tax upon the company and upon no one else."[86(a)]

This decision was, however, reversed by the House of Lords who held that a husband could be made the subject of an apportionment under section 21 FA 1922, in respect of a company in which he is not a member if his wife is shareholder of the company.

Lord MacDermott said that it was plainly the intention of section 21 that the sums apportioned should be subject to surtax and the only question was whether the wife or her husband was to be assessed. It was held that a husband living with his wife was liable to pay surtax in respect of undistributed income of a company notionally attributed to his wife as a member of the company not withstanding that the terms of section 21 FA 1922 were, on their face, confined to members of the company and that the husband himself was not a shareholder.

86(a). pp180-1
87. p193

Another point was that section 21(2) provided that surtax chargeable under section 21 on any member "shall be assessed upon that member in the name of the company" and was payable by the company. Therefore surtax could be assessed at any time within 6 years after the end of the year of assessment to which it related. Subsection (3) provided that a notice of charge to surtax should, in the first instance, be served on the shareholder and that if he did not elect to pay within 28 days of the date of notice, the Special Commissioners could serve a Notice of Charge on the company and the tax would then become payable by the company. If, however, the shareholder elected to pay but did not, in fact, pay the tax by 1st January in the year following the year of assessment, or within 28 days after he had elected, whichever was the later, the right of recovery from the company would be available to the Crown. Notwithstanding the fact that Inland Revenue could recover the surtax from the company where the member did not pay, section 19(5) FA 1936 provided that, if the company did not pay within three months of the Notice, or before 2nd January following the year of assesmsent, whichever was the later, the tax could be recovered from the shareholder on whom it was assessed, without prejudice to the right of recovery from the company. It can be seen, therefore, that the Crown had a joint and several right of recovery from the member and the company.

A further point concerns negotiated settlements. When the Special Commissioners indicated that they intended to take formal action under section 21 FA 1922 or, one of the provisions that replaced it, it was generally possible to negotiate a settlement with the Special Commissioners if the company could not persuade them that the dividend polcicy actually adopted had been a reasonable one. Negotiated settlements usually took the form of the payment of a dividend or an increased dividend for the years for which action was contemplated by the Special Commissioners. This might be for each of the previous six years of for such of those years for which the Special Commissioners maintained that a reasonable dividend had not been made.

It was important to consider the cost of such a settlement in terms of surtax and, when appropriate, profits tax, when contrasted with the cost of a surtax direction less any profits tax relief available under section 31 FA 1947. If a direction to surtax was made and full profits tax relief was given under section 31(2), it might have been found that the liability was not greatly in excess of the surtax and profits tax payable as the result of the declaration of a dividend which was thought by the Special Commissioners to be reasonable. This might be due to the fact that the members of the company between whom the income is apportioned paid surtax at only low rates. It was also necessary to take into account the fact that, where relief was under section 31(2), there would be no potential future liability to profits tax by way of non-distribution relief for the period covered by the direction.

The Treatment of Investment Companies

A distinction between investment companies and other companies was first made by the Finance Act 1936, which contained amended provisions defining the circumstances under which a company would be deemed to be under the control of not more than five persons for the purposes of section 21 FA 1922. For example, it was provided that an investment company should be deemed to be under the control of not more than five persons if five or fewer persons would, if the company were wound up, be entitled as members or loan creditors, to receive more than half the assets.

Section 20 FA 1936[88] defined the term "investment companies" as companies, the income whereof consisted mainly of investment income, namely, income which, if the company were an individual, would not be earned income as defined in section 14(3) of the Income Tax Act 1918.

In considering whether a company fell within this definition, it seems that a broad view was taken of its course of business, and that its activities considered, not only during the year of assessment in question, but over a reasonable period: FPH Finance Trust v IRC[89].

The mischief at which this section was aimed - and the difficulties facing the draughtsmen - were clearly explained by Sir Wilfred Greene MR in IRC v Kered. He said:

> "Now the particular way in which the original provisions were escaped was, instead of vesting in the person to be benefited the shares in the company, to give them debentures which were paid off periodically, the amount of the debentures bearing a

88. Later section 257 ITA 1952
89. (1945) 28 TC 209, supra

close relation to the income which would have been distributable among the shareholders if the matter had been done by means of an issue of share capital. The actual shares were left in the hands of persons who were not subject to surtax.

The Legislature were minded to bring such dispositions within the ambit of the charge, and accordingly, in the year 1936, section 20 of the Finance Act 1936 was enacted. The method by which the Legislature aimed at achieving this result was by providing that the holders of loan capital (that is to say, loan capital within the meaning of the section), creditors or debenture holders, should, in certain circumstances, be treated as in the same position as members. In the circumstances stated - I need not go into details of them - it is provided that the definition of the expression 'member' shall for the purposes of section 21 of the original Act of 1922 be extended so as to include any loan creditor of the company, and then any income of the company which is applied in repaying a loan creditor is to be treated in the same way as though it was profit distributable among shareholders. That in effect, was the object which the legislature apparently had in view. To anyone closely familiar with the difference between a shareholder of a company and a creditor of a company it would have at once appeared that that particular draughting technique was a matter of great difficulty and complication because it involved bringing artificially into the class of members of a company persons, namely, loan creditors, whose relations with the company were as different from those of members as anything could possible be."[90]

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90. (1938) 22 TC 354 at p374

His conclusion about the result of the draftsmen's effort came in an exchange with counsel at the end of the case, when he commented:

> "The trouble is, putting it quite frankly, that the section is badly drafted."[91]

The definition of "investment company" wsa examined in an interesting context in FS Securities Ltd v IRC[92], in that it concerned a company engaged in dividend stripping. This case has been examined in the context of dividend stripping[93] but, for present purposes, the facts may be summarised as follows. The taxpayer company carried on the business as dealers in stocks and shares. As part of a dividend stripping operation, it purchased the entire share capital of three other companies which held large undistributed profits that had borne tax. The taxpayer company caused dividends to be paid to itself by the three acquired companies, the dividends being paid after deduction of income tax. The market value of the companies' shares fell considerably as a result of the dividends and the taxpayer company claimed that this fall in value was a loss sustained by it in the trade of dealing in shares and, accordingly, obtained repayment by the Inland Revenue of tax deducted at source from the dividends received from the three companies. In making up its trading income account showing the loss, the taxpayer company did not enter the dividends.

The Special Commissioners made a direction under section 245 on the footing that the taxpayer company was an investment company and directed that, for the purposes of assessment to surtax, its income from all sources during the relevant period should be deemed to be the income of its members. The taxpayer company contended that it had no income which was not properly taxable under Schedule D

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91. p378
92. (1964) 41 TC 666
93. See Part 4, supra

Case I as profits of its trade and that it therefore had no investment income. This contention conflicted with the previous accountancy treatment of the dividends which, based on the taxpayer company's contention, should have fallen to be included as trading income in its trading account.

It was held that the dividends received by the taxpayer company ought to be excluded from the computation of the taxpayer company's profits or losses for the purposes of Schedule D Case I and that, accordingly, the dividends were not earned income. The dividends were therefore investment income and so the taxpayer company was within the definition of "investment company" and the surtax direction was correctly made.

The Special Commissioners had found that "the company's primary object in purchasing the shares in the three companies subjected to the "dividend stripping" operation was to obtain the dividends, i.e., the income arising from the shares and not to deal in the shares themselves, which could only have been sold at a loss after the operations had been carried out and which in fact were never sold or otherwise disposed of."[94]

For the purposes of section 20 FA 1936, any income apprortioned to a company under section 21 FA 1922 was deemed to be investment income.

Where a sum was expended or applied out of the income of a company in or towards the redemption, repayment or discharge of any loan capital or debt (including any premium) in respect of which any person was a loan creditor of the company, that sum could not be taken into account as having been applied to meet the current requirements of the company's business or such other

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94. p673

requirements as might be necessary or adviseable for the maintenance and development of that business.[95] The application of funds of the company in this way was not, therefore, a factor on which reliance could be placed to support the view that a reasonable distribution had already been made.

For the purposes of these provisions, the term "loan creditor" was defined by section 258 (4) as a creditor in respect of any debt incurred by the company:

(a) for any money borrowed or capital assets acquired by the company;

(b) for any right to receive income created in favour of the company;

(c) for consideration, the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt including any premium thereon, or in respect of any redeemable loan capital issued by the company.

Persons carrying on the business of banking were not to be deemed to be loan creditors where they lent money to the company in the ordinary course of that business.

The effect of this subsection together with subsection (3), was to give to loan creditors an "interst in the income of the company" and artificially to include them in the category of members, so that, where a direction and apportionment was made by the Special Commissioners, their position vis a vis the company would be exactly for this purpose as though they were members.

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95. Section 258(1) ITA 1952

The purpose of this section was clearly to stop avoidance by looking at the reality of the company's affairs rather than their form. This is reinforced by the proviso to sub-section (2) which enacted that, where a loan creditor had settled his financial interest in the company on a beneficiary, so that under the terms of the settlement, he could be required to pay money received by virtue of such financial interest to the benficiary, the beneficiary stepped into the loan creditor's shoes and was himself deemed to be a member of the company. Where the loan creditor had settled only part of his interest, then the beneficiary was to be deemed to be a member only as regards that part, the loan creditor remaining a member as regards the balance.

A case which shows the operation of the section to loan creditors is one already mentioned: IRC v Kerred.[96] The taxapyer company was an investment company within section 20 FA 1936. Its main asset consisted of an annuity which it had purchased for cash provided partly by the issue of interest bearing debentures repayable by annual instalments.

During the year ended 30th November 1935, the company's income consisted of the annuity and a small amount of mortgage interest, all received under deduction of tax, from which it paid debenture interest under deduction of tax, management expenses, a dividend (declared "free of tax"), and the instalment due on 31st December 1934 in redemption of debentures, leaving a small balance in its hands.

The company's gross income for the period in question (after deduction of its management expenses and the gross amount of debenture interest) was apportioned under section 21 FA 1922 and section 20 FA 1936, as to the

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96. (1938) 22 TC 354

amount of the dividend paid (with an appropriate addition for income tax) to its shareholders, and as to the balance to the loan creditor holding the debentures.

The company contended that the amount of income to be apportioned to the loan creditor was (i) the actual income of the debenture capital redeemed, or alternatively (ii) the actual net amount of income in its hands after repayment of management expenses and of the net amounts of the debenture interest and dividend and it futher contended that, in any event, no addition for income tax should be made to the amount of income apportioned to the loan creditor.

It was held that the Special Commissioners can only apportion to loan creditors the actual amount of income expended in discharge of their loan capital, and not that amount grossed up by the addition of tax. It was further held that the Commissioners could apportion to loan creditors only the sum actually paid in redemption of debt, and not a sum larger than that. Although the company had income sufficient to redeem a larger amount of the debt, that larger sum was not a sum "available to be expended or applied in redemption" within section FA 1936. In addition, where a company had the option to redeem a larger sum upon giving a specified notice, its income was not available for the discharge of such larger sum unless such a notice had been given.

<u>Section 259 ITA 1952</u> provided that, where a direction was given by the Special Commissioners with respect to an investment company, the Commissioners could apportion the company's income by attributing to each member, if appropriate, an interest corresponding to his interest in the company in a winding up. Members and loan creditors,

both having an interest in the company's assets on a winding up, were thus liable. Section 260[97] took the matter even further by allowing an apportionment, not by reason of interest in income[98] or in assets on a winding up[99], but by the ability or likelihood of any person to secure that income or assets present or future, could be applied for his benefit either directly or indirectly. The Special Commissioners were empowered to treat such a person as a member of the company for this purpose.

They were also empowered to make an appropriate apportionment in respect of two other classes of persons. These classes differed from those mentioned above in that they both comprised persons who were already members of the company but who, in the absence of this provision, might escape liability. They were:

(i) Members of the company who had no relevant interests (that is, who would not otherwise be liable to an apportionment) in the company but who, in the opinion of the Special Commissioners, were or were likely to be able to secure that income or assets, whether present or future, could be applied either directly or indirectly for their benefit; or

(ii) Members of the company who, in the opinion of the Special Commissioners, were or were likely to be able to secure that income or assets, whether present or future would be applied directly or indirectly for their benefit to a greater extent than was represented in the value, for apportionment purposes, relative to other persons interested, of their relevant interests in the company.

97. Which was originally section 15 FA 1939
98. As under section 248
99. As under section 249

The effect of these provisions was to enable the Special Commissioners to consider factors other than direct financial interest in a company, and the strict legal position of the interested parties, and to make an apportionment based on the reality of the situation as they saw it. These were very wide provisions and gave the Special Commissioners important discretionary powers.

It can be seen that all three classes of persons covered by this section had, in order for the section to operate, to be either able, or likely to be able, to secure the application of income or assets for their benefit. Section 260 (3) stated that a person was to be deemed to be able to secure such application if he was in fact able to do so by any means whatsoever, whether he had any legal or equitable rights in the matter or not. This very wide provision has been considered a number of times by the Courts.

These provisions were, for example, considered in IRC v LB (Holdings) Limited[100]. The taxpayer company was incorporated on 17th March 1934 as an investment trust company with a capital of 1,000 shares of £1 each. On the same day, a trading company was incorporated and acquired from a Mr. Brady the business of which he was sole proprietor. The shares which formed the consideration for the sale were directed by Mr. Brady to be issued to the investment company and that company issued to Mr. Brady or his nominees 500 shares. Mr. Brady, by reason of his shareholding and his powers as governing director, was in complete control of the investment company. On 22nd March 1934, Mr. Brady, by a Declaration of Trust, declared himself sole trustee of any such investments as should be specified in the schedule to the Trust Deed, and a few days later, he included in the schedule the shares of the investment company together with investments valued at £100,000.

100. (1946) 28 TC 1

Under the Declaration of Trust, Mr. Brady, as trustee, had to pay the annual income of the trust up to £2,000 to his wife and the balance equally between his five children and the survivors of them during their respective lives.

Shortly afterwards, Mr. Brady, as trustee, sold to the taxpayer company all the investments held in trust with the exception of the shares in the taxpayer company itself. The taxpayer company in consideration issued to Mr. Brady, as trustee, a further 105 shares at a premium of £999 per share, with the result that the only shares subject to the trust were the 605 shares in the taxpayer company, and the only income of the trust was derived from the dividends payable by the taxpayer company. The whole of the trust income was paid into the account of the trading company and in that company's books an account was kept in the name of Mr. Brady, to which was credited, not only the trust income, but payments due to Mr. Brady personally, and to this account were debited sums paid by Mr. Brady on his own account as well as sums paid as trustee. It was not possible to identify all the drawings for the benefit of beneficiaries nor to ascertain the balance of the trust fund in the hands of the trust company.

In July 1939, on the introduction of the clause which was to become section 15 FA 1939, the taxpayer company went into liquidation and its assets were distributed in specie to Mr. Brady as trustee. In July 1934, two additional trustees were appointed and a separate bank account opened for the trust. The three children, who were then of full age, executed a Deed of Release in favour of Mr. Brady in respect of acts or omissions in the course of his trusteeship.

Directions were made in respect of the income of the taxpayer company and the income was apportioned to Mr. Brady under section 15 FA 1939.

The question to be decided was whether Mr. Brady was caught by the words: "a person shall be deemed to be able to secure that income or assets will be applied for his benefit if he is in fact able to do so by any means whatsoever." The Board of Referees held that the words "able to secure" meant "able to secure by lawful means" and, as Mr. Brady, as trustee, was not able by lawful means to secure that the income or assets of the company would be applied directly or indirectly for his benefit, the apportionments could not stand. The Courts, however, took a different view holding that the application of the words "by any means whatsoever" was not limited to lawful means and the the word "secure" in the phrase "able to secure" did not imply some necessary element of permanency or certainty. It was further held that, since "interest" for the purposes of section 15, meant interest in the capital or profits or income of the company, the beneficiaries as well as the trustee were to be regarded as members of the company and the income was apportionable among them as was appropriate in accordance with their interests.

Lord Uthwatt was of the opinion that the test was, to some extent, an objective test and that the possibility of any particular person resorting to any particular means was not to be considered. If, on a rational view of all the facts, a person could be said to be able to bring about an application of income or assets for his benefit, then whether such operations, if they took place, would be unlawful or not, the section applies. Lord Uthwatt illustrated his point in the following way:

> "In the realm of tax avoidance, ingenuity need not deny, and in practice does not deny, itself any extravagance. The thoughtful praepositus if faced by the section with the necessity of rendering any exercise of its ability unlawful, might readily secure the inclusion in the Articles of Association

of the company a provision that no assets or income .... shall be applied for his benefit by any means whatsoever.... and set up trusts applicable to the shares in favour of a class no member of which could be ascertained in his lifetime.

Surely it was not the intention of the Legislature in its repeated efforts to secure the avoidance of surtax to leave such a door open."[101]

It can be seen that the courts were determined to give effect to the section by construing it widely.

Three months after the House of Lords were delivering their judgement in the LB (Holdings) case, the Court of Appeal were dealing with a similar question in Hulme Estate Co Limited v IRC[102]. It is interesting to note that one of the judges in the Court of Appeal was Somervell LJ who, before his elevation to the Bench, during his tenure as Attorney-General appeared for the Crown in the High Court and the Court of Appeal in the LB (Holdings) case, the Clark and the Langrange Trust case[103], the Heddon Court House case[104], and the Chamberlain & Talbot case[105]. It will be seen that the Crown won in each of these cases.

In the Hulme Estate case, the taxpayer company was incorporated in 1922 with a capital of £10,000 dividend into 1,000 £1 A shares and 9,000 £1 B shares. The company acquired from Sir John Prestige part of his shareholding in a trading company in consideration of £9,000 to be satisfied by the issue to him of 900 A shares and 8,100 B shares fully paid. The A shares carried the right to 1 vote each, but the B shares

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101. p38
102. (1946) 28 TC 107
103. Clark and the Langrange Trust and Investment Co Ltd v IRC (1947) 28 TC 55, infra
104. Heddon Court House Ltd v IRC (1947) 28 TC 79, infra
105. A.G. Chamberlain and Talbot Investment Co v IRC (1945) 28 TC 88, infra

conferred no voting rights. In 1922 trusts were declared in respect of £2,900 B shares (to which a further 400 were added in 1937) in favour of Sir John Prestige's son and in respect of 1,950 B shares in favour of his daughters. The trustees of the trust were Sir John Prestige, his solicitor and his sister. In 1925, following the birth of a second daughter, Sir John Prestige acquired from the trustees of his elder daughter's trust 975 B shares at £3 a share and, in respect of these shares, he made a declaration of trust similar to that in favour of his elder daughter. Shortly afterwards, 1,950 B shares, the subject of the trusts for the two daughters, were converted into C shares conferring the right to receive, in priority to other shares, a cumulative preference dividend of 100% free of income tax (altered in 1937 to 100% gross). The C shares conferred no voting rights.

The taxpayer company was converted into a public company in 1927. 100 unissued A shares were abolished and in their place 100 D shares were created carrying a right to dividends not exceeding a total distribution of 30 shillings per share, but conferring no right to vote. Of these D shares, 50 were issued to 50 persons outside the family. At all material times subsequent to 1937, Sir John Prestige held beneficially 900 A shares and 3,750 B shares. He held with other trustees 3,300 B shares on trust for his son and 975 C shares for each of his two daughters. By virtue of the voting rights under the Articles, Sir John Prestige was in control at directors' meetings and at meetings of the company.

Under the trusts, the trustees had discretion to apply the income for the maintenance and education of the children by paying it over to Sir John Prestige who was not accountable to them for its application. The trustees in the exercise of their discretion in the case of the son, paid to Sir John Prestige, in the 12½ years from the inception of the trust to 5th April 1935, the whole income derived by them from the taxpayer company, amounting in the aggregate to £34,000 and, thereafter, under an agreement between Sir John Prestige and the trustees, at a rate of £3,000 per annum. Similarly, the income of the shares held by the daughters trusts was, in the exercise of the trustees' discretion paid over practically in full to Sir John Prestige during the relevant period.

In 1927 the taxpayer company purchased an estate in Kent and a house in London at a cost of £25,000 and £3,250 respectively. A portion of the estate, consisting of a mansion house and 27 acres of land was let to Sir John Prestige at a rent of £200 per annum and the London house was let to him at £150 per annum. Over the next twelve years the taxpayer company spent over £16,000 on structural repairs and maintenance of the mansion house and the London house. It can be seen that, by virtue of his control over the company and his position as trustee, Sir John Prestige was receiving virtually the full benefit of the income from the relevant shares.

A direction in respect of the income of the taxpayer company other than estate or trading income and the relevant income was apportioned to Sir John Prestige under section 15 FA 1939. The taxpayer company appealed against the apportionment but the Special Commissioners confirmed it, holding that Sir John Prestige was able to secure that the whole of the income or assets of the company should be applied either directly or indirectly for his benefit and that it was appropriate that the whole income of the company, except its estate or trading income, should be apportioned to him under section 15. On appeal, the courts were asked to distinguish this case from the LB (Holdings) case on the grounds that, here, there was an application, not by the company, but by a body of trustees separate and distinct from the company. This contention was rejected, the court taking the view that it was immaterial that other persons may have the legal right to restrain such application, if the Special Commissioners considered that such persons would not exercise their rights.

It can be seen that the ambit of the section was extended still further by this case.

LB (Holdings) was also followed in Clark & Langrange Trust and Investment Co Limited v IRC[106] and Heddon Court House Limited v IRC[107].

Provided the existence of the ability to secure the application of income or assets as required by the section was proved, it was immaterial that this ability never ripened into anything more tangible. This can be seen from the case of AG Chamberlain and Talbot Investment Co v IRC[108]. This was another case concerning a complicated scheme involving several classes of shares and family trusts.

The taxpayer company, an investment company, was incorporated on 26th March 1938. Its authorised share capital was £400,000 divided into 40,000 prefernce shares, 120,000 A cumulative preference shares and 240,000 ordinary shares, all of £1 each. Preference shares were entitled to a preferential dividend of 20%, and the cumulative preference shares to a cumulative preferential dividend of 30%, but each class of preference shares was redeemable on payment of the amount paid up thereon at any time at the option of the company on one month's notice. The shares were held as follows: (i) 30,000 preference shares, one shilling paid up, and

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106. (1947) 28 TC 55
107. (1947) 28 TC 79
108. (1945) 28 TC 88

80,000 A cumulative preference shares, one shilling paid up, by a company as nominee of the trustees of two settlements made by the individual taxpayer in 1938 in favour of his children; (ii) 223,500 ordinary shares fully paid up by an unlimited investment company, S, which the individual taxpayer had formed in 1935; and (iii) two ordinary shares by two unconnected signatories to the Memorandum of Association.

By the Articles of Association, the individual taxpayer, though not at any time a shareholder in the taxpayer company, had wide powers as goverining director for life, including the power to appoint and remove directors at his pleasure. Each share carried one vote so that the voting power of the taxpayer company rested with S. The capital of S was divided into preference and ordinary shares, and the individual taxpayer held all the issued preference shares, this shareholding giving him voting control of that company, in addition to which he possessed wide powers as governing director. The ordinary shares of S were divided into 5 classes and each class of ordinary share was entitled to such dividend (if any) as the company in general meetings should determine. The 5 classes of ordinary shares were respectively held by the trustees of 5 settlements made by the individual taxpayer in 1936. The funds settled by 4 of the settlements were to be held in each case on irrevocable trusts for the individual taxpayer's four infant children. By the other settlement, the individual taxpayer directed the trustees to hold the trust funds on trust until 21 years after the death of the survivor of his wife and his four infant chilren, to pay or apply the income to or benefit of any one or more of those persons as the trustees should, in their absolute discretion, think fit. The individual taxpayer was originally one of the trustees and was given power, during his life, to remove any trustee of the settlement at his pleasure and to appoint a new trustee. He retired from the trusteeship in September 1938 but retained his power to remove and appoint trustees.

The taxpayer company, whose income consisted solely of dividends on company shares, only paid three dividends, two on the preference shares and one on the cumulative preference shares. These dividends were received by the trustees of the settlements that held the preference shares and cumulative preference shares, and lent by them free of interest to a company in which the individual taxpayer was interested.

Directions were made on the taxpayer company and the actual income of the company for the relevant years was wholly apportioned to the individual taxpayer under section 15 FA 1939. The taxpayer company appealed against the apportionments, and the individual taxpayer against the consequential surtax assessments, contending that, although the necessary requirements of section 15 were admittedly satisfied, the actual income of the taxpayer company should not be wholly apportioned to the individual taxpayer.

However, it was held in the Court of Appeal that, since the individual taxpayer, by virtue of his control through company S of the voting power of the taxpayer company, could secure the redemption of the taxpayer company's preference shares and the declaration of the whole of its income as a dividend on the ordinary shares held by S, he could by his voting control of S decide that, subject to the payment of the dividend on the preference shares to himself, the whole of its income should be applied as a dividend on the class of its ordinary shares held by the trustees of the settlement in which his wife and his four infant children were beneficiaries. He could reappoint himself a trustee of that settlement, remove the other trustees, and decide that the dividend should be paid wholly to his wife and, therefore, he was able to secure that the whole of the income of the taxpayer company for the years in question should be applied for the benefit of himself or his wife and that the apportionments should stand.

It can be seen that the route by which the individual taxpayer could secure that income was paid to himself or his wife was very indirect and he had not taken advantage of that power. Nevertheless, the section was wide enough to cover this complicated scheme which had sought to distance the individual taxpayer and his wife from the taxpayer company.

Also of interest is the case of Burlah Trust Limited v IRC[109]. The taxpayer company was an investment company formed by a Mr. Burston in March 1937 with a capital of £500 divided into 490 preference shares of £1 each which were issued to Mr. Burston, and 10 ordinary shares of £1 each which were issued to a company to which section 245 did not apply. The preference shares enabled Mr. Burston to control the company and carried the right to the surplus assets on a winding up. An annuity agreement was entered into by Mr. Burston under which he contracted to pay an annuity to the company for 8 years or for the remainder of his life, whichever was the shorter, and on the day on which this agreement was entered into, the company agreed to lend him and equivalent amount subject to interest of 4%.

In January 1938, the company's capital was increased to £1,500 by the creation of deferred ordinary shares acquired by trustees under an irrevocable settlement made by Mr. Burston in favour of his children. The deferred ordinary shares carried voting control of the company and the right to surplus profits and assets on a winding up. At the same time, the company gave Mr. Burston an option to purchase at par a large number of deferred ordinary shares. In 1940, Mr. Burston transferred certain shares to the company and in consideration for the release of his obligation to pay the annuity and, in 1941, his loan was repaid out of the proceeds of a sale of shares by Mr.

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109. (1953) 35 TC 162

Burston to the company. The whole of the income of the company for the years 1942/43 to 1946/47 inclusive was apportioned to Mr. Burston.

On an appeal to the Board of Referees, the apportionments were confirmed, the Board of Referees drawing the inference that Mr. Burston was likely or able to secure that assets or income of the company would be applied for his benefit. They arrived at this conclusion because they considered that the directors of the company and the trustees of the settlement were at all material times likely to act in accordance with the wishes of Mr. Burston should he ask for a loan either on commercial terms or on more favourable terms.

Both Upjohn J and the Court of Appeal held that the Board of Referees were not entitled to conclude that the trustees would be likely to make a loan on terms more favourable than commercial terms and they therefore remitted the case to the Board of Referees for them to reconsider the position. Upjohn J, for example, put the matter in the following way:

> "Here, as I have already pointed out, we are only dealing with what Lord Thankerton[110] called the second case, that is the "likely ability" case, to put it shortly. Lord Thankerton is saying that in such a case the section contemplates that the powers or rights are to be properly exercised. Therefore, in my judgement, as it would have been an improper exercise of powers and rights to lend money to Mr. Burston... at less than commercial rates of interest, the Board of Referees were not, as a matter of law, entitled to come to the conclusion that the trustees would be likely to lend money to this gentleman upon more favourable terms than commercial terms. They may well have thought that

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110. In IRC v LB (Holdings) Ltd (1946) 28 TC 1, supra

that would happen in fact, but that seems to me, as Lord Thankerton has pointed out, to be outside the contemplation of the second case because of the absence of the words "able to do so by any means whatsoever". Therefore, in my judgement, the Board of Referees were not entitled to come to that conclusion.

On the other hand, it follows from what I have said that they were, in my judgement, entitled, having in mind the construction I have put on the settlement, to come to the conclusion that the trustees would be likely to act in accordance with the wishes of Mr. Burston and make him a loan out of any dividends received on commercial terms."[111]

It is clear from the judgement of Upjohn J and of the Court of Appeal that the making of a loan on commercial terms might be the application of a sum for the benefit of the borrower.

These cases demonstrate that, even though the individual behind the company may not by reason of voting power be able to obtain directly the benefit of the company's income or assets, he can still be caught if he can obtain those benefits in an indirect way where an investment company is concerned.

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111. p178

Capitalisation of Profits by the issue of Bonus Shares

The extraction of profits from a company in capital form has been examined above.[112] Here, the analysis is restricted to the apportionment aspects of this question.

The effect for taxation purposes of an issue of bonus shares by a company has been considered in a number of cases and it was decided in Blott's case[113] that a member of a company was not liable to surtax on respect of bonus shares received by him. The company does not part with assets when making a bonus issue and the total value of the share capital as a whole is unaffected by the bonus issue. Blott's case was one of the factors forcing the introduction of section 21 FA 1922.

It will be recalled that, in Blott's case, the Inland Revenue sought to tax an issue of bonus shares made out of the undivided profits of the company. The shareholder had no option to receive cash and the House of Lords held that the bonus shares, being distributed by the company as capital, were not income in the hands of the shareholders for supertax purposes. In the course of his judgement, Viscount Haldane said:

> "But if, acting within its powers, it disposes of these profits by converting them into capital instead of paying them over to the shareholders, that, as I conceive it, is conclusive as against all the outside world, including the Crown and the form of the benefit which the shareholder receives from the money in the hands of the company, is one which is for determination by the company alone."[114]

Similarly, Viscount Finlay commented that:

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112. Part 1, supra
113. IRC v Blott (1921) 8 TC 101
114. p125

"it is necessary to consider closely what it was that the shareholder got. Did he get anything in the nature of payment of income? It is obvious that he did not. He gave up any claim to the income. What might have been paid as income went to increase the capital of the company. The shareholder got his proportionate share in the business of the company as increased by the additional capital."[115]

The principle established in this case was never overruled.

Under the apportionment legislation, as has been seen, the Special Commissioners could take action if the close company had not made a reasonable distribution of its income in such manner as to render the amount distributed "liable to be included in the statements to be made by the members of the company of their total income for the purposes of surtax". Therefore, as bonus shares received by a shareholder were not liable to surtax under the Blott case, they could not be taken into account as if they were distributions when considering the application of section 21.

Bonus shares also received consideration in relation to profits tax. Section 36 FA 1947 provided that no amount applied in reducing the share capital of a company would be treated as a distribution for profit tax purposes. If a company went into liquidation, the excess of the distributions made by the liquidator over the nominal amounts of the paid up share capital had to be treated as a distribution of the final chargeable accounting period during which the trade was carried on. It was accordingly recognised that if the share capital could be increased by way of a bonus issue prior to the commencement of the liquidation, the distributions for profits tax purposes would be reduced.

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115. pp132-3

In order to prevent loss of profits tax in this way, the provisions of section 31 FA 1951 were introduced but, as was demonstrated in the case of IRC v Pollock and Peel Limited[116] they did not achieve their objective[117]. In that case it was held that the amounts distributed by the liquidator were not repayments of share capital.

Section 246 ITA 1952 provided that the Special Commissioners would have regard, not only to the current requirements of the company's business, but also to such other requirements as may be necessary or adviseable for the maintenance and development of that business. The section then set out certain matters that were not to be taken into account for this purpose and the amount applied in these ways out of income of the company was to be regarded as income available for distribution among the members of the company.[118] One of these classes was the redemption or repayment of any share or loan capital or debt "issued or incurred otherwise than for adequate consideration".

If, therefore, an issue of bonus shares had been made out of profits and these shares were subsequently redeemed, the amount so applied was to be regarded as income available for distribution among the members of the company and not as having been applied to the maintenance and development of the business of the company, because the shares would not have been issued for adequate consideration.

The question of bonus shares in relation to section 245 was considered in the case of IRC v Thornton Kelley Limited[119].

In 1920, a company applied part of the surplus shown on a revaluation of its capital assets in paying up in full

116. (1957) 37 TC 240
117. See Part 2, supra
118. Supra
119. (1957) 37 TC 98

10,000 cumulative preference shares of £1 each, which it issued by way of capitalisation to the holders of its 10,000 ordinary £1 shares.

In 1951, when 8,865 of the 10,000 ordinary shares were owned by two directors, under a Special Resolution of the company and with the confirmation of an Order of the High Court, the capital of the company was reduced from £20,000 to £10,000 by repayment of the whole amount of the preference shares, and the nominal capital was simultaneously again increased to £200,000 by the issue of 10,000 new ordinary shares of £1 each. In 1952 the company applied part of a surplus shown by a further revaluation in paying up in full 10,000 new ordinary shares of £1 each which it issued by way of capitalisation to the holders of the existing ordinary shares. Surtax directions requiring the actual income of the company from all sources for the years ending 30th June 1951 and 1952 to be deemed to be the income of the members of the company and the amount thereof to be apportioned among the members were given by the special commissioners under section 21 FA 1922.

In considering the application of section 246, the Special Commissioners often had regard to payments made for the business, undertaking or property which the company was formed to acquire or which was the first business, undertaking or property of a substantial character in fact acquired by the company. They also treated as income available for distribution among the members any sum applied in redemption or repayment on any share or loan capital issued or incurred towards the payment of the first business, undertaking or property of a substantial character in fact acquired by the company. As has been seen above, section 246 also provided, however, that sums applied in redemption or repayment of any share or loan capital or debt issued or incurred otherwise than for adequate consideration was to be regarded as income available for distribution among members for the purposes of section 245.

In the Thornton Kelley case, Wynn-Parry J decided that the bonus shares were issued "otherwise than for adequate consideration", and he therefore remitted the case to the Board of Referees who had originally taken a contrary view. Wynn-Parry J said that it was necessary to have regard to two separate factors, one being the company law aspect of the matter, and the other the effect of section 245. He said that he agreed with the company that there was some benefit to the company as a result of the bonus issue but, the mere fact that the capitalisation by way of the bonus issue was beneficial to the company because the shares were fully paid up did not mean that the shares were issued for adequate consideration within the meaning of section 245.

It has been seen that, in 1965, provisions were introduced specifically covering bonus issues of shares following a repayment of share capital and repayments of share capital following bonus issues.[120]

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120. See Part 3, supra

Dividend Limitation and the Prices and Incomes Act 1966

It has been seen that, following the Second World War, the apportionment provisions were in conflict with Government policy to restrict dividends. The most important instances of this were the policy of restricting dividends reflected in the Cripps statement, the penal provisions in the Profits Tax legislation from 1947 and by the "excess dividend" provisions of section 83 FA 1965. A further conflict was posed by the Prices and Income Act 1966 which received the Royal Assent on 12th August 1966. The Act provided for the establishment of the National Board for Prices and Incomes which was required to keep under continuous review incomes, prices and charges. The Act provided that, by Order in Council, the provisions could be brought into force for a period of twelve months beginning with the dates specified in the Order.

The Act explained, in paragraph 16 Schedule 2, that a main category of non-employment income constituted profits of companies, a part of which was distributed in the form of personal income to shareholders. It was said that an effective policy for avoiding price increases and securing price reductions wherever possible should ensure that increases in profits arise from increased efficiency, and where the growth of profits or dividends is based on excessive market power, this would indicate scope for price reductions so that such cases would be referred to the National Board for Prices and Incomes for examination.

These criteria were superceded by an Order made under the Act (SI 1966, no. 1020) which, in paragraph 31, specified that all company distributions, including dividends paid by companies, were subject to a standstill and should not be increased during the twelve month period ending in

July 1967, with the exception of distributions made to meet the requirements of the special tax rates for closely controlled companies. Precisely what this meant was not explained. Close companies, were by this time liable to corporation tax. Like other companies they had to deduct income tax from the payment of dividends and account for this tax under Schedule F in accordance with Section 47 FA 1965. There was thus no special tax rate which applied to close companies. Admittedly, under section 77 FA 1965, there could be a shortfall assessment on the company where the distributions for an accounting period did not reach the required standard. In these circumstances there was assessed on, and recoverable from, the company "as if it were an amount of income tax chargeable on the company" an amount equal to the income tax for which the company would be liable to account under section 47(3) on a distribution equal in amount to the shortfall. Therefore, the obvious intention was that close companies should continue to pay dividends of an amount equal to the required standard for each accounting period and that a standstill would not be enforced in such cases. In those circumstances, it is surprising that the legislation was not drafted with more care.

The Government's view of the operation of these provisions to close companies can be seen from the following letter from the Chancellor of the Exchequer, James Callaghan to James Dickens MP, printed in "Taxation" magazine on 17th September 1966. The letter read:

"Dear Jimmy,

> You have written to me about the application of the Government's incomes policy to company distribution.
>
> The policy is this:

companies should not pay their shareholders a total dividend in respect of their last financial year greater than that for the preceeding financial year and dividends paid during the period of the standstill (which means twelve months from July 20th last) should not exceed those paid during the twelve months up to that date. There are two qualifications to this: first "closely controlled companies" are exempted from the standstill to the extent that they have to meet the requirements of the special tax rules which apply to them. Secondly, companies who consider that there are special circumstances which create for them an imperative need to pay an increased dividend are expected to inform the government of the circumstances and to have regard to the advice which the Government then gives them..."

The 1965 Provisions

Section 245 ITA 1952 only applied for accounting periods and parts of accounting periods up to 5th April 1966. For accounting periods or parts of accounting periods falling after that date, the shortfall provisions in sections 77 and 78 FA 1965 applied.

Section 77 provided that, where in any accounting period of a close company, there was a shortfall in the company's distributions, the company had to account to the Inland Revenue for tax at the standard rate on the amount of the shortfall as if it were a gross amount of distribution paid twelve months after the end of the accounting period, and an assessment was raised upon the company on the amount of the shortfall. Section 78 empowered the Inland Revenue to apportion the income of a close company among the participators for the purpose of raising assessments to surtax upon them.

Where the company was a trading company, its income for any accounting period could not be apportioned under section 78 unless an assessment was raised upon the company under section 77 in respect of a shortfall in its distributions for that period; and in such a case, the amount apportioned to participators under section 78 was the amount assessed upon the company under section 77. On the other hand, where the company was not a trading company, under section 78 (3), the Inland Revenue could, if they saw fit, apportion the whole of the company's income for an accounting period up to the amount of the required standard even though there was no shortfall in distributions for that period. Where this procedure was followed there had to be made from the amounts to be apportioned such reduction "as may be just" in respect of distributions made to persons other than participators and associates of participators. For these purposes, a "trading company" was defined as: "any company which exists wholly or mainly for the purpose of carrying on a trade and any other company whose income does not consist mainly of investment income".[121] In this connection, "investment income" was defined as income which, if the company were an individual, would not be earned income, but it also included any income apportioned to a company under the provisions of section 78 FA 1975 or section 245 ITA 1952.

Even though the apportionment provisions by this time had been on the statute books for over 40 years, the drafting of sections 77 and 78 left a lot to be desired. This can be demonstrated by the case of C & J Clarke Limited v IRC[122]. In effect, what the taxpayer company did here was to place itself under a heavy burden to make covenanted donations and avoid an apportionment by distributing up to the standard required by section 77, the small income it left itself. Basically, the company was trying to be charitable at the public expense.

The taxpayer company was a close company carrying on the business of boot and shoe manufacturers. There was no shortfall in its distributions for the accounting period ending 31st Decmeber 1966, but it made covenanted donations to charity totalling £53,354 in that period, and that sum (having been duly allowed as a deduction against its profits) was apportioned for surtax purposes among the participators under section 78.

The Company appealed contending that the provisions of section 78(2), which provided for an addition in respect of annual payments where an apportionment was made for the purposes of section 78, did not authorise the making of an apportionment where none could be made under the rest of the section and that, accordingly, the words "subject to sub-sections (2)... above" in section 78(4)

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121. Para 8, Sch 18 FA 1965
122. (1974) 50 TC 103

did not override the prohibition in that sub-section against an apportionment of the income of a trading company where no assessment to tax in respect of a shortfall in distributions had been made under section 77. The Crown contended that the words "subject to sub-sections (2)..." applied in relation to the said prohibition as well as to the provisions in section 78(4) as to the amount of the apportionment, and, accordingly, section 78(4) did not preclude the making of an apportionment in respect of the sums in question by virtue of section 78(2).

Both Megarry J and the Court of Appeal held for the taxpayer on the basis that section 78 (2) did not come into play unless there was first an apportionment under section 78(1) or (3), in which case it made an addition to the income to be apportioned.

The actual decision was not of very wide importance except to show the unsatisfactory drafting of sections 77 and 78. In the Court of Appeal, Scarman LJ commented that: "the difficulty arises from the weak drafting of section 78 of the Finance Act 1965"[123]. Later he noted that: "the drafting of section 78 certainly bears all the marks of drafting under pressure without sufficient opportunity for revisal".[124] He noted that the drafting flaws had been corrected by section 94 and schedule 16 FA 1972. The FA 1972 recast the apportionment legislation and its drafting stood the test of time well, remaining in substantially the same form, through the gradual easing of the apportionment provisions until their abolition in 1989.

An apportionment for the purposes of section 78 was made in accordance with the procedure laid down in section 249 ITA 1952 although certain modifications were made to

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123. p116
124. p117

section 249 for the purpose of applying its provisions to section 78 FA 1965. In particular, whereas under section 249 income of a period of account apportioned in accordance with the provisions of section 245 was treated as income of the member accruing to him on the date to which the company's accounts were made up, it was provided that income apportioned for the purposes of section 78 should be deemed to have been received by the participator at the end of the accounting period to which the apportionment related. Where the company had consistently made up accounts for periods of 12 months, the modification involved no departure from the old procedure, but an accounting period for corporation tax purposes cannot exceed 12 months in duration and, if a company makes up accounts for a period of more than 12 months, the modified procedure operated more advantageously for the participator than did the original provisions.

Sections 77 and 78 did not apply in relation to any accounting period or part of an accounting period falling before 6th April 1966, even though the profits of that period were subject to corporation tax. Therefore, the profits of a company for the year ended 31st December 1965, which were chargeable to corporation tax, fell to be dealt with under section 245 and not section 78. But, where a period of account fell partly in the year of assessment 1965/66 and partly in the year of assessment 1966/67, each part had to be treated as a separate accounting period. The income for the period up to 5th April 1966 was dealt with in accordance with the provisions of the ITA 1952, while that for the period falling after that date was dealt with under the provisions of FA 1965.

However, where section 245 applied in relation to a period falling before 6th April 1966, some modification of those provisions was required. Section 249(5) ITA

1952 provided that, where undistributed income which had been assessed and charged to surtax in accordance with the provisions of the ITA 1952, was subsequently distributed, the amount distributed was to be excluded from the total income for surtax purposes of the person entitled to the distribution. But, where the distribution occurred after 5th April 1966, section 249 (5) only applied to exempt the amount distributed from liability to surtax if, on the occasion of the distributions for the accounting period exceeded the required standard (computed in accordance with the provisions of section 77), and the exemption then applied only to that proportion of the income falling to be taken into account for exemption which the excess of the distributions over the required standard bore to the total of the distributions made for the period.

Paragraph 9 Schedule 18 FA 1965 was concerned with the attribution of distributions to particular accounting periods. Dividends which were paid for a period and paid during or within twelve months after a period were regarded as distributions of that period, where they were all distributions made in the period (except dividends which related to any previous period), and any amount by which the directors' remuneration paid for the period exceeded the deduction allowed for in computing the income of the period would be regarded as distributions of the period. Where an accounting period fell partly in the year 1965/66 and partly in the year 1966/67, the two parts were dealt with as separate accounting periods for the purposes of section 245 and section 77 and 78 respectively. Where, however, it was necessary to apportion any dividend treated as dividends for any period of account, this had to be done according to the proportion which the income of the part falling in 1965/66, computed as for section 245 but less income tax at the standard rate, bore to the distributable income for the part falling in 1966/67. The actual income of the company for section 245 purposes was computed as for income tax.

The term "distributable income" was defined in paragraph 7 Schedule 18 as meaning the distributable profits less that part attributable to chargeable gains net of tax but including franked investment income and any group income. Where the distributions for an accounting period which overlapped 5th April 1966 were treated as including any amount in respect of the remuneration of directors, then, in the case of a trading company, that amount was apportioned between the two parts of the period and the amount apportioned to the part up to 5th April 1966 could be treated as a distribution for section 245 purposes. In the case of a company which was not a trading company, the whole amount was taken into account in the part of the period falling in the year 1966/67.

It has been seen that, although the provisions of section 245 were penal in that the whole of the actual income of the company, as computed for tax purposes, could be apportioned among the members and charged to surtax accordingly, it was recognised that a trading company could not normally be expected to make a full distribution of all its income. It was customary for the Special Commissioners to invite a company to discuss its affairs if they contemplated action against the company under section 245. It was usual for settlements to be arranged on the basis that the company would pay late dividends whereupon the Special Commissioners would refrain from taking action under section 245 for the years in question.

This was often of considerable advantage. What was a reasonable distribution for section 245 purposes was always a matter to be decided in the light of the facts and circumstances of the case. It could not be expected that the Special Commissioners, not being businessmen, would look at the circumstances of a case in precisely the same way as the directors of the company would do. Nevertheless, the settlments were normally a very good thing for both sides.

The fact that, when a case was taken to appeal, the whole of the income of the company as computed for tax purposes was at risk, and not merely a reasonable distribution, did deter companies from going to appeal in many cases where a particular point of principle was at stake and companies preferred to agree a compromise which involved liability on only a part of the profits of the company.

Under the 1965 legislation the required standard in the case of a trading company did not extend to the whole income of the company and therefore companies were more prepared to have points of prinipIe argued before an independent tribunal.

One of the difficulties taxpayers and their advisors found in dealing with the application of sections 77 and 78 FA 1965, when they replaced section 245, was to distinguish between the old law and the new law. Taxpayers and their advisers had to put section 245 out of their minds but the Inland Revenue did not suffer from this difficulty. The administration of section 245 was carried out by the Companies Division of the Special Commissioners, whereas the section 77 and 78 provisions were administered in individual tax districts by Inspectors who had no practical experience of the operation of the old law.

The object of section 245 was to prevent the avoidance of the payment of surtax through the withholding from distribution of the income of a close company. It was not aimed at preventing loss of income tax because companies were charged to income tax on profits and income up to 1965/66 and this was an important difference between section 245 and section 77. Surtax did not affect all shareholders, whereas income tax affects all those who have income in excess of their allowances and reliefs. Section 77(1) therefore provided that, if a close company had a shortfall in its distributions, there was to be assessed on and recovered from the company as if it were an amount of income tax chargeable on the company, an amount equal to the income tax for which the company would be liable to account under Schedule F on a distribution equal in amount to the shortfall and made 12 months after the end of the accounting period.

Section 245 was thus intended to prevent the avoidance of surtax, whereas section 77 was aimed at preventing the avoidance of income tax, with section 78 as a consequential preventative measure so far as surtax was concerned.

A further important difference was the type of company to which the old law and the new law was directed. Section 256 provided that section 245 should apply to any company under the control of not more than five persons and which was not a subsidiary company or a company in which the public were substantially interested. Section 77, however, was concerned with close companies and paragraph 1, schedule 18 FA 1965 defined such a company as one which was under the control of five or fewer participators or of participators who were directors.

The term "participator" was wider than the term "member" because loan creditors are participators. Loan creditors were important to some extent where an investment company came within section 245 but control by loan creditors could bring a company within the definition of close company for the purposes of section 77, even if it were a trading company.

Under section 245, there was no half-way house. If the company was able to satisfy the Special Commissioners that its distributions were reasonable, having regard to all the circumstances and in particular to the current requirements of the company's business and to such other requirements as might be necessary or adviseable for the maintenance and development of that business, there could be no liability under the section in the case of a trading company.

If, however, the company could not satisfy the Special Commissioners in this way, the whole of the actual income of the company for all sources for the period in question could be the subject of apportionment among the members of the company with a resultant charge to surtax. In practice, the Special Commissioners, as has been seen, were usually willing to agree a negotiated settlement in the case of a trading company on a reasonable basis. This was, however, a rather inexact science.

Furthermore, the old law was penal in its effect if it applied to the full extent, whereas section 77 placed an upper limit on the required standard for distributions equal to the amount of the company's distributable investment income plus 60% of its estate or trading income. The new law, therefore, recognised that a company with estate or trading income needed to retain 40% of that income net of corporation tax for the maintenance and development of the business. But, when considering this aspect of the matter, it must not be forgotten that section 77 required the company to account for income tax on whatever distributions were considered to be proper out of its estate or trading income, with a maximum of 60%. Under section 245, any income tax deducted from dividends could be retained by the company against its own liability and section 245 was concerned only with the surtax charge on the close dividends.

Under section 245, the Special Commissioners were empowered to make a direction and, if the case went to appeal, the onus was on the Revenue to show that the direction was justified in the light of the circumstances of the case. Section 77(2), on the other hand, placed the onus on the company where it sought to retain a larger sum than the 40% of the estate or trading income authorised by the Act. It was for the company to show that distributions up to the maximum required standard could not be distributed without prejudice to the requirements of the company's business. Nevertheless, section 77(3) provided the rule that, in arriving at the required standard for any accounting period, regard had to be had not only to the current requirements of the company's business but also to such other requirements as might be necessary or adviseable for the maintenance and development of that business.

It can therefore be seen that there were important differences between the apportionment regime under section 245 and the allied provisions of the ITA 1952 and the shortfall provisions of the FA 1965.

Later Developments

The development of the appointment legislation since 1922 has been examined in this Part. The legislation went through three more changes, two of which it is only necessary here to mentioned because they are fully dealt with in other works.

Liability to surtax ceased to apply at the end of the tax year 1972/73 and the apportionment provisions were redrafted and set out in section 94 and Schedule 16, FA 1972. Details of the redrafted legislation can be found in, for example, "Taxation of Companies" by Richard Bramwell and John Dick.[125]

Section 44 and Schedule 9, FA 1980 made an important change to the apportionment rules for accounting periods ending on or after 27 March 1980. This followed the reduction of the top rate of income tax on earned income to 60% in 1979. The main affect of these changes was to remove trading income from shortfall liability. Many trading companies thereafter fell outside the ambit of the apportionment legislation altogether. The legislation, as thus amended, is discussed in detail in "Taxation of Companies and Company Reconstructions" by Richard Bramwell, Thomas Ivory and Guy Brannan.[126]

Reference to the apportionment legislation in its 1972 and 1980 manifestations will disclose that the substance of the provisions had not changed. By this time, although the drafting and form, to a certain extent, had altered from the pre-1972 legislation, the structure and thrust of the legislation had been moulded by the decades of activity to which the apportionment rules had been subject; the substance of the legislation did not change although the legislation was eased over the years,

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125. 2nd edition, 1979
126. 3rd edition, 1985

particularly in 1980, as mentioned above. It is not intended to examine these provisions here.

However, what does call for comment is the fiasco surrounding the abolition of the apportionment legislation, and its replacement by the "Close Investment Companies" legislation in 1989. This ridiculous situation was symptomatic of a dangerous trend in modern legislation; major new provisions proposed with apparently little thought being given to the implications, little real consultation and little effective Parliamentary debate on the matter. In this particular case, the Government plans for the replacement of the apportionment legislation were so patently ill-conceived, and the protests so vehement, that the original proposals had to be hastily scrapped.

The first indications of these new rules came in an Inland Revenue Press Release issued on Budget day 1989 (14 March) misleadingly entitled "Abolition of Close Company Apportionment"; misleading because, although it did indeed foreshadow the end of apportionment, it did not exactly highlight in its title or initial paragraphs, the major proposals for its replacement. It was only when the reader examined the details did the full picture emerge; a picture of proposals so shortsighted as to be barely credible. It is also interesting that the Budget Speech itself contained no reference whatsoever to these major and radical changes.

The Press Release claimed that:

> "some provisions are still needed to deal with the small minority (probably less than 5 per cent) of close companies which are largely concerned with passive investments."[127]

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127. Para 3

The proposals applied to a new category of company; the "close investment company" ("CIC") which were defined as close companies other than those:

(a) whose business consists mainly (over 50 per cent) in trading and whose investment income does not exceed its other income; or

(b) which exist mainly to co-ordinate the administration of trading subsidiaries or for the purpose of trades carried on by fellow subsidiaries.

Significantly, dealing in land, shares or securities were not trested as a trade.

A CIC would only be liable to the normal rate of corporation tax (or the small companies rate, if appropriate) if it distributed a specified portion of its profits. These were initially fixed at 70% for CICs whose income comes mainly from property or trading, and 85% in other cases. "Profits", for these purposes, included capital gains and dividends received from other UK resident companies. Failure to satisfy this distribution test for an accounting period would result in a tax liability equal to the higher rate of income tax (40%).

Furthermore, CICs were to be denied the opportunity to obtain a deduction for interest[128] and annual payments which would not be deductible if made by an individual and they would not get tax relief for management expenses or capital allowances on their plant and machinery.

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128. So, for example, interest on loans to repair properties would only have been deductible from rental income. On newly acquired sites, of course, there is often a substantial period in which no rental income arises.

These proposals gave rise to a storm of protest, particularly from the property industry. This is hardly surprising very many companies whose proprietors had no thought of tax avoidance would have been severely disadvantages by these proposals. For example, property dealing and investment companies carrying on their normal commercial activities would, out of sheer business necessity, have to employ staff and rent offices, probably take out loans to acquire property, and quite possibly purchase plant and machinery. They would have been denied the normal tax reliefs their non-close competitors would enjoy, whether or not they passed the distribution test.

What is more, some income, namely, trading income of property dealing companies, which at the time, was outside the apportionment legislation, would have been caught by the CIC provisions.

It is striking that the proposals contained no transitional relief. Accordingly, companies that, for example, incurred management expenses or interest obligations in the past in accordance with the law as it then stoo, would have found that their relief would abruptly have come to an end. Some management expenses, of course, are even required by law, such as those incurred in having accounts audited.

This disallowance of management expenses, interest and capital allowances would have made it impossible for many companies to meet the severe distribution requirement, so they would have suffered corporation tax at 40%. What is more, in many cases, companies whose properties are subject to controlled rents would not have been able to pass on the burden of disallowed expenses etc. or increased corporation tax to tenants. Many would simply have gone out of business.

Particularly aggrieved would have been those individuals who were enticed into investing in assured tenancies under the business expansion scheme by the tax reliefs granted only the previous year[129] and who would have found themselves subject to much more severe restrictions than when they decided to invest their money.

All in all, these proposals showed apparent incompetance and shortsightedness in their originators that is breath-taking. It is astonishing that it should have intended that legislation that had survived and had been adjusted and honed for 67 years, but which had lost most of its purpose, should be swept away and replaced by such foolish measures.

The protests were so intense that, less than two months later, the Government had to announce in Parliament the scrapping of these proposals and their replacement by a much simpler system. The details first appeared in an Inland Revenue Press Release issued on the day of the Parliamentary announcement, 25 May 1989. The abolition of the apportionment provisions and the introduction of the new code was eventually embodied in sections 103-107 and Sch 12 FA 1989.

The new code, as enacted, restricted the types of company falling within the definition of CIC: all dealing and trading companies, plus property investment companies were excluded. The only major penalty in the final legislation for being a CIC is that the small companies rate of corporation tax is not available[130] although, in certain circumstances, the tax credit attaching to certain non-dividend distributions is not available.[131]

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129. Section 50 and Sch 4, FA 1988
130. Section 105 ibid
131. See section 106, ibid

PART 8

PERSONAL SERVICE COMPANIES

For many years it was attractive for high earning professionals, particularly in the entertainment field, to sell their services to a company in return for shares. Thereafter, the company would sell the individual's services and receive the consideration, paying the individual his expenses plus a modest "salary". Subsequently, the individual would sell his shares realing a capital sum. He thereby shaved substantial amounts of tax.

This practice became widespread in the 1960's when very high income and surtax rates coincided with very high earning by "pop" stars in the music boom of those years, and also by film actors. So much tax was being avoided that, in 1969, the Labour Government introduced a wide and, as it has turned out, very effective anti-avoidance provision. It has been effective in that it has stopped the schemes against which it was aimed; whether it actually brought in much (if any) extra revenue to the Exchequer is debatable. High earning entertainers, faced with what many considered to be an oppressive tax regime, left the UK in large numbers, taking their high incomes, much of it from non-UK sources, with them.

The most popular manifestation of this scheme was that the individual formed a company and granted it exclusive rights to exploit his services. The shares in that company would then be sold to a public company[1] in return for the issue of either shares or loan stock of the public company. In fact, the scheme was widely known as the "Constellation" scheme after the public company,

1. Sometimes the individual's services would be sold to the public company direct in return for a salary and shares.

"Constellation Investments Ltd"[2] which acquired the services of many entertainers in the 1960's.

If loan stock was taken, it would be converted into shares when the individuals earnings rose to certain specified amounts.

Alternatively, the individual's personal company, instead of being sold to a public company, might exploit the individual's services itself and subsequently be wound up. By this means, instead of the entertainer having to pay income tax and surtax on his earnings at up to 91.25%, he became liable only for capital gains tax on the increase in the value of his shares or loan stock at 30%. The company would also pay corporation tax at 45% so, with capital gains tax on the balance, the combined tax rate was reduced to 61½%.

The provision introduced to stop this kind of avoidance was <u>section 31 FA 1969</u>[3]. This section was drafted in very wide terms and it is not restricted to entertainers, although, in practise, the Inland Revenue have, in most cases, only used it against entertainers, even though other professionals such as estate agents and solicitors, who use service companies to exploit some of their activities can come within the section.[4] The reason for thus restricting its use probably was that the section was seen to be preventing the abuses by entertainers which it was brought in to combat and the Revenue had no desire to apply the section to other individuals who, although within the terms of the section, were not within its mischief. The Revenue's attitude in this respect being different from the one they have taken in many other cases in which anti-avoidance provisions have

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2. Presumably, because it was a collection of "stars"
3. Now section 775 ICTA 1988
4. For an example of the section being used against someone other than an entertainer, see <u>IRC v Brackett</u> [1986] STC 521, infra

caught taxpayers who were not intended to within its ambit.

The most striking contrast is between this section and those provisions which are now sections 703[5] and 739[6] ICTA 1988. All three provisions were introduced to combat specific types of avoidance and they were presented to the House of Commons as so restricted. the legislation that ensued, however, was, in each case drafted in very wide terms; much wider than was required to deal with the mischief of each provision. Only in the case of section 775 has the application of the section been restricted to attacking those schemes with which it was supposed to deal.

Section 775 operates where:

"(a) transactions or arrangements are effected or made to exploit the earning capacity of an individual in any occupation by putting some other person in a position to enjoy all or any part of the profits or gains or other income, or of the receipts, derived from the individual's activities in that occupation, or anything derived directly or indirectly from any such income or receipts; and

(b) as part of, or in connection with, or in consequence of, the transactions or arrangements any capital is obtained by the individual for himself or for any other person; and

(c) the main object or one of the main objects of the transactions was the avoidance or reduction of liability to income tax."

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5. See Part 5, supra
6. See Chapter 9

It is noticeable that the individual's activities have to be from an "occupation". References to an "occupation" are defined as references to "any activities of any of the kinds pursued in any profession or vocation, irrespective of whether the individual is engaged in a profession or vocation."[7] The section does not, therefore, apply to trades.

The section is extended to cover payments for copyright, licences, franchises or other rights deriving their value from the individual's activities.[8]

Where the section applies, income tax (and originally surtax) is imposed on the "capital amount" received by the individual. The charge is under Sch D, Case VI.[9] Also caught is a capital amount received by another person who has been put in a position to receive it by the individual in question.[10]

The provisions of section 775 are supplemented by those of section 777 ICTA 1988. This section, inter alia, extends section 775 by stating that:

> ".... account shall be taken of any method, however indirect, by which -
> (a) any property or right is transferred or transmitted; or
> (b) the value or any property or right is enhanced or diminished....."[11]

The application of the original section was made effectively retrospective because, although it was expressed not to apply to capital sums received before 15 April 1969, sums received after that date were caught by the section even if the transactions giving rise to them

7. Section 775 (3)(a) ICTA 1988
8. Section 775 (3)(b) ibid
9. Section 775 (2) ibid
10. Section 775 (8) ibid
11. Section 777(2) ibid

were implemented before that date. An individual could have put arrangements into operation before 15 April 1969 and subsequently have found that the sums generated by those arrangements were subject to the tax regime imposed by section 31.

It is interesting that five cases have come before the courts dealing with personal service companies, four of which concerned arrangements implemented before section 31 was enacted, and each scheme has failed for other reasons.

The first of the cases came before the courts in 1960 (High Court) and 1961 (Court of Appeal) and concerned the actor Jack Hawkins. His scheme failed, but it appears that the surtax saving part of the arrangement, being implemented prior to the introduction of the anti-avoidance provisions in 1969, would have succeeded. The scheme, however, contained further elements which, as in a later case concerning the actress Hayley Mills, fell foul of the effective and sweeping settlement provisions.[12] The case in question was Crossland v Hawkins.[13]

The first part of the Jack Hawkins scheme followed the conventional course. He formed a company to which he would render his services in return for a low salary (£50) plus expenses. The company was given the rights to assign those services to third parties, subject to Jack Hawkins' approval. This is a typical section 775 situation and, at that time, would have succeeded.

However, his scheme did not stop there. He tried to ensure that the consideration received by the company for his acting services enured for the benefit of his children. The rest of the arrangements are examined in Chapter 2. For present purposes, it is only necessary to note that the formation of the company, together with the

12. These provisions are discussed in Chapter 2.
13. (1961) 39 TC 493

other transactions were held to constitute an "arrangement" within what is now section 670 ICTA 1988 and so the transactions were caught by section 663 ibid. The straightforward first stage of the scheme would not, of course, have been caught by this, of indeed any other, anti-avoidance provision.

Danckwerts J (who was overruled by the Court of Appeal on the settlement point)[14] thought that the formation of the company was a proper commercial way for Jack Hawkins to conduct his career. He said:

> "Eventually what happened was that some £25,000 was received, not by Mr. Hawkins but by the company, as a result of acting by Mr. Hawkins. The money was received by the company and belonged to the company under the arrangements which had been made, and Mr Hawkins was only entitled to payment of £50 a week and his expenses from the company. It has been said: Why on earth should he do that? and it was, I think, suggested that it was not a proper commercial transaction. I do not agree. Having regard to the high incidence of Surtax upon persons who at one moment may make a considerable income, but who would make an income which is always subject to vicissitudes, it has, as is well known, been common practice by people such as actors and actresses to enter into agreements of this kind.... with the very natural object of trying to minimise their liabilities for Surtax and consequent diminution of the results of their labour."[15]

In the Court of Appeal, Donovan LJ described this as "perfectly legitimate and indeed, in the case of persons whose high earnings may be short-lived, understandable."[16]

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14. See Chapter 2
15. p501
16. p502

The next two cases concerned the well-known Mills family; first John and, secondly, his daughter Hayley. In each case the arrangements were implemented before the introduction of the 1969 anti-avoidance provisions, although the Hayley Mills case actually came to court afterwards.

The first of these two cases was John Mills Productions Ltd v Mathias.[17] Here the normal arrangement was set up. It was not this structure which was under attack in this case, even though Ungoed-Thomas J commented that "as was frankly stated in the course of the hearing, the Company in this case is a legal device for tax avoidance, and, so it would appear, designed for not very much else."[17A]

The point at issue was the nature of a sum paid on the termination of a contract with a film production company. The taxpayer company contended that the payment was capital, whereas the Revenue said it was a revenue receipt. The court, in fact, agreed with the Revenue on the facts.

The Hayley Mills case, Mills v IRC[18], was another in which, as with Jack Hawkins' scheme, the normal company arrangement would probably have succeeded, but it was part of a wider arrangement which was caught by the settlement provisions. This wider arrangement is examined in Chapter 2. This arrangement failed because of the operation of what is now section 673 ICTA 1988, Hayley Mills herself being deemed to be the settlor by virtue of her entering into the service agreement with her company which had been formed for her by her father.

The fourth case is different from the others in that, although it was based on the same principle, an entertainer selling her services to a company which would

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17. (1967) 44 TC 441
17A. p453
18. (1974) 49 TC 367

exploit them, it involved a highly artificial pre-packaged scheme. This case concerned a tax-avoidance device known as the "open commercial trust scheme" which was, in this case, used by the actress, Julie Christie. The scheme was viewed with severe displeasure by Templeman J; in contrast to the benign attitude taken by judges in the earlier cases. This case was Black Nominees Ltd v Nicol[19]. It is, thankfully, not necessary to set out all of the steps in this circular and artificial scheme.

The bare bones of the scheme were that a series of three trusts was set up (not by Julie Christie, but by another settlor who played no further part in the transactions). Julie Christie entered into a service agreement with a company called Rosebroom Ltd to provide her services in return for a relatively low salary (£7,500, rising to £13,500 per annum).

Rosebroom Ltd sold to the first trust an option to acquire the services of Julie Christie. The terms of this first trust were that its income for 21 years was settled on the second trust and, in the second trust, the income was held for a discretionary class, including Julie Christie. The third trust was also a discretionary trust but the beneficial class did not include Julie Christie.

The option acquired by the first trust was sold to another company, Cymbeline Ltd. The trustees of the third trust agreed to buy the services which were the subject of the option for £475,000. As Cymbeline received sums from exploitation of Julie Christie's services, the sale proceeds receivable by it were reduced accordingly.

The trustees of the third trust had to deposit the £475,000 with a stakeholder, but as the amount it had to

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19. (1975) 50 TC 229

pay to Cymbeline reduced as mentioned above, the amount by which it was reduced was released to them.

The trustees of the second trust had sold their rights to the income for 21 years to Cymbeline for £475,000, which they then lent to the trustees of the third trust, to given them the funds to lodge with the stakeholder.

It can be seen that the £475,000 passed in a circle.

Black Nominees were, in fact, the trustees of the second trust. As Julie Christie's services generated fees, they were used by Cymbeline to reduce the sum deposited by the trustees of the third trust with the stakeholder and, as the funds were returned by the stakeholder to the trustees of the third trust, those released funds were used to repay the loan from Black Nominees, the trustees of the second trust.

Black Nominees were assessed to income tax on the sums they received in the form of loan repayments; whereas the company contended that they were capital receipts (ie proceeds from the sale of trust property). The sums were, therefore, available, so it was argued, to be applied for Julie Christie's benefit free of tax.

Templeman J held that the only effect of the payments by which £475,000 passed in a circle was that profits from the rights to exploit Julie Christie's services were distributed between Julie Christie and those acting in her interests, on the one hand, and the financiers, on the other. Black Nominiees received its share of those profits in the form of the repayments and they were assessable under Case VI of Schedule D.

The judge, as in other cases in which he was faced with highly artificial arrangements, used colourful language in denouncing the scheme. The banker's draft representing the £475,000 was, he said, only a "baton stick" which each holder was bound to hand on "until the end of the race against the Revenue". The documents effecting the various transactions constituted a "trick" and the purchase price was a "fake".[20]

The writer has been informed by one of the solicitors involved in this case that, at one stage in the case, Templeman J took the view that the transactions in this scheme were so complicated that he suspected that the object of some of them was merely to obscure what had really happened and that the whole plan was bordering on evasion. It was only after he was informed that the scheme had been approved by several leading members of the Bar, more than one of whom had, by that time, been elevated to the Bench, that he dropped any thoughts of evasion.

Finally, reference should be made to IRC v Brackett[21], a case concerning a chartered surveyor who entered into a contract with a Jersey company for the exploitation of his services. Although he was assessed under, inter alia, section 775, it was held that his arrangements fell foul of section 739 ibid and section 79 TMA 1970, so seciton 775 was not decided by the court.[22]

To conclude, despite the fact that no taxpayer has actually lost a case in the courts under section 775, on the whole, the section appears to have been successful in preventing the worst abuses. The success of the section is partly due to the wide terms in which is has been drafted, but also the selective manner in which it has been used by the Inland Revenue. In fact, the section has greater potential than has to date been exploited by the Revenue. At the moment, however, with individual tax rates being so low in the UK, there is little incentive to get involved with the sort of schemes that are likely to be attacked by the section unless, as in Brackett's

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20. p280
21. [1986] STC 521
22. See Chapter 9

case, an attempt is made to use a company in a low tax area, in which case, the arrangements are probably susceptible to attack under other provisions.[23]

On the subject of personal services, and other "one man" companies, reference should be made to Chapter 9, where the use of such companies in an international context is examined; Chapter 10, Part 1, where the different approach of the courts in the USA to this problem is discussed; and the Chapter 12, where there is an examination of the general topic of "piercing the corporate veil".

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23. See Chapter 9

CHAPTER 2

THE EXPLOITATION OF SETTLEMENTS

INTRODUCTION

As soon as taxpayers began seriously to think of ways of avoiding tax, they saw settlements as an ideal vehicle, particularly for spreading income and capital amongst their families while, at the same time, retaining control or the ability to benefit from the income or capital; or, perhaps to unwind the settlement in the future.

In this Chapter, the use of settlements for the purposes of income tax and surtax avoidance is examined. Their use to avoid capital gains tax is considered in Chapter 8 and various international aspects of the avoidance of settlements and trusts are dealt with in Chapter 9.

The Legislature took action very early to prevent the exploitation of settlements for the purposes of income tax and surtax avoidance: the first anti-avoidance legislation was enacted in 1922. Since that time, the legislation has been considerably tightened and extended as Parliament has fought to match the ingenuity of taxpayers and their advisers.

The result is that there is now a comprehensive, thorough and wide-ranging collection of measures now contained in Part XV ICTA 1988, bringing within their boundaries arrangements which no-one unfamiliar with tax law would ever consider to be "settlements". The various definitions of "settlement" used in Part XV cover a much wider area than the normal trust law definition and the definitions used, for example, for the purposes of capital gains tax[1] and inheritance tax.[2]

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1. See sections 46, 51, 61(4) and 93 CGTA 1979
2. See sections 43 and 44 IHTA 1984

Although the various settlement provisions are now collected together in Part XV, they have been introduced and amended at various times over the last 68 years so they do not represent such a unified whole as might be expected. To take just one example, that will be examined in details in this Chapter, the various sections are not even consistent in their definitions of "settlement".

The position was summed up well by Walton J who said:

> "The difficulty, of course, in discerning any consistent pattern in the various Chapters of Part XVI of the 1970 Act[3] is that they all spring from totally different origins, and thus do not in any sense represent a 'code', in any shape or form."[4]

The format of this Chapter is that in Part 1 the extremely wide meaning of "settlement", and related expressions, for income tax purposes is considered. Certain limitations of this means are dealt with in Part 2. Parts 3 to 8 each examine a particular provision or group of provisions that have been introduced over the years and are now contained in Part XV ICTA 1988.

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3. The predecessor to Part XV, ICTA 1988
4. Ang v Parrish [1980] STC 341 at p 345

PART 1

THE DEFINITION OF "SETTLEMENT"

Introduction

There are effectively three definitions of a settlement for the purposes of Part XV ICTA 1988.

Section 660[5] deals with dispositions for periods which cannot exceed six years. The term "disposition" is defined as including:

> "any trust, covenant, agreement or arrangement".[6]

Settlements on children[7] are governed by section 663 et seq. For the purposes of this section "settlement" includes:

> "any disposition, trust, covenant, agreement, arrangement or transfer of assets."[8]

The various other sections[9] are subject to the definition of "settlement" in section 681(4) which states that it includes:

> "any disposition, trust covenant, agreement or arrangement."

Similarly, there are two definitions of "settlor". The one covering settlements on children is:

> "'settlor', in relation to a settlement, includes any person by whom the settlement was made or entered into directly or indirectly and, in particular (but without prejudice to the generality

5. See Part 5, infra
6. Section 660(3) ICTA 1988
7. See Part 3, infra
8. Section 670 ICTA 1988
9. See Parts 4 to 8

of the preceeding words of this definition) includes any person who has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."[10]

The other definition is:

"'settlor' in relation to a settlement, means any person by whom the settlement was made; and a person shall be deemed for the purposes of this Chapter[11] to have made a settlement if he has made or entered into the settlement directly or indirectly, and, in particular, but without prejudice to the generality of the preceding words, if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."[12]

Not only are these definitions widely drafted but they have been given a wide interpretation by the courts. An analysis of the cases will show just how many transactions full within these definitions. The elements of the definitions that have come in for judicial examination are dealt with below.

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10. Section 670 ICTA 1988
11. Chapter III of Part XV ibid. The same definition is also used for Chapter IV.
12. Section 681(4) ibid.

"Arrangement"

This term is in each of the definitions and it has come in for considerable judicial examination over the years. It is an indication of the broad interpretation given by the courts to this term that of all the cases in which it has been considered, with only a few notable exceptions, went in the Crown's favour.

The first of the cases in question was IRC v Clarkson-Webb.[13] This case concerned mutual covenants executed by two brothers in favour of the other's children. Finlay J held that the two covenants were part of an "arrangement" which must be looked at as a whole and that, in substance, the two covenants constituted one disposition for the purposes of section 20 (1)(c) FA 1922.[14]

In these days of highly complex arrangements, it seems strange to see the judge referring to this as "a curious case.... not free from difficulty"[15], particularly when it was not denied by the taxpayer that each brother wanted to make provision for the benefit of his own child and that, in consideration for one brother making provision for his nephew, the other brother would do the same.

The question, as identified by the judge, was whether one was entitled to look at the two deeds together. He said:

> "I think one is. Of course, if one looks at only one deed, if one looks only at the deed whereby the [taxpayer] settles the sum of money and covenants to pay the sum of money to his brother for the brother's infant son, quite clearly that would not be a disposition for the benefit of his own son. But it seems to me that when one looks at the facts

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13. (1933) 17 TC 451
14. See Part 3 infra
15. p445

as they are found and when one appreciates ...... that this is part of one transaction and that the [taxpayer], by making this provision for the benefit of his nephew, is, I think, directly procuring the making of a provision precisely of the same amount for the benefit of his own son, one ought to look at the substance of the matter and one ought to look at these deeds together. You constantly must look at several deeds to get the true effect of an arrangement. I think one ought to look at these deeds together, and if one does, it seems to me to be reasonably plain that this was, in substance, the procuring of an arrangement by the [taxpayer], the arrangement being that he was to provide £350 a year for the benefit, really of his own son. I have no doubt, it is stated in the case, that the brothers went through what I cannot help regarding as being the form of handing over cheques. In substance, as they were the trustees, that form does not seem to me to affect the matter."[16]

The judge held that the dispositions "were made by mutual arrangement; and ...... they were part of an arrangement which must be looked at as a whole, with the result that they really for this purpose, constituted one disposition".[17]

In the circumstances of the case, it is difficult to see that Finlay J could have come to any decision other than that there was an "arrangement" in this case.

It should be noted that the definition of "settlor in section 21(9)(c) FA 1936 [18] specifically dealt with reciprocal arrangements. Presumably, Parliament had Clarkson Webb in mind when that definition was being drafted.

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16. pp456-7
17. p457
18. Now contained in section 670 ICTA 1988

A rather more complicated transaction was held to be an "arrangement" and therefore a "settlement" in the case of Copeman v Coleman.[19]

A company was formed to take over the taxpayers business. It had a share capital of £1,000 in £1 shares which were held equally by the taxpayer and his wife, who were also the directors.

A few months later, the company increased its capital to £6,000 by the creation of 25 preference shares of £200 each, entitled to a 10% preference dividend and, thereafter, to participate with the existing ordinary shares in amounts available to dividend. The preference shareholders were only entitled to vote if the preference dividend was more than three months in arrear. The rights of the preference shareholders could be increased, reduced or abrogated by the company in general meeting.

The preference shares were allotted to relations of the taxpayer, one being issued to each of his minor children, on payment of £10 cash, which came from the children's own resources. £190 was left uncalled.

Shortly afterwards, the company declared a dividend of 20%, free of tax, on the preference shares and, accordingly, each child received £40, equivalent to a gross dividend of £52 9/2d, less tax of £12 9/2d. By the same resolution that authorised the dividend, a call of £40 on each share was made.

The taxpayer claimed, on behalf of the children, repayment of income tax on the dividends. However, the Crown contended that, having regard to the effective control of the company by the taxpayer and his wife, the resolution and the allotment of the preference shares to

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19. (1939) 22 TC 594

the children constituted an "arrangement" which was a settlement within section 21 FA 1936,[20] that the taxpayer was a settlor within that section as being a person who "has provided..... funds directly or indirectly for the purpose of the settlement" and, accordingly, that the dividends must be regarded for income tax purposes as income of the taxpayer, and not of his children.

The Crown contended that the transactions by which these shares were created and allotted to the preference shareholders, including the children, was not a bona fide commercial transaction. The Crown relied upon the fact that the children could not have been called upon to pay up the unpaid capital of £190 per share, and that there could not have been a genuine intention to raise capital as the company received only £250 and within two weeks distributed £1,000. The Crown also pointed to the provisions for altering the rights of the preference shareholders, the power to create further capital ranking in priority to the preference shares, and the insignificant voting rights attaching to the preference shares. It was argued by the Crown that, in order to be excluded from the section, the transaction must be a bona fide commercial one.

With reference to the definition of "settlor" in section 21(9)(c) FA 1936, the Crown contended that the taxpayer was a person by whom the settlement was made or entered into indirectly and that, in any event, he was a person who provided the funds indirectly for the purpose of the settlement because, by using the legal framework of the company which he and his wife entirely controlled, he made the settlement in consequence of which his children derived the income.

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20. See part 3, Infra

Lawrence J agreed, saying:

> "In my opinion, it is impossible to come to any other conclusion but that this was not a bona fide commercial transaction, and it appears to me that there was a disposition within the meaning of the definition in subsection (9), or an arrangement in the nature of a disposition within the meaning of that subsection."[21]

Another case in which the taxpayer's control over a company was a vital factor in the finding that there was an "arrangement" was IRC v Payne [22], a case under section 38 FA 1938. [23]

The taxpayer controlled a company, Derwent Limited. He covenanted to pay to the company, for the remainder of his life or until a resolution for winding up the company was passed, such a weekly sum as after deduction of tax would amount to £72. The aggregate of 52 weekly payments up to the 31st March 1938 (two days after the date of the deed) was to be paid on or before that day. Six months later, it was resolved that the company should be wound up. Prior to 31st March 1938, £3,744 had been duly paid to the company.

The Revenue refused the taxpayer's claim to deduct the corresponding gross sum (£4,922) from his income for Surtax purposes, claiming, inter alia, that:

(1) The deed of covenant, together with the whole framework of Derwent Ltd, which the taxpayer controlled, was a settlement within the definition in section 41(4)(b) FA 1938.[24]

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21. p601
22. (1940) 23 TC 610
23. See Part 4, infra
24. The predecessor to section 681(4) ICTA 1988

(2) The taxpayer was the settlor, as he was the person who entered into the deed, and was also the person responsible for the setting up of Derwent Ltd, which he controlled.

(3) Accordingly, the sums payable by the taxpayer under the settlement fell to be treated as his income.

It is clear that Derwent Ltd was set up specifically to avoid tax[25] and that the covenant had no business purpose whatsoever and, furthermore, that it was linked up with the rest of the scheme.[26]

Sir Wilfrid Greene MR addressed himself to the question of whether there was here a settlement of which the taxpayer was settlor having regard to the relevant definitions in section 41(4)(b) and (c). He was clearly of the opinion that the taxpayers was the settlor of a settlement within the section. He said:

> "The word in the definition clause of 'settlement' which is relevant to that question is the word 'arrangement'. The word 'arrangement' is not a word of art. It is used in my opinion, in this context in what may be described as a business sense, and the question is: can we find here an 'arrangement' as so construed? It is said that the only element in this transaction which falls within the definition of 'settlement' is the deed of covenant itself. I am unable to accept that argument. It appears to me that the whole of what was done must be looked at; and when that is done, the true view, in my judgment, is that [the taxpayer] deliberately placed himself into a certain relationship to the

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25. See Lawrence J at first instance, at p619
26. See Sir Wilfrid Greene MR in the Court of Appeal, at p624

company as part of one definite scheme, the essential heads of which could have been put down in numbered paragraphs on half a sheet of notepaper. Those were the things which it was essential that [the taxpayer] should do if he wished to bring about the result desired. He did it by a combination of obtaining the control of the company, entering into the covenant, and then dealing with the company in such a way as to achieve his object. Now, if a deliberate scheme, perfectly clear cut, of that description is not an 'arrangement' within the meaning of the definition clause, I have difficulty myself in seeing what useful purpose was achieved by the Legislature in putting that word into the definition at all. I am clearly of opinion that, by placing himself into these relationships with the company, [the taxpayer] was engaged in making an 'arrangement' within the meaning of that clause. That he was the settlor under it is manifest, and I need not take up time in dealing with that aspect of the matter."[27]

A very similar case was Burston v IRC.[28] The taxpayer formed a company with a capital of £500, dividend into 490 £1 preference shares and ten £1 ordinary shares. The taxpayer had control of the company by virtue of his holding of the preference shares, and on a winding up of the company, he would be entitled to all the surplus assets. The taxpayer entered into a covenant to pay to the company for a period of eight years, or for the remainder of his life, whichever should be shorter, an amount equal to three quarters of the net dividends for the year.

Less than a year later, the capital of the company was increased to £1,500 by the issue of ordinary and deferred

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27. p626
28. (1942) 24 TC 285

shares, and an alteration of rights was effected, by attaching to the new shares the right to the surplus profits and assets on winding up. The taxpayer was given the option of subscribing up to 100,000 of the new shares and, as a result of the option, the taxpayer was in a position to secure substantially all of the company's income and assets.

At the same time, the taxpayer executed an irrevocable settlement of £2,000 for his children. The trustees invested £1,000 out of this sum in purchasing some of the new deferred shares. Shortly afterwards, the taxpayer paid to the company over £32,000 in pursuance of the covenant.

Lawrence J, as he had done in Payne, held that the various transactions constituted an "arrangement", so as to render the sums paid under the covenant the taxpayer's income under section 38 FA 1938.

Before the end of the 1940's there were several other cases, besides Payne and Burston (with Copeman v Coleman in 1939) in which the meaning and scope of the word 'arrangement' would be in point. Like Copeman v Coleman, Payne and Burston, each involved the formation of a company. It is instructive to examine the transactions in these cases and the way they were viewed by the courts that dealt with them, because, although most of the early cases went in favour of the Crown, three important decisions went in favour of the taxpayer.

The first of these to consider is IRC v Prince-Smith.[29] Here, the taxpayer owned all but 401 of the 50,000 shares in a company. His father executed a settlement of £2,500 on trust for the taxpayer's children. The trustees, pursuant to an express agreement to that effect between

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29. (1943) 25 TC 84

them and the taxpayer, invested this money in the purchase of the 50,000 shares. There was an alteration of rights, the 50,000 ordinary shares being converted into preference shares with a right to a fixed non-cumulative dividend of 50%.

It was held by Macnaghten J that all these transactions constituted an "arrangement".

Although this settlement was not a "revocable" one for the purposes of section 21(8) FA1936 [30], most of the payments were for a period of less than six years and so fell to be regarded as the taxpayer's income.

Another decision of Macnaghton in 1943 was Macandrew v IRC. [31] Here the taxpayer acquired all the shares in a company and transferred all the preference shares and 5,590 of the ordinary shares to his wife and one of his daughters (who died in 1939), who in 1928 executed a declaration of trust declaring that they held the shares as both capital and income for the wife and children of the taxpayer as he should appoint. The remaining 10 ordinary shares were held as to 5 by the taxpayer and 5 by his son. The income of the company was accumulated and no dividends were declared, and the whole of the company's income was treated as the taxpayer's income by virtue of section 21 FA 1922, section 15 FA 1939 [32] and, for 1937/38, section 38 FA 1938.

By a deed dated 11 July 1940, the taxpayer's wife, son and his other daughter consented to the payment to the taxpayer of all income (less tax) arising from the shares subject to the earlier declaration of trust which had been, or should be, treated as the taxpayer's income for tax purposes, and the taxpayer covenanted to pay, less

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30. See Part 4, infra
31. (1943) 25 TC 500
32. See Chapter 1, Part 7

tax, to his surviving daughter, as trustee for her two infant children, in each year commencing with the year ending 5 April 1941, an amount equal to the gross income which he should have received in that year from the company under the above consent. Pursuant to the authority in the 1940 deed, the company paid £2,592 (out of undistributed profits) to the taxpayer in 1940/41, and the taxpayer paid this sum to his daughter, as trustee for her children.

The taxpayer claimed a surtax deduction in 1940/41 in respect of the sum of £2,592. The Crown contended that the structure of the company and the various transactions, including the original declaration and the 1940 deed, which could be determined by the winding up of the company, so that the sum of £2,592 must be treated as income of the taxpayer under section 38(1).

Macnaghton J held that, as the taxpayer's wife could wind up the company, and thereby put an end to the covenant by the taxpayer under the 1940 deed, the income arising from the shares in question must be deemed to be his under section 38(1), and that the deduction could not be allowed.[33]

However, in the light of Chamberlain's case,[34] which had by this time been heard by the House of Lords, this finding seems incorrect. The judge did not mention Chamberlain and it seems likely that the taxpayer, who appeared in person, did not bring the House of Lords' decision to Macnaghton J's attention. That being so, the judge would have been influenced by the Special Commissioners' findings, which would have been based on the much wider approach of the Court of Appeal in Chamberlain, which was overruled by the House of Lords. Considering that Macnaghton J stated that the

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33. See p506
34. <u>Chamberlain v IRC</u> (1943) 25 TC 318, infra

"settlement" in MacAndrew included the transfer of shares to the taxpayer's wife and the 1940 deed, he cannot have had the House of Lords' judgments in Chamberlain in mind.

Lord Normand in the Wolfson case [35] was of the opinion that MacAndrew was wrongly decided. He said:

> "... I think that MacAndrew v Commissioners of Inland Revenue .... may be inconsistent with the conclusion to which I have come.[36] The report of this case is not satisfactory, but I assume what was stated by Counsel in this appeal, that according to the Crown's case the deed of 11 July 1940 alone constituted the settlement. On that assumption [37] MacAndrew's case was on all fours with the present case and must be regarded as wrongly decided."[38]

The other Law Lords reserved the question of whether MacAndrew was rightly decided .

In the following year, there was the case of Jenkins v IRC[39]. The taxpayer here formed an unlimited company with a share capital of £26,000 dividend into 5,000 'A' and 21,000 'B' shares of £1 each. The profits of the company were to be applied, firstly to payment of a non-cumulative 2½% preference dividend to the holders of the 'B' shares, and next to payment of a dividend to the holders of the 'A' and 'B' shares, or to the holders of one or other of these two classes to the exclusion of the holders of the other. On the winding up, the 'A' shares were entitled to payment of double their capital. The holders of the 'A' shares were entitled to forty votes per share, whereas the holder of the 'B' shares were entitled to only one vote per share.

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35. Wolfson v IRC (1949) 31 TC 141 infra
36. Examined infra
37. Which, in fact, was not the basis of the judgment of Macnaghton J.
38. p171
39. (1944) 26 TC 265

The taxpayer and his wife each subscribed for one 'A' share and the taxpayer was appointed governing director for life.

On the same day, another company was registered which was identical in all respects, except for the fact that the capital consisted of £38,000, dividend into 12,000 'A' shares and 26,000 'B' shares of £1 each.

After the formation of these two companies, the taxpayer settled £500 on each of his three daughters, the trustees being his wife and secretary. The powers to invest and to borrow conferred on the trustees were exercisable only with the taxpayer's consent.

The trustees invested in 21,000 'B' shares in one of the companies, the "Woodlands Company", making up the deficiency by a loan of £19,000 from the taxpayer. The taxpayer himself subscribed for 4,988 'A' in the Woodlands Company. The Woodlands Company subscribed for 26,000 'B' shares in the other company, the 'Dilnot Company', the taxpayer himself subscribing for all but one of the 'A' shares in the Dilnot Company. The taxpayer then sold property to the Dilnot Company for £48,699, the taxpayer advancing £2,699 to the Dilnot Company for this purpose.

It was held, in effect, that the medium of these companies had been employed, and the settlements and the purchase of the shares effected, in such a way that an "arrangement", and consequently a "settlement", had been constituted.[40]

However, as will be explained below,[41] this settlement was held not to be revocable or determinable by the

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40. See also IRC v Wachtel (1970) 46 TC 543, infra
41. See Part 3, infra

taxpayer notwithstanding that he had the power to wind up the the companies and thereby to return to his own pocket the whole of the trust funds. It should be noted, however, that what was under consideration here was the special meaning of "revocable" in section 21(8) FA 1936[42], not under what is now section 671 ICTA 1988.[43]

It was also held, however, that, as the trust income might because payable to the taxpayer, he held an interest in the income, so that the income for the year 1937/38 was caught by section 38(4) FA 1938.[44]

It can be seem from the above cases that the word "arrangement" has brought with the "settlement" provisions a wide range of transactions. However, there are limits to this as the next line of cases demonstrates. In one of the cases that went in favour of the taxpayer, Wolfson,[45] the House of Lords expressly reserved the question how far the Payne[46] decision can still be regarded as correct in the light of the decision in the first of the cases to be decided in favour of the taxpayer, Chamberlain.[47]

However, before considering Chamberlain, it is necessary first to deal with three other cases in which the Crown triumphed because Chamberlain and the third case to be decided in favour of the taxpayers, Vestey[48], placed important limitations on the meaning of "arrangement" as interpreted in the earlier cases.

Three cases must be examined here, two heard by the Court of Session and one by the High Court, the decisions in which were all given in a period of less than four months in 1941.

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42. Now section 665 ICTA 1988, see Part 3, infra
43. See Part 4, infra
44. Now section 673 ICTA 1988, see Part 6 infra
45. Wolfson v IRC (1949 31 TC 141 infra
46. IRC v Payne (1940) 23 TC 610 supra
47. Chamberlain v IRC (1943) 25 TC 318 infra
48. Vestry v IRC (1949) 31 TC 1 infra

The first of these cases was IRC v Morton[49]. The facts of this case were that the taxpayer and his wife transferred to an unlimited company assets at a price of £308,000, which was satisfied by the allotment of 308,000, shares in the company. Of these, 150,000 8% cumulative first preference shares and 83,000 6% cumulative second preference shares were allotted to the taxpayer and his wife, and a total of 75,000 ordinary shares were allotted to their son and to trustees under deeds of trust, executed on the same day, in favour of their three daughters.

The articles of association provided that each share carried one vote, so the taxpayer and his wife controlled the company. It was also provided that, in any return of capital to the shareholders, no payment should be made to the ordinary shareholders until all claims of the preference shareholders had been satisfied.

The taxpayer was assessed to surtax in a sum representing the difference between the total income of the company and the amount distributed to the taxpayer and his wife in the form of dividends.

The questions for the decision of the Court of Session were, firstly, whether there was an "arrangement" and therefore a "settlement" within the meaning of section 41(4)(b) FA 1938 and, secondly, whether the taxpayer and his wife had power to revoke the settlement. Although the issue of revocable settlements is considered in detail later,[50] the decision of the court on this point will be mentioned here because it turns on what falls within the "arrangement" and what does not.

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49. (1941) 24 TC 259
50. See Part 4, infra

The Court of Session held that the whole transaction was an "arrangement" within section 41(4)(b) and, Lord Moncrieff dissenting, that the taxpayer and his wife, by their control of the company, had power to determine the settlement, and that, on such a determination, they might become beneficially entitled to the whole property comprised in the settlement and that, accordingly, the whole of the income of the settlement fell to be treated as income of the taxpayer.

Lord Fleming, agreeing with the Crown's contention that the transaction to which the taxpayer and his wife were parties fell within the meaning of "arrangement", commented:

> "The transaction involved the obtaining of the consent of a number of persons to it, namely, the [taxpayer], his wife, their son and the trustees for each of the daughters. It also required that the [taxpayer] and his wife should mass their property together and transfer the estate so massed to a company, which they themselves created, in return for which they were to be allotted specified amounts of the different kinds of shares in the company. I think it must be taken that it was a part of the intention of the [taxpayer] and his wife that they should make a provision out of the funds belonging to them for their issue as well as for themselves, and, accordingly, they arranged with the company that the ordinary shares which fell to be allotted to them should be allotted to the son and to the trustees for the daughters. To make the provisions effective it was, of course, necessary that this allotment should be accepted by the beneficiaries. It appears to me that all the things that were done by the [taxpayer] and his wife were just one scheme or transaction and the term 'arrangement' is apt to describe what was done."[51]

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51. p266

Lord Fleming noted that there is a wide difference between a body of trustees and a company and also between property belonging to an individual absolutely and property belonging to a company of which the individual is a member. But, here, he thought, an unlimited company was interposed between the settlors and the beneficiaries "for, inter alia, the purpose of defining the rights of the settlors and the beneficiaries in the property transferred and of imposing drastic restrictions both on the settlors and the beneficiaries with regard to the right of alienation".[52] The rights of the various parties in the company, he said, were determined by their share-holdings and by the documents constituting the company.

He noted that, in Payne's case, the Court of Appeal considered that an obligation by an individual to pay a fixed sum to a company controlled by him during his own lifetime or until the winding up of the company was a "settlement". He agreed and regarded the present case of being a fortiori of it.[53]

Lord Fleming then considered what was "the property comprised in the settlement". He thought it was the whole assets which the taxpayer and his wife transferred to the company. He continued:

> "The funds required for carrying out this transaction were specific assets which belonged to the [taxpayer] and his wife at the time of the transaction. This is not a case where a sum of money was settled, nor can the shares of the company be properly regarded as the property comprised in the settlement, because in my view the function of the company was to act merely as a piece of machinery for the purpose of holding the settled property and of defining the rights of parties

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52. Ibid
53. Ibid

> interested in it. This does not mean that the company was under any obligation to retain the investments transferred by the [taxpayer] and his wife in forma specifica, but it does not mean that the property comprised in the settlement is the whole capital assets of the company."[54]

The Lord President (Normand) agreed, although he appeared to go further as regards the definition of "arrangement". He said that, to be described as an "arrangement" something must have "a certain unity in its composition". He was of the opinion that:

> "all the components of the arrangement - the agreement of the [taxpayer] and his wife to transfer their massed property to the company, the allotment arrangements, the structure of the company itself as expressed in its memorandum and articles and in general company law, and the trust deed in favour of daughters - constitute a single whole contrived and fitted so as to settle funds belonging to the [taxpayer] and his wife, though that may not have been their sole purpose."[55]

Lord Carmont agreed with Lord Fleming, although he did admit to having had "some difficultly in applying the statutory definition of 'settlement' to the facts of this case."[56] This is surprising, given the clear state of the authorities at the time.

Lord Moncrieff, however, while agreeing that there was an "arrangement" within section 41(4)(b), did not think that the taxpayer and his wife could revoke the settlement. The reason for this is important in the light of the Chamberlain and Vestry cases. Lord Fleming and the Lord President considered that because the "arrangement" included:

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54. pp266-7
55. p271
56. p272

(1) the agreement of the taxpayer and his wife to transfer their assets to the company;
(2) the formation of the company;
(3) the memorandum and articles of association;
(4) the transfer of assets in return for shares; and
(5) the deeds of trust

the "property comprised in the settlement" was the assets transferred to the company.

Lord Moncrieff, however, was of the opinion that "settlement" remained the dominant word. A "settlement" meant, in his view, "the charging of the property of the settlor with rights constituted in favour of others".[57] Accordingly, the "property comprised in the settlement" could only be the shares transferred by the taxpayer to the trustees and held by them in trust for the taxpayer's daughters. Therefore, the fact that the taxpayer and his wife could force the winding up of the company did not, contrary to the view of the majority, mean that they had power "to revoke or otherwise determine the settlement or any provision thereof" within section 38(2) FA 1938.

Less than three months later, an identically constituted Court of Session gave their decision in IRC v Rainsford-Hannay.[58] The facts were similar to those in Morton's case and again the court decided, Lord Moncrieff dissenting, that the taxpayer and his wife had, by virtue of their control of the company, power to determine the settlement.

The following month, Macnaghton J dealt with the case of Dalgety v IRC[59], in the High Court. Again the facts were similar to Morton and it was conceded by the taxpayer that the case was covered by Morton.

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57. p269
58. (1941) 24 TC 273
59. (1941) 24 TC 280

The first of the cases that went in favour of the taxpayer was Chamberlain v IRC[60]. The judgments in this case bear close examination because the line taken by the Court of Appeal, which found for the Crown, can be seen as a development and extension of the line of cases considered above; whereas the judges of the House of Lords were firmly of the opinion that, although the transactions were clearly designed to avoid tax, the assets of the company controlled by the settlor did not constitute "the property comprised in the settlement".

In December 1935, the taxpayer formed an unlimited investment company (the Staffa Investment Co) to which he transferred certain assets in consideration of the issue to him of preference shares. By virtue of this holding, he controlled the company. In March 1936, he paid to the trustees of a settlement for his wife and children, certain sums which were invested in the purchase of ordinary shares in the company. This settlement was within section 38(2) FA 1938 [61] so that the income thereunder was treated as the taxpayer's income.

In December 1936, the ordinary shares of the company were divided into five different classes, 'A', 'B', 'C', 'D' and 'E' shares. The ordinary shares acquired by the settlement were converted into 'A' shares. Subsequently, the taxpayer paid the trustees, under identical deeds, four equal sums to be invested, according to his directors, on irrevocable trusts for his four children. The trustees invested the sums, in equal amounts, in the 'B', 'C', 'D' and 'E' ordinary shares. These ordinary shares were entitled to such dividends as the company might declare. In 1937/38, the company paid dividends on the preference shares and on the 'B', 'C', 'D' and 'E' ordinary shares.

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60. (1943) 25 TC 318
61. Now section 672 ICTA 1958, see Part 4, infra

The Special Commissioners, Lawrence J, and the Court of Appeal all held that the formation and the structure of the company together with the settlements and agreement for sale constituted an "arrangement" within section 41(4)(b) FA 1938.

In the Court of Appeal, du Parcq LJ gave the court's reasons as follows:

> "Where things have been done, whether at one time or over a period of time, with the deliberate intention that, in conjunction, they shall produce a certain result, there is, in our opinion, an 'arrangement'. We should have thought this to be plain apart from authority; but the submission of the [taxpayer], that some limitations must be put in this context on the generally accepted meaning of the word 'arrangement', is inconsistent with the decision of this Court in [Payne]".[62]

He then mentioned the facts of Payne and Lord Greene MR's definition of "arrangement"[63]. Lord Greene MR was also a member of the Court of Appeal in this case. du Parcq LJ then continued:

> "In the present case the scheme invented by the [taxpayer], or those who advised him, was more complex than the comparatively simple plan devised by Mr Payne, but the words of the Master of the Rolls are no less applicable to it."[64]

The House of Lords, however, upheld the taxpayer's appeal, considering that the tribunals below had lost sight of what was the subject matter of the settlement. The Law Lords held that the whole of the assets of Staffa were not comprised in the settlement, so that, contrary

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62. p323
63. Supra
64. Ibid

to the findings of the Special Commissioners, the company's income could not be taken as being the notional income of the taxpayer.

Lord Thankerton, with whom Viscount Simon LC and Lord Atkin agreed, said:

> "While the formation of Staffa provided an available investment for the sums settled under the five deeds of settlement, under which the children's provisions were actually constituted, the continuance of such investment was not essential to the continuance of the trusts under the deeds of settlement. In other words, the sums settled under these deeds were the funds provided for the purpose of the settlement within the meaning of section 41 (4)(c). Staffa, though controlled by the (taxpayer), did not, in my opinion, hold its assets as part of the provisions settled on the children."[65]

Lord Macmillan developed this in his speech. He accepted that the extension of "settlement", which included an "arrangement", justified and required a broad application of section 38 FA 1938.[66] However, to come within the statute, a settlement or arrangement had to be of the type contemplated by the language of the section.

He agreed with Lord Moncrieff in IRC v Morton[67] that the settlement or arrangement must be one whereby the settlor charges certain property of his with rights in favour of others. The settlement must comprise certain property which is the subject of the settlement and it must confer the income of that property on others. Lord Macmillan said that there could be no question that the March and December 1936 deeds were settlements, but none of them comprised any property of Staffa. The trust funds, he

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65. p329
66. p331
67. Supra

noted, were invested in shares of Staffa which "is quite a different matter". "In point of fact" he observed, "the whole assets of the company have never been settled at all so as to dedicate the whole of its income to any trust purposes."

In other words, Lord Macmillan here was taking the line adopted by Lord Moncrieff, rather than that of the majority of the Court of Session, in Morton and Rainsford-Hannay.

He continued:

> "But it is said that the 'formation and structure' of the company was just a part of an 'arrangement' which must be looked at as a whole and which, when looked at, is seen to be a settlement of the company's whole assets, namely, the 470 shares of Commercial Structures Ltd, which originally belonged to the [taxpayer]. I am prepared to agree that the creation of the Staffa Investment Company and its very special constitution were essential steps towards the effecting of the [taxpayer's] object. So no doubt was the sale to the company of his 470 shares in Commercial Structures Ltd. But that sale was for consideration in money or money's worth, and resulted, inter alia, in the [taxpayer] receiving 35,000 preference shares of the Staffa Investment Company for himself, the income of which he has himself enjoyed. How can it be said that the whole assets of the Staffa Investment Company have been composed in a settlement by the [taxpayer] when he himself retains a substantial interest in the company which has never been the subject of a settlement at all? The most attractive way of presenting the Crown's case is to characterise the whole transaction as a single scheme which begins

with 470 shares in Commercial Structures Ltd in the hands of the [taxpayer] as his personal property, and after much manoeuvring ends with the income from those shares no longer payable to himself but settled in favour of third parties. He who wishes the end wishes the means. This, however, is not, in my opinion, an accurate legal presentation of the matter, which requires a much closer analysis. I have already pointed out that the [taxpayer] has never settled the whole of the shares in the Staffa Investment Company. And further shares might still be issued. It is, I think, fallacious to confuse the steps taken by the [taxpayer] with a view to effecting a settlement or arrangement with the settlement or arrangement itself. When the [taxpayer] created the Staffa Investment Company, and sold to it his 470 shares in Commercial Structures Ltd., he made no settlement or arrangement such as the Statute contemplates. In point of fact, he never settled any shares of the Staffa Investment Company. What he did was to settle certain sums of money, with the intention, which he was in a position to carry out, that these sums should be invested in shares of the Staffa Investment Company. It was not until he granted the trust deeds that he entered the legal stage of the settlements. All that he did previously was preparatory to making settlements. No settlement or arrangement of the nature of a settlement existed when the company was registered and the [taxpayer] sold to it his shares in Commercial Structures Ltd. As I have said, what the [taxpayer] settled was money. That money was invested, as it was intended to be in shares of the Staffa Investment company, but I see nothing to prevent the trustees under the trust deeds from selling their shares in the company and investing the proceeds in other securities. Could it then be said that the whole of the assets of the Staffa Investment Company were 'settled'?

It is essential to the Crown's case that it should make out that the whole assets of the Staffa Investment Company are comprised in a settlement or arrangement made by the [taxpayer] within the meaning of the Statute. In my opinion the Crown has failed to establish this."[68]

Lord Romer commented that the taxpayer admitted that there was a very close connection between the forming of Staffa, the sale to it of the 470 Commercial Structures shares and the application of the £3,500 in subscribing for 350 ordinary shares in Staffa. They were:

"all so many steps taken or caused to be taken by the [taxpayer] for the purpose of making some provision for his children out of the interest that he possessed in Commercial Structures Ltd., while retaining control over both that company and over Staffa. But the forming of Staffa and the sale to it of the [taxpayers] 470 shares in Commercial Structures Ltd, were capable of serving, and may well have been intended to serve, in the future other purposes as well."[69]

Furthermore, although, in view of s41(4)(b) FA 1938, there was a compound settlement in the form of an arrangement consisting of the forming of Staffa, the agreement for the sale to it of the 470 shares in Commercial Structures, the trust deed, and the subscription by the

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68. pp331-2
69. p334

trustees of 350 shares, the property in the settlement consisted of nothing but the 350 shares. It did not and could not consist of all of Staffa's assets or even the 470 Commercial Structures shares held by Staffa.[70]

Lord Romer noted that the Special Commissioners had included the structure of Staffa as one of the elements of the settlement. However, he said that "it passes my comprehension how the structure of a company can form part of a settlement."[71] He admitted that the constitution and character of Staffa "have a very direct and important bearing upon the nature and subject matter of the settlement", but he said that "its constitution and character can no more form part of the settlement itself than can the constitution and character of the settlor."[72]

This approach appears to be different from that taken by the court in the Pilkington case[73]. Furthermore, the statement in the last sentence is clearly taking matters too far.

Lord Romer commented on the effect of s21 FA 1936[74] on the settlor's arrangements. He said:

> "After the execution of the deed of settlement of 10 March 1936, and the investment of the £3,500 in taking up the shares in Staffa, a settlement had been finally made, and one of the purposes, possibly the main purpose, for which Staffa had been formed and the 470 shares in Commercial Structures Ltd had been transferred to it had been fully accomplished. I can find nothing that even remotely suggests that at that time it was in the contemplation of the [taxpayer] to settle further Staffa shares upon his

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70. Ibid
71. p225
72. Ibid
73. <u>Pilkington v IRC</u> (1982) 55 TC 705, see Chapter 4
74. See Part 3, infra

children; and had it not been for the Finance Act of 1936 I do not suppose that any such further settlement would in fact have taken place. But section 21 of that Act put the [taxpayer] in danger of having all the income arising under the settlement of 10 March 1936, treated as his income for the purposes of Surtax, and it was only after he had considered the provisions of that Section that he took the further steps that resulted in the execution of the four deeds of settlement of 7 December 1936, and the acquisition by the trustees of those settlements of the 'B', 'C', 'D' and 'E' ordinary shares now held by them."[75]

It can be seen that the structure of a company may have an important bearing on the question of whether or not there is an "arrangement". Although it is by no means simply a question of control, if the settlor does not have control of the company, it may generally be argued that the company does not come into the picture, and that the settlement is to be confined to the deed or deeds under which the funds are settled. Even if the taxpayer does have control, it does not necessarily mean that the structure of the company must be taken into account.

Consider for example, the situation in Wolfson v IRC.[76] The taxpayer held 700 of the 1,000 £1 shares in a private investment company, the remaining 300 shares being held equally by each of his two brothers and his father. The taxpayer and one of the brothers covenanted to pay trustees for the benefit of their sisters in a net sum equal to the net amount of the dividends received by them during the year on their shares in the company.

Having regard to his 70% holding, the taxpayer was in a position to prevent any dividends being declared during the whole or any part of the period covered by the

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75. p335
76. (1949) 31 TC 141

covenant. He was also able, with the co-operation of another shareholder, to secure the passing of a special resolution for winding up the company. The Crown accordingly argued that the taxpayer had the power to revoke the covenant.[77]

However, the House of Lords held that the taxpayer had not placed himself in control of the company as part of a definite scheme, it was not permissible to go outside the deed of covenant itself and to contend that the settlement was constituted by an arrangement of which the structure of the company was part. As a result, only the deed itself could be considered in order to determine whether it contained a power of revocation and, if so, who was the person in whom that power was vested.

No such power could be found in the deed of covenant and, accordingly, the income payments under the deed of covenant were not to be treated as the income of the taxpayer.

In the light of this finding, the Crown's concession that the deed of covenant alone constituted the settlement was crucial. As the settlement did not include the structure of the company, the power to determine was not, in the circumstances of the case, a power within the terms of the settlement.

The House of Lords expressly reserved the question how far the Payne line of cases can be regarded as correct after the decision in Chamberlain.[78] In fact, in the light if the finding in Payne that, on the facts of that case, the structure of the company was part of the settlement, the Payne case would not be inconsistent with Chamberlain. The general view in the lower courts was that Payne could stand with the Wolfson approach; see for example, Tucker LJ who said that:

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77. See Part 4, infra
78. See for example, Lord Simonds at p169

"the contention of the Crown [in Payne] that the settlement in question consisted of the deed of covenant of 29 March 1938, together with the whole framework of Derwent Ltd., which was controlled by Mr Payne, was accepted. Accordingly, no question arose as to whether it was necessary or permissible to look outside the settlement to find the power [to revoke]".[79]

It should also be noted that Payne was cited without disapproval by Lord Wilberforce in Chinn v Collins.[80]

Chamberlain was followed in Clark and The Language Trust and Investment Co Ltd v IRC.[81] The facts of this case have been given above in relation to the apportionment provisions.[82] The Special Commissioner held that the formation of the taxpayer company, the transfer to it of assets by the individual taxpayer, the execution of the deed of settlement, the subsequent deeds of appointment and revocation, and the allotment of the taxpayer's company's shares, together constituted an "arrangement", and therefore a "settlement", within section 41(4)(b) FA 1938.

The Court of Appeal, however, following Chamberlain, held that the various transactions did not constitute a "settlement", and the point was not taken up in the House of Lords where, as noted above, the income of the taxpayer company was apportioned to the taxpayer under section 15 FA 1939, following the LB (Holdings) case.[83]

In the light of the fact that, on the authority of Chamberlain, it was held that there was no "settlement", the Supplemental Case required by the House of Lords relating to the apportionment question shows the

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79. pp 160-1, see also Atkinson J at pp 150-1
80. (1980) 54 TC 311 at p351
81. (1947) 28 TC 55
82. See Chapter 1, Part 7
83. IRC v LB (Holdings) Ltd (1946) 28 TC 1

limitations that were placed on the settlement provisions by the Chamberlain case. The Commissioners found as follows:[84]

> "In our opinion Mr Clark had such powers under the Memorandum and Articles of Association of the Company as to enable him, without in any way infringing the Company's regulations, to cause the income or the assets of the Company to be applied directly or indirectly for his benefit. For instance, he was able to arrange for payment to him, as remuneration, of a substantial part of the income of the Company thereby securing for himself or for his benefit a new class of shares. He was able to arrange for loans to be made to him by the Company with or without security upon such terms as the Company might approve. He was able to finance other concerns, in which he was interested, out of the assets of the Company".

The Commissioners concluded that the taxpayer was able to secure that income or assets of the company could be applied directly or indirectly for his benefit. Despite this it was held that there was no "settlement", based on the Chamberlain decision.

The line taken by the House of Lords in Chamberlain, which, has been seen, differed from that of the majority of the Court of Session in Morton and Rainsford-Hannay, was followed by the House of Lords in Vestey v IRC.[85]

One of the interesting features of this case is that Lord Normand, who had been in the majority in the Court of Session in Morton and Rainsford-Hannay, here delivered a strong judgment in support of the Chamberlain approach.

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84. p77
85. (1949) 31 TC 1

This does not, of course, indicate any inconsistency on Lord Normand's part because the minority view in Morton and Rainsford-Hannay had been approved by the House of Lords in Chamberlain and therefore represented the state of the law that Lord Normand should, and did, apply.[86]

The facts of this case are set out in detail in Chapter 9 in connection with the "Transfer of Assets Abroad" provisions. Section 18 FA 1936[87] was one of the unsuccessful lines of attack adopted by the Revenue; the other, and the one of interest here, was under section 38 FA 1938.

For present purposes, the facts may be summarised as follows:

By a lease made on 29 December 1921, the Vestey brothers demised to a company of their own creation certain assets situated in various parts of the world. The term was for 21 years from 10 April 1921, determinable by either party on six months' notice. The rent was £960,000 a year, payable to three trustees residing in Paris. The Vestey brothers were authorised to withdraw properties from the lease, in which case the rent was to be proportionately reduced.

By a trust deed made on 30 December 1921, the Vestey brother, as settlors, declared the trusts on which the Paris trustees were to hold the rent and trust income. No beneficial interest was reserved to the settlors, but they enjoyed special powers of appointment in favour of issue and in favour of a widow.

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86. A similar thing happened in the case of du Parcq LJ who gave a strong judgment in favour of the Crown in the Court of Appeal in Chamberlain but, seven years later, when he was in the House of Lords he held for the taxpayer in Wolfson.
87. Now section 739 ICTA 1988

Under the trust deed, the trustees were required to capitalise the rent until the expiration of 21 years from the death of the last surviving grandchild then living of the settlors by investing it in the manner stated in the deed and power was conferred on the settlors to direct how the money should be invested and, under this power, they could direct the trustees to invest upon personal credit or upon loans to any company with or without security.

The residue of the income arising from the settled fund, when invested, after meeting certain costs and charges, was, until the period of accumulation had expired, divided into two funds "William's Fund" and Edmund's Fund". After the end of the accumulation period, the two accumulated funds were to be held in trust for the benefit of the children or remoter issue (and their wives and widows) of Lord Vestey (ie William) and Sir Edmund Vestey. The trust deed further reserved a power to Lord Vestey and Sir Edmund to appoint by will any interest in the funds in favour of the widow of the appointer.

In November 1935, Lord Vestey irrevocably appointed by deed, all funds, both capital and income, which he had power to appoint, to his issue, but without releasing his power to appoint to his widow. In December 1935, Sir Edmund irrevocably appointed to his issue part of the property and later, in 1937, he irrevocably appointed the remainder of the property to his children and extinguished his power of appointment in favour of his widow.

The executors of Lord Vestey (who had died in 1940) and Sir Edmund were assessed to tax on the footing that the lease and the settlement together constituted a settlement which fell within section 38(2) FA 1938 and also one in which the settlors had an interest within section 38(3)(4).[88]

The House of Lords held that the "property comprised in the settlement" meant only the property charged with rights in favour of others, and accordingly did not include the properties which were the subjects of the lease. Therefore, the power to determine the lease was not a power to determine the settlement within section 38(2)(a) and, consequently, neither Lord Vestey nor Sir Edmund, nor their respective wives, could become beneficially entitled to property comprised in the settlement or income arising therefrom within section 38(2)(b).

The Crown's contention had been that the whole thing was an "arrangement", and therefore a "settlement" and the lease was part of the arrangement, and therefore "a provision of the settlement".

It followed, it was argued, that the power vested in lessors or lessee, to determine the lease was a power to determine a provision of the settlement, with the result that the settlors would become beneficially entitled to the whole or part of the property then comprised in the settlement.

The majority of the Court of Appeal accepted this argument, but it was unanimously rejected by the House of Lords. It is interesting to note that, in the Court of Appeal, one of the judges in the majority who would effectively have limited the effect of the Chamberlain decision was Somerwell LJ who, when he was Attorney-General, was unsuccessful leading counsel for the Crown in the Chamberlain case. The Law Lords, on the other hand, fully respected the Chamberlain decision.

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88. Regarding this latter assessment, see Part 6, infra

Lord Simonds said that the principle of the Chamberlain decision was that steps taken towards a settlement must not be confused with the settlement itself and that the "property comprised in the settlement" is only the property in respect of which some beneficial interest is created. Applying this principle, Lord Simonds said that the only property comprised in the settlement was the rent payable to the Paris trustees with the investments and accumulations of income arising from it. Accordingly, no one had power to determine the settlement or any provision thereof in such a manner that the settlors could become entitled to the property comprised in the settlement or any part of it.[89]

Lord Normand who, it has already been noted, was part of the majority in the Court of Session in Morton and Rainsford-Hannay, agreed. With reference to that he noted that:

> "It was a possible view that the intention of section 38 was that the Court should first determine what was the whole 'arrangement' devised with the object of avoiding tax, and having dones so should then treat all assets transferred or leased or affected by any document forming part of the 'arrangement' as 'property comprised in the settlement'. That was the view taken by the Court of Session in Morton's case...."[90]

He then pointed out that the Court of Appeal in Chamberlain took the same view (as has been explained above), but that the House of Lords construed "settlement" in relation to the words "property comprised in the settlement" as Lord Moncrieff had done in Morton.[91]

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89. p82
90. p88
91. Ibid

The rule to be deduced from Chamberlain, he said, "is that the property comprised in the settlement is that and that only in respect of which some beneficial right is created in favour of benficiaries under the settlement". It was also implicit in the judgment of the House of Lords in Chamberlain "that documents which form part of an 'arrangement' within the meaning of section 41(4)(c) of the Finance Act 1938, are to be construed as they would be if they were unconnected with a purpose of tax avoidance."

Lord Normand concluded:

> "If I am correct in my understanding of Chamberlain's case it will follow in the present case that even if the lease and the deed of settlement may both be properly treated as components of the 'arrangement', yet the property 'comprised in the settlement' is the property settled by the deed of settlement, that is the rents under the lease, and not the property which were the subjects of the lease. An from that it will follow that there can be no liability under section 38(2), for the only power to revoke in the case is a power to revoke the lease, and the exercise of that power would merely end the payment of the rent without conferring on the settlors any rights in the property comprised in the settlement or in the income arising from it."[92]

An important case on the meaning of "arrangement" is Crossland v Hawkins.[93] As has already been explained, the facts were that the actor, Jack Hawkins was one of two directors, but not a shareholder in a company, Roehampton Productions Ltd., which was formed in December 1954, with a share capital of £100, divided into 100 £1

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92. p89. See also Lord Morton at p107, whose analysis was the same as that of Lords Simonds and Normand.
93. (1961) 31 TC 493, see Chapter 1, Part 8

shares. At the same time he entered into a service agreement with the company whereby he was to receive a salary and expenses, and the company was given the rights to exploit his services.

In March 1955, the taxpayer's father-in-law settled £100 out of his own money on trust for the taxpayer's three infant children. The trustees used £98 of this money in purchasing 98 shares in the company. The taxpayer was aware that steps were being taken to put into effect arrangements of his accountants and solicitors, but he was not consulted regarding them and he was not fully familiar of them.

Subsequently, the taxpayer acted in a film, for which the company received £25,000 out of which the company paid a dividend of £500 free of tax, to the trustees who applied it for the benefit of the children.

The taxpayer, on behalf of his children, claimed repayment of the tax deducted. The Revenue rejected the claim, contending that, under section 397 ITA 1952,[94] the income in question fell to be treated as the taxpayer's income on the basis that the formation of the company, the service agreement, the settlement of £100 and the trustees' acquisition of the company's shares together formed an "arrangement", and therefore a "settlement" within section 403 ITA 1952,[95] and the taxpayer was a "settlor" within that section, as being a person who had entered into it or provided funds for it.

It is very instructive to compare the reasoning and decision of Danckwerts J, who found for the taxpayer, with that of the Court of Appeal, who found for the Crown. In the High Court, Danckwerts J held that there was no arrangement, and that the dividend was the income

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94. Now section 663 ICTA 1988
95. Now section 670 Ibid

of the children. This was based on the fact that the formation of the company and the execution of the service agreement were before the execution of the settlement, with which there was no proof of any connection; that the taxpayer had no control over the company; and that there was no arrangement between the taxpayer and his father in law for the provision of the £100 which was settled on the children.[96]

An interesting aspect of the judge's analysis related to the taxpayer's state of knowledge as regards the scheme. In his view, it was not enough, to constitute an "arrangement", that the taxpayer was aware that steps were being taken by his accountant and solicitor to arrange his tax affairs. On the other hand:

> "if it had been proved that a scheme had been evolved by Mr Hawkins in consultation with his solicitor and accountant so that the whole scheme involved the formation of the company, the entering into the service agreement by Mr Hawkins and a settlement of a sum of money which would involve, eventually, the purchase of the shares, it would be possible to say that there was an arrangement within the meaning of the definition contained in section 403".

But, as he was not consulted with regard to the proposals and was not present at any meeting when the settlement was discussed, he was not a party to the scheme. This, according to the judge, was "a most material factor".[97]

The Court of Appeal, however, upheld the Crown's appeal, holding that there was a sufficient connection between the formation of the company and the execution of the service agreement, on the one hand, and the execution of

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96. pp500-1
97. Ibid

the settlement and the purchase of the shares in the company on the other hand, as to constitute an "arrangement".

Donovan LJ, at the beginning of his judgment, noted that a similar scheme to the first stage (ie the personal service company element) had once before been carried out by the taxpayer.

The judge said, as regards this scheme, that "it may be useful to bear its existence in mind".[98] He did not elaborate, but perhaps he bore it in mind when considering quite how much the taxpayer did know of the various steps and the connection between them.

Donovan LJ then dealt with the argument that, initially, nothing more was intended than a Surtax saving operation using the personal service company, and that the settlement of the shares three months later was not contemplated from the beginning. To this, the judge made the point that the initial surtax saving scheme could not stand on its own, observing, undoubtedly correctly, that:

> "one conclusion is obvious and not, I think, disputed, Mr Hawkins was not going to make a present of his service, less £50 a week[99] to two clerks in his solicitor's office, who on the face of things, were at the beginning, the only shareholders in the company. At some time he would want to have the money which had escaped Surtax for himself, for example in the liquidation of the company, or to bestow it on others whom he wished to benefit, for example his family. Otherwise, the whole operation was pointless. I will accept for the moment the proposition that the family settlement which

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98. p502
99. His salary from the company

> followed was not decided upon at the outset; but what is important, I think, it that the eventual enjoyment by some individual or individuals of the money which had escaped Surtax must have been in contemplation at the outset. Otherwise, as I say, the scheme had no rational purpose."[100]

Turning to the question of whether there was an arrangement, Donovan LJ rejected the taxpayers argument that, to constitute an "arrangement", the whole of it must be in contemplation at the outset. He did not think the language of section 397 required this to be the case. He thought there was "sufficient unity about the whole matter to justify it being called an 'arrangement' because the ultimate object was to secure for somebody the money free from the full burden of surtax.[101] He continued:

> "Merely because the final step to secure this objective is left unresolved at the outset and decided upon later does not seem to me to rob the scheme of the necessary unity to justify it being called an 'arrangement'. Particularly is this so in a case such as the present, when one recalls certain other features of it. Thus, Mr Hawkins, though not on the register of members, was a director of the company. He entered into this contract for services for a consideration which is a fraction in value of what he gives the company in return. He, as a director, has to agree to the issue of the 98 shares to the trustees: he as a director has to agree to the interim dividend of £500 free of tax being paid on this £100 of capital. Bearing in mind the ultimate object of securing money free from the burden, or the full burden, of Surtax, can it matter for present purposes that the precise way of

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100. p503
101. p505

> securing this result was not decided upon at the very outset? I think not."[102]

Donovan LJ then turned to the Crown's other argument, although, in the light of his above finding, it was strictly not necessary to do so. This argument was that the taxpayer provided funds for the settlement constituted by the March 1955 deed, regarded alone, and so was the "settlor" in relation to it. Danckwerts J, as noted above, had been of the opinion that the taxpayer could not be regarded as providing funds for a settlement of which he was not the settlor, and to which he contributed nothing, unless the formation of the company and the service agreement could be read into the settlement. This he refused to do, for the reasons explained above.

With Danckwert J's conclusion that the taxpayer was "quite obviously not a party in any way" to the settlement, Donovan LJ disagreed. In the light of the Commissioners' finding that the taxpayer "was aware that steps were being taken to put into effect proposals of the accountants and solicitors...."[103] he commented:

> "Mr Borneman [counsel for the taxpayer], when asked what the 'proposals' of the accountants and solicitors were, conceded that they included this deed of settlement. The [taxpayer], therefore, was aware of this item in the proposals and that steps were being taken to put it into effect, albeit that he may not have been consulted when the terms of the settlement were discussed or the settlement signed. Even if the matter stopped there, I should, in those circumstances, have little difficulty in holding that when the dividend was ultimately declared it came from funds indirectly provided by Mr Hawkins

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102. Ibid. It is interesting to compare this line of reasoning to that adopted in relation to a "pre-ordained series of transactions" in relation to the "New Approach" see Chapter 11.

103. Para 2(f) of the case stated

for the purpose of the deed of settlement. The matter, however, does not stop there. On 10 December 1954, when Mr Hawkins agreed to give his services to the company for a fraction of the reward the company would get by lending him to some theatrical or film producer, the two shareholders in the company were either the two solicitor's clerks or Mrs Hawkins and the accountant jointly as to one share and the accountant as to the other. If it were the two solicitor's clerks, the irresistible inference from the facts is that they were mere nominees for Mr Hawkins. It can hardly be imagined that they were free to exploit the service agreement for their own individual benefit. If, therefore, the beneficial ownership of the shares was in Mr Hawkins, then when he later transferred, or concurred in tranferring, or concurred in the issue of, shares to the trustees of the deed of settlement so that they became the only shareholders, he was in fact concurring that the equity in the company should pass from him to them; and when eventually there is a fund of profit derived from Mr Hawkins' services and a distribution of part of it to the trustees, again I see no difficulty in holding that the result of all that has gone before is that he has provided funds indirectly for the purposes of this settlement. If however, at the date of the service agreement, the two persons who afterwards became trustees of the settlement were the shareholders, then two conclusions would seem to me to follow: (1) that the idea of this family settlement was in mind at the outset, and (2) that by this agreement Mr Hawkins was taking steps to see that the trustees would eventually get funds. When that event happened it was he who indirectly provided the money."[104]

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104. pp506-7

Pearce LJ gave a concurring judgement during which he emphasised that a person could not keep himself outside section 397 by leaving the arrangements to his professional advisers.[105]

The Court of Appeal, then, decided that it was not necessary, in order to constitute an "arrangement" that the whole of the eventual arrangement should be in contemplation at the outset.

Bearing the analysis of the Court of Appeal in mind, the next stage is to compare Crossland v Hawkins with another case involving a company set up to exploit the services of a film star, a case in which, once again, different courts took a different view of the matter and, in the course of their judgments, gave further important guidance on the meaning of "settlement". This case was Mills v IRC.[106] The relevant facts for present purposes were that when Hayley Mills, the actress, was 14, the Walt Disney organisation wanted to enter into a contract with her. Her father John Mills, therefore formed a company, Sussex Productions Ltd, and three months later, he settled his shares on trust for his daughter absolutely on reaching 25. On the same day, Hayley Mills entered into a service agreement with the company to render her services to it for five years at an annual salary of £400. The following year, an agreement was made between the company, Hayley Mills and the Walt Disney organisation, whereby the company undertook to make Hayley Mills' services available to Walt Disney for five years in return for payments to the company ranging from US$ 30,000, in the first year, to US$ 75,000 in the fifth year. The bulk of the company's profits was paid by way of dividend to the trustees of the settlement but they in turn distributed none of it.

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105. pp507-8
106. (1974) 49 TC 367 see Chapter 1, Part 8

Hayley Mills, the taxpayer is this case, when the arrangements were made, knew that her father was making arrangements concerning her earnings which would be for her ultimate benefit, and she signed the necessary documents, but she did not know the details of the steps being taken and she did not read the documents she was signing.

The taxpayer was assessed to surtax on the footing that the undistributed income of the trustees fell to be treated as her income under section 405 ITA 1952.[107]

It was contended for the taxpayer that there was only one settlement to which section 405 was applicable: that executed by John Mills, in relation to which he alone was the settlor. Alternatively, if the incorporation of the company, the execution of the settlement and the service agreement taken together constituted a "settlement", it was argued that John Mills alone was a settlor, the income originated, with section 409,[108] from John Mills, who had settled the shares and made the arrangements.

The Crown contended that the formation of the company, the execution of the settlement and the service agreement constituted an "arrangement", and therefore a "settlement", in relation to which the taxpayer was a "settlor" within section 411(2) [109] as having provided funds directly or indirectly for it. Also, for the same reason, the Crown argued that she was a "settlor" in relation to the settlement created by John Mills on its own, regardless of the fact that her father might also be a settlor.

In the Court of Appeal and the House of Lords counsel for

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107. Now section 673 ICTA 1988
108. Now section 679 Ibid
109. Now section 681(4) ICTA 1988

the taxpayer accepted that there was an "arrangement" but contended that it was not made by the taxpayer.

The Court of Appeal held that the taxpayer was not a "settlor" in relation to the settlement.

Lord Denning MR pointed out that, when the arrangements were being made, the taxpayer was only 13 or 14. This, he thought, differentiated her case from Crossland v Hawkins in which Jack Hawkins was a grown man "who had all his wits about him"; he "was aware of the proposals and actively forwarded them by personally carrying out and assisting in the vital parts". On the other hand, Hayley Mills could not be a settlor because:

> "She had not the least understanding of this particular arrangement, or of the documents which she signed.."[110]

She could not therefore be said to have "made or entered into the arrangement directly or indirectly".

That, however, was not the end of the matter because it then had to be decided whether she provided funds directly or indirectly for the purpose of the settlement. Lord Denning MR's view was that she did not. In his opinion, all the taxpayer had done was to act, at her father's request, in films. She had, he pointed out, no conception of the amounts received by the company. Accordingly, it was the company which received the funds and provided them for the settlement. Lord Denning MR here agreed with Danckwerts J in Crossland v Hawkins rather than what he called, surely incorrectly, the obiter dictum of Donovan LJ in that case.[111]

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110. p384
111. p385

He then considered the words "for the purpose of" the settlement. He considered that the word "purpose" connoted a mental element, and therefore:

> "According to this, in order that Miss Hayley Mills herself should provide funds 'for the purpose of the settlement', she must have had the object - the end view - of promoting the purposes of the settlement. For that to be her purpose, she must have had some understanding of the 'arrangement' and have intended to facilitate it. No doubt Jack Hawkins in his case had all the necessary understanding and intention.
>
> By providing his services, he was knowingly and intentionally providing funds for the company, out of which it could pay dividends. But Miss Hayley Mills was so young that she had neither knowledge nor the intention".[112]

Therefore, he concluded, the taxpayer was not a "settlor" of either the formal settlement or the statutory "settlement".

Buckley LJ agreed.[113] He considered that the phrase "provide funds....for the purpose of the settlement" "imports a motivating intention.....to benefit those interested under the trusts". He considered that this gave the phrase its most natural primary meaning.[113] This appears to be correct, the Shorter Oxford Dictionary, as Lord Denning MR pointed out[114], gives, for the meaning of "purpose", "intending or meaning to do something" or "the object for which anything is done".

He also thought that his interpretation accorded with what he considered to be the policy of the relevant part of the Act, namely:

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112. Ibid
113. p387
114. p384

"that a man should not be able to avoid liability for tax on what would otherwise be his taxable income by transferring or undertaking to transfer what is his or what is at his disposal to trustees of a settlement falling within the statutory provisions".

He also distinguished Crossland v Hawkins on the same basis as Lord Denning MR, namely, that Jack Hawkins was an adult answerable for the results of his actions, whereas Hayley Mills was not.[115]

Orr LJ delivered a dissenting judgment, holding that the taxpayer was a "settlor", considering that the matter had been settled in Crossland v Hawkins.[116] It may not be irrelevant to observe that Orr LJ was junior counsel for the Crown in Crossland v Hawkins.

He was of the opinion, it is submitted correctly, that Donovan LJ's view that Jack Hawkins had provided funds for the purpose of the formal settlement was not obiter, and that the Court of Appeal in Crossland v Hawkins had decided in favour of the Crown both on the basis that there was a comprehensive "arrangement", and also on the alternative basis that there was only a formal settlement. From an examination of the judgment of Donovan LJ, this appears to be correct.

On the question of the interpretation of the words "for the purpose of the settlement",he agreed with the other members of the Court of Appeal that the words do import an element of intention but he said that:

"where, as here, the settlement is a statutory one arising from an arrangement, it is not, in my judgment, necessary that the settlor should have

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115. pp387-8
116. p392

> specifically directed his or her mind to the detailed provisions of the formal deed of settlement.... In my judgment the necessary element of intention was present, in that the taxpayer, being aware that her father was making arrangements designed for her benefit, and being willing on his advice to participate in those arrangements, so far as her participation was required, intended that all those things should be done which the arrangements involved."[117]

The House of Lords reversed the decision of the majority in the Court of Appeal. The judgment of the court was delivered by Viscount Dilhorne.

On the first question to be considered by the House of Lords, it was held that the taxpayer had provided funds for the purpose of the settlement. Viscount Dilhorne said that it was taking too narrow a view of the arrangement to conclude that the dividends were merely provided by the company:

> "To do so means shutting one's eyes to the fact that the source of the dividends was money paid for [the taxpayer's] work and money which but for the arrangement would have been received by her."[118]

He disagreed that "purpose" connoted a mental element[119] or that there must be a motivating intention.[120] He said:

> "I do not consider it incumbent, in order to establish that a person is a settlor as having provided funds for the purpose of a settlement, to show that there was any element of mens rea. Where is is shown that funds have been provided for a

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117. pp394-5
118. pp407-8
119. As stated by Lord Denning MR
120. As stated by Buckley LJ

settlement, a very strong inference is to be drawn that they were provided for that purpose, an inference which will be rebutted if it is established that they were provided for another purpose. In this case there is not a shred of evidence that the funds were provided for any other purpose."[121]

Viscount Dilhorne concluded that the taxpayer had the legal capacity to enter into the contract with the company. By entering into it she entered into the arrangement which constituted a settlement. By that contract, and the agreement with Walt Disney, she secured that her earnings should be paid to the company and so she indirectly provided funds for the trust. Therefore, she was a "settlor" within section 411(2).[122]

The cases of Crossland v Hawkins and Mills underline how wide is the meaning of "arrangement". In Crossland v Hawkins, when the taxpayer sold her services to the company, the formal settlement was not even in contemplation and, in Mills, the taxpayer was too young to understand what was going on; yet, in each case, these facts did not prevent there being a settlement.

Another aspect of the meaning of "arrangement" was considered by Plowman J in IRC v Leiner.[123]

The facts were that, in 1954, the taxpayer's mother lent £34,000, at interest, to a company in which the taxpayer had an interest. In the following year, that company, with the assistance of a loan from another company, repaid the sum to the mother, which she then lent to Treforest Ltd, another company in which the taxpayer had an interest. This loan, which was interest-free, was charged as security for the second company's loan to the first company.

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121. p408
122. pp408-9
123. (1964) 41 TC 589

In 1957, the mother wished to settle the £34,000 for the benefit of the taxpayer and his son, and the taxpayer and his legal advisers devised the following plan. In May 1957, the mother executed a settlement under which the taxpayer, his wife and son had discretionary interests.

On 1st October 1958, three transactions were effected: (1) the chargee company consented to its repayment by Treforest, (2) Treforest repaid the loan to the mother, (3) the mother paid £34,000 to the trustees of the settlement. On 13 October 1958, two steps were implemented: (1) the trustees lent £34,000 to the taxpayer: and (2) the taxpayer lent £34,000 to the Treforest. The taxpayer agreed to pay interest on his loan from the trustees (and this amounted to £2,040 in the relevant year, ie, 6%) but no interest was payable on the loan from the taxpayer to Treforest.

The Crown contended that the transactions constituted an "arrangement" and therefore a "settlement", within section 403 ITA 1952; that the taxpayer was a "settlor"; and that the settlement income of £2,040 originated from the taxpayer in that he had provided it directly or indirectly.

The Special Commissioners held that the transactions did constitute an "arrangement", and therefore a "settlement", and that the taxpayer was the "settlor", but held that the payment of interest by the taxpayer did not constitute the provision of income by him.

Before Plowman J, the taxpayer did not dispute the Commissioners' decision on the first two points, ie that there was a settlement of which he was the settlor. Therefore, the case in the High Court was concerned solely whether the taxpayer had provided income for the purposes of the settlement so that it could be assessable on him under section 397 ITA 1952[124] and section 22 FA 1958.[125]

Plowman J held that the transaction had to be looked as a whole and, on this basis, he held that the taxpayer had provided the settlement income of £2,040.

The judge said that the real question was whether the interest paid by the taxpayer on the £34,000 loan to him was income originating from him as having been provided by him. On the face of it, it obviously was income provided by him in the sense that he had paid it, but it was common ground that it was implicit in the fasciculus of sections, of which the relevant provisions formed part, that some element of bounty was necessary to make the sections apply, and that, on the authority of Copeman v Coleman[126], a bona fide commercial transaction would be excluded from their operation.[127]

Looking at the transaction as a whole, it was impossible to say that the taxpayer did not provide the trustees with an income of £2,040 a year, in the sense which the word "provided" was used in section 401,[128] that is to say, as importing an element of bounty.[129]

The taxpayer had submitted that the only relevant settlement for the purposes of section 397 was the settlement executed by the mother, and that the £2,040 was income from the property settled by the mother. As between the trustees of the mother's settlement and the taxpayer, it was argued, there was no element of bounty

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124. Now section 663 ICTA 1988
125. Now section 674 ICTA 1988, see Part 6, infra
126. (1939) 22 TC 594, supra
127. See Part 2, infra
128. New section 668 ICTA 1988
129. p596

at all; the only recipient of bounty, so far as the taxpayer was concerned, was Treforest, which received the loan of £34,000 from him free of interest. Therefore, it was submitted, in so far as the taxpayer was a settlor at all, the matter was a commercial transaction and section 401 did not apply.

In considering the validity of this argument, Plowman J compared the positions of Treforest and the taxpayer before the arrangement was entered into with their respective positions after it. As the judge pointed out, before the arrangement, Treforest owed the mother £34,000 interest free, and, afterwards it still owed £34,000 interest free, although it was owed to the taxpayer rather than to his mother. In those circumstances, it was difficult to see how it could be said to have received any bounty. As far as the taxpayer was concerned, before the arrangement he was neither a debtor nor a creditor; afterwards he was both a debtor and a creditor for the same sum (£34,000), in addition to which, he was liable to pay £2,040 a year to the trustees and, to that extent, he was worse off. Therefore, looking at the transaction as a whole he had "provided" that sum within section 401.[130]

The definition of "arrangement" was considered in an interesting context in another case in which the question of bounty arose, and which is considered in detail below: Chinn v Collins[131]. The facts of this case have already been given.

This case, in fact, concerned the definition of "settlement" in what was then section 42(7) FA 1965[132] for the purposes of capital gains tax but the words "settlement" and "settlor" are stated as having the same meaning as in Chapter III of Part XVIII. ITA 1952, for

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130. Ibid
131. (1980) 54 TC 311, see Part 2,infra
132. Later section 17(7) CGTA 1979, now repealed.

the purposes of which, section 411(2) of that Act applied.[133]

The Crown said that the appointment, the assignment and the sale agreement together constituted an "arrangement". At first instance, Templeman J agreed. The judge was of the opinion that the various transactions constituting the scheme were all part of an arrangement instigated by the settlor and put into effect by the settlor, the trustees, Rozel, and Anthony. He said:

> "In my judgment, all the relevant events which took place between the appointment of new trustees dated 31 March 1969 and the final transfer of the shares to Anthony were part of an arrangement instigated by the settlor and carried into effect by him, by the trustees, by Rozel and by Anthony. The trust fund, the subject of the arrangement, consisted of 184,500 shares. That trust fund was vested in N.M Rothschild & Sons (C.I) Ltd and the other three trustees of the settlement. They were the trustees of the arrangement because they held the trust fund which was comprised in the arrangement. Similarly, the settlor was the settlor of the arrangement because he was the person who had provided the trust fund comprised in the arrangement."[134]

The Court of Appeal, on the other hand, held that there was no "settlement" on the basis that there was no element of bounty.[135]

The House of Lords also dealt with the matter on the question of bounty. They held that there was an element of bounty, and so agreed with the Crown that there was an "arrangement". During his judgment, Lord Wilberforce, with whom Lords Fraser and Russell agreed, said:

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133. Now section 681(4) ICTA 1988
134. p329
135. see Part 2, infra

"The scheme as a whole, it is said, constituted an arrangement, under which Anthony was a beneficiary. The word 'arrangement' is wide in scope, and may include a combination, or series, of transactions some of which may be for consideration or of a commercial character (see Inland Revenue Commissioners v Payne...) In Inland Revenue Commissioners v Plummer it was decided, in order to place some limitation on the extent of the word [136], that there must be an element of bounty in the transaction, a conception admittedly not without its difficulty. In this case I have no difficulty in finding this test satisfied. It was part, an essential part, of the arrangement that interests under the settlement should be appointed to Anthony (and Steven). This was done on 28 October 1969. Before that date, the interest of each son was liable to be overridden by an exercise of the power of appointment, which might wholly exclude him: after the date each son had a contingent interest, likely to become vested after three days in 184,500 shares. I fail to see how this can be regarded otherwise than as an act of bounty in their favour, and that, taken together with the sale and repurchase, makes an arrangement. If it be said that there must be an act of bounty of the settlor and that the latter had fully divested himself of his settled property when he made the settlement, I would reply that his bounty was at that point incomplete, and became completed only when an appointment was made, thereby, as it were, filling in the names of his intended beneficiaries. If one looks at the whole scheme more broadly, Anthony and Steven at the end of it became entitled to shares worth over £350,000 for which they had not provided consideration (other than the small amount of

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136. ie. "settlement"

Rozel's commission) and this was brought about by the action of the settlor and of the trustees. If the word arrangement does not cover this, its prescence in the definition is hard to appreciate."[137]

The cases considered above[138] show that the term "arrangement" has a very wide meaning and brings within the statutory definition of "settlement" a large number of transactions that could not be considered settlements under general law.

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137. p351 see also Lord Roskill at pp356-7, who took a similar view.
138. See also Butler v Wildin [1989] STC 22 in Part 3, infra

"Transfer of Assets"

This term appears only in the definition in section 670 ICTA 1988 relating to settlements on children.[139]

In view of the inclusion of "transfer of assets" within this definition, an absolute and unconditional gift by a parent to his child comes within the meaning of "settlement", with the result that the income derived from that gift will constitute the income of the parent. This was decided in the case of Hood Barrs v IRC.[140]

The taxpayer transferred a block of shares to each of his two infant and unmarried daughters absolutely without consideration or restriction. He represented this transaction as a purchase by them out of money given to them by his sister out of her own resources, but he later admitted that he had himself provided his sister with the money.

He was assessed to Surtax on the dividends on the shares. He claimed that the absolute transfer of the shares did not constitute a settlement within section 21 FA 1936[141] and that, to constitute a settlement within the section, there must be a condition or limitation whereby capital and income have different interests. This was rejected by the Special Commissioners and both the High Court and the Court of Appeal.

Lord Greene MR, in the Court of Appeal, commented that if the word "settlement" in section 21 had been left without any interpretation, he would probably have accepted the argument that the transaction in this case could not, in the ordinary sense of the term, have been called a settlement.[142]

139. See Part 3, infra
140. (1946) 27 TC 385
141. See Part 3, infra
142. p400. Lord Morton expressed similar views in Thomas v Marshall (1953) 34 TC 178 at p201, discussed infra.

The taxpayer had argued that the transfer of assets, to fall within the meaning of the interpretation section, must be something in the nature of a settlement in the ordinary meaning of that word, and that "transfer of assets" must be read ejusdem generis with the other transactions all of which, it was claimed, were in the nature of a settlement in the ordinary meaning of that word.

Lord Greene MR agreed with Wrottesley J in the High Court that the idea of ejusdem generis does not seem very applicable to the words used in the definition, and he noted that Cohen LJ had asked, in the course of the argument, to what genus "transfer of assets" belonged. It seems he received no answer to the question.

The Hood-Barrs case was approved in Thomas v Marshall.[143] Here the taxpayer had two children and he opened a Post Office Savings account for each of them. He made payments into these accounts from time to time and he also gave each of them £1,000 in 3% Defence Bonds. Both the sums paid into the bank accounts and the bonds were absolute and unconditioned gifts.

The interest on the bank accounts and on the bonds were treated as the income of the taxpayer for income tax purposes. The taxpayer appealed, contending that an absolute transfer of assets was not a settlement within the meaning of section 21 FA 1936.

It was held by all the courts up to and including the House of Lords that the transfers were settlements within section 21.

The matter, to the judges in this case, was clear. For example, in the Court of Appeal, Sir Raymond Evershed MR said:

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143. (1953) 34 TC 178

"It is not in doubt that, according to the ordinary acception of language, if a man transfers to somebody else, as Mr Hood-Barrs did in the Hood-Barrs case, a block of shares by way of gift to that other person, then there has been a 'transfer of assets'. Accordingly, if the word 'settlement' in the first sub-section [of section 21 FA 1936] is to be treated as comprehending, but virtue of the language of sub-section (9)(b), 'transfer of assets', it seems to follows as night follows day that such a 'transfer of assets' is a 'settlement' to which the section applies."[144]

It has not been seriously questioned since these two cases that an absolute gift to an infant, unmarried child of the donor can be a "settlement" within what is now section 663 ICTA 1988.

The decision in Hood-Barrs and Thomas v Marshall that an absolute gift by a parent to his child constitutes a "settlement" can have some rather anomalous results.

Take, for example, section 664(2)(3) ICTA 1988 which, in effect, says that, in the case of an irrevocable settlement by transfer of assets (other than by way of covenant), payments out of trust capital made to the child will be caught by the section. Accordingly, any income subsequently derived from that capital by the child will be treated as the child's own income, and not as the notional income of the settlor.

For example, assume the following figures for trust income from an irrevocable trust set up by a parent and payments to the child:

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144. p191

YEAR	TRUST INCOME	PAYMENTS TO CHILD
1	£ 1,000	£ 500
2	£ 3,000	£ 4,000
3	£ 6,000	£10,500
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	£10,000	£15,000
	======	======

The extra £5,000 paid to the child came out of trust capital. This sum would be treated as monies not comprised in any settlement with the result that, if the child invested that money, the income derived from it would be his income and not his parent's.

If however, the father had made a direct payment of £5,000 to his child, or bought £5,000 of investments for him, the subsequent income would have been treated as the parent's income for income tax purposes. But, because the parent settled trust capital on trustee under an irrevocable settlement for his child, and the trustees subsequently released part of the trust fund to the child, the subsequent income resulting therefore would be the income of the child, not the parent.

"Trust", "Covenant"

The normal meanings of these terms which appear in all three definitions are, of course, fairly clear but, in the context of these anti-avoidance provisions, the cases have raised a number of points of specific relevance, probably the most important of which is the requirement for an element of bounty, which is dealt with in detail below.[145] The cases set out below also helped to delineate the boundaries of the statutory definition.

The definition of "settlement" in section 21(9)(b) FA 1936 [146] arose in an interesting context in the case of Yates v Starkey.[147]

The taxpayer divorced his wife and the court ordered him to pay to his former wife an annual sum, less tax, in trust for each of the three children. The wife, on behalf of the children, made repayment claims on the basis that the annual sums were income of the children. The Revenue allowed these claims. The taxpayer, however, claimed that he was entitled to the benefit of the allowances because, inter alia, the trust was caught by section 21 FA 1936 and, accordingly, the income had to be treated as his.

The Court of Appeal accepted this argument: the court order must be taken to have created a "settlement" for the purposes of section 21 because within the definition in subsection (9)(b) was "any...trust". Furthermore, the taxpayer was a "person who has provided....funds....for the purpose of" the settlement by means of the annual sums paid under the order and he was, accordingly, a "settlor" within section 21(9)(c). It followed, therefore, that section 21 applied to the payments made under the court order.

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145. See Part 2, infra
146. Now section 670 ICTA 1988
147. (1951) 32 TC 38

The Crown raised the point that, as the annual sums had been compulsorily extracted from the taxpayer by an order of the court, it was a different situation from one in which a parent had furnished sums of his own free will. This was rejected by the Court of Appeal.[148] It was not clear to what extent this fitted in with the requirement for there to be an element of bounty, which appears from the subsequent Plummer case.[149]

This point was clarified by Nourse J in Harvey v Sivyer.[150] The facts were that the taxpayer and her husband separated, and her infant children continued to live with the taxpayer. Under the terms of a deed of separation the husband covenanted to pay to each of the children a certain sum per month. He duly made the covenanted payments less tax and completed certificates of deduction of income tax. The taxpayer, on behalf of the children, made a claim to the Inspector of Taxes for repayment of the income tax deducted. Her claim was refused on the ground that the covenanted sums were paid under a settlement so that they fell to be treated for tax purposed as the husband's income under section 437 ICTA 1970.[151]

Nourse J held that, for a deed of separation to constitute a settlement for the purposes of section 437, it had to contain an element of bounty. Although the husband being the children's father, was compelled by parental obligation to make payments for their maintenance, the natural relationship between a parent and child was one of such affection and concern that there had always to be an element of bounty in the making of such payments. Accordingly, the husband's deed constituted a settlement with the result that the payments had to be treated as his income and not as the income of the children.

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148. See Hodson LJ at p53 and Jenkins LJ at pp47 and 49
149. IRC v Plummer (1979) 54 TC 1, see Part 2, infra
150. [1985] STC 434
151. Now section 663 ICTA 1988

Although the deed of separation was unquestionably a covenant, the point Nourse J had to determine was whether it was within the statutory definition in section 444(2) ICTA 1970.[152]

Nourse J noted that, since the Yates v Starkey decision, the Revenue practice had been to treat a court order made in family proceedings as not being a settlement for the purposes of section 437(1), except in the rare cases where it in terms creates a trust (as in Yates v Starkey itself), or is in some other way brought within the statutory definition.[153] The judge said that the foundation of this practice was a passage from the judgment of Jenkins LJ in Yates v Starkey which ran:

> "The order here in question (particularly as it was not made by consent) was hardly a disposition, agreement or arrangement. It certainly was not a covenant, not, I think, was it a transfer of assets, though......compliance with it did involve transfers of assets in the shape of the payment of [the sums in question]."[154]

It is difficult to square this fully with Hood-Barrs and Thomas v Marshall and, furthermore, it is not clear why a transaction, compliance with which involved a transfer of assets, would not be a "transfer of assets" within the statutory definition unless, of course, there was an element missing which was necessary for the statutory definition, such as bounty. But there was sufficient bounty for the trust in Yates v Starkey to be within the statutory definition, so that could not have been the missing element. Neither Jenkins LJ, nor Nourse J in Harvey v Sivyer explained was the missing element might be.

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152. Now section 670 Ibid
153. p439
154. 32 TC 38 at pp47-8

Nourse J said that the Revenue practice based on Jenkins LJ's above mentioned passage applies just as much to orders made by consent as to orders made after a contested hearing. On the other hand, he said, where provision for the children is made by one of the parents out of court by way of covenant or some other transaction within the statutory definition, the practice of the Revenue had been to treat it as a settlement, and they regarded it as immaterial that the provision may have been made under some for of compulsion or exclusively out of parental obligation.

It may be interposed here that the Revenue's practice appears to have been formulated either in ignorance or in disregard of the case law.

Nourse J, in fact, went on to consider whether the Revenue practice represented good law. He started by noting that, in the Plummer case,[155] it was held by the House of Lords that a transaction had to have an element of bounty to be within the statutory definition. He then posed the question:

> "how can it be said that a transaction which is entered into under compulsion contains and element of bounty. Has Yates v Starkey been overruled in this respect?[156]

He said that the report of arguments of counsel in Plummer records that Yates v Starkey was cited only in reply but it was not referred to in any of the Law Lords' opinions.

Nourse J referred to a passage from the judgment of Lord Wilberforce in Plummer where he set out the "bounty" requirement, and Nourse J then said that it was clear to

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155. IRC v Plummer (1979) 54 TC 1, see Part 2, infra
156. p439

him that, if Lord Wilberforce had intended to overrule Yates v Starkey, he would certainly have said so. The judge continued:

> "[Lord Wilberforce] evidently thought that there was no inconsistency between the element of bounty test and that decision. He may well have thought that the natural relationship between parent and young child was one of such deep affection and concern that there must always be an element of bounty by the parent, even where the provision is on the face of things made under compulsion.... I therefore conclude that the decision in Yates v Starkey remains good law."[157]

On the contrary, there is nothing at all in Lord Wilberforce's judgment to show that he had Yates v Starkey in mind, and his bounty test does not sit very happily with the Court of Appeal's decision in Yates v Starkey. However, that case was not expressly overruled and Nourse J has suggested what is a common sense reconciliation between the two, but his conclusion on the Harvey v Sivyer facts is hard to justify other than on pragmatic grounds:

> "In my judgment, if compulsory provision by a parent for his child is a settlement, all the more so is provision made exclusively out of parental obligation. I am certainly prepared to accept that the commissioners' finding goes further than that and to accept the formulation of counsel for the taxpayer, which was that the provision was made in order to avoid a compulsion which was inevitable once the separation had occurred. But that cannot be more than compulsion. It is either the same thing or less than the same thing, and if it is the latter it is a fortiori case."[158]

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157. p440
158. pp 440-1

In the case of IRC v Craw[159] it was held by the Court of Session that payments made under an agreement made on the separation of the taxpayer and her husband by the husband of her children were caught by section 437 ICTA 1970 and that an order of the court made later purporting to have retrospective effect to the date when the payments started did not take the payments out of section.

The Court of Session held that the sums under the agreement could not be treated "as if" they had been made under the court order; but, presumably, even if the payments had been made under the court order, section 437 must still have applied on the authority of Yates v Starkey, it having been accepted that the original agreement, which the court order sought to ratify, was within the section. The Court of Session were not called on to decide this point, and no mention of it was made in the court's judgment.

Similarly, a court order varying an earlier court order could not retrospectively alter the tax effects of the earlier order. So held the Court of Appeal in Morley-Clarke v Jones.[160]

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159. [1985] STC 512
160. [1985] STC 660

"Disposition"

It is one of the peculiarities of the provisions now within Part XV ICTA 1988 that "disposition" is the operative word in section 660 but is itself part of the definition of "settlement" in section 670 for the purposes of section 663 et seq, and in section 681(4) for the purposes of the other provisions in Part XV (apart from Chapters I and II).

The meaning of the word "disposition" in the definition of "settlement" in section 670 has been considered in two cases concerning the surrender of life interests. In each case the surrender was held to be a "disposition", this underlining how wide is the definition of "settlement" for these purposes.

The first of these cases was IRC v Buchanan[161]. Under the will of Lord Iveagh, one of his sons, Arthur Guinness, had a life interest in part of the estate, with remainder to Lady Dufferin (a daughter of Arthur Guinness) for life, with remainder to Lady Dufferins's issue. Under Lord Iveagh's will the life interests were protected but might be surrended to any one or more of the persons immediately entitled in remainder, and it was provided that such a surrender should operate so that the persons in whose favour it was made should become entitled to the same estate or interest under the will or an appointment thereunder as if the life tenant were deed. The will also made provision for the maintenance of infant beneficiaries out of income.

On 8 March 1948, Lady Dufferin surrended her life interest in remainder in favour of her children and, on the next day, Arthur Guinness surrended his life interest to them. Subsequently, Arthur Guinness died. In the

161. (1957) 37 TC 365

years 1949/50 and 1950/51 Lady Dufferin's children were infants and her husband, the taxpayer, was assessed to surtax in respect of the trust income applied for their benefit.

The taxpayer argued that the surrender of a life interest could not be a "settlement" within the meaning of section 21 FA 1936.

The Court of Appeal had no hesitation in rejecting this argument: the surrender was a "disposition", and therefore a "settlement", within section 21, in consequence of which income was paid for the benefit of Lady Dufferin's children.

Lord Goddard CJ said:

> "A person can dispose of his interest in a fund or in a chattel or in anything else in a variety of ways, but if, having an interest in a fund, although the interest may not then be in possession, he surrenders that interest, it seems to me that he disposes of that interest."[162]

Applying that to the facts of the case he stated:

> "In my opinion, when Lady Dufferin executed the surrender in question she did dispose of her interest under her grandfather's will.... She exercised the power which the will had given her to surrender in favour of her children and, therefore, I think she disposed of the interest to her children. Under those circumstances, looking at the clear words of section 21, it seems to me that it is in consequence of that disposition that income is paid for the benefit of the children of the

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162. p374

settlor, because if a disposition is a settlement, the person who disposes is, of course, the settlor, and therefore the income is being paid for the benefit of her children. It seems to me, therefore, that the section entirely covers the facts of this case."[163]

This is clear and not surprising given the ordinary meaning of "disposition". It is then, perhaps surprising that over 20 years later the same point should be disputed in relation to the same definition[164] but, that is what happened in d'Abreu v IRC.[165] It is not necessary to state the facts of this case. Oliver J considered that the case was "wholly indistinguishable" from Buchanan[166] and, accordingly, his decision in favour of the Crown was inevitable.

Reference should also be made to the case of IRC v Plummer[167], in which the annual payments were undeniably dispositions, but section 434(1) ICTA 1970 [168] was not applicable because they were made for "valuable and sufficient consideration" and section 457(1)[169] did not apply because there was no element of bounty.[170]

As a final point, it should be noted that, for the purposes of section 663 ICTA 1988, has been held that the term "disposition" does not include a will: Willingale v Islington Green Investment Co.[171]

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163. Ibid
164. Then contained in section 444(2) ICTA 1970
165. [1978] STC 538
166. p548
167. [1979] 54 TC 1
168. Now section 660(1) ICTA 1988, see Part 5, infra
169. Now section 683(1) Ibid, see Part 8, infra
170. See Part 2, infra
171. (1972) 48 TC 547 at pp556-7 per Goff J; see also IRC v Buchanan, supra, at pp373-4 per Lord Goddard CJ.

PART 2

LIMITS ON THE DEFINITIONS

The Requirement of an Element of Bounty

The statutory definitions of "settlement" for income tax purposes have already been considered. There is one element which various cases have held to be common a requirement throughout the income tax code: there must be an element of bounty if a "settlement" is to be constituted.

The point arose in a case which has already been considered: Copeman v Coleman,[1] a case under section 21 FA 1936.

The matter was dealt with, not in terms of whether there was an element of bounty, but whether the transaction in question amounted to a bona fide commercial transaction, which, in the circumstances of this case, amounted to the same thing. The Crown had contended that the transaction by which the shares were created and allotted to the preference shareholders, was not a bona fide commercial transaction and therefore a "settlement" within section 21(9) FA 1936.[2]

Lawrence J agreed, saying:

> "it is true that the Commissioners.... have not found as a fact that this transaction was not a bona fide commercial transaction. They have expressed their decision without making any specific finding upon this topic..... In my opinion, it is impossible to come to any other conclusion but that this was not a bona fide commercial transaction, and it appears to me that there was a disposition within the meaning of the definition in subsection (9), or

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1. (1939) 22 TC 594
2. See p599

> an arrangement in the nature of a disposition within the meaning of that subsection."[3]

That this amounted to saying that there must be an element of bounty was confirmed by Plowman J in IRC Leiner,[4] the facts of which have already been given.[5] The judge said:

> "But the real question with which I am concerned is, I think, whether the interest paid by the [taxpayer] on the £34,000 loan to him is income originating from him as having been provided by him. On the face of it, it obviously is income provided by him in the sense that he paid it, but it is common ground that it is implicit in the fasciculus of sections of which section 401 [ITA 1952][6] forms a part that some element of bounty is necessary to make the sections apply and that a bona fide commercial transaction would be excluded from their operation: see Copeman v Coleman...[7]

On the facts of the case, Plowman J held that the transaction could not be treated as a commercial arrangement and that there was an element of bounty giving rise to a settlement.[8]

As well as these two cases, which have been concerned with issues of commerciality, there were other indications that bounty was required to constitute a "settlement".

It has already been noted that Lord Moncrieff in IRC v Morton considered that a "settlement" meant "the charging of the property of the settlor with rights constituted in

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3. p601
4. (1964) 41 TC 589
5. See Part 1, supra
6. Now section 668 ICTA 1988
7. p596
8. Ibid

favour of others". This, by implication, suggests an element of bounty.[9]

When this approach was adopted by Lord Macmillan in Chamberlain v IRC, he appeared to take the view that a sale for consideration in money or monies worth could not be a "settlement".[10]

This was taken up in Vestey v IRC[11], in which Lord Simonds said that the principle of the Chamberlain decision was that the "property comprised in the settlement" is only the property in respect of which some beneficial interest is created.[12]

Copeman v Coleman and Leiner were applied in Bulmer v IRC[13], a decision of Pennycuick J, in which it was held, on the facts, that the scheme in question was a bona fide commercial one without any element of bounty and that it did not therefore constitute a "settlement" within section 411(2) ITA 1952.[14]

The taxpayers, together with relatives and associates, owned a substantial minority holding in Bulmer & Lumb (Holdings) ltd., a public company. They discovered that another company was attempting to acquire control of Bulmer & Lumb by purchasing its ordinary shares on the Stock Exchange. The taxpayers and certain other shareholders wished to avoid a takeover and to gain control of Bulmer & Lumb for themselves. To this end, they arranged with Sanderson, Murray & Elder (Holdings) Ltd, another public company, for Sanderson to incorporate a subsidiary, Yorkshire Investment Co Ltd. The taxpayers and the other shareholders involved then lent money to Yorkshire at a commercial rate of interest to enable it

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9. (1941) 24 TC 259 at p269, see Part 1, supra
10. See (1943) 25 TC 318 at pp331-2
11. (1949) 31 TC 1
12. p82 Lord Normand agreed, p88, as did Lord Morton, p107, and Lord Reid, p120
13. (1966) 44 TC 1
14. Now section 681(4) ICTA 1988

to acquire shares in Bulmer & Lumb in the market. The taxpayers sold their own shares in Bulmer & Lumb to Yorkshire at below market value (because Sanderson wished the balance sheet of Yorkshire to show creditors outside the group at a low figure) and the purchase price was left outstanding as an interest-free loan. Under the arrangement, the net profits of Yorkshire (ie the dividends on its shares in Bulmer & Lumb) were applied towards the servicing and repayment of the loan from Sanderson (although there was no bar to the loan being repaid from other sources); and each of the taxpayers was given an option, exercisable when the loan from Sanderson had been repaid, to purchase shares in Bulmer & Lumb held by Yorkshire, in proportion to the shares originally sold by him to Yorkshire, for an amount equal to that left on loan by him in respect of the original sale. In addition, when the loan from Sanderson had been repaid, the taxpayers were obliged to buy at par from Sanderson the issued capital of Yorkshire in proportion to their interests.

The taxpayers were assessed to surtax in respect of the dividends paid by Bulmer & Lumb to Yorkshire on the footing that the transactions constituted a "settlement" within section 411(2) ITA 1952.

Counsel for the Crown argued that an absence of bounty does not preclude the application of the "settlement" provisions.[15] It was argued that the definition should be taken literally without reading in the words "containing some element of bounty". It was further submitted that Plowman J in Leiner had not been asked to decide whether a bona fide commercial transaction could be a settlement; he merely applied the construction presented by the parties as common ground between them. Accordingly, it was said, Plowman J's remarks should be treated as obiter.

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15. See p22

Pennycuick J, however, took a different view. Referring to Copeman v Coleman he concluded that "there is no doubt that the judgment proceeded from the premise that the section..... only applied to a transaction which is not a bona fide commercial transaction". He also noted that Plowman J in Leiner, following Copeman v Coleman, proceeded on the same premise.[16] Pennycuick J then continued:

> "It seems to me that in this Court I ought to adopt the premise on which the two decisions which I have cited proceed and treat the section an inapplicable to a bona fide commercial transaction by the Crown without argument. Again the premise was not strictly necessary to the decision, ie, the Court could have proceeded on the basis that, whatever might be the position in the case of a bona fide commercial transaction, the particular transaction before it was not a transaction of that nature. Nevertheless, the earlier decision[17] has stood for nearly 30 years and in each case the judge accepted, and indeed insisted on, the premise."[18]

Pennycuick J also noted that Counsel for the Crown placed great reliance on Thomas v Marshall[19] as negativing what was said in Copeman v Coleman and Leiner.[20] Thomas v Marshall, as has been explained above,[21] was a case on "transfer of assets", which phrase was held by the House of Lords to cover an outright gift. Pennycuick J said:

> "The House of Lords rejected the contention that the definition of a settlement in the provisions corresponding to section 402 of the Income Tax Act 1952 must be restricted to a disposition having an

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16. p28
17. <u>Copeman v Coleman</u>, supra
18. p28
19. (1953) 34 TC 178, supra
20. pp28-9
21. See Part 1, supra

effect comparable to that of a settlement and held that it embraced an outright gift, see in particular, per Lord Morton of Henryton, at page 202:

> "...... The object of [section 21(9)(b) FA 1936] is, surely, to make it plain that in section 21 the word 'settlement' is to be enlarged to include other transactions which would not be regarded as 'settlements' within the meaning which that word ordinarily bears. Its effect is that whenever the word 'settlement' occurs in section 21 one must read it as 'settlement, disposition, trust, covenant, agreement, arrangement or transfer of assets' and if 'by virtue or in consequence of' any of these transactions or deeds income is paid to or for the benefit of a child of the settlor, section 21 comes into operation.'

That decision is, of course, conclusive as to the proper construction of the definition. On the other hand, the House of Lords were not concerned with dispositions other than by way of bounty, and I do not think their decision can fairly be treated as negativing the entirely different kind of implied restriction upon the definition of 'settlement' which was adopted in the Coleman case. That case does not appear even to have been cited in the Thomas case."[22]

On a more general note, Pennycuick J stated that there is no doubt that, where the context so requires, a court may imply some restriction on the scope of general words in a statute.[23] In the case of the definition of "settlement" it must be legitimate to hold that a sufficient context exists for a restriction in the scope of the definition.

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22. p29
23. Ibid

In the circumstances, he followed the Copeman v Coleman and Leiner cases and, on the facts of the case, held that the transaction was a bona fide commercial one, concluding:

> "Clearly the [taxpayers] did not intend to confer a bounty either on Yorkshire or on Sanderson. It may be that the transaction has been framed - largely, it appears on the instigation of Sanderson - in such a way as to procure tax advantages to the [taxpayers], but that circumstances does not of itself prevent it from being a bona fide commercial transaction or import any element of bounty."[24]

The requirement of bounty was dealt with directly by the House of Lords for the first time in IRC v Plummer[25]. This case concerned the "reverse annuity scheme" and the facts are set out in detail below.[26]

The Revenue attacked the arrangements under, inter alia, section 434 ICTA 1970[27] and section 457 of that Act.[28]

In the High Court, Walton J held that neither section applied.

Dealing with section 457, which was the section in point in the Bulmer case, Walton J considered that Pennycuick J in that case did not come to a final conclusion on the question of whether or not a scheme falls within the definition of "settlement" depends on the question of whether it is a bona fide commercial transaction or is one in which there is no element of bounty.[29] In fact, the higher Courts disagreed with Walton J on this point, considering that

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24. p30
25. (1979) 54 TC 1
26. See Chapter 11
27. Section 660 ICTA 1988
28. Section 683 Ibid
29. p19

Pennycuick J had held that a commercial transaction without any element of bounty could not constitute a "settlement" for the purposes of section 457 (1) ICTA 1970.[30]

In any case, Walton J held that, in Plummer, there was no element of bounty. On the question of whether there was a bona fide commercial transaction, the judge noted that counsel for the Crown had argued that the principle of the Bulmer case did not apply to a transaction the sole purpose of which was tax avoidance.

Walton J quoted Russell LJ in IRC v Goodwin who said:

> "Bulmer v Inland Revenue Commissioner... was a case indicating that the expression 'bona fide commercial transaction' was used judicially to describe something lacking an element of bounty, in determining whether there was a 'settlement'. It does not we think help, though it indicated, as one would expect, that there can be bona fide commercial transaction with the obtaining of a tax advantage as a main object."[31]

The Special Commissioners in Plummer had found as follows:

> "We regard it as a fair description of the transaction to say that it was a bona fide commercial transaction without any element of bounty notwithstanding that the benefits from it were largely to be derived from the tax advantages which the parties expected would accrue to them."

Walton J considered that the Commissioner were correct. He concluded that:

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30. See Buckley LJ in the Court of Appeal at p28 and Lord Wilberforce in the House of Lords at pp43-44. In fact, counsel for the Crown accepted that Pennycuick J had so held in their argument before the House of Lords in the Plummer case, see p35.
31. 50 TC 583 at p607

"The idea behind Bulmer and the cases which it followed is surely this: that, however wide the statutory language in which the term 'settlement' is defined, the overriding idea is that of bounty of some description. If there is no bounty, then there is nothing which can even remotely be classed as a settlement with a settlor..... Therefore, as in the present case there is no question of bounty on either side, it appears to me quite clear that the Bulmer principle applies as found by the Special Commissioner."[32]

Walton J also held that the Bulmer principle applied to section 434. He found the respective definitions in sections 434(2)[33] and 454(3)[34] " quite indistinguishable". He did not consider it relevant that there was an element of tautology in section 434(1)[35] in expressly excepting any disposition made for valuable and sufficient consideration.[36]

In the Court of Appeal it was agreed that neither section 434 nor section 457 applied, although it was held that Bulmer had no application to section 434.

Buckley LJ rejected the Crown's submission that, in using the word "commercial", Pennycuick J in the Bulmer case intended to indicate that the transaction referred to must be one effected in the course of commerce or trading. Buckley LJ did not think that Pennycuick J was using the word "commercial" in so restricted a sense. He said:

"In my opinion it is clear from the judgements of Pennycuick J in Bulmer v Commissioner of Inland Revenue and of Plowman J in Commissioners of Inland

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32. p20
33. Now section 660(3) ICTA 1988
34. Now section 681(4) Ibid
35. Now section 660(1) Ibid
36. p21

Revenue v Leiner that those learned judges were there using the term 'commercial transaction' to indicate any transaction in which there was not element of bounty. It follows that a transaction effected for full consideration in money or money's worth is not a 'settlement' for the purposes of section 457. The express exception contained in section 434 of 'a disposition made for valuable and sufficient consideration' appears to me to have a similar effect."[37]

Buckley LJ said that, a transaction effected for full consideration in money or monies worth is not a "disposition" for the purposes of section 434.

On the Crown's contention that a transaction, the sole object of which is tax avoidance, cannot be a bona fide commercial transaction, Buckley LJ said that fiscal consequences are incidents of a very large number of business transactions. Such considerations must inevitably affect the willingness of the parties to enter into a transaction and the amount of consideration which a party is willing to give or to accept in order to close a bargain. They must, he said, be elements to be taken into account in determining whether the consideration given by either party is sufficient. In the present case, both parties entered into the transaction in anticipation that the taxpayer would be able to deduct the annuity payments from his total income for surtax purposes and to pay the annuity subject to deduction of tax at the standard rate, and that HOVAS would be able to recover the tax so deducted. These were expected incidents of the transaction and Buckley LJ could see no reasons why the parties should have excluded them from consideration in negotiating the price which HOVAS was

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37. p29

prepared to pay, and the taxpayer was prepared to accept for the annuity. He concluded:

> "It is, in my opinion, quite fallacious to regard the fiscal advantages as constituting any part of the consideration for the bargain as [counsel for the Crown] was inclined to do. They were incidents of the bargain and no more. The consideration was the purchase price on the one hand and the grant of the annuity on the other."[38]

Finally, Buckley LJ said that, in his judgement, the decision in Bulmer has no bearing upon section 434. The presence in subsection (1) of that section of the exception for any disposition made for valuable and sufficient consideration makes it unnecessary to imply in section 434 any such limitation on the meaning of "disposition" as was implied in Bulmer in respect of the meaning of "settlement" in section 457.[39]

Bridge LJ and Foster J agreed.

In the House of Lords, although the Law Lords unanimously held that section 434 did not apply, only a majority considered that section 457 had no application. Viscount Dilhorne and Lord Diplock considered that it was not a requirement of the section that there should be an element of bounty and, in any case, Lord Diplock thought there was an element of bounty in this case.

Before the House of Lords, the Crown did not dispute that Bulmer was correctly decided on its facts, and they

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38. p30
39. p31

accepted that some limitation must be imposed on the very wide literal meaning of the word "settlement" in section 454(3). But, it was argued, it cannot have been intended by the Legislature, when enacting a section specifically aimed at tax avoidance, that the word "settlement" should be so limited as to except from the provisions of the section a transaction such as the one in the Plummer case, the sole purpose of which was tax avoidance.[40]

Lord Wilberforce, on the section 434 point, agreed with the reasoning of the Court of Appeal and did not feel the need to elaborate on that reasoning.[41]

On section 457, he noted that it was not disputed that, if the agreement in the Plummer case was a "settlement" within the definition and section 454(3), the annuity payments would be treated as the income of the settlor. On the meaning of "settlement", he said:

> "My Lords, it seems to me to be clear that it is not possible to read into the definition an exception in favour of commercial transactions whether with or without the epithet 'ordinary' or 'bona fide'. To do so would be legislation, not interpretation: if Parliament had intended such an exception it could and must have expressed it. But it still becomes necessary to enquire what is the scope of the words 'settlement' and 'settlor' and of the words which are included in 'settlement' in the context in which they appear. It it appears, on the one hand, that a completely literal reading of the relevant words would so widely extend the reach of the section that no agreement of whatever fell outside it, but that, on the other hand, a legislative purpose can be discerned, of a more limited character, which Parliament can reasonably be supposed to have

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40. p35
41. p42

intended, and that the words used fairly admit of such a meaning as to give effect to that purpose, it would be legitimate, indeed necessary, for the Courts to adopt such a meaning."[42]

Lord Wilberforce referred to various settlement provisions and said that they had a common character in that the Courts that had so far dealt with the problem had selected the element of "bounty" as a necessary common characteristic of all "settlements" which Parliament had in mind.[43] On the facts of the case, he said that there cannot be any doubt that no element of bounty existed and that the transaction was a bona fide commercial transaction.[44]

Lord Fraser delivered a judgement making the same points[45] and Lord Keith agreed with Lord Wilberforce.[46]

However, Viscount Dilhorne took a different view. On section 457 he said that it was not right for the Courts to amend the definition of "settlement" by adding words limiting its scope. That, in his view, would be legislating.[47] He said that, if Parliament had intended that the definition in section 454(3) should apply only to a settlement in which there was an element of bounty, they could easily have said so. He refused to construe the definition as if it required an element of bounty.[48]

On section 434, however, Viscount Dilhorne agreed with Walton J and the Court of Appeal that the section did not apply.[49]

Lord Diplock took an even more robust view. On the section 457 point he said:

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42. Ibid
43. p43
44. p44
45. See pp56-57
46. p58
47. p48
48. p49
49. p50

"So it seems to me that in order to reach a conclusion whether in addition to those transactions which are expressly excluded from section 457 by subsections (1) to (4) any other kinds of transaction whereby income is paid by one person to another were intended to be excluded from its operation, it is necessary to apply to this part of the Act a purposive construction and to ask oneself the question in relation to the particular kind of transaction which is under consideration: 'Can Parliament really have intended to tax this particular kind of transaction by the wide words that the draftsman has used?' If the only sensible answer to that question is 'no' the words of the Act should be understood as inapplicable to the transaction. That question when asked about a transaction which not only falls within the literal meaning of the words used in the section but has no other object than to enable the settlor to avoid a liability to surtax on his income which he would otherwise be obliged to pay, so far from inviting the answer: 'no', invites the answer 'whatever kind of transaction Parliament may have intended to exclude it cannot have been this one'".[50]

In any case, Lord Diplock considered that there was an element of bounty in this case. He said:

"If one is to disregard the underlying realities of the whole tax avoidance scheme in which that document [under which the annual payments were made]" played an essential part and recognise only the legal obligations which it imposed on the parties to it, Mr Plummer undertook an obligation to pay to HOVAS in return for a payment of £2,480, 5 sums of £851 each over a period of just over 4 years

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50. p53

or a total sum of £4,255. This, as it seems to me, involves a substantial element of bounty".[51]

It is submitted that the relevant case law considered above supports the decision of the majority in the House of Lords, rather than that of the minority.

The question of bounty was next considered by the Court of Appeal and House of Lords in Chinn v Collins.[52] The facts of this case have already been given.[53]

In the High Court, Templeman J dealt with the settlement question without reference to the question of whether there was an element of bounty. His views are set out above in connection with the examination of the meaning of "arrangement" in Part 1 of this Chapter.

However, the question of bounty was an important part of the judgements of the Court of Appeal, which found that there was not a settlement, and the House of Lords, which held that there was. The reasoning behind this difference if opinion is interesting in that the Court of Appeal took a more traditional view and held that an appointment by the trustees under a special power did not contain an element of bounty since they were merely the agents of the settlor whose bounty had been exhausted on the creation of the settlements. The House of Lords, on the other hand, took the view that the settlor's act of bounty in making the settlement was completed by the trustees making the appointment to the beneficiaries.

This case was, as noted above, concerned with the definitions of "settlement" and "settlor" in section 42(7) FA 1965 for the purposes of capital gains tax. However, those terms were expressed to have the same meanings as in section 411(2) ITA 1952.[54]

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51. pp53-4
52. (1980) 54 TC 311
53. See Part 1, supra
54. Now section 681(4) ICTA 1988

Buckley LJ, having referred to the Plummer case said:

> "I feel unable to agree with [Templeman J] that the settlor in the present case was the settlor for the purpose of any 'settlement' constituted by the scheme. The settlor parted with all his interest in the trust fund comprised in the settlement of 24 February 1960 when he made that settlement. Thereafter he had no interest whatever in the trust fund and no power to dispose of it or of any interest in it. He cannot, therefore, have conferred any bounty on any one in relation to the trust property after that date. Whatever bounty accrued to Anthony on the execution of the appointment derived not from anything done at the time of the appointment but from the settlor's original disposition at the time of the settlement. It is true that the settlor's consent was necessary for the exercise of the power of appointment under the settlement, but by consenting to the appointment the settlor did not, in my opinion, confer any bounty on Anthony. The appointment was an exercise by the trustees of a discretion vested in them, which the settlor could not influence except by way of embargo. He could unlock the door or keep it locked, but he could not open it: he could confer no bounty, although he could prevent the trustee conferring a particular beneficial interest. To discover whether a particular arrangement can be regarded as constituting a settlement within section 42(7) one must clearly, in my opinion, look at the state of affairs when the arrangement is put into effect. In this case the earliest date that could be selected in this respect was 31 March 1969 when the new trustees were appointed: on the other hand no new beneficial interest was brought into existence until the appointment was made on 28 October 1969. It is, in my opinion impossible to

say that at either of those dates the settlor was in a position to confer any bounty out of the trust fund on Anthony or anyone else. The trustees of the settlement could confer no bounty for, although they had a power of appointment, they had no beneficial interest in the trust fund out of which to confer any bounty on anyone. The benefit conferred on Anthony by the appointment was a fruit of an earlier of bounty by the settlor on 24 February 1960. It follows, in my opinion, that on a true view of the facts the scheme involved no act of bounty by anyone and consequently cannot have constituted a settlement within the meaning and effect of section 42(2)."[55]

Goff LJ analysed the situation in the same way[56] and Shaw LJ agreed with both judgements.

As has been noted above, the House of Lords were of a different opinion. The views of Lord Wilberforce, with whom Lords Fraser and Russell agreed, have been set out above when this case was dealt with in connection with the meaning of "arrangements".[57] Lord Roskill, who was of the same opinion, made the following observation:

"My Lords, I would venture to point out that the word 'bounty' appears nowhere in the Statute. It is not a word of definition. It is a judicial gloss on the Statute descriptive of those classes of cases which are caught by the section in contrast to those which are not. The courts must, I think, be extremely careful not to interpret this descriptive word too rigidly. ....What the cases have sought to do is to distinguish between those cases where the recipient has in return for that benefit which he

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55. p339
56. p346
57. See Part 1, supra

has received accepted some obligation which he has to perform, either before receiving the benefit or at some stated time thereafter, and those cases where the recipient benefits without any assumption by him of any correlative obligations. In Plummer's case the transaction in question was for consideration. Under this scheme there was an appointment without consideration."[58]

These words were picked up by Nourse J in IRC v Levy.[59] The facts were that the taxpayer was the sole beneficial shareholder of a company called "Parkspar Securities Limited", a company trading in stocks and shares. In May 1973 the taxpayer loaned £3,330,000 to Parkspar. The loan was interest free and repayable on demand, subject to the possibility of six months deferral after demand. Parkspar used the money in the general course of its business and it earned income on it. The loan was repaid in October 1973.

The Crown contended that the loan was a disposition or an agreement within the meaning of section 454(3) ICTA 1970 and, being interest free, did not involve Parkspar in assuming any correlative obligations. Accordingly, it was argued, the disposition conferred an element of bounty and was a settlement for the purposes of section 434(3).

Nourse J rejected this argument. He said that, on the face of it, this was an "extraordinary claim". An interest free loan to a company in which the lender was the sole shareholder is, he said, an everyday transaction in the commercial world. As such it would invariably be regarded as one made for good commercial reasons divorced from altruism or charity. He held that it did not come within the definition of "settlement" in section 454(3).

58. p357
59. (1982) 52 TC 68

The Crown had fastened on to the words of Lord Roskill in Chinn v Collins and submitted that Parkspar benefited from the loan without any assumption by it of any correlative obligation for the payment of interest or otherwise. There was, therefore, an element of bounty. Nourse J correctly pointed out that Lord Roskill had also said that, on the authorities, it seemed clear that if the particular transaction was a commercial transaction devoid of any element of bounty, it was not a "settlement". He concluded:

> "It is obvious that Lord Roskill was not saying that something which would otherwise be a commercial transaction devoid of any element of bounty ceases to be one merely because he who is at the receiving end of it does not assume any correlative obligation."[60]

The judge then summarised the law and applied it to the facts of the present case as follows:

> "Before a disposition, trust, covenant, agreement pr arrangement can be a settlement within section 454(3) of the 1970 Act, it must contain an element of bounty. For that purpose a derivative bounty of the kind conferred by the exercise of a special power of appointment may be enough. On the other hand, a commercial transaction devoid of any element of bounty is not within the definition. The absence of any correlative obligation on the part of him who is at the receiving end of the transaction may be material, but is not conclusive in determining whether it contained an element of bounty or not. If those principles are applied to the facts of the present case, in particular to the Commissioners' finding that the transaction did not involve any

60. p86

bounty on the part of Mr Levy, it is clear that there was no disposition, agreement, or other transaction within section 454(3) of the 1970 Act. It was the simple case of a commercial transaction devoid any element of bounty, and immaterial that Parkspar did not assume any correlative obligation for the payment of interest or otherwise."[61]

Nourse J then noted that the Commissioners had thought that the question was to be determined subjectively and not objectively. He very much doubted whether this was correct although, he said, in any objective determination, the motives of the lender must be an important factor.

Although the case law clearly shows that an element of bounty is now required to constitute a "settlement", not every commentator agrees. Tax barrister, Robert Venables in his book, "Tax Planning Through Trusts"[62], thought that, once the House of Lords have the opportunity to reconsider the language they used in Plummer, they will limit its scope severly by reference to the facts of that case. He thought the bounty test only works in the context of annual payments. He concluded:

"Whatever the final gloss which may be put upon the decision in Plummer, it is considered that tax planning cannot safely proceed on any other assumption that that a trust...constitutes a settlement for the purposes of Part XVI [of ICTA 1970] whether its creation was an act of bounty or not."[63]

This, it is submitted must be wrong. Even without taking into account the statements from the lower courts, the pronouncements from the majority in the House of Lords in

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61. p87
62. 1983
63. pp291-2

Plummer and Chinn v Collins are too clear to be disputed in the absence of a major change in direction as in the Ramsay case or the Vestey case.

Territorial Limits

The Finance Act 1938 altered the territorial limits of the settlement provisions. The original legislation in section 20 FA 1922 only caught income which could be liable to UK tax. This was established in the case of Ormonde -v- Brown.[64] The taxpayer, by a deed executed in 1922, assigned certain property to an American trustee upon trust, inter alia, to pay the income to herself and her husband in equal shares during their joint lives. The deed contained a power of revocation and modification and the taxpayer, acting under this power, modified the provisions of the deed from time to time directing the trustee, inter alia, to make payment of irrecoverable annuities to her children and other persons. In 1928, the taxpayer relinquished, until 1st January 1929, the power of revocation except with her husband's consent.

In 1929, the taxpayer, with the consent of the beneficiaries, revoked the trust and, by a separate deed, dated 25th April 1929, transferred the trust estate to an American trust company, declaring trusts which provided for the payment of annuities to each of three named persons as a charge on the whole fund, and for the payment to the taxpayer and her husband of the annual sum of £6,000 each. This deed contained a power of revocation and modification, which, to the extent that its exercise might infringe the rights of the three named annuitants, was exercisable only with their written consent, but it was declared that revocations which should leave assets in the trust fund sufficient, in the judgement of the trustee, to assure payment of the annuities should not be deemed to infringe such rights.

It was contended by the Crown that, by the exercise of the power of revocation contained in the trust deeds, the taxpayer could, without the consent of any other person,

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64. (1932) 17 TC 333

except her husband, obtain for herself the beneficial enjoyment of the whole income arising from the assets in the trust fund (except the sums required to meet the inevocable annuities). Accordingly, it was argued, that income must, under section 20(1)(a) FA 1922,[65] be deemed to be the income of the taxpayer, and that the taxpayer was assessable to income tax in respect of the whole income arising from the stocks, shares and securities comprising the trust funds, less the amount of the annuities. Finlay J found for the taxpayer on both of these points.

On the question of whether the taxpayer was liable on the whole of the trust income (less the annuities), Finlay J said that this depended on the construction of the words "Any income" at the beginning of section 20. The taxpayer had argued that the words "any income" means income within the ambit of English tax legislation. Therefore, in as much as this income was the income of a non-UK resident trustee and was not income derived from the UK, it was not within the ambit of English tax legislation and the words "any income" must be cut down accordingly.

The judge agreed with the following analysis of the law as submitted by Counsel for the taxpayer. Section 20, he said, was not a charging section in that it did not bring into charge income which was altogether outside the ambit of English tax legislation; although it undoubtedly created a liability where there would not otherwise be one, in the sense that a liability is shifted. The income which, but for the section, would be the income of B was made the income of A, but always it was income within the ambit of English tax legislation. Counsel for the taxpayer relied on a passage in the speech of Lord Wrenbury in the case of Whitney -v- IRC. The judge said

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65. See Part 4, infra
66. p344

that the passage had "a close bearing upon the matter which I have to decide here" [66]. In that case, Lord Wrenbury said:

> "As regards the word 'income' I agree again with the conclusion at which the Lord Chancellor has arrived. It means such income as is within the Act taxable under the Act. Section 5(1) assists in taking this view. The Act has nothing to do with the foreign income of one who is not a British subject and who is not resident here. The territorial limit of the Act to which Lord Herschell referred in Colquhoune -v- Brooks does not extend to the foreign income of the person who is foreign both by nationality and by residence. The Act nowhere purports to tax income which is neither derived from property in the United Kingdom nor income received by a person resident in the United Kingdom. The word income wherever found in the statute is to be understood as excluding income neither so derived nor so received. But it includes all other income by virtue of the express words of Schedule D." [67]

Finlay J said that this passage was a general statement of the law. Accordingly, the Judge held that section 20(1)(a) did not operate to bring within the charge to income tax any income not within the ambit of the Income Tax Acts.

On the second point, this is an example of one of the major defects in section 20 that section 38 FA 1938 was introduced to counter. As is explained below [68], where a power of revocation could only be exercised with the consent of another person, section 20(1)(a) could not apply. Applying that principal to the facts of this case, Finlay J held that the consent of the trustee was

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67. 10 TC 88 at p113
68. See Part 4, infra

necessary and, in fact, he also thought that the consent of the annuitants was required. He added:

> "It is, of course, not the least to the point to say that the trustee would very likely be very willing to consent to any reasonable arrangement."[69]

The Crown, therefore, failed on both grounds.

This case was approved by the House of Lords in Perry -v- Astor.[70] The arrangements in this case were typical of schemes that were fairly widespread at the time for transferring assets abroad to a foreign trust or company. At the time the transactions in this case were carried out, the legislation covering transfer of assets abroad had not been introduced; they were contained in section 18 FA 1936.[71]

The facts were that the taxpayer was a British national, resident in the United Kingdom. He transferred certain foreign stocks and shares to American trustees under a settlement governed by the law of the State of New York, upon trust to collect the income therefrom and, after paying all expenses properly chargeable against such income, to pay or apply the balance of the income to or for the use of the taxpayer during his life, in such amounts and at such dates as he might direct. Power was reserved to the taxpayer to revoke or to alter the settlements so that, if section 20(1)(a) FA 1922 applied to the settlement, the whole of the income of the settlement would have been deemed to be the income of the taxpayer.

Under the law of New York, which differed in this respect from English law, the whole of the legal and equitable interests in the transferred stocks and shares became

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69. p347
70. (1935) 19 TC 255
71. See Chapter 9

vested in the trustees and the only right of the beneficiary was to call upon the trustees to pay over to him the balance remaining in the hands of the trustees after repayment of the outgoings. Furthermore, the power of revocation, under New York law, had no effect on the nature of the taxpayer's rights until it was exercised.

The Crown conceded that, had there been no power of revocation, the taxpayer would only have been chargeable to UK tax on remittances to him in the UK by the trustees. The Crown, however, contended that the deeming provisions of section 20 applied so as to render the whole of the trust income, whether remitted or not, the income of the taxpayer with the result that it was all liable to tax in his hands.

At first instance, Finlay J decided that the case was governed by Ormonde -v- Brown and held for the taxpayer. However, on appeal, the Court of Appeal unanimously found in favour of the Crown. Referring to the contention that section 20 did not cover income which was not already taxable, Lord Hanworth MR commented:

> "It appears to me that the section is intended to bring within the purview of the income tax receipts of a person liable to income tax, receipts which without that section would not come within the purview of the income tax, but which by virtue of that section, are to be deemed to be his income, although, in fact, they are not at the moment. It is plain, that, under the facts as stated here, there is a power in the [taxpayer] to exercise this power of revocation. It is a valid power that has no effect until it is exercised. But it is a power which can be exercised by him without let or hindrance from any other person, and if he did so

exercise it, it would secure to him the beneficial enjoyment of the income derived from the dividends payable from these stocks and shares now held by the trustees."[72]

The House of Lords by a majority (Lord Russell dissenting) reversed the decision of the Court of Appeal. Lord MacMillan, with whom Lords Atkin, Tomlin and Wright agreed, pointed out that if the Crown was correct in saying that the words "any income" in section 20 are read without any qualification, territorial or other, "the most startling anomalies result".[73] He explained:

"Thus, if the section is to be read as applicable to any income anywhere of which any person anywhere can by the exercise of a power of revocation obtain for himself the beneficial enjoyment, it covers the case of a revocable disposition to an American trustee of American stocks and shares by a person resident in America under which the income is payable to a person resident in this country. In the case put, the American settlor is able by exercising his power of revocation to obtain for himself the beneficial enjoyment of the income of the stocks and shares which he has settled. That income, therefore, is to be deemed for British income tax purposes to be his income and not to be the income for those purposes of the person resident in this country who is entitled to it. ... Or suppose a resident in America makes a disposition there under which the income of American stocks and shares is payable to a resident in the United Kingdom for a period of five years. The section, read literally, as the Crown would have your Lordship's read it, would have the effect, under paragraph (b), of

72. p273
73. p286

deeming the income to be the income of the American resident who made the disposition and not the income of the beneficiary in this country. In both the cases supposed the person resident in this country would under section 20 be entirely exempt from tax in respect of the income, however, large, to which he was entitled under the American disposition, even although the whole of it were remitted to him in this country.

Perhaps the most anomalous, because the simplest, case that could be put is that the person resident in this country who makes a revocable settlement of assets abroad under which another person also resident in this country is the beneficiary of the income. The settlor then goes abroad and ceases to be resident in this country. Under section 20 the income is still, according to the Crown, to be deemed to be his income and not that of the beneficiary; the result is that neither the settlor nor the beneficiary pays any tax, although the whole of the income may be received and enjoyed by the beneficiary in this country.

But under Schedule D, the annual profits or gains arising or accruing to any person resident in the United Kingdom from any kind of property whatever, whether situate in the United Kingdom or elsewhere, are chargeable to tax. Under this, which is a cardinal provision of our income tax legislation, the income, in the three cases I have put, would be chargeable to tax while under section 20 of the 1922 Finance Act ... the same income would be exempted from tax.

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74. pp286-7

The learned Solicitor General did not flinch from these remarkable results of his unqualified reading of the words 'any income' in the Finance Act of 1922 but to your Lordship's they may well suggest a doubt as to whether these words should not be read in a sense would be avoid such a conflict."[74]

In Lord MacMillan's opinion, the difficulties did not stop there. He noted that, on the Crown's construction, if a UK resident person makes a disposition of the income of American stocks and shares in favour of a US resident for a period of five years, and under section 20(1)(b)[75] is charged with tax on that income, under subsection (2) he is given a right to recover the tax from the US beneficiary. Lord MacMillan said that a construction would leads to "the remarkable result of him passing a liability of recoupment on an American citizen is not likely to be accepted." He then noted subsection (3) and said that it would require the UK resident person in certain circumstances to pay to his American beneficiary sums in addition to the income which he had settled on him, which, he said, would be fair enough if, under subsection (2), he could succeed in recovering from him the tax paid in the UK, but would, otherwise, be "quite unreasonable".[76]

Lord MacMillan observed that the section does not provide that the power of appointment or power of revocation is to be deemed to have been exercised. On the contrary, it assumes that the power has not been exercised and that the income continues to be applied as the disposition directs. The section does not declare that the disposition is to be treated as non-existent as between the maker of the disposition and the Inland Revenue. The scheme of this section is that the income which the settlor, by his disposition, diverted from himself and conferred on another, shall be notionally restored to

75. See Part 5, infra
76. p287

him, while, in fact, continuing to be applied as he has directed.[77] Lord MacMillan suggested that section 20 was designed to effect a notional amalgamation of two existing incomes both charged to UK income tax.[78]

In reaching this conclusion, Lord MacMillan did not rely on the argument that section 20 was not a charging section and so ought not to be read as imposing a charge which is not elsewhere created. He said:

> "It seems to me that to say that a particular item of income which belongs to B is for income tax purposes to be deemed to belong to A is quite an effectual way of charging A with tax on the transferred income. ... Indeed, on the reading of section 20 which I propose to your Lordships the section is a charging section in the sense that it charges with tax on certain income a person who would not otherwise be chargeable with tax on that income. But it is not a charging section, as the Crown would make it out to be in the sense of charging with tax income which according to the existing law could not be charged at all, except so far as received in this country."[79]

Lord MacMillan concluded:

> "The result of the process of "deeming" which the section directs is, in my opinion, not to bring into tax income not previously chargeable but to substitute one person for another as the person liable to be charged in respect of income already chargeable. To justify reading this section as on the one hand imposing a charge on income not at present subject to charge and on the other hand as exempting from charge altogether income which is at

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77. p289
78. p290
79. Ibid

present chargeable - for that is the result of the Crown's contention - would, in my view, require much more express and precise language than the section contains."[80]

Lord Russell dissented, stating that he could not depart from the language of section 20(1). He did not consider that the supposed conflict with the provisions of Schedule D entitled the Court to give to the words of section 20(1) a meaning different from their ordinary meaning.[81] Lord Russell commented:

"The plain words of the Act may in some cases lead to results which to some may appear strange. That does not concern us, or justify us in altering the meaning of the plain words in order to produce what we may consider more sensible or less anomalous results. That course is only open to us if we find it necessitated by the language employed in other parts of the statutes."[82]

Apparently with the decision of the House of Lords in Perry -v- Astor in mind, section 38 FA 1938[83] was drafted in wider terms than section 20 FA 1922. Section 38 came up for consideration by the Courts in IRC -v- Kenmare[84]. The facts of this case are set out in Part 4 of this Chapter.

One of the arguments put forward by the taxpayers was that the UK legislature had no jurisdiction to impose a charge to surtax on her in respect of income which did not arise to her, as she was a non-resident; and that the provisions of section 38 FA 1938 did not apply to the settlement because the trustees were not resident in the UK. It was, however, held by each of the Courts up to

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80. pp290-1
81. p281
82. p282
83. See Part 4, infra
84. (1957) 37 TC 383

and including the House of Lords that no such limitation could be put on the provisions of section 38.

The view expressed by Danckwerts J, in the High Court, which was echoed by the higher Courts, was that the decision in Perry -v- Astor was based on the narrower wording of section 20 FA 1922. He refused to limit section 38 in the same way. He pointed out that section 38(7) stated that the section should apply to any settlement "wherever made". He pointed out that this "certainly seems to indicate some extension to settlements made in other countries, like the one in the present case." Furthermore, he noted the provisions of section 41(4) where the expression "income arising under a settlement" was defined in a way which led him to the conclusion that the section was intended by the legislature to deal with income which might be payable to non-residents.[85]

This view was upheld in the Court of Appeal[86] and the House of Lords also agreed.[87]

The only other case that needs to be considered here is Becker -v- Wright.[88] The taxpayer's father-in-law executed deeds of covenant in Trinidad under which he covenanted to pay to an English bank in trust for the taxpayer's wife, annual sums for three years. At all material times, the father-in-law was resident abroad and the taxpayer and his wife were resident in the UK. The taxpayer was assessed to income tax under Case V, under section 392 ITA 1952.[89] The taxpayer contended that, by virtue of section 392, the payments, being payable for a period of less than six years, were to be deemed to be

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85. See pp 391-2
86. See Singleton LJ at pp397-8, Morris LJ at p401 and Romer LJ at pp404-5
87. See Viscount Simonds at p408, Lord Reid at pp411-2 and Lord Cohen at pp413-4
88. (1965) 42 TC 591
89. Now section 660 ICTA 1988, see Part 5, infra

the income of his father-in-law and not of any other person. The Crown, on the other hand, contended that section 392 did not apply where its affect would be to declare foreign income of a non-resident to be liable in his hands to UK tax.

Stamp J held that section 392 did not apply because the income in question was not susceptible of being deemed to be the father-in-law's income for all (or any) of the purposes of the Income Tax Acts. He agreed with the Crown's contention that section 392 cannot apply to any income which, if the section were applied, would cease to be income within the meaning of the Income Tax Acts.[90]

With reference to the words "any income" at the beginning of the section, Stamp J said that it is clear that these words do not refer to that which is not income within the meaning of the Income Tax Acts but in another context might be treated as income; and he gave the examples of income derived from gambling or income received by a man by way of allowance from his father. He said that the section is confined to income which is, under the Income Tax Acts, taxable under those Acts.[91]

Stamp J concluded:

> "Paying regard to the considerations to which I have alluded, I find sufficient in section 392 itself to lead me to the inevitable conclusion that the section is concerned only with any income which, when the deeming process contemplated by the section has taken place, can be, for all the purposes of the Income Tax Acts, the income of the person by whom the disposition was made. For the reasons that I have given, that [the father- in-law] is

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90. p594
91. p595

resident abroad, that Case V cannot apply to subject him to tax, and that there is no such thing as a section 392 assessment, it is impossible to deem this income to be 'for all the purposes of' the Income Tax Act 1952, the income of [the father-in-law]."[92]

Later in his judgment, he said:

"No doubt the income in this case is susceptible of being deemed to belong to [the father-in-law], but it is not, in my judgement, susceptible of being deemed to be income of [the father-in-law] for all, or indeed any, of the purposes of the Income Tax Acts. To deem it to belong to him will be to deem it to be money which is not income within the meaning, or for the purposes, of the Act, and since the process contemplated by the section is an impossible one if the phrase 'any income' is to be taken to exclude all income subject to United Kingdom income tax, it must, in my judgement, be construed in a sense which will exclude from its ambit income which cannot be subjected to the treatment which this section contemplates. Additional support for this view is, I think to be found, as [the Crown] submitted in section 394(3) of the Act which provides that;

> 'Any income which is deemed by virtue of this chapter to be the income of any person shall be deemed to be the highest part of his income.'

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92. p596

The process directed by section 394(3) cannot be carried out unless the phrase 'any income' in both that subsection and in section 392 is confined in its meaning to income which, if deemed to be the income of the person who made the disposition, would be income for the purposes of the Income Tax Act 1952."[93]

93. p597

PART 3

SETTLEMENTS ON CHILDREN

Super-tax and the progressive rates of income tax were introduced by the F(1909-10)A 1910 and thereafter the rates rose sharply, particularly in the period from 1913/14 to 1919/20. At the same time there was a general increase in wages and a substantial rise in estate duty rates. These factors provided a powerful incentive for a taxpayer to spread his income amongst his family, particularly his infant children, so that he could reduce the family's overall tax bill.

Section 20 FA 1922 sought to combat this and other[1] perceived abuses. Section 20(1)(c) was the provision aimed at settlements on infant children and it still survives today as para 10, Sch 30, ICTA 1988. These provisions were quickly exposed as being almost useless to prevent well advised taxpayers passing income to infant children and they were replaced by section 21 FA 1936. This provision proved very successful and has survived with only minor amendments as section 663 et seq ICTA 1988. The original provisions only operate in respect of dispositions made after 5 April 1914 and before 22 April 1936.

Section 20 FA 1922 was stated as covering "dispositions" which included "any trust covenant, agreement or arrangement". The 1936 Act, on the other hand, used the term "settlement", defining it as including "any disposition, trust, covenant, agreement, arrangement, or transfer of assets."[2] So, this definition introduced the word "disposition" which, in the FA 1922 was defined as

1. See also Parts 4 and 5, infra
2. Section 21(9)(b) FA 1936. This definition has survived to this day and is now in section 670 ICTA 1988.

including the other types of disposition referred to in the 1936 definition which also introduced the expression "transfer of assets".

Therefore, by 1936, the provisions relating to settlements on children covered a very wide range of transactions, particularly by virtue of the inclusion of "transfer of assets".

The present legislation, in Chapter II of Part XV, ICTA 1988, dating from 1936, can best be understood by first considering the flaws in the original legislation which the 1936 changes were introduced to rectify.

Section 20(1)(c) FA 1922 read:

> "Any income....(c) which by virtue or in consequence of any disposition made, directly or indirectly, by any person after the fifth day of April, nineteen hundred and fourteen, is payable to or applicable for the benefit of a child; shall, subject to the provisions of this section, but in cases under the above paragraph (c) only if and so long as the child is an infant and unmarried, be deemed for the purposes of the enactments relating to income tax (including supertax) to be the income of the person who is or was able to obtain the beneficial enjoyment thereof, or of the person, if living, by whom the disposition was made, as the case may be, and not to be for those purposes the income of any other person....
>
> Provided also that-
>
> (1) *the above paragraph (c) shall not apply* as regards any income.... which is payable to or applicable for the benefit of a child during the

whole period of the life of the person by whom the disposition was made; and

(2) for the purposes of the said paragraph (c) income shall not be deemed to be payable to or applicable for the benefit of a child for some period less than its life by reasons only that the disposition contains a provision for the payment to some other person of the income in the event of the bankruptcy of the child, or of an assignment thereof, or a charge thereon being executed by the child.

Section 20(1)(c), along with the other paragraphs of the subsection, treated the income as income of the person who settled or agreed to pay that income to other persons, in the case of paragraph (c), his infant unmarried children, if the gift was for a period less then the child's life. On the other hand, income given away absolutely to a child in a manner dealt with in the provisos, or for the whole of the giver's life, was not affected.

Furthermore, a disposition for the life of a child with powers of revocation to be exercised with the consent of named persons, who might be nominated by the settlor, was also not caught, and defeated the clear intention of the Legislature in putting section 20(1)(c) on the statute books.

Things had started well for the Revenue: they won the first case on section 20(1)(c). This was the decision of the Court of Session in Levitt v IRC.[3]

The taxpayer here transferred by deed certain shares to trustees upon trust to apply the income for the maintenance education and upbringing of his children until the youngest of them attained the age of 21 and

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3. (1932) 17 TC 719

then to divide the capital among the surviving children. Power was given to the trustees to postpone the division of the capital and to continue paying the income to the children. The deed also contained a provision that a *child marrying a person not of the Jewish faith without* the consent of the parents should forfeit all right or interest in the trust estate.

The taxpayer, on behalf of his children, who were minors, claimed repayment of income tax paid in respect of the trust income. This claim was refused because the Revenue were of the opinion that the income should be deemed to be the income of the father by virtue of section 20(1)(c).

The Court of Session agreed with the Revenue's claim. Their reasons for doing so are interesting because one of them is inconsistent with the decision of the House of Lords in the Watson Trustees case.[4]

The first ground of the decision of the Court of Session was that the right of the children to the income was limited in that it expired when the youngest of them attained twenty-one, and this was a period less than their lives. The fact that a child might die before the youngest reached twenty-one and so enjoy the income for the whole of his life was irrelevant. According to the Lord President (Clyde) the question to be determined "is one concerning the right conferred under the settlement, and does not depend on the mere accidents of life and death."[5]

The Lord President also relied on the fact that a child might lose all right or interest in the trust by participating in an unapproved marriage.[6]

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4. Watson's Trustees v Wiggins (1933) 728, infra
5. p725
6. Ibid

The other judges agreed with the Lord President.

As noted above, the second ground for their decision is inconsistent with the decision of the House of Lords in Watson Trustees v Wiggins.[7] It was this case which exposed the enormous shortcomings of section 20(1)(c), leading to an increase of avoidance of the section and the introduction, three years later of the much more effective legislation in the FA 1936.

The taxpayer by deed covenanted to pay to trustees, during the joint lives of himself and his son, an annuity to be held in trust for the son, with power to the trustees, during the son's minority, to apply the annuity to the son's education, maintenance and benefit. The deed of settlement contained a power of revocation which could be exercised by the settlor with the consent of any one of five specified persons. The power of revocation had not been exercised.

A claim was made for repayment of the income tax paid on the annuity which the trustees claimed constituted income of the son. This claim was refused on the basis that, by reasons of the power of revocation contained in the deed, the annuity was payable to or applicable for the benefit of the son for a period less then his life and was not payable during the whole life of the settlor. The income must therefore, it was claimed, be deemed to be income of the settlor within section 20(1)(c).

At first instance, Rowlatt J heard the case before the Court of Session's decision in Levitt. Rowlatt J was in no doubt that the Crown's claim must fail. He said:

> "What the paragraph [ie paragraph (c) of section 20(1)] says is: Income which is '- I lay some stress upon the word 'is' - payable to or

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7. (1933) 17 TC 728

applicable.....for some period less than the life of the child.' At the present moment this income certainly is payable to the child for his whole life, or, at least, the life of himself and his father."[8]

He said that the power of revocation, not having been exercised, did not mean that the income was payable for a period less then the life of the child. He commented:

> "As matters now stand, [the income] is payable for the life of the child. It may be that the deed under which it is payable may be altogether torn up by the exercise of the power of revocation. The power of revocation is dealt with in another subsection which will not hit the case."[9]

The other subsection referred to was subsection 20(1)(a). As will be seen below,[10] it could not catch the deed here because the power of revocation could only be exercised with the consent of others.

The decision of Rowlatt J that the power of revocation did not bring the deed within section 20(1)(c) was inconsistent with the second ground for the decision of the Court of Session in Levitt (ie that relating to unapproved marriages).

The Court of Appeal, who heard Watson's Trustees in the month following the decision in Levitt, agreed with Rowlatt J that section 20(1)(c) did not apply.

Lord Hanworth MR noted that counsel for the Crown had urged, in his view rightly, the court to look at the substance of the matter.[11] The Crown argued that, looked at from a practical point of view, the settlement was a device whereby the father's income was passed to trustees

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8. p733
9. Ibid
10. See Part 4, infra
11. p735

for his son and the indication that it was the income of the father was plain from the power he reserved to revoke the settlement. A deed, it was said, which was revocable with the consent of any one of five persons was, for all practical purposes, in substance, a revocable deed.

In the view of the Master of the Rolls, the difficulty in looking at the substance of the matter:

> "is the very meticulous nature of section 20 which provides with precision for a great number of events, and it does not boldly and baldly say that such a provision as is made by this deed is one which is quite ineffective to transfer income from the settlor to the beneficiary."[12]

Looking at the words of the section, the first point was that, clearly, the fact that the income was payable for the joint lives of father an son did not help the Crown because of proviso(i).[13]

Dealing with the main part of section 20(1)(c), Lord Hanworth MR said:

> "Really a glance at paragraph (c).....makes it plain that the subsection is drawn with great precision and must be considered accordingly, and in view of the fact that, for the purposes of revocation an outside consent must be obtained, there is not a benefit given to the child for a period less than the life of the child, nor can that provision by virtue or in consequence of this disposition be revoked except with the consent of some outside persons."[14]

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12. Ibid
13. p736
14. p737

In fact, from the tenor of Lord Hanworth's judgement, even a power of revocation without the consent of another could not have brought the deed within section 20(1)(c).[15] This was certainly the view of Slesser LJ[16] and Romer LJ[17] and the House of Lords.[18]

Lord Hanworth MR also mentioned the Levitt case. He noted the primary ground for the decision of the Court of Session, ie, the one relating to the provision for payments to be made until the youngest child reached 21; he did not deal with the secondary reason, the one based on unapproved marriage, although it seems that the Master of the Rolls did not agree with the secondary ground, which was inconsistent with his own approach.[19]

In the House of Lords, Viscount Buckmaster, with whom the other Law Lords agreed, was clear that the Crown's case must fail. He said:

> "If you disregard wholly, as the Crown are prepared to do, the fact that this [ie the limitation in the deed] is a limitation for joint lives and consider it merely as a limitation for one life, it appears to me that it is impossible to say that it is for a period less than the life of the child merely because there is a means by which the actual estate that is conferred may be terminated and cut short."[20]

He said that he was "strongly confirmed" in that view by the contrast between paragraphs (c) and (a). He commented:

> "It is quite plain that whoever was drafting this

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15. Although it would have been caught by section 20(1)(a), see Part 4, infra.
16. p739
17. p740
18. infra
19. see pp 737-8
20. pp742-3

section realised entirely what might happen if a person had a power of revocation, and, in the case where the deed was dealing with any beneficiary, whether related or not to the settlor, and there was a general power of revocation without the consent of any person, then, in that case, special provisions are made for it, and the provisions would have affected the particular circumstances that have arisen in this case but for the fact that the power of revocation, which is referred to in paragraph (a), is one that must be exercised without the consent of any other person, and here the power of revocation can only be exercised with the consent of one of five named persons.

My Lords, these reasons satisfy me that in paragraph (c) it was never intended that a limitation for the life of a child should be regarded as a limitation for less than that period by reasons of the introduction of a power of revocation which would enable the whole of the provisions to be destroyed."[21]

The Law Lords did not even mention Levitt's case, but it is clear that the House of Lords' decision in Watson's Trustees effectively overruled the secondary ground of the decision of the Court of Session in Levitt.

It will be seem below that a power of revocation such as that in this case would be caught by the provisions introduced in 1936.

The secondary ground for the Levitt decision was also rejected by Lawrence J in Whigham v IRC.[22]

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21. p743
22. (1941) 24 TC 41

The taxpayer settled a fund upon trust for all or any of his children, then minors, who should attain the age of 25 years, and if more than one, in equal shares, absolutely. The settlement directed that a child should forfeit all his interest it, before the interest became vested, he ceased to be a British subject , or if by any act on his part or on the occurrence of any event, his share, on becoming payable to him absolutely, should be alienated. It can be seem that this is a restriction of a similar nature to the "unapproved marriage" condition in Levitt. Indeed, the Special Commissioners held that Levitt applied and that, accordingly, the income from the trust property should be deemed to be the taxpayer's income under section 20(1)(c).

Lawrence J disagreed. He followed the decision in Watson's Trustees rather than Levitt. He held that the disposition was for the lives of the children and not until they ceased to be British subjects, the provision for defeasance if a child should cease to be a British subject could not bring the settlement within paragraph (c).[23]

Despite their defeat in the Watsons's Trustees case, the Revenue took an unjustifiable narrow view of that decision and considered that it did not apply, for example, to a conditional defeasance capable of cutting down a life interest; this they continued to treat as within section 20(1)(c). How they could possibly reconcile this with the judgements in the Watson's Trustees case is hard to see, but that it was the case apparent form the dialogue between counsel for the Crown, J.H Stamp and Lord Greene MR at the end of the case of Mauray v IRC.[24]

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23. p44
24. (1944) 26 TC 91 at pp98-9

Both Macnaghton J and the Court of Appeal in Mauray totally rejected that narrow view of Watsons's Trustees.

The facts were that the taxpayer, by a deed of 1932, settled, during the life of his wife, one third of the income of the trust fund upon protective trusts for such of his children and in such manner as he should appoint, and until and subject to any such appointment, for the benefit of his daughter, Joan, on her attaining 21 or marrying under that age. On the death of the taxpayer's wife (who had a life interest in the remaining two thirds of the income) the whole trust fund was to be held in trust for such one or more of the taxpayer's children or remoter issue as he should appoint, and in default of and subject to any such appointment, in trust for the taxpayer's children living at his death (or the issue then living of any child then deceased) in equal shares. The trustees had power (with the consent of the taxpayer during his life) to raise out of accumulated income up to £200 per annum for the education or advancement of any child of the taxpayer.

During the relevant years, Joan, who was the taxpayer's only child, was under 21 and unmarried, the taxpayer's wife was alive and he had made no appointment.

The taxpayer was assessed to surtax on the one third share of the income of the trust fund in which Joan had the life interest under section 20(1)(c).

Although the Special Commissioner were persuaded that the assessment was valid, Macnaghten J in the High Court and the Court of Appeal took little time in rejecting the Crown's case. In fact, Macnaghten J was so convinced of the invalidity of the Crown's arguments that he allowed the taxpayer's appeal without even bothering to analyse his reasons for doing so.

In the Court of Appeal, Lord Greene MR, delivering the judgment of himself and Luxmore LJ (with which Mackinnon LJ agreed) did analyse the reasons why the taxpayer succeeded. He first summarised the effect of the settlement as follows:

> "In the years of assessment [in question] the one third of the income was applicable for Joan's benefit and would remain so applicable during her infancy. On her attaining twenty one it would be payable to her during the rest of the [taxpayer's] life. On his death she would become entitled to the whole of the capital. But these interests were liable to be cut down or defeated as follows: (1) during the life of the wife by the birth of another child and an exercise of the [taxpayer's] power of appointment in such a way as to reduce Joan's interest during that period to less than one third; (2) after the death of the wife (a) by the existence of at least three more children of the settlor, (b) by an exercise by the settlor of his power of appointment over the whole fund under which another child or other children of the [taxpayer] or the issue of another such child or other such children or of Joan herself took an interest or interests in more than two thirds of the income of the settled fund so as to reduce Joan's interest to less than one third."[25]

Accordingly, the Crown had argued that the one-third of the income of the trust fund was applicable for the benefit of Joan for a period less than her life because, if any of the above events were to happen, Joan's interest would be reduced or eliminated.

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25. p96

Lord Greene MR said that this argument rested "on a misconception as to the true meaning" of section 20(1)(c). This was because the provisions of the section:

> "can only come into operation in respect of a particular assessment. In other words, the Crown by means of an assessment is asserting that the income in the particular year to which the assessment related is income of which it can be truly said at the time that it is 'payable to or applicable for the benefit of' the child for some period less than the life of the child. In the years to which these assessments relate it was impossible to support this assertion. Whether the income would or would not continue to be payable to or applicable for the benefit of Joan for the whole of the rest of her life depended on quite unpredictable events. All that could be said of it was that the income might or might not continue to be so applicable according to circumstances. This, however, is not sufficient to discharge the burden imposed upon the Crown by the section, which is to establish affirmatively that the income is - not that it may be - payable or applicable for some period less than the life of the child. In applying the section what has to be considered is the effect of the settlement in the light of circumstances as they exist at the relevant time."[26]

The Crown's narrow view of Watson's Trustees was therefore rejected.

Section 20(1)(c) survives, although it can hardly ever now have any application, tucked away in Sch 30 ICTA 1988. The relevant paragraph is para 10 and it applies

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26. pp96-7

only to dispositions made after 5 April 1914 and before 22 April 1936 which immediately before 22 April 1936 was irrevocable.[27]

The fact that the severe limitations of section 20(1)(c) were quickly realised by the Revenue and professional advisers is underlined in an article entitled "The Background to the Anti-Avoidance Provisions Concerning Settlements by Parents on their Minor Children" by David Stopforth.[28] This is an interesting article insofar as the author has examined the public records available relating to, basically, the circumstances leading up to the FA 1936.

As a preliminary point it should be noted that this article states[29] that the only part of section 20 "which remains in any recognisable form today" is section 434 ICTA 1970[30]. What the article fails to point out is that, as mentioned above, section 20(1)(c) itself lives on, albeit in relative obscurity, in para 10, Sch 30 ICTA 1988.

Nevertheless, there is some useful information in the article.

The article discloses that, by 1927, the Inland Revenue were concerned about the ease with which section 20 could be circumvented.[31] The article cites a memorandum by the Board of Inland Revenue to the Cabinet Tax Evasion Committee, which was formed in December 1926. The memorandum comments that, initially, section 20 was very effective but that lawyers began to find ways around it.

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27. Para 10(6) states that sections 661 and 662, infra, apply as if para 10 were contained in Chapter 1 of Part XV.
28. [1987] BTR 417
29. At pp422-3
30. Now section 660 ICTA 1988, originally 20(1)(b) FA 1922, see Part 5, infra.
31. P423

There was then a second memorandum to the Committee, now called the Cabinet Revision Committee, which set out the general defects of the section.

It is noticeable that the memorandum did not deal directly with possible methods of avoiding section 20(1)(c), although it did refer to the device of having a power of revocation exercisable with the consent of other persons, which was one of the features of the Watsons's Trustees case.

The article points out[32] that the Revenue urged the Government to introduce remedial legislation in the Finance Bill 1927. The memorandum stated:

> "Having regard to the helplessness of the Revenue in the face of devices...mentioned it is for consideration whether amendments of section 20 to deal with these points should be introduced in the forthcoming Finance Bill..."

No legislation was, of course, introduced in 1927 and the article cites the conclusion of the Revision Committee that it was unnecessary to legislate at that time.[33]

David Stopforth states that the professional journals of the time did not reflect the Revenue's view that section 20 was a dead letter by 1927, although he notes that a weekly journal, "The Accountant Tax Supplement", first published in January 1926, apparently increased general awareness of tax avoidance devices. In the present context, of relevance was an article which Stopforth disclosed appeared in the above journal on 13 October 1928 entitled "The Legal Avoidance of Income Tax and Supertax by Individuals and Companies" based on a series of lectures given by a Mr A.W Rowlinson dealing with inter alia, the use of covenants to make payments to

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32. p424
33. Ibid

infant children. It is stated by Stopforth that, following the articles, interest in the avoidance devices discussed gradually increased.[34]

However, as Stopforth pointed out, without doubt correctly, the event that really raised the public's consciousness to the avoidance possibilities regarding section 20(1)(c) was the Watson's Trustees case and the taxpayer's success in it.

Stopforth expressed surprise that the Revenue decided to take the case because the loophole was mentioned in the Revenue's memorandum to the Revision Committee, mentioned above, and, he said, there was no suggestion then[35] that it was not effective. But what Stopforth appears not have appreciated was that the Watson's Trustees case was not concerned with that loophole in itself; the Revenue did not try to argue that the power of revocation with the consent of others fell within paragraph (a); but that it meant that the annuity was payable for a period less than the life of the child under paragraph (c). On the contrary, given the Revenue's success on both grounds in Levitt's case, it would have been surprising had they not taken the point.

There is an interesting disclosure made in Stopforth's article that, in August 1931, the Board of Inland Revenue ordered inspectors of taxes to reject any deed containing a limited power of revocation.[36] Stopforth is undoubtedly right in thinking that this was apparently based on the fact that the Watson's Trustees case was to be taken before the courts. The article states that some 230 cases were rejected in the period to 30 September 1931.

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34. p425
35. In 1927
36. p430

Stopforth's conjecture about the effect of the forthcoming Watson's Trustees case is, in fact, correct. That this is so is clear if reference is made to the timing of the relevant events. The General Commissioners' hearing in Watson's Trustees took place on 17 November 1931[37] and so, in August that year, the preparation of the Crown's case must have been well advanced. The Commissioners gave their decision on 17 December 1931 and Rowlatt J heard the taxpayers' appeal on 16 and 17 March 1932.[38]

The General Commissioner had also heard the Levitt case[39] but their findings, favourable to the Crown, were not delivered until 3 March 1932.[40]

Stopforth explains that, by 1933, the Inland Revenue were so concerned about avoidance that they set up a committee. The Board's Committee on Evasion which, despite its name, dealt with tax avoidance, not evasion. It appears that this committee was concerned with all forms of avoidance although, inevitably, avoidance of section 20 was one of its major concerns. It is not necessary to repeat here the various factors cited in the article as increasing the Revenue's concern at the level of avoidance by means of settlements on children.[41]

One point, however, that can be mentioned here is that the amount of tax it was estimated was lost by such settlements,[42] and which caused the Inland Revenue so much concern, seems minute by today's standards. Losses measured at around the £½million mark seem insignificant compared, for example with the estimated potential Revenue losses of £100 million tax in pending cases alone which were prevented by the Ramsay decision.[43]

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37. See 17 TC at p729
38. Ibid at p732
39. This was on 5 February 1931
40. 17 TC pp719 and 723
41. See [1987] BTR at pp425-9
42. Ibid pp 426-7 and p430
43. W.T Ramsay Ltd v IRC (1981) 54 TC 101, see Chapter 11

The article says that the Revenue's committee reported in February 1934 and draft legislation was prepared by the committee, but the Chancellor decided to take no action.[44]

The Revenue, understandably, did not give up and continued to keep track of the spread of avoidance, news of which was beginning to spill over from the professional journals into the ordinary newspapers. Furthermore, adverts began to appear in the newspapers offering tax savings. Stopforth quotes[45] the following example:

> "Why pay tax on your child's education and maintenance? You need not! - British Taxpayers Association Ltd., Grand Buildings, Trafalgar Square, London."

The scale of avoidance continued to grow rapidly[46] so that, at the insistence of the Revenue, the Chancellor was, in 1936, persuaded to act and, consequently, section 21 FA 1936 passed into law, a section which was, and remains in its modern manifestation, section 663 ICTA 1988, a highly effective anti-avoidance section.

Section 21(1) FA 1936 read:

> "Where, by virtue or in consequence of any settlement to which this section applies and during the life of the settlor, any income is paid to or for the benefit of a child of the settlor in any year of assessment, the income shall, if at the commencement of that year the child was an infant and unmarried, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person."

44. p428
45. p429
46. See pp429-32

In section 21(9)(b) ibid "settlement" was defined as including "any disposition, trust, covenant, agreement, arrangement or transfer of assets".

The definition of "settlor" was contained in section 21(9)(c) which provided that:

> "the expression 'settlor', in relation to a settlement, includes any person by whom the settlement was made or entered into directly or indirectly, and in particular (but without prejudice to the generality of the foregoing words of this definition) includes any person who has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with any other person a reciprocal arrangement for that other person to make or enter into the settlement."

Section 21(10) & (11) ran as follows:

> "(10) This section applies to every settlement, wheresoever it was made or entered into, and whether it was made or entered into before or after the passing of this Act, except a settlement made or entered into before the twenty-second day of April, nineteen hundred and thirty-six which immediately before that date was irrevocable.
>
> (11) Paragraph (c) of subsection (1) of section 20 of the Finance Act, 1922, and any other provisions of that subsection relating to that paragraph, shall cease to have effect as respects any settlement to which this section applies."[47]

Therefore, a settlement on a child of the settlor made before 22 April 1936 was not touched by section 21 FA

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47. It can be seen that this legislation survives to this day with only very minor amendments as sections 663(1), 670 and 663(3) ICTA 1988 respectively.

1936, provided that it was, immediately before that date, irrevocable. Such a settlement would accordingly, only fall to be tested by the provisions of section 20 FA 1922 and would, therefore, if a mere "transfer of assets", escape altogether.

On the other hand, if a settlement were only for a part of the child's life and did not, for instance, include a provision for the capital to be handed over to the child in due course, it would be caught by section 21 FA 1936 even though it was, to that extent, irrevocable. But such a settlement made before 22 April 1936 which was revocable even if it were a mere transfer of assets, and all such settlements made after that date, whether revocable or not, came within the ambit of section 21 FA 1936.

A settlement was not deemed to be revocable for the purposes of the section by reason only that it contained a provision whereunder any income or assets could become applicable for the benefit of the settlor or his wife on the bankruptcy of any child, or in the event of an assignment of or charge on that income or those assets being executed by a child, or because it provided for the determination of the settlement in such a manner that the determination would not benefit any person other than the child or his spouse or issue during the lifetime of the child, or because the settlement (being within section 33, Trustee Act 1925) directed income to be held for the benefit of the child on protective trusts, unless the trust period was a period less than the life of the child, or the settlement specified some event on the happening of which the child would have been deprived of the right to receive any part of the income.[48]

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48. see now section 665(2) ICTA 1988

It is important, in determining whether section 21 FA 1936, and its various replacements over the years, apply to see what is meant by "irrevocable". This is considered later in this Part. The meaning of "irrevocable" is also important in relation to settlements in which income is accumulated for infant unmarried children of the settlor.

Section 21 FA 1936, as well as introducing the provisions now contained in section 663 ICTA 1988, also contained the measures now enacted in section 664 ibid relating to "Accumulation Settlements".

Section 664(1)(a) states that income shall be deemed to be paid to or for the benefit of a child of the settlor (and so taxed in the hands of the settlor) if it is:

> "income which, by virtue or in consequence of a settlement to which this Chapter [ie Chapter II, Part XV ICTA 1988] applies, is so dealt with that it, or assets representing it, will or may become payable or applicable to or for the benefit of a child of the settlor in the future (whether on the fulfilment of a condition, or the happening of a contingency, or as the result of the exercise of a power or discretion conferred on any person, or otherwise)."

Paragraph (b) of subsection (1) then goes on to state;

> "any income dealt with as aforesaid which is not required by the settlement to be allocated, at the time when it is so dealt with, to any particular child or children of the settlor shall be deemed to be paid in equal shares to or for the benefit of each of the children to or for the benefit of whom or any of whom the income or assets representing it will may become payable or applicable."

In other words, settlements for a class of children are covered. It should be noted that not all of the class need be infant and unmarried; the income not required to be allocated is apportioned among the children, and that part apportioned to infant unmarried children is deemed to be the settlor's income.

However, the deeming provisions in subsection (1) do not apply to all settlements, as is specified in subsection (2) which states that, in the case of an "irrevocable settlement":

> "(a) subsection (1) above shall not apply to that income unless and except to the extent that the income consists of, or represents directly or indirectly, sums paid by the settlor which are allowable as deductions in computing his total income; and
> (b) any sum whatsoever paid thereafter by virtue or in consequence of the settlement, or any enactment relating thereto, to or for the benefit of a child of the settlor, being a child who at the time of the payment is unmarried and below the age of 18, shall be deemed for the purposes of section 663 to be paid as income."

Subsection (3) states that subsection (2)(b) shall not apply:

> "if and to the extent that the sum so paid as is mentioned in that paragraph together with any other sums previously so paid (whether to that child or to any other child who, at the time of the payment, was unmarried and below the age of 18) exceeds the aggregate amount of the income which, by virtue or in consequence of the settlement, has been paid to or for the benefit of a child of the settlor, or dealt with as mentioned in subsection (1) above, since the date when the settlement took effect or the date when it became irrevocable, whichever is the later."

In other words, the charge in subsection 664(1) does not apply to the income of "irrevocable" settlements unless that income represents sums which are deductible from the total income of the settlor. Subsection 664(2)(b) and (3) is saying that, where income is accumulated in an irrevocable settlement and, out of the accumulated income, capital sums are paid to infant unmarried children of the settlor, those capital sums are deemed to be income of the settlor except to the extent that those capital sums (plus any other sums paid to infant unmarried children of the settlor) exceed the income which has been paid to or for the benefit of a child of the settlor or accumulated.

Were it not for paragraph (b) of section 664(2) and (3), the deeming provisions of section 663 could easily be avoided by the income being accumulated and capitalised and paid to the infant unmarried children of the settlor in a subsequent tax year.

It can be seen that, both for the purposes of section 664 and for the purposes of determining whether section 633 or the original section 20(1)(c) applies, it is necessary to know whether a settlement is irrevocable.

Some assistance is given by section 665[49], but reference must also be made to case law for a full understanding of the position.

What section 665 does is, not to give a comprehensive definition of "irrevocable", but describes, in subsection (1), three types of settlement that are not treated as "irrevocable" and, in subsection (2), three types of settlement that are not treated as revocable. The provisions of subsection (2) have already been mentioned.[50]

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49. Also dating from 1936
50. See fn 48, supra and the text relating thereto

By virtue of subsection (1), a settlement is deemed not to be irrevocable if its terms provide either:

(a) for payment to the settlor (or settlor's spouse during the lifetime of the settlor) or for the application for the benefit of the settlor (or of the settlor's spouse during the lifetime of the settlor), of any income or assets in any circumstances whatsoever during the life of any child of the settlor who is a beneficiary; or

(b) for the determination of the settlement by the act or on the default of any person; or

(c) for the payment of any penalty by the settlor in the event of his failing to comply with the provisions of the settlement.[51]

In the case of IRC v Lord Delamere.[52], the taxpayer argued that, in deciding whether section 21 FA 1936 applied, the word "irrevocable" in section 21(10) was used in its ordinary meaning, and should not be interpreted by reference to the provisions of section 21(8) just mentioned and, in particular, the provision which said that for the purposes of section 21, a settlement was not deemed to be irrevocable if it provides for the payment to the settlor of any income or assets in any circumstances whatsoever during the life of any child of the settlor to or for the benefit of whom any income or assets may be payable by virtue of the settlement. Lawrence J rejected this contention.

The facts were that the taxpayer, on 20 June 1932, executed a settlement under which certain properties were conveyed to trustees upon trust to pay or apply the

51. Originally section 21(8) FA 1936
52. (1939) 22 TC 525

income thereof, at the trustees' discretion, to or for the benefit of all or any of a class of persons, including the taxpayer, his wife and children. The deed contained no power of revocation.

In the year 1936/37 the trustees paid (partly before and partly after 16 July 1936), for the benefit of the taxpayer's three infant children, sums which in each case amounted to about £500, after deduction of tax. The taxpayer was assessed to surtax on these sums.

The taxpayer tried to rely on section 21(10) FA 1936 which said that section 21 was to apply to every settlement except one made before 22 April 1936 "which immediately before that date was irrevocable".

Lawrence J held that reference had to be made, not only to the ordinary meaning of "irrevocable", but also to the extended meaning in subsection (8). In this settlement, provision was made for "payment to the settlor during the life of a child of the settlor", although such payment was at the discretion of the trustees. The settlement was therefore not irrevocable.

This was approved by Macnaghten J and the Court of Appeal in Eastwood v IRC.[53]

Similarly, there is the Court of Session decision in IRC v Warden.[54] By deeds of trust executed before 22 April 1936, a parent bound himself, during the joint lives of himself and his two daughters, one of whom was of full age and the other (the taxpayer) a minor, to pay to his wife and elder daughter as trustees monthly sums to be applied, at their discretion, for the benefit of his daughters. It was

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53. (1943) 25 TC 100
54. (1938) 22 TC 416

declared that the trust deeds were irrevocable at the settlor's instance, but the trustees were given power to cancel the obligations thereunder, in whole or in part, without the consent of the settlor or his daughters.

A claim was made on behalf of the taxpayer for repayment of tax for the year 1936/37. The Crown, however, contended that the trust deeds were not irrevocable within section 21 FA 1936 and that the sums paid to the taxpayer under the deeds could not be treated as her income for tax purposes.

The Court of Session agreed that the sums had to be treated as income of the parent under section 21(1) because the deeds were not irrevocable at common law in view of the power of termination given to the trustees. The Lord President (Normand) also held that the deeds were not irrevocable within section 21(8).

The question of the meaning of "irrevocable" was one of the points raised in Jenkins v IRC,[55] the facts of which have already been given.[56] It was decided in this case that it is only permissible to consider the actual provisions of the settlement in deciding whether a settlement is irrevocable; extraneous circumstances cannot be taken into account. The taxpayer could liquidate the companies in the arrangements in question and thus get possession of the whole of the settled funds. Nevertheless, in those circumstances, the settlement would remain, and the liquidation of the companies would not constitute a revocation of the settlements within the meaning of section 21(8) FA 1936. It might be otherwise if the formation of a company were part of the settlement.[57]

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55. (1944) 26 TC 265
56. See Part 1, supra
57. See Lord Greene MR at pp281-2

The point was also made that, apart from the extended meaning of "irrevocable" in section 21(8) FA 1936, it is not permissible to give that word a loose interpretation. Lord Greene MR put it strongly and clearly as follows:

> "The distinction between a revocable and an irrevocable settlement is the veriest A.B.C in legal language; and nobody familiar with the language of lawyers, and in particular of those concerned with settlements, could have the slightest doubt, I should have thought, when finding the word 'irrevocable' used in relation to a settlement, what that word was intended to mean. It seems to me quite illegitimate to take a word which has a technical and precise meaning in conveyancing and then to argue that it has some extended meaning. If the Legislature wished to give to the word 'irrevocable' some unusual and extended meaning of this sort, I ask myself why in the world did it not do so. The Legislature is the master of the draftsmanship of these Acts, and if it intends to use a word which is to have the widest possible scope it is little short of carelessness or incompetence in drafting to select for that purpose a perfectly familiar word which to everyone has a quite limited scope. I cannot bring myself to give to the word 'irrevocable' in subsection(10) the meaning which the Crown wishes to place upon it."[58]

The Master of the Rolls then noted the specific extension provided for in subsection (8) and held that there were no terms in the settlements which provided for payment to the settlor of any of the income or assets of the settlement. He agreed with Macnaghten J who had rejected the Crown's argument that it was legitimate to consider the whole structure of the tax avoidance scheme and to

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58. p281

say that, as the result of the whole mechanism, it would be possible for the settlor to get out of the settlement all of its funds.

He said:

> "Such a disintegration of the scheme and recapture of the funds by the settlor, if it were to take place, would not be due to some provision in the terms of the settlement, but it would be due to the circumstance that the settlor, by virtue of extrinsic matters, is in fact in a position to produce that result."[59]

The Crown had also argued that the loan repayments, if made to the settlor, would be caught as payments to the settlor within subsection (8). The Master of the Rolls asked whether the terms of the settlement provided for payment to the settlor as required by the subsection. He answered that they did not:

> "What [the terms of the settlement] do say and what can be extracted by implication is that if the trustees choose to exercise their power to borrow and if the person from whom they borrow happens to be the settlor then the person to whom they will have to repay the loan will be the settlor. If it was intended to cover that state of facts by this subsection, I say once more, nothing would have been easier than to do it, If that case has got to be squeezed into the language of this section by means of the ingenious argument presented to us, then all I can say is that the Legislature has singularly failed in its duty to make its intentions clear. The language, 'if the terms thereof provide', seems to me to have a perfectly clear, simple and

59. pp281-2

straightforward meaning, and I find no justification for giving to it a crabbed or artificial or highly intricate meaning such as would be necessary to enable it to cover the state of facts which I have mentioned."[60]

However, this last finding of the Master of the Rolls was overruled by the House of Lords in Jamieson.[61]

In the case of IRC v Lord Glenconner,[62] there was a settlement which was revocable but, in the circumstances of that case, it could not be revoked before 22 April 1936. It is not surprising that Macnaghten J held that the exception from the section 21 FA 1936 charge in subsection (10) did not apply. As the judge pointed out:

"A revocable settlement or covenant is a settlement or covenant which can be revoked at some future time. An irrevocable settlement or covenant is a settlement or covenant which can never be revoked.... If the Legislature had intended that the exception should apply not only to irrevocable settlements but also to such revocable settlements as could not have been revoked 'immediately before 22 April 1936', it would have been quite easy to say so."[63]

The most recent case on the meaning of "irrevocable", and an important case, is Jamieson v IRC.[64] This case is also of interest in demonstrating how the legislation[65] could operate before it was amended by section 20 FA 1958, and also because one of the findings in the Jenkins case was overruled.

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60. p282
61. Jamieson v IRC (1963) 41 TC 43, infra
62. (1941) 24 TC 82
63. p85
64. (1963) 41 TC 43
65. Then contained in sections 397-9 ITA 1952

The facts were that the taxpayer settled a fund in trust for all or such one or more of his children and remoter issue and their wives, husbands, widowers and widows, in such shares, and either absolutely or with such trusts, as the trustees should appoint. At the material times, in default of such appointment, the fund was held in trust for the taxpayer's three children, who were infants and unmarried, at 25. All the income was accumulated.

The taxpayer was assessed to surtax for 1955/56 to 1957/58 in respect of the income arising under the settlement for the purposes of sections 397 to 399 ITA 1952, (prior to the amendments made by section 20 FA 1958).[66]

The Crown argued that the terms of the settlement provided for determination of the settlement by appointment of the fund absolutely, and in such manner that the determination could benefit persons not mentioned in proviso(i), namely, spouses of the settlor's remoter issue.[67] It was held in the House of Lords that the Crown's contention was correct.

In view of the changes made in the wording since the date of this case, it is helpful to set out the relevant wording at the time. It was as follows:

> "For the purposes of this Chapter, a settlement shall not be deemed to be irrevocable if the terms thereof provide....
> (b) for the determination of the settlement by the act or on the default of any person....Provided that a settlement shall not be deemed to be revocable by reason only.....

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66. Infra
67. This argument relates to the wording of section 399 ITA 1952 (now section 665 ICTA 1988) prior to the amendments made by section 20 FA 1958, explained infra.

(ii) that it provides for the determination of the settlement as aforesaid in such a manner that the determination will not, during the lifetime of any such child as aforesaid, benefit any person other than such a child, or the wife, husband or issue of such a child."

The taxpayer had argued that any exercise of the power of appointment would constitute the effectuation of the settlement and not its determination within section 399(b).[68]

At first instance, Plowman J looked at this question in the light of the Kenmare case[69] which concerned section 38(2) FA 1938.[70]

The provision of the settlement in the Kenmare case of relevance here was the following:

"Notwithstanding the trusts herein before declared the trustees if they in their absolute discretion think fit may at any time and from time to time during the lifetime of the settlor....declare that any part of the trust fund not exceeding [£60,000 in any three years].....shall henceforward be held in trust for the settlor absolutely and thereupon the trusts hereinbefore declared concerning the part of the trust fund.......to which such declaration related shall forthwith determine and the trustees shall thereupon transfer such part of the trust fund.....to which such declaration relates to the settlor absolutely."

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68. Now section 665(1)(b) ICTA 1988
69. <u>IRC v Countess of Kenmare</u> (1957) 37 TC 383, see Part 4 infra
70. Now section 672 ICTA 1988, see Part 4, infra

Plowman J noted[71], as is explained below when the Kenmare case is examined in detail, that the House of Lords in that case was concerned with the question whether the above provision was a power to determine the settlement.

Lord Simonds in Kenmare was of the opinion that a power to exhaust the trust fund was a power to determine the settlement.[72] Lord Reid agreed, concluding that "if there is nothing left for the trusts of the settlement to operate on, then the settlement can properly be said to have been determined or brought to an end."[73]

In the light of these views, Plowman J considered whether the trustees' power of appointment in this case constituted a power to determine the settlement. The judge referred[74] to the following passage from the judgement of Lord Reid in the Kenmare case:

> "Then the question arises: If the exercise of the power may release the whole of the trust fund and revest it in the settlor, is that power a power to determine the settlement: In my opinion, it is."[75]

Plowman J rephrased Lord Reid's question to fit the present case follows:

> "If the exercise of the power may release the whole of the trust fund and vest it in an object of the power, is that a power to determine the settlement?"

The judge's reaction to this question was that "it is difficult to suppose that Lord Reid would have answered that question differently."[76]

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71. p51
72. 37 TC at p409
73. Ibid at p411 Lord Cohen propounded the same test at p414
74. at p52
75. 37 TC at p411
76. p52

Plowman J concluded:

> In my judgment, therefore, the decision in the Kenmare case compels me to hold that the power of appointment in the present case is a provision for the determination of the settlement within section 399(b). This conclusion appears to me to fit in with the structure of section 399 in those respects in which it differs from section 404(2) [ITA 1952]. The second proviso to section 399 contemplates a determination of a sort which will benefit someone; and an appointment under a power in favour of an object of the power absolutely, so bringing the settlement to an end, appears to me to be both a determination of the settlement and a determination of the sort which is contemplated by the section."[77]

The House of Lords agreed. Lord Reid noted that the taxpayer would not have been covered by section 399 as amended by section 20(5) FA 1958 but that the original form of the section did not exclude the settlement in this case because the trustees could use their power to benefit the husbands or wives of grandchildren as well as those mentioned in the original proviso(ii) to the section.[78] The amended proviso (ii) did not cover the settlement, however, because the trustees could not use their powers to benefit the settlor or his wife.[79] Unfortunately, for the taxpayer, the amendments were not made retrospective.

Lord Reid first considered whether the trustees' power of appointment was a power to determine the settlement. He thought that, unless a more limited meaning was indicated by the context, "determination" must include every case in which the trustees do an act authorised by the

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77. Ibid
78. p69
79. See now section 665(2)(b) ICTA 1988

settlement which brings it to an end.[80] Exercising a power of appointment is the doing of an act, and if its exercise vests the whole trust fund absolutely in a major beneficiary the settlement is determined, Lord Reid referred to the Kenmare case for the authority for this proposition. He considered whether there was any justification for giving "determination" a restricted meaning but in the end he was forced to say:

> "I can see no escape from the conclusion that any act which results in the settlement being brought to an end is an act by which the settlement is determined."[81]

Lord Reid then turned to the other argument advanced by the taxpayer, and it is here that one of the findings of the Court of Appeal in Jenkins was overruled. This argument turned on the meaning of "provide". The argument was that the settlement provided means whereby the trustees could do an act which in fact determines the settlement, but, it was argued, that would not be providing for the determination of the settlement by that act, because the settlement must expressly provide that it shall come to an end if a certain act is done.

There was, he noted, some support for this argument in the decision of the Court of Appeal in the Jenkins case. Lord Reid dealt with this aspect of the Jenkins case as follows:

> "[The taxpayer] gave the trustees a general power to borrow and authorised them to repay any loan out of income. So they need not have borrowed from him or anyone else, and if they did borrow they need not have repaid the loan out of income. It just so happened that they did borrow from the settlor and

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80. p70
81. Ibid

they did use the trust income to repay him. Then the taxpayer succeeded in his contention that the settlement did not 'provide' that all this should be done - it merely authorised it. In my opinion, that decision was wrong... I can only say that to my mind a person who contemplates or desires a certain result and gives powers to trustees which enable that result to be achieved could properly be said in ordinary parlance to provide for that result by giving those powers."[82]

Applying that approach to the present case, he said that the settlor must have known that the terms of the settlement would enable the trustees to appoint the whole fund absolutely to any person who might come within the class of beneficiaries. If such an appointment would in law determine the settlement, the settlor would, in his view, have made provision for its being determined.

Accordingly, Lord Reid "with some regret" had to find for the Crown.

Lords Guest and Pearce agreed with Lord Reid's judgment. Lord Jenkins delivered a judgment along the same lines as Lord Reid. Lord Jenkins said that the taxpayer was unfortunate because it was only "through a mistake which brought about the inclusion in the trusts of the settlement of too wide a class of beneficiaries."[83] Lord Hodson also delivered a judgment making basically the same points as Lord Reid.

So, here we have a decision, undoubtedly correct in the light of the law at the time, which bore harshly on the taxpayer. At the date of the case was actually heard, an identical settlement would not have been caught because the unduly wide language of proviso(ii) to section 399 had been amended by section 20(5) FA 1958.

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82. p71
83. p75

In fact, section 20 FA 1958 amended sections 397-9 ITA 1952 in a number of ways.

The wording of section 397,[84] dating back to the FA 1922, provided that where, in consequence of a "settlement", any income was paid to or for the benefit of a child of the settlor in any year of assessment, that income was treated as the settlor's if "at the commencement of that year" the child was an infant and unmarried. The result of this original wording was that income was not treated as that of the settlor in the first year of a child's life (unless he was born on 6 April). On the other hand, where income was accumulated contingently on the child attaining 21, and the settlement thus came within the exception provided by what then section 398(2)[85] while the income was being accumulated, it was only by concession that, when the accumulations were handed over, they were not treated as caught by section 397. Furthermore, income accruing between the attainment of 21 and the following 5 April was not excluded from section 397 if it was paid over to the beneficiary.

The anomalies were dealt with by section 20 FA 1958 which replaced the word "at the commencement of that year" in section 397 with the words "at the time of payment".

Section 398(2)(b)[86] was amended to the same effect. That subsection, as is explained above, provided that, where the settlement was a capital settlement, and the income was accumulated, the income was not treated as the parent's. However, whenever any income or capital was paid for the infant child's benefit, that amount was to be subject to surtax in the parents hands. Following the amendments made by section 20, the section applied if the child was an infant and unmarried at the time of the

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84. Now section 663 ICTA 1988
85. Now section 664(2) Ibid
86. Now section 664(2)(b) Ibid

payment, rather than at the beginning or the year.

The above changes applied for 1957/58 unless the settlement was made before 9 July 1958 and the payment was made in 1958/59 for the benefit of a child born after 6 April 1958.

Section 20(5) FA 1958 contained a relieving provision relating to the proviso to section 399 ITA 1952, which was the subject of the Jamieson case. It was explained above that section 399 set out as section 665 ICTA 1988 now does, certain situations in which a settlement was not to be deemed to be irrecovable, in the light of the fact that it is only in respect of irrevocable capital settlements that income could be accumulated without liability on the parent.

It has been explained that one of the sets of circumstances where section 399 prevented a settlement from being irrevocable was where the terms of the settlement provided "for the determination of the settlement by the act on the default of any person." However, proviso (ii) to the section said that, nevertheless, a settlement was not to be deemed to be revocable by reason only that it provided for the determination of the settlement in such a manner that the determination would not, during the lifetime of the infant beneficiary, benefit any person other than the child or the wife, husband or issue of the child. The unnecessarily wide scope of the words "other than such a child, or the wife, husband or issue of such a child" was exposed in a number of instances, and it will be recalled that, subsequently, but it relation to events before the amendment, the taxpayer in Jamieson was harshly caught out.

Section 20(5) cured this defect by replacing the words quoted above with the words "the settlor or the wife or husband of the settlor". As a result, proviso (ii) excluded from charge all settlements which could be determined but where the determination would not benefit the settlor or the settlor's spouse. For settlements under section 398, the charge operated from 6 April 1958 onwards.

The legislation originating in 1936, with these and a few other minor amendments, has survived for over 50 years and continues to be effective in preventing the perceived abuses at which it was aimed. The legislation has a wide ambit, but the wording is clear and, these days, well understood by professional advisers, so it gives rise to few disputes in the courts these days.

In any case, with a reduction in the highest rate of income tax by the FA 1988 to 40%, the incentive to split income amongst the members of one's family is much reduced. Even if income is accumulated within a capital settlement, the trustees pay tax on the trust income at only 5% less than the settlor so, here again, there is less incentive to avoid making payments to infant unmarried children of the settlor.

There has been one recent case on section 663 ICTA 1988, although it related to arrangements made before the 1988 income tax reductions. This case was Butler v Wildin[87], which concerned a not uncommon arrangement, namely, where a parent instigates a transaction whereby his infant children acquires shares in a company which the parent can ensure makes a profit.

The taxpayers were two brothers who, in 1980, incorporated a company of which they were unpaid directors. The

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87. [1989] STC 22

company had a capital of £100 divided into 100 shares of £1 each. These shares were allotted to the two taxpayers and their four infant children. The infant's shares were paid for out of money provided by their grandparents. They paid par value of £1 per share. Subsequently, two more children were born. One of these newly born children received 12 shares from his father and seven shares from his uncle; and later the other received five shares from her father and 11 shares from the five existing infant shareholders. The two newly born children also paid £1 share out of their own resources. At that stage, the taxpayers retained no shares in the company.

The company commenced trading by acquiring a disused railway yard from British Rail for development in 1981. It was financed by a bank loan guaranteed by the taxpayer. Profits were made in the accounting year ending 31 October 1985 and dividends were declared in that year.

Each taxpayer, on behalf of his children, claimed repayment of the tax credit attributed to the dividends. These repayments were refused by the Revenue on the grounds that the dividends represented income derived from a settlement by the taxpayers and therefore the income had to be treated as the taxpayers' under what was then section 437 ICTA 1970.[88]

Before the Special Commissioner, the Revenue contended that the taxpayers, by incorporating the company and allotting shares to the children which they could have allotted to themselves, by adopting the whole risk of the venture for the benefit of the children, by giving personal guarantees to the bank and acting as unpaid directors, entered into an "arrangement" which had an

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88. Now section 663 ICTA 1988

element of bounty, and that they had provided funds directly or indirectly for the purpose of the arrangement. Accordingly, it was argued, the taxpayers were settlors within section 437.

Although the Special Commissioner found for the taxpayers, Vinelott J substantially allowed the Crown's appeal.

The judge considered it "plain beyond question" that each taxpayer was a party to an "arrangement" and that the dividends paid to the four older children were paid to them "by virtue or in consequence" of "the arrangement". The various steps taken by the taxpayers were directed towards ensuring that the company and the four older children took the benefit of the development at no cost or risk to themselves.[89] In addition the arrangements were clearly reciprocal.[90]

Furthermore, Vinelott J held that there was the necessary element of bounty insofar as the payments to the four older children were concerned because these children contributed nothing but trifling sums and were exposed to no risk.[91]

On the other hand, there was no evidence that the arrangements for the older children were to extend to future children. The shares received by the elder of the two newly born children from his uncle and all the shares received by the younger of the two newly born children were not part of the reciprocal arrangements for they paid less than market value.[92]

Three points arise from this decision:

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89. p36
90. p38
91. See pp36-7
92. See pp38-9

1. The width of the definition of "arrangements" was confirmed, although little confirmation was necessary in the light of the cases considered in Part 1 of this Chapter.

2. The Revenue accepted that they had to show that there was an element of bounty if there was to be a "settlement".

3. The parents do not have to provide funds directly to or for the benefit of their infant unmarried children to be caught by section 663 ICTA 1988. Again, this was not seriously doubted prior to this case.

PART 4

REVOCABLE SETTLEMENTS

The Attack on Revocable Settlements

Revocable settlements as a tool for tax avoidance were first tackled by section 20(1)(a) FA 1922 but that provision was very soon found to have severe limitations, and so section 38(1) and (2) FA 1938 overhauled the whole legislation. The 1938 legislation formed the basis for the provisions applicable today and which are contained in sections 671 and 672 ICTA 1988.

Section 20(1)(a) FA 1922 read:

> "Any income (a) of which any person is able, or has, at any time since the fifth day of April, nineteen hundred and twenty-two, been able, without the consent of any other person by means of the exercise of any power of appointment, power of revocation or otherwise howsoever by virtue or in consequence of a disposition made directly or indirectly by himself to obtain for himself the beneficial enjoyment .....shall..... be deemed for the purposes of the enactments relating to income tax (including supertax) to be the income of the person who is able or was able to obtain the beneficial enjoyment thereof ....and not be for those purposes the income of any other person."

However, it was soon realised that this provision could easily be circumvented. The two main methods used were:

1. By providing that revocation required the consent of a person other than the settlor.

2. By providing that the settlor could revoke on the payment of a nominal penalty.

The first escape route was illustrated by the case of Watson's Trustees v Wiggins[1], a case on section 20(1)(c)[2]. It will be recalled that there was a power of revocation in that case which could be exercised by the settlor with the consent of any one of five specified persons. The Crown accepted that paragraph (a) could not apply to the settlement and the courts were not called upon to comment on the point.

As noted above, the defects in section 20(1)(a) FA 1922 were tackled by section 38 FA 1938. Subsection 38(1)[3] dealt with deeds of covenant under which the settlor covenants to make annual payments to a beneficiary, whether directly or through a trustee. The situation in which a settlor transfers capital to trustees, which the trustees hold on certain trusts in favour of one or more beneficiaries, is covered by subsection 38(2)[4].

In view of the fact that the wording of the 1938 legislation has, under its original designation or under the 1952 or 1970 consolidations, been frequently considered by the courts, it would be helpful to set out the provisions before dealing with the relevant cases.

Section 671(1)[5] states:

> "(1) if and so long as the terms of any settlement (wherever made) are such that-
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> > (a) any person has or may have power, whether immediately or in the future, and whether with or without the consent of any other person, to revoke or otherwise determine the settlement or any provision thereof and, in the event of the exercise of the power, the settlor or the wife or husband of the settlor will or may cease to

1. (1933) 17 TC 728
2. See Part 3, infra
3. Now section 671 ICTA 1988
4. Now section 672 ibid
5. Originally section 38(1) FA 1938

be liable to make any annual payments payable by virtue or in consequence of any provision of the settlement; or

(b) the settlor or the wife or husband of the settlor may, whether immediately or in the future cease, on the payment of a penalty, to be liable to make any annual payments payable by virtue or in consequence of any provision of the settlement,

any sums payable by the settlor or the wife or husband of the settlor by virtue or in consequence of that provision of the settlement in any year of assessment shall be treated for all the purposes of the Income Tax Act as the income of the settlor for that year and not as the income of any other person".

Section 671(2)[6] reads:

"Where any such power as is referred to in subsection (1)(a) above cannot be exercised -

(a) in the case of a covenanted payment to charity .... within the period of three years, or

(b) in any other case, within the period of six years,

from the time when the first of the annual payments so referred to becomes payable, and the like annual payments are payable in each year throughout that period, subsection (1)(a) above shall not apply so long as that power cannot be exercised."

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6. Originally, para 2(b) was the proviso to section 38(1) FA 1938, para 2(a) was added by section 55(2) FA1980.

What constitutes the power to revoke or determine a settlement and the cessation of liability to make annual payments is clarified in subsection 671(3) which runs:

> "(3) In subsections (1) and (2) above -
>
> (a) the references to a power to revoke or otherwise determine a settlement or any provision thereof shall be deemed to include references to any power to diminish the amount of any payments which are or may be payable under the settlement or any provision thereof and to any power to diminish the amount of any annual payments which the settlor or the wife or husband of the settlor is or may be liable to make by virtue or in consequence of any provision of the settlement;
>
> (b) the references to the settlor or the wife or husband of the settlor ceasing to be liable to make any annual payments payable by virtue or in consequence of any provision of the settlement shall be deemed to include references to a diminution of the amount of any such annual payments which the settlor or wife or husband of the settlor is or may be liable to make..."

Section 672 ICTA 1988[7] states:

> "(1) If and so long as the terms of any settlement (wherever made) are such that -
>
> (a) any person has or may have power, whether immediately or in the future, and whether with or without the consent of any other person, to

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7. Originally section 38(2) FA 1938

revoke or otherwise determine the settlement or any provision thereof; and

(b) in the event of the exercise of the power, the settlor or the wife or husband of the settlor will or may become beneficially entitled to the whole or any part of the property then comprised in the settlement or of the income arising from the whole or any part of the property so comprised, any income arising under the settlement from the property comprised in the settlement in any year of assessment or or from a corresponding part of that property, or a corresponding part of any such income, as the case may be, shall, subject to subsection (2) below, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any person.

(2) Where any such power cannot be exercised within six years from the time when any particular property first becomes comprised in the settlement, subsection (1) above shall not apply to income arising under the settlement from that property, so long as the power cannot be exercised."

Subsection 672(3) clarifies what constitutes a power to revoke or determine a settlement by saying:

"In subsection (1) above the references to a power to revoke or otherwise determine a settlement or any provision thereof shall be deemed to include references to -

(a) any power to diminish the property comprised in the settlement; and

(b) any power to diminish the amount of any provision thereof to any person other than the settlor and the wife or husband of the settlor".

The definition of "settlement" in the FA 1938 was contained in section 41(4)(b) which said:

"the expression 'settlement' includes any disposition, trust, covenant, agreement or arrangement, and the expression 'settlor' in relation to a settlement means any person by whom the settlement was made."[8]

Subsection 41(4)(c) stated that:

"a person shall be deemed to have made a settlement if he has made or entered into the settlement directly or indirectly, and in particular (but without prejudice to the generality of the foregoing words of this paragraph) if he has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement."[8]

When the FA 1938 provisions were introduced, there were transitional provisions in Part II of the Third Schedule to make the retrospective effect of section 38 less oppressive. It would have been totally unfair if persons who had entered into covenants and settlements of the type covered by section 38 at a time when they were not fiscally disadvantaged were not given the chance of getting rid of the offending powers.

Accordingly, Paragraph 1 of Part II of the Third Schedule provided that:

"in the case of a settlement made before the twenty-seventh day of April nineteen hundred and

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8. See now section 681(4) ICTA 1988

thirty-eight, Subsection (1) of [section 38] shall not, by reason of the provisions of paragraph (a) thereof, apply to sums payable by the settlor by virtue or in consequence of any provision of the settlement in a year to which that Part of this Schedule applies."

These years were 1937/38 and 1938/39.[9] The provisions which had to be fulfilled to qualify for this exemption were set out in sub-paragraphs (a), (b) and (c). The subparagraphs stated that:

"if - (a) at the expiration of three months from the date of the passing of this Act (i) no person has or can have any such power as is referred to in the said paragraph (a) [of section 38(1)]; and (ii) the settlor has not received and is not entitled to receive any consideration in respect of the release or disclaimer of any such power; or

(b) the life annual payments have been payable by the settlor by virtue or in consequence of that provision of the settlement in each of the seven years of assessment ending with a year to which this ... Schedule applies; or

(c) before the expiration of three months from the date of the passing of this Act (i) the settlement, or the provision by virtue or in consequence whereof the annual payments are payable, has been revoked; and (ii) a new settlement has been made by the settlor by virtue or in consequence whereof the settlor is liable to make the like annual payments and cannot, except in the event of his death, cease to be liable to make those payments before the expiration of six years from the date when the first

9. Paragraph 7 Third Schedule FA 1938

of the annual payments payable by virtue or in consequence of the revoked settlement became payable."

Paragraph 4 stated:

"Notwithstanding that the payments payable by virtue or in consequence of any such new settlement as in referred to in subparagraph (c)(ii) of paragraph 1 of this Part of this Schedule are payable to or applicable for the benefit of another person for a period which cannot exceed six years from the date when the settlement was made, they shall not be treated as the income of the settlor by virtue of paragraph (b) of subsection (1) of section twenty of the Finance Act 1922".

This paragraph refers to the provision in FA 1922 relating to covenants for less than six years.[10] The effect of paragraph 4 was to protect the taxpayer notwithstanding that under the new settlement made pursuant to subparagraph (c)(ii) of paragraph 4, the only sums payable under the new settlement might be payable for a period less than six years.

The taxpayer in IRC v Payne[11] tried to take advantage of the Third Schedule to the FA 1938. This case has been considered in connection with the definition of "arrangement"[12] and it will be recalled that the "arrangement" and, therefore, the "settlement" involved the deed of covenant and the company, Derwent Ltd.

The taxpayer argued that he fell within paragraph 1(a)(i) because the company had gone into liquidation before 29 October 1938 (ie three months after the passing of FA 1938) and so no person, on that date, had or could

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10. See Part 5, infra
11. (1940) 23 TC 610
12. See Part 1, supra

have "any such power as is referred to in" section 38(1)(a), namely, a power "to revoke or otherwise determine the settlement or any provision thereof". Lawrence J and the Court of Appeal rejected this argument; Sir Wilfrid Greene MR, for example, saying:

> "It seems to me that language [ie of paragraph 1(a)(i) of the Third Schedule] is completely unsuitable to describe the case where the non-existence of any such power is not due to the fact that it has been revoked or eliminated, but is due to the fact that the settlement in which it is embedded has disappeared altogether."[13]

This analysis is correct on the language of the Schedule, but it does show the absurdity of the position because existing settlements could be protected from the harsh retrospectively of section 38, but there was nothing that could be done to protect settlements that had come to an end before 29 October 1938. Sir Wilfrid Greene MR, however, was not the least disturbed by this taking the view that the Legislature had deliberately chosen not to give such settlements protection from the section.[14]

Four months after he had given his judgment at first instance in Payne. Lawrence J came to a similar decision in IRC v Becher.[15]

Here, under a deed of 3 August 1937, the taxpayer covenanted to pay trustees, to be held in trust for her daughter (who was over 21), monthly sums during the joint lives of herself and her daughter, or such shorter period as she should thereafter fix by deed, executed with the consent of at least one of the trustees. The deed was revoked on 19 April 1938.

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13. p630
14. Ibid
15. (1940) 23 TC 606

The taxpayer claimed a deduction in respect of the monthly sums paid under the deed in 1937/38.

The taxpayer contended that, although by section 38(7) FA 1938, the section was to apply for the purposes of assessment to income tax for 1937/38 and to any settlement whenever made, it could not be applicable to settlements revoked before the Act was passed since, by section 38(7)(c), the provisions of the section were to have effect in relation to settlements made before 27 April 1938 - which this one was - subject to the provisions of Part II of the Third Schedule. The taxpayer submitted that, as she had revoked the settlement before the passing of the Act, she cannot have known of the terms of the option given in the Third Schedule and so, on the principles stated in Reid v Reid[16], and ex parte Todd. In re Ashcroft[17], the retrospective action of the Act ought to be confined to settlements which were in existence unrevoked at the time of the passing of the Act.

Lawrence J did not accept this, his view being that the words: "If and so long as the terms of any settlement are such" must be read retrospectively, ie, as looking back into any part of 1937/38 in respect of which an assessment is to be made under section 38(7). There is nothing in the Third Schedule to prevent a settlor taking advantage of the option, even if he has revoked the settlement before the passing of the Act.

This again shows how harshly the rules operated, the settlor could have released the power to revoke, but did not do so because she did not, and could not, have known that it would retrospectively become so important.

See also IRC v Fitte[18] for an example of a case in which, on the facts, the taxpayer successfully released his

16. 31 ChD 402 at p408
17. 19 QBD 186 at p198
18. (1943) 25 TC 337

power of revocation in time and so came within the protection of the Third Schedule.

As a final general point on these provisions, it should be noted that it is clear that, for the purposes of section 672(1)(b) ICTA 1988, when the section refers to the settlor becoming beneficially entitled to the income of the settlement, he does not have to become entitled to is as income.

This was confirmed by a case decided on section 20(1)(a) FA 1922: D'Ambrumenil v IRC[19]. The taxpayer covenanted, by a deed dated 4 February 1937, to pay to trustees £20,000 in respect of the year to 31 January 1937, and a sum equal to three quarters of his income in each subsequent year until the year commencing 1 February 1945, all payments to be made in arrear on the following 31 March. The trustees were to hold these sums upon trust to accumulate them and to pay to one Beatrice Philp, out of the income arising, such sums as the taxpayer should direct, and to accumulate the balance. The trustees were to invest sums due for investment as the taxpayer might direct and were required to advance to him, on his request, any part of the funds in their hands with or without security or interest, for such a period and upon such terms as he chose. The trustees were not liable for any loss of monies so advanced.

The payment of £20,000 was made to the trustees on 3 March 1937. On 4 April 1938, the taxpayer paid the trustees £10,441 8/4d, being the amount due for the year to 31 March 1938 (£20,255 4/5d), less income tax for the two years. On the same date, the trustees loaned the taxpayer £10,500. No payment under the deed had ever been made to Beatrice Philp.

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19. (1940) 23 TC 440

The taxpayer claimed that the sums of £20,000 and £20,255 4/5d should be allowed as deductions for surtax purposes.

Wrottesley J held that no deductions were admissible. As regards the first payment, both section 20(1)(a) and (b) FA1922 applied so that the sums in question had to be treated as the income of the taxpayer.

Wrottesley J dealt with the section 20(1)(a) point as follows:

> "Next comes the question, was the [taxpayer] able by a disposition to obtain for himself the beneficial enjoyment of this amount of income? If by this the Act means beneficial enjoyment of this income qua income, the answer is in the negative, for the whole design of this deed is that this income shall go, anyhow in name, into a trust fund. Not less is it the design of this deed that it should not remain there for a second longer than the giver wishes. The giver can at once borrow every farthing of it, possibly for ever, if in such a connection the word 'loan' has any meaning, but certainly for 1,000 years, without interest or security. Moreover, should the giver lose the whole of the money after borrowing it, the trustees are in no event to be liable. Beatrice Philp, the person for whose benefit the trust is apparently created, has no remedy against them [the trustees] or the giver.
>
> If I have the right to borrow, that is to say, to be paid the whole of a man's income as fast as he receives it, against his will, on terms that I need neither repay it in any period which interests either of us or our descendants to the twentieth generation, nor pay him interest on it, nor give him security, which of us can be said to have the beneficial enjoyment of this income, if I exercise

> those rights? It seems to me that in such a case the income does the borrower good, and not the lender. The borrower enjoys. The lender may suffer; he certainly cannot be said to enjoy.
>
> Bearing in mind the object of this legislation, I am not disposed to read into the section the words 'as income'. I have no doubt that in the case before me that [taxpayer] was able, if he chose, to obtain for himself the beneficial enjoyment of all this money. He was able so to dispose of matters that that income should benefit him, and that he should enjoy it rather than Beatrice Philp."[20]

The circumstances of this case were extreme, but the principle is clear, and in fact, would have been so even without this case.

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20. p446

The Power to Revoke or Determine a Settlement

This subject has already been considered in relation to what is now section 663 ICTA 1988[21]. Here, it is dealt with in relation to the provisions originally contained in section 20(1)(a) FA 1922, and then in a more comprehensive form in section 38 FA 1938 and now contained in section 671 et seq ICTA 1988.

The first case to consider is IRC v Payne[22] which has already been examined in this Part and also in connection with the meaning of "arrangement".[23] It will be recalled that both Lawrence J and the Court of Appeal held that the taxpayer had power, through his control of Derwent Ltd "to revoke or otherwise determine the settlement" for the purposes of section 38(1)(a) FA 1938.[24]

In the Court of Appeal, Sir Wilfrid Greene MR commented that the taxpayer had "engaged in a scheme, the object of which was to enable him to reduce his taxable income and, at his own volition, to receive back the sum by which he had reduced it in the form of capital, thereby evading taxation."[25] The Master of the Rolls obviously meant "avoiding", rather than "evading" taxation.

The Master of the Rolls noted that the taxpayer could by virtue of his voting power, bring his obligations under the covenant to an end at any moment that he pleased. He was also in a position to alter the constitution of the company and thereby obtain repayment to himself of the sums that he had paid under the covenant by way of repayment of the nominal amount of his preference shares.[26]

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22. (1940) 23 TC 610
23. See Part 1, supra
24. For Lawrence J's view, see p620
25. p624
26. pp624-5

The question to be answered was whether the taxpayer was thereby in a position "to revoke or otherwise determine the settlement or any provision thereof" within section 38(1) FA 1938. To the Master of the Rolls, with whom Clauson and Goddard LJJ agreed, the answer was clear. He said:

> "In my opinion, there is only one answer to that question. The position in which he had placed himself was one in which he could bring to an end his liability under his deed of covenant. That deed of covenant was a provision of the settlement[27]; it was an integral part of it; and his liability under could be determined by him at any moment that he pleased by the mere exercise of his voting rights in which a way as to put the company into liquidation."[28]

A similar case is another one considered in Part 1 of this Chapter: MacAndrew v IRC.[29] Reference to the circumstances of this case set out above will show that it was held by Macnaghten J that, as the taxpayer's wife could wind up the company and thereby put an end to the covenant by the taxpayer under the 1940 deed, the income from the shares in question was deemed to be the taxpayer's under section 38(1).

As has been mentioned in Part 1, this decision seems incorrect in the light of the Chamberlain decision; a case which the taxpayer, appearing in person, did not bring to the attention of the judge. See Lord Normand in Wolfson who expressed the opinion that MacAndrew was wrongly decided.[30]

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27. See the examination of the definition of "arrangement" in Part 1, supra
28. p626 See also Burston v IRC (1942) 24TC 285
29. (1943) 25 TC 500
30. Wolfson v IRC (1949) 31 TC 141 at p171

Also relevant are the cases of IRC V Morton[31], IRC v Rainsford-Hannay[32], and Dalgety v IRC[33], all cases in which, by virtue of the taxpayers' control over companies, they were held to have power to revoke the "settlements" of which the transactions relating to the companies formed part. As has been seems, in the light of the Chamberlain and Wolfson cases, these decisions no longer represent good law. For an analysis of Chamberlain v IRC[34] see Part 1 of this Chapter.

Next came the decision in Wolfson v IRC[35] which emphasised the point that the power to revoke for the purposes of section 38 must be contained in the settlement itself. It will be recalled that the Crown had contended that, by virtue of the control the taxpayer had over the company, he was in a position to revoke or determine the settlement.[36] The House of Lords rejected this contention and found that the taxpayer had no power whatever within the terms of the settlement to revoke or determine it.

Lord Morton summarised the postion thus:

> "In my view, no settlement comes within section 38(1)(a) of the Finance Act 1938 unless the power described in that subsection is found in, and conferred by, the terms of the settlement. This seems to be to be the natural meaning of the words used."[37]

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31. (1941) 24 TC 259
32. (1941) 24 TC 273
33. (1941) 24 TC 280
34. (1943) 25 TC 318
35. (1949) 31 TC 141
36. See Part 1, supra
37. P171 The words referred to were "If and so long as the terms of any settlement are such that".

In this respect, this case can be compared with Payne in which it was held, on the facts, that the structure of the company was part of the settlement.[38]

The taxpayer in Wolfson was undoubtedly exploiting a loophole in the section, but the courts could not, of course, rectify the mistake of the Legislature. Lord Simonds, for example, said:

> "It was urged that the construction that I favour leaves an easy loophole through which the evasive taxpayer may find escape. That may be so; but I will repeat what has been said before. It is not the function of a court of law to give to words a strained and unnatural meaning because only thus will a taxing statute apply to a transaction which, had the Legislature thought of it, would have been covered by appropriate words. It is the duty of the Court to give to the words of this subsection their reasonable meaning and I must decline on any ground of policy to give them a meaning which ...I regard as little short of extravagant. It cannot even be urged that unless this meaning is given to the section it can have no operation. On the contrary, given its natural meaning it will bring within the area of taxation a number of cases in which by a familiar device tax had formerly been avoided."[39]

Similarly, Lord Normand's view was:

> "In general the [Crown's] argument overstrains the language of the subsection, though it may at no point be plainly inconsistent with it. More than once it was urged that unless the argument was accepted the subsection would be nugatory or easily

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38. See Part 1 supra
39. p169

evaded.That the subsection will be nugatory I see no reason to think, and I have little doubt that it was framed to deal with and has successfully dealt with settlements of a certain type which had come to the notice of the Inland Revenue. That it may be easily evaded is possible. That is a consideration which is irrelevant to is proper interpretation, and there is the practical answer that it may be easily amended, but that that is for Parliament not the Courts."[40]

The principle to be drawn from Wolfson is that the power to revoke or determine a settlement must be given to the settlor by the terms of the settlement itself. It is immaterial that external circumstances are such that the settlor can do something which has the same practical effect as the revocation of the settlement. He may be in a position, by means of a transaction one stage removed from the settlement itself, to relieve himself of the necessity of implementing the settlement terms but, as long as he cannot do this as a result of specific power given to him by the settlement itself, he would be unaffected by section 38.

Accordingly, as a comparison of the cases of Payne and Chamberlain shows, it is essential to determine what transactions fall within the statutory definition of settlement. This has been considered in Part 1 of this Chapter.[41]

In the case of IRC v Fitte[42] the taxpayer covenanted to pay to trustees an annual sum for the benefit of his niece, and the deed reserved power to the taxpayer to declare new trusts of the income for the benefit of himself or any other person and, for that purpose, to revoke, wholly or partially, the original trusts. With a

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40. p171
41. See also the examination of the case of Vestey v IRC (1949) 31 TC 1, in Part 1, supra
42. (1943) 25 TC 337

view to taking advantage of Part II of the Third Schedule to the FA 1938[43], the taxpayer executed a supplemental deed, directing that the income payable under the principle deed should be held on trust to pay the same for the benefit of such of the persons whose names appeared in the schedule to the supplementary deed as he might appoint, or in default of appointment as the trustees might think fit. The schedule contained the names of eleven individuals (including the niece but not the taxpayer) and also past, present and future employees of the taxpayer or of one of his companies.

The taxpayer claimed a deduction in respect of the sums paid by him for surtax purposes. This was refused on the ground, inter alia, that the taxpayer might himself qualify as a beneficiary under the deeds by becoming an employees of one of his own companies and might therefore determine the settlements within the meaning of section 38(1)(a) FA 1938 because he could then appoint the whole of the future income irrevocably to himself and, by so doing, would become the sole beneficiary thereunder and so be in a position to determine the trusts declared by the deed.

However, on a true construction of the deeds, it was held by Macnaghten J and by the Court of Appeal that the taxpayer could not become an appointee under any of the deeds but it was generally accepted that, if he could have become an appointee, section 38(1)(a) would have applied.[44]

Although, section 38 FA 1938 has in general worked very well and is still on the statute books in very much its original form, a major loophole was exposed by Saunders v IRC[45].

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43. Supra
44. Although Luxmore LJ stated that it was unnecessary for him to decide this point, see p350
45. (1957) 37 TC 416

To get the complete picture, however, it is necessary to consider another case in which the decisions were given by the same judges of the Court of Appeal and the same Law Lords in the House of Lords and on the same days, at both stages, as the Saunders case: IRC v Countess of Kenmare[46].

The facts were that, by a settlement executed in Bermuda, the taxpayer, who at the relevant times was neither resident nor ordinarily resident in the UK, transferred securities in the UK worth £700,000 to non-resident trustees. The trustees were directed during the taxpayer's life to pay the trust income to her or accumulate it at their discretion and, after her death, to hold the trust fund on trust for her issue. The settlement also provided that the trustees might at any time and from time to time during the taxpayer's lifetime declare in writing that any part of the fund, not exceeding £60,000 in any triennial period, should be held in trust for her absolutely and that, thereupon, the trusts concerning that part of the fund should determine. The whole income of the fund from the creation of the settlement on 24 September 1947 to 5 April 1948 was distributed to the taxpayer in the exercise of the trustees' discretion.

The taxpayer was assessed to surtax for 1947/48 on the basis that the trust income fell to be treated as her income under section 38(2) FA 1938.

The taxpayer contended, inter alia, that the settlement was not revocable because the powers given to the trustees were exercisable only within its framework. The Crown, on the other hand, argued that the settlement was revocable in view of the trustees' power to take out the funds by successive stages.

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46. (1957) 3T TC 383

All of the courts, up to and including the House of Lords, held that the income had to be treated as the taxpayer's income under section 38(2) because the power given to the trustees might enable them to determine the settlement by exhausting the trust fund during the settlor's lifetime.

In the Court of Appeal, Singleton LJ said that the word "provision", when used for the second time in section 38(1)(a) clearly meant a clause, or part of a clause, of the settlement, and it had the same meaning earlier in section 38(1)(a) and also in section 38(1)(b). In subsection (2), the words "or any provision thereof" following the word "settlement" should be given the same meaning.[47] This point is dealt with further in the Saunders case.[48]

Turning to the settlement itself. Singleton LJ said:

> "On a fair reading of the terms of the settlement I am satisfied that the position created was within the words of section 38(2)(a); and that consequently the income from the settled fund falls to be treated as the income of the settlor...... The words 'or may have' follow the words 'if .... any person has'. It appears to me that the term of the settlement.......that the trustees may pay out to the settlor in any three years the sum of £60,000 (with a carry forward) might result in time in the fund being exhausted.... it is something which might happen - in other words, it is covered by the words 'may have'. If the settled fund disappeared, that would be a determination - not a revocation - of the settlement. There would be nothing left except a document...."[49]

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47. p396 See also Romer LJ at p403
48. Infra
49. p396 See also Romer LJ at p404

The House of Lords unanimously agreed. Viscount Simonds for example, like the judges below, pointed out that the powers given to the trustees might enable them, by successive withdrawals of the trust fund, to exhaust it during the settlors lifetime and thus determine the settlement. If and when the whole of the trust fund had been transferred back to the taxpayer, there would merely be left a deed of settlement, with nothing for the document to operate upon.[50]

The Kenmare case should be compared with Saunders v IRC[51]. The taxpayer here transferred two sums of £100 and £25,000 to trustees to hold on certain trusts. The trustees were empowered at any time at any time during the taxpayer's life, with his consent, to pay any part of the capital of the trust funds absolutely to any member of a specified class which included his wife, provided that they left at least £100 of capital subject to the trusts. Although there were two transfers, the Crown agreed that the case should be decided on the footing that there was only one settlement.

The income from the trust investments was included in the taxpayers's total income for surtax purposes on the ground that section 38(2) FA 1938 applied.

It was clear that the requirement to keep £100 in the trust was inserted specifically to escape section 38, and the judges acknowledged that this was so.[52] Nevertheless, it was held by the Court of Appeal and the House of Lords (Lords Keith of Avonholm and Somervell of Harrow dissenting) that there was no power in the settlor's lifetime to "revoke or determine the settlement or any provision thereof."

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50. p409
51. (1957) 37 TC 416
52. See for example, Viscount Simonds at p430 and Lord Reid at p433

Viscount Simonds encapsulated the central issue as being whether the words "revoke or otherwise determine the settlement or any provision thereof" are satisfied if the settlement is in part revoked or if a beneficial interest created by the settlement is in part determined. He analysed the situation as follows:

> "Let me take a concrete case. The beneficial interest which is said to be liable to be determined is the life interest of A in a capital fund of £100,000: the trustees in the exercise of their power withdraw from the trust £10,000 or £50,000 or £90,000. Upon such withdrawal is the beneficial interest of A determined? Is there on each withdrawal a new beneficial interest created and on the next withdrawal a new determination? Alternatively, is each pound or other unit of the trust income to be regarded as a separate provision, so that upon the withdrawal of the relevant capital it can be said that a provision for A has been determined? I do not think that either of these explanations is plausible. Yet one or other of them must be adopted if a provision of the settlement or a beneficial interest created by it is to be regarded as determined by the diminution of it in greater of less degree. The problem may be stated in a slightly different way, perhaps more attractive to the Crown's case. I can well imagine that a beneficiary for whom the handsome provision of (say) £5,000 a year has been made would say, upon finding it cut down to £50 a year, that he no longer enjoyed the provision he formerly had. Colleqially, he was no longer provided for. But he would in fact be provided for though on a less handsome scale and it would be a provision made by the settlement. Therefore the same question would have to be asked:

has the earlier provision been determined and a new one substituted? Or would it be more accurate to say that the provision made for him had been not determined but diminished? This is to put in other words the question that I asked earlier: does the word 'revoke' include partial revocation and the word 'determine' include partial determination? I do not think that it does. A purist would, I think, say that there can be no such thing as a partial determination of a single provision. An end is an end and there is no part left. At any rate, nothing could be easier than to use words appropriate to the revocation or determination of part of a provision if it were intended to cover the reduction of a provision for any person or body of persons, and I think that I should not be justified in giving a strained meaning to the words which the Legislature has preferred to use."[53]

Lords Reid and Cohen agreed but, as mentioned above, Lord Keith of Avonholm and Lord Somervell of Harrow dissented. Both Lord Keith and Lord Somervell adopted a much wider interpretation and looked more to the intention of the Act rather than the precise words used.

Lord Keith was of the opinion that the Act was not concerned "with subtleties of conveyancing".[54] In other words, he was saying that the Act allows the court to disregard the actual transactions and to look to the underlying substance. This, it is submitted, is nonsense; the Act went to great lengths to describe precisely the transactions which would be affected by it. He then went on to say that "removing a part of the settled fund from the trusts of the settlement for the benefit of the settlor or his wife is a determination of a provision of the settlement."[55] This is either an

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53. pp432-3
54. p437
55. p438

inaccurate interpretation of the meaning of "determination" or a loose interpretation of "provision". As regards the meaning of "determination" the correct position was as Lord Reid had analysed it, namely:

> "It has not been argued that the word "determine" can mean anything else then "bring to an end". It cannot mean 'modify' or 'diminish'. Accordingly, the subsection cannot apply unless there is power to bring something to an end."[56]

It is not clear whether Lord Keith disagreed with this: he did not develop this point, but it seems he mainly relied on the fact that, in his perception of "the reality of the transaction", the settlor made two provisions, one of "the income and capital of so much of the settled fund as should be at any time above £100 in value, which was subject to the trustees' power of determination", and the other, "a provision of the income and capital of £100, which was not subject to this power of determination."[57] Lord Keith did not explain how he reached this conclusion. Perhaps, it was based on the fact that the taxpayer had transferred two separate sums to the trustees, one of £100 and the other of £25,000, but even the Crown admitted that there was still only one settlement. Lord Keith's construction amounts to a recharacterisation of the transaction which is not legitimate principle of construction.[58]

The other dissenting judge, Lord Somervell, when Attorney-General had represented the Crown in cases such as Payne, Burston, Chamberlain and Jenkins, so perhaps sympathy with the Crown's case here was understandable. He based his conclusion on the meaning of "provision". He said:

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56. p433
57. p438
58. See Chapter 11

> "No provision, it is said, has been revoked or determined. I do not think that in its context in this clause 'provision' can be so construed. I am giving, I think, a natural meaning to the word as applied to a settlement. What are the provisions of a settlement? The first matter with which the answerer would naturally deal would be the amount of the settled fund. I think a provision is revoked or determined if, as in the present case, £25,000 is taken out of the settlement."[59]

This is in contrast to the more detailed analysis of Viscount Simonds which is set out above and which, it is submitted, is the correct interpretation of the legislation as it then stood.

The House of Lords decision in Saunders left an obvious loophole in the Act and it was quickly counteracted in the following year by section 21(a)(a) FA 1958.[60]

Section 21 enacted that references to a power to revoke or otherwise determine were to include references to any power to diminish the amount of any payments; similarly, references to the settlor or spouse of the settlor ceasing to be liable to make any annual payment are to include references to a diminution of any such payment.

The provisions that section 21(2) were amending were at the time contained in section 404(2) ITA 1952. Because of the amendments to section 404 by section 21(2), a case such as Saunders would be caught because, as has been seen above, although the settlement could not be determined, the amount of property in the settlement income flowing from the diminishable proportion of the trust fund would have had to be treated as the settlor's income. For example, if a quarter of the trust fund

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59. p438
60. Now section 672(3) ICTA 1988, a similar amendment was made to what is now section 671 ibid

could have been transferred back to the settlor, a quarter of the income would have been assessed on him, regardless of who was entitled to it in the meantime.

Section 21(2)(b) FA 1958 dealt with the kind of case where the settlor or the settlor's spouse is entitled to the balance of the settlement income over that portion of it which has to be paid to other persons. Any power to diminish the amount of income payable to the other persons is, as a result of section 21(1)(b), to be treated as a power to effect a partial determination of the settlement, with the result that the corresponding diminishable amount of income is treated as the settlor's.[61]

For example, if a settlement provides that three quarters of the income is to be paid to a beneficiary "x", and the balance to the settlor's wife, but there is power for the trustees to decrease the amount of income payable to "x", the increased amount of income thus capable of going to the settlor's wife is treated as the settlor's income in addition to the one quarter to which the wife is already entitled.

Section 21(1) FA 1958 made similar amendments to section 404(1) ITA 1952 as section 21(2) FA 1958 had made to section 404(2). Section 404(1), prior to the 1958 amendment, said that, if there is a revoking or determining power, which can be so exercised as to make the settlor cease to be liable to make annual payments, then all sums payable by him are treated as his income. There is the same result if the settlor can pay a penalty and then cease to be liable to make his annual payments.

Section 21(1) directed that the same result is to occur if there is power to diminish either the amount of the

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61. See now section 672(3)(b) ICTA 1988
62. See now section 671(3) ibid

payments to be made to the beneficiary by the trustees or the amount of the annual payments that the settlor has to make.

The same result occurs if the amount of the settlor's annual payment can be diminished in consideration of his paying a penalty. However, section 21(1) specified that the settlor's liability for any year arising from the diminution of his annual payment is to be only that part of the sum he has to pay in the year, as corresponds to the amount of the diminution.

Section 21 applied for income tax purposes for 1958/59 and for surtax for 1957/58. However, by section 21(4) FA 1958, if the settlement was made before 16 April 1958, there was no liability under the section, if the power to diminish was not exercised from that date onwards, or could not become exercisable after 5 April 1959, or such later date as the Inland Revenue allowed, and provided also that neither the settlor nor the spouse of the settlor could be entitled to any benefit in connection with the non-exercise of the power. It seems that the purpose of this alleviation was so that, in cases where a power could not be released without the consent of the Court, there was time for an appropriate application to be made.

In the case of an income settlement made before 16 April 1958, section 21 did not affect it if the settlement was entered into in connection with a judicial separation, or with a separation agreement, or with the dissolution or annulment of a marriage.

Section 21(5) FA 1958 was designed to remove doubts about the application of sections 404 and 405 ITA 1952 to settlements executed outside the UK and to deal with a point which was overlooked when the legislation was consolidated in the ITA 1952. As noted above, sections 404 and 405 ITA 1952 were previously section 38(1) and (2) and section 38(3) and (4) FA 1938[63] respectively. Section 38(7) FA 1938 said that the section applied to any settlement "wherever made", but subsection (7) was not repeated anywhere in the ITA 1952. Section 21(5) FA 1958 retrospectively supplied this deficiency and "for the removal of doubts" it declared that sections 404 and 405 applied, and had always applied, in relation of any settlement "wherever made". In fact, there appears to be no reported instance of these "doubts" ever having been exploited by a taxpayer.

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63. Subsections 38(3) and (4) FA 1938 are considered in Part 6, infra

Suspension of Powers of Revocation

The effect of clauses suspending powers of revocation will now be dealt with. This subject is tied up with the question of compound settlements and the provisions now contained in section 671(2)(b) and section 672(2) ICTA 1988 relating to powers of revocation that cannot be exercised for six years.

In a number of cases the courts have had to consider the effect of a compound settlement. Under general trust law, of course, settlement may be constituted by a single instrument, or by two or more instruments executed at different times. To take a straightforward example, a settlement may settle property for the benefit of several beneficiaries who take varying interests on certain trusts. The settlor may, however, have reserved power to alter or vary the trusts and, when a resettlement takes place varying the terms of the original settlement, a compound settlement is thereby constituted. This compound settlement will constitute a new settlement, consisting of both the original settlement and the later variation.

Without doubt, a compound settlement will constitute a "settlement" for the purposes of section 671 and 672.

Where more than one instrument has been executed in relation to the same trust property, the important question to be determined is whether a compound settlement has been constituted. It may be that the original settlement has not been affected in any way by the execution of the later instrument, as was held to be the Scott case.[64]

If the original settlement has not been affected, the settlement in relation to which it is necessary to

64. Scott v IRC (1957) 37 TC 486, infra

consider whether the income tax provisions can operate will still be the settlement under the original instrument which created it. On the other hand, if a compound settlement has been constituted by the new instrument, it is that new settlement which has to be considered, as in the Taylor[65] and Nicolson[66] cases dealt with below.

The first of these cases was Taylor v IRC[65]. By a deed dated 10 September 1936, the taxpayer covenanted to pay to trustees for his son, during their joint lives the monthly sum of £33, 6/8d clear of all deductions. This deed contained a power of revocation. On the passing of the FA 1938, it was clear that the deed was subject to section 38(1) and so the settlor took the opportunity provided by Part II of the Third Schedule[67] He therefore exercised the power of revocation and he executed a new deed on 9 September 1938, under which he covenanted to make, during the joint lives of himself and his son, identical monthly payments clear of all deductions. This new deed reserved a power of revocation to the taxpayer exercisable at any time after the lapse of six years from 11 September 1936 with the consent of any one of a number of specified persons. The suspension of the power of revocation would therefore expire on 11 September 1943. By a modifying deed dated 6 March 1938, the taxpayer reduced the monthly sum to £22 13/4d.

As the provision for the payment clear of deduction of income tax was void under General Rule 23, Income Tax Act 1918, and the taxpayer wished the monthly sums to be free of income tax, he executed a further deed dated 30 December 1939, by which it was agreed that, as from 31 March 1939, the deed of 9 September 1938, as modified by the deed of 6 March 1939, should be read as though he had bound himself to pay to the trustees such monthly sum as

65. Taylor v IRC (1946) 27 TC 93
66. IRC v Nicolson and Bartlett (1953) 34 TC 354
67. Supra

after deduction of income tax at the rate for the time being in force, would amount to £22 13/4d.

By a further supplemental deed of 1 April 1940, the power of revocation under the deed of 9 September 1938, was expressed to have effect as if the power of revocation was exercisable at any time after the lapse of six years from 6 April 1940, instead of after the lapse of six years from 11 September 1936.

The taxpayer claimed deductions for payments under the deed of 9 September 1938 and 30 December 1939 in respect of the year 1941/42.

It can be seen that the second deed, the one dated 9 September 1938, suspended the power of revocation for six years from 11 September 1936 (ie, the day after the date of the execution of the first deed of 10 September 1936). That suspension would therefore have expired on 11 September 1942, ie, within six years after the execution of the second deed of 9 September 1938, but later than six years after the execution of the first deed of 10 September 1936.

The Crown, in fact, conceded that the covenant in the deed of 9 September 1938, as amended by the deed of 6 March 1939, was within the proviso to what was then section 38(1)(a) FA 1938.[68]

As can be seen from the analysis above, this was incorrect, but it is not material to the point at issue here, because it was the fourth deed, the one made on 30 December 1939, which was important. That deed altered and increased the amount of the annual payments. If that settlement of 30 December 1939 was to be taken by itself,

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68. See the judgment to Macnagton J, at first instance at p98

then, as the suspension of the power of revocation was to expire (until and apart from the alteration made by the deed of 1 April 1940) on 11 September 1942, it was quite clear that the six year minimum period could not be satisfied. This was the basis of Macnagton J's decision in favour of the Crown.[69]

However, the Court of Appeal went further and held that the material deed for calculating the six year period of suspension was the deed of 1 April 1940, purporting to extend the period of suspension to 6 April 1946, instead of 11 September 1942.

The argument put forward by the Crown, which was accepted by the Court of Appeal, was as follows:

1. The expression "the annual payments so referred to" in the proviso meant "the annual payments payable by virtue or in consequence of any provision of the settlement";

2. It was common ground that, taking the December 1939 settlement by itself, the conditions of the proviso were not complied with;

3. After the deed of 1 April 1940 was made, a new settlement composed of the earlier deed and the 1940 deed came into being, and that settlement was the one to be considered in respect of the year 1941/42; and

4. If that was the case, the first payment under the new settlement was made on 30 April 1940, and it was common ground that the power of revocation could be exercised within six years of that date.

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69. See pp98-9

Cohen LJ, with whom Lord Greene MR and Somervell LJ agreed, thought that these arguments were "well founded".[70] Accordingly, as the period of suspension expired on 6 April 1946, the period of suspension fell short of six years calculated from the first payment under the new settlement (30 April 1940). This was short of six years by just 24 days. This shows how harshly the rules could operate; the taxpayer tried to fall within the relieving provisions but got it slightly wrong.

Cohen LJ pointed out that the obligation to pay, the power to revoke, and the restriction on the exercise of the power to revoke must all be found in the same settlement.[71] This settlement might, of course, consist of more than one instrument.

From this case it can be seen that, where there is a series of instruments and, in such cases a new settlement is created, the date of which is the date of the last instrument.

A very similar case was IRC v Nicolson and Bartlett,[72] a decision of Upjohn J. Like Taylor, there was here a covenant to make annual payments during the settlor's life. By a deed dated 27 March 1943, Patience Nicolson covenanted to pay, during her lifetime, the monthly sum of £350 to herself and Barlett (the taxpayers) as trustees of a charitable trust, the sums to be paid on the last day of every month. She reserved a power to revoke the covenant at any time after the expiration of seven years (ie after 27 March 1950). By a supplemental deed dated 28 February 1950, the settlor postponed her power of revocation for three years, until after 27 March 1953.

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70. p101
71. Ibid
72. (1953) 34 TC 354

The payments up to an including the last payment (due on 28 February 1950), before the power became exercisable after 27 March 1950, were clearly exempt. There was therefore a difference between this case and Taylor in that, in Taylor, the original deed never satisfied the requirements of the proviso; in this case, the original deed fell within the proviso, so as to avoid the deeming effect of the section. This difference does not affect the underlying principle concerning the taking into consideration of the effect of a compound settlement.

The question in Nicolson and Barlett arose in connection with the payments which fell to be made after the expiry date of the original power of revocation, namely, after 27 March 1950.

The point at issue can be looked at as follows. As regards these subsequent payments, if the relevant settlement for the purpose of calculating the period of suspension was the original deed of 1943, then that period had expired and the power to revoke was no longer suspended. If, on the other hand, the relevant settlement was the settlement of 1943 coupled with the deed of 1950, then there was a compound settlement, under which the first payment fell due on 31 March 1950. But, as the power of revocation, even after the three year extention, came into operation in 1953, the suspension was for a period of only three years, so that the proviso was not satisfied.[73]

Upjohn J rightly considered himself as bound by the Taylor case to find for the Crown.

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73. See p361

The principle to be taken from the Taylor and the Nicolson and Barlett cases is, therefore, that, whenever a period of suspension of the power of revocation is extended, a new compound settlement comes into being, and that the calculation of the new period of suspension must be made by reference to the first payment to be made after that compound settlement has been created. If the new period exceeds six years, calculated from the date of that first payment, then the requirements of the proviso[74] will be satisfied; if it does not exceed six years, then all the payments will be caught.

The Taylor and the Nicolson and Bartlett cases should be compared with Scott v IRC.[75] In this case, the taxpayer made a deed of covenant on 31 July 1941 to pay, during his life, £420 monthly to trustees for the benefit of certain charities. The deed contained a power of revocation exercisable after 1 August 1948, so that the period of suspension of the power of revocation was seven years. The taxpayer released his power of revocation on 26 January 1948.

There is therefore a significant difference between this case and the Taylor and the Nicolson and Barlett cases; whereas, in the earlier cases, the suspension was extended for a limited period which fell short of the six year period, if the calculation was to be made by reference to the date of the later deed; in Scott, the suspension was extended for the remainder of the life of the settlor. In other words, the power to revoke was completely barred.

What is more, Scott was concerned with a different provision, section 28 FA 1946.[76]

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74. Now sections 671(2)(b) and 672(2) ICTA 1988
75. (1957) 37 TC 486
76. At the time of the case this had become section 415 ITA 1952 and is now, after certain amendments section 684 ICTA1988, See Part 8, infra

Section 28 was aimed principally at stopping settlors avoiding surtax by entering into "seven year covenants" in favour of charities or employees, which were not revocable within the six year period.

The section only applied to deeds made on or after 10 April 1946 and the question in this case was whether the relevant settlement was one made on or after that date.

If the first deed of 31 July 1941 was the material one, the section would not have applied and the payments made after the FA 1946 would not have been caught by the provisions of section 28; on the other hand, if the relevant deed was the deed of 1 August 1948, then the settlement would have been one made on or after 10 April 1946, and the payments made after the FA 1946 would have been caught.

The question was not, therefore, related to the calculation of any new period of suspension of the power of revocation as the result of the extension of the suspension by a new deed, but as to what was the settlement under which the payments were made.

The Special Commissioners, on the basis of the Taylor and the Nicolson and Bartlett cases, held that a new compound settlement had been created as a result of the second deed of 26 January 1948, so that the relevant settlement was one made after 10 April 1946.

Harman J, however, disagreed. He pointed out that, following the release of the power of revocation by the deed of 26 January 1948, the taxpayer continued to be liable under the original covenant and there was then no way out of it. The source of his liability was still that same covenant.[77] As to the Commissioners' finding that there was a compound settlement, the judge said that they had:

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77. p491

"been confused by looking back at the [FA] 1938 and reading certain cases which were connected with that Act. The Commissioners, in some way or other, make a compound settlement out of the deed of covenant and the release of the power. But, as I have said, payments made by this covenantor have been made throughout under the 1941 contract and no other, and I cannot see how it can be said, when you look at section 28 of the Finance Act 1946, that this is income arising under a settlement made on or after 10 April 1946. It simply is not true, and I cannot see why it can be said to be true in law."[78]

So, a compound settlement is, on this basis, not constituted where there is merely a complete release of the power of revocation for all time, as opposed to an extension for a further period of the period of suspension.

For another case where, on the facts, the taxpayer was held to have created a compound settlement by the execution of a supplemental deed, see FitzGerald v IRC.[79]

An associated point is that, if a settlor is caught by section 671 or 672 ICTA 1988, he can avoid the income tax charge by releasing the power of revocation completely. It is perhaps an obvious point that, if he wishes to do so, he ought to make sure that the document he uses is adequate for the job. However, the taxpayer got it wrong in IRC v Cookson.[80]

The taxpayer settled certain land on trust for himself for life and after his death for his children. The trust instrument empowered the taxpayer to appoint to his wife a rentcharge for life or lesser period by way of jointure. He was further empowered to charge portions

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78. Ibid
79. (1944) 26 TC 126
80. [1977] STC 140

for younger children. The trustees by virtue of clause 6 could, in their absolute discretion, at the taxpayer's request, pay or transfer to the taxpayer the whole or part of the trust property. This, of course, brought the settlor within section 672.[81]

The taxpayer executed a deed of release under which he surrendered his life interest "to the intent that the said life interest shall forthwith be merged.....in the capital....and that the trustees shall stand possessed of the released property upon the trusts declared by the trusts declared by the trust instrument as if the [taxpayer] were dead". The deed of release made no reference to clause 6 of the trust instrument.

The taxpayer was assessed to surtax on the basis that the trustees' power under clause 6 had not been extinguished by the deed of release and therefore the income arising under the settlement had to be treated as his under section 404(2) ITA 1952. The taxpayer, on the other hand, claimed that section 404(2) did not apply because the deed of release showed a clear intention by the taxpayer to extinguish the trustees' power in clause 6.

The taxpayer's argument was rejected both by Goff J[82] and by the Court of Appeal.[83] On a time construction of the deed of release, the provision stating that the trustees should stand possessed of the trust property as if the taxpayer were dead did not operate to extinguish the power conferred by clause 6 because the deed could not be construed as providing that the taxpayer was also to be treated as being dead for the purposes of clause 6. The mere fact that he had released his life interest did not show an intention to destroy the overriding power conferred by clause 6, and that power therefore remained exercisable.

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81. At the time the relevant legislation was contained in section 404(2) ITA 1952
82. [1975] STC 536
83. [1977] STC 140

Stamp LJ, with whom Scarman and Shaw LJJ agreed, said that, in the absence of express words, an instrument will only operate to release a power if it operates in such a way that the power cannot be exercised within interfering with with operation of the earlier instrument. He commented:

> "However probable it may be that the author of the instrument intended to destroy a power you must, in order to destroy it, find words which have that effect or something which shows by necessary implication an intention so to do."[84]

The taxpayer argued that, based on Blausten v IRC,[85] a court will sometimes attribute to a draftsman and a settlor a knowledge of tax law as part of the surrounding circumstances by reference to which an instrument may be construed. But, Stamp LJ pointed out that Blausten was special in that, having regard to the form of the instrument and the transaction which it was clearly intended to effect, there was internal evidence of the fiscal result intended to be achieved, namely, to take advantage of a particular enabling provision.[86]

Stamp LJ thought that no such considerations applied in this case. He said that there is no presumption that advisers of a settlor know the tax law; he said:

> "The suggestion that a draftsman ought to be taken to have been aware of the fiscal consequences of what he is doing and that ambiguity should be resolved on that basis is, in my judgment, a heresy and cannot be supported. There is nothing in the Blausten case which does so far as that."[87]

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84. p144
85. (1972) 47 TC 542
86. p146
87. Ibid

PART 5

DISPOSITIONS FOR A PERIOD WHICH CANNOT EXCEED SIX YEARS

This part is concerned with the third category of settlement covered by the FA 1922. Section 20(1)(b) FA 1922 read:

> "Any income.....(b) which by virtue or in consequence of any disposition made, directly or indirectly by any person after the first day of May, nineteen hundred and twenty two (other than a disposition made for valuable and sufficient consideration), is payable to or applicable for the benefit of any other person for a period which cannot exceed six years.....shall..... be deemed for the purposes of the enactments relating to income tax (including supertax) to be income of the person.....if living, by whom the disposition was made... and not to be for those purposes the income of any other person."

Substantially the same wording still applies and is now contained in section 660(1) ICTA 1988, although, in the case of covenanted donations to charity, they must be capable of exceeding three years, as opposed to six years.[1]

These days, the ability of a covenanter to obtain income tax relief for certain covenanted payments has been extremely limited by section 347A ICTA 1988[2]. By this section, payments due on or after 15 March 1988, and not made under an obligation incurred before that date, are not deductible from income for tax purposes, nor are they regarded as taxable income in the hands of the recipient. This does not apply to (a) interest; (b) charitable

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1. Section 660(2)(3) ICTA 1988
2. Inserted by section 36 FA 1988

covenants; (c) payments made for bona fide commercial reasons in connection with the individual's trade, profession or vocation; and (d) payments to which section 125(1) applies.[3]

The word "disposition" is defined as including "any trust, covenant, agreement or arrangement". This is the original 1922 definition which, in the case of the provisions discussed in Parts 3 and 4 of this Chapter, has been replaced by wider definitions.

When considering the effects of this section, it should be kept in mind that the payments to which it applies are income payments and not capital payments. It became common practice for deeds of covenant to be drawn up whereby the covenantor agreed to pay a fixed sum annually for a period of seven years thus being entitled to treat such payments as forming no part of his income for the purposes of income tax and, originally, surtax as well. However, if by reference to the terms of the covenant or to the surrounding circumstances, it could be established that the payments were not income payments but, instead, payments of a lump sum by instalments, such payments were in the nature of capital and not subject to relief.

This distinction came up for consideration in IRC -v- Mallaby-Deeley[4]. In November 1926, the taxpayer undertook to pay £33,000 in five equal amounts to a publishing firm to finance the completion of a book. On 10th March 1930, he entered into a deed of covenant (which was exchanged for the original undertaking, but contained no reference to it in terms) to pay in each of seven years ending 31st March 1936 sums, after deduction of income tax, ranging from £5,600 in the first year to £700 in the last year, which amounted in the aggregate to the balance remaining due at 1st April 1927 (£28,000) under the original undertaking.

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3. Infra
4. (1938) 23 TC 153

The taxpayer claimed that the respective amounts payable under the deed of 10th March 1930, with an appropriate addition for income tax, were proper deductions in computing his total income for surtax purposes for the years in question. The Special Commissioners decided that the payments under the deed were income payments; that the deed was not "a disposition made for valuable and sufficient consideration" within the meaning of section 20(1)(b) FA 1922; and that, in the computation of the taxpayer's liability to surtax, the deductions allowable in respect of the payments under the deed must be restricted each year to the gross amount, before deduction of income tax, corresponding to the net sum of £700 as being the only amount payable for more than six years.

On the question of whether the sums were capital or income, Lawrence J, at first instance, said that it was open to the taxpayer, in conferring the benefit upon the company, to choose the form in which that benefit should take. He could have done it by way of capital payment or by way of income payment and the judge could see nothing to prevent the taxpayer changing his mind in 1930 and altering the form of covenant into which he had entered and entering into a new covenant, without referring to the previous under-taking, treating the payments to be made under that new covenant as income payments.[5] The judge made the mistake of referring only to the terms of the deed itself without reference to the surrounding circumstances. The Court of Appeal took a much broader view on this point.[6]

The next question to consider was whether the disposition under the 1930 deed was made for valuable and sufficient consideration. Lawrence J held that it was open to the Commissioners, when considering all the facts of the

5. p161
6. Infra

transaction and considering that it arose out of a voluntary undertaking on the part of the taxpayer, to find that the 1930 deed was not made for valuable and sufficient consideration. He said:

> "I read the passage in the Commissioners decision, beginning 'we have no doubt that', as meaning that they are of opinion that the deed was entered into on the terms that the undertaking was discharged, but that, having regard to all the other circumstances of the case, among which is the circumstance that the undertaking was a voluntary undertaking, they do not consider that the deed was entered into for valuable and sufficient consideration, and that is a finding of fact which I think they were entitled to make."[7]

The judge does not explain why he took into account the surrounding circumstances when considering the second question, but not when examining the first.

Finally, he agreed that the only sum payable for more than six years was £700.

The Court of Appeal, which found for the Crown, did so on the basis that the payments were capital rather than income.

Sir Wilfrid Greene MR, with whom Finlay and Luxmoore LJJ agreed, considered that the approach of Lawrence J was wrong. The Master of the Rolls pointed out that the judge had considered the deed itself without reference to surrounding circumstances.[8] Sir Wilfrid Greene MR said that this was "not a permissible way of approaching the question". He said that the distinction between capital and income payments "is sometimes a very fine and rather

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7. p161
8. p166

artificial one". It depends upon the precise character of the transaction. A capital sum may be paid in instalments and, this method of payment will not give those instalments the character of income. On the other hand, where there is no undertaking to pay a capital sum, and all that exists is an undertaking to pay annual sums, then, in the absence of other considerations, those payments may be income. Turning to the facts of the present case he said that in the 1930 deed there was nothing in its terms other than a covenant to make annual payments. There was no reference to a lump sum or to any pre-existing debt. However, the Master of the Rolls said:

> "It appears to me that, for the application of the principal which in quite general language I have stated, it is not merely legitimate, but necessary, to examine what the true legal position was and what the true legal transaction was of which the execution of the deed of 10th March 1930 formed part. It is not legitimate to isolate that element in that legal transaction and to pay attention to that alone. The matter, I think, becomes clear if it be assumed that the parties, that is to say the company, on the one hand, and Sir Harry Mallaby-Deeley on the other, instead of keeping all reference to the pre-existing position off the face of the deed of 10th March 1930, had written out at length on the face of that document what the true legal position was and what the true legal results were that they were aiming at and carrying into effect. If this document had been in the form of a deed inter partes, by which the then existing obligations of Sir Harry Mallaby Deeley under the letter [relating to the voluntary undertaking] were recited and the amount of the payments which had

> been made under that letter was recited and the amount of the payments still falling to be made was recited, and then the company, in consideration of Sir Harry's covenants, had released him from his obligations under the letter of November 1926, it would have been impossible to say that only that part of the document must be regarded which contained the actual covenant by Sir Harry Mallaby-Deeley. It seems to me quite impossible to say that, because the parties have not put their transaction into that shape but have left the bargain, which is the true consideration for Sir Harry's covenant, to be inferred from their actions and the letter, the previous existing legal relationship and the true nature of the transaction ought to be ignored."[9]

Accordingly, it was necessary to have regard to the pre-existing legal position and, therefore, it had to be decided whether the obligation entered into in 1926 was an obligation to pay a lump sum by instalments, so as to be capital; or whether it was an obligation to make income payments. On the terms of the earlier document, Sir Wilfrid Greene MR held that it was an obligation to pay a capital sum by instalments.[10]

The Master of the Rolls concluded:

> "Now, proceeding upon that basis, the position at the date when the deed of 10th March 1930 was executed was that Sir Harry was under an obligation to pay a capital sum or what was left of a capital sum of £28,000 by certain annual instalments. That obligation he gets rid of, substituting for it the obligation under the deed. It seems to me that, putting all those circumstances together, what he was doing under the deed of 10th March 1930 was that

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9. pp166-7
10. See pp168-9

he was liquidating a capital obligation of his own, an obligation, it is true, was only to be carried out by instalment payments but which nevertheless was of a capital nature, and he was liquidating that obligation by a series of instalments differing in amount and times from those which were referred to in the pre-existing document. On that basis, it seems to be me that the case is one where it is not possible to say of the payments made under this document that they are of an income nature. They are given the character of capital; that character is stamped upon them by the circumstance that they are the means of liquidating a capital obligation, and it is quite wrong to say that you must look at the document alone and disregard the other elements in the legal relationship between the parties and the legal results which the transaction achieved."[11]

One element of the wording introduced in 1922 which has been exploited by some taxpayers, but which has caught out others, is the provision that the section catches all dispositions which cannot last more than six years. An interesting case on this is IRC -v- Black[12]. The taxpayers who had a controlling interest in a company owning property, covenanted to pay the company certain sums annually over a period of seven years. These sums were to correspond to 4/5ths, in the case of the first taxpayer and 1/5th, in the case of the second taxpayer, of the difference between the annual letting value of the company's property and the net annual income produced from it. The total amount payable was not to exceed £100,000. In fact, the limit of £100,000 was reached with two annual payments. The Crown contended that the disposition was one which could not last more than six years since it had in fact only lasted two. The Court of Appeal rejected this contention because the covenant, in its terms, was clearly outside the section and the

11. pp169-170
12. (1940) 23 TC 715

existence of the limit on the sums payable under it (which limit might never be reached) did not alter the position at all. Section 20(1)(b) did not specify a period that, in the events which happened, did not exceed six years; but one which, by virtue of the disposition could not exceed six years.

The period of six years referred to in this section is the period covered by the payments, not the period covered by the covenant. It is immaterial that the deed lasts for ten years if the payments are capable of lasting for only five. Similarly, the section cannot be avoided by naming in the deed as the due date for the first payment some date prior to the date when the deed was signed. A Court can only look at the dates of the first and last payments in order to calculate the intervening period. This was the point at issue in IRC -v- St. Lukes Hostel Trustees[13]. A deed was executed on 3rd February 1927, to run for seven years from 6th April 1926, and the first payment under the deed was expressed to be due on 31st December 1926. It was held that the relevant period was less than six years since it ended on 31st December 1933 (the last due date), but began only on 3rd February 1927, when the deed came into effect.

Also relevant here is the case of IRC -v- Verdon-Roe[14]. By a deed dated 14th March 1958 the taxpayer covenanted to pay to trustees during the period of seven years from the date of the deed, or during the joint lives of himself and the survivor of the beneficiaries (whichever period was the shorter) the yearly sum of £2,000, the first of such payments to be made on the date of the deed, the second on 1st March 1958 and subsequent payments on 1st March in every year. The taxpayer was assessed to surtax on the footing that the income under

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13. (1930) 15 TC 682
14. (1962) 40 TC 541

the covenant was payable for a period which could not exceed six years. He contended that the deed provided for eight payments, the last being due on 1st March 1965, which fell within seven calendar years from the date of the deed. The Crown contended that, by covenanting to pay during the period of seven years a yearly sum of £2,000, the taxpayer had undertaken to make seven such yearly payments, so that the last payment was due on 1st March 1964. It was held that the series of payments under the deed was to continue until 1st March 1965 and the taxpayer was not caught by what was then section 392 ITA 1952.

The object of the section was, of course, to check tax avoidance and, therefore, where it can be shown that a disposition is made for valuable and sufficient consideration, it would clearly be inequitable to apply it. It has been seen above in the Malleby- Deeley case, that the substitution of one deed entered into voluntarily to pay the balance owing under another prior deed entered into voluntarily has been held not to be valuable and sufficient consideration within the section. If the later deed had covered an existing contractual debt or obligation and had been entered into other than voluntarily, it might have been that the consideration would have been adequate on the authority of Pinnel's case in 1602.[15] There does not appear to be any difference between consideration which is "adequate" and that which is "valuable and sufficient" but, Lawrence J, in the Malleby-Deeley case, held that the question is one of fact for the Commissioners, and his finding on this point was not dealt with by the Court of Appeal.

Another question that arose in a number of cases was concerned with dispostions which were to last for more than six years but which provided for payments of varying amounts each year during that period. It can be seen

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15. 5 Co. Rep 117a

above that the question was raised in Malleby-Deeley where the covenant of 1930 was to pay an annual instalment of £5,600 in the first year, with smaller amounts in each succeeding year, falling to only £700 in the seventh year. Lawrence J held that the only sum which could be said to be "payable to ... any other person" for a period of more than six years was the final increment of £700. He agreed with the finding of the Special Commissioners who expressed their view as follows:-

> "... the words of the section appear to apply the recurrence in each year of some definable unit of income, only that income which is payable for a period which can exceed six years not being deemed to be the income of the disponer. A payment equal, e.g. to the yearly dividend from a given block of ordinary shares would be such a recurring unit and the variation in amount would not be relevant. But when stated sums of varying size are to be paid in successive years, the only definable unit which can be found to recur throughout the series is the minimum sum."

Similarly, in IRC -v- Prince-Smith,[16] certain shares were settled on the taxpayer's children and, by a special resolution of the company, such shares were to carry a fixed non- cumulative preference dividend of 50% for a period of five years and of 5% thereafter. Macnaghten J held that any payment of dividend on the shares in excess of 5% was for a period which could not exceed six years and such excess was therefore within the section and was properly treated as income of the taxpayer, not of the beneficiaries.

In D'Ambrumenil -v- IRC[17], the principal was established that the amount of money payable over a period exceeding

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16. (1943) 25 TC 84
17. (1940) 23 TC 440

six years need not be quantified if in fact there is some "constant element" in such payments; if, for example, it is a constant fraction of the taxpayer's income, or the interest from a fixed block of shares or the difference between the net Schedule A valuation of, and the net income from, a fixed block of properties. In all these cases, although the amount of money paid by vary, the method of calculation is fixed and constant. The facts of D'Ambrumenil have already been given[18] and it will be recalled that the taxpayer covenanted to pay £20,000 in the first year and a sum equal to three quarters of his actual income in every year thereafter. Wrottesley J held that the £20,000 had nothing in common with the later payments and was therefore within the section.[19]

In IRC -v- Payton[20], the taxpayer, by a deed dated 22nd March 1935, covenanted during his life to pay to a trustee an annual sum (after deduction of tax) equal to one-quarter of his income. The term "income" was defined in the following words:

> "The expression 'income' means the income of the settlor as computed for the purpose of the Income Tax Acts but excluding therefrom such income as may accrue to him as a member of an underwriting syndicate at Lloyds and after deducting therefrom all annual sums, annuities or interest (excluding the sum payable under this deed) as are allowed as deductions in computing total income for the purpose of the said Acts."

For the year in question, a sum of £45,484 was apportioned to the taxpayer out of the income of an investment company and assessed to surtax upon him in the name of the company under section 21 FA 1922 and section 20 FA 1936.[21]

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18. See Part 4, supra
19. p447
20. (1940) 23 TC 722
21. See Chapter 1, Part 7

The taxpayer contended that the sum apportioned to him was part of his income as defined in the deed, that he was liable to pay, and had in fact paid, a sum equal to one-quarter of it to the trustee, and that this payment should be allowed as a deduction for surtax purposes.

It was held by the Court of Appeal that, on construction of the deed, the income of the taxpayer "as computed for the purposes of the Income Tax Acts" included the sum apportioned to him. The income referred to in the definition in the deed was "total income". The taxpayer was therefore entitled to relief from surtax on the sum paid by him to the trustee under the deed.

The Payton case turned on the words used in the deed. This can be seen from comparing that case with Earl Normanton -v- IRC[22]. By coincidence, this concerned a not dissimilar deed made in the same month as the deed in the Payton case. This deed was dated 1st March 1935 and, under it, the taxpayer covenanted during his life to pay to trustees on the last day of every year ending on 5th April, "an annual sum equal to one-half of his total income from all sources for that year". By a further deed dated 23rd March 1936, he covenanted to pay to the trustees similarly "an annual sum (subject to deduction of income tax at the standard rate for the time being in force) equal to a third part of his total income which shall accrue to and be receivable by him in that year." The deeds provided that, in computing total income, no deductions should be made except those allowed in computing total income for the purposes of the Income Tax Acts. It was admitted for the purposes of the case that a deduction should be made in computing the total income of the taxpayer for the year 1936/37 of the annual payments secured by the deeds. For 1936/37, a sum of £9,539 was apportioned for surtax purposes to the

22. (1939) 23 TC 403

taxpayer under section 21 FA 1922 and section 20 FA 1936 out of the income of an investment company.[23]

The taxpayer contended that the expression "total income" in the two deeds must be construed to mean total income within the meaning of the Income Tax Acts, and included the sums apportioned to him; and that accordingly, he was bound to pay to the trustees the specified proportions £9,539 apportioned to him, which should be deducted from the assessment to surtax.

The Court of Appeal held that, on a true construction of the deeds, the expression "total income" related to the settlor's actual income, and not his total income as estimated in accordance with the Income Tax Acts.

In order to take a disposition outside these provisions, payments made by the covenantor must be effective. This can be seen from the case of D'Ambrumenil[24] mentioned above. It has been noted above in connection with revocable settlements[25] that, in D'Ambrunenil, the taxpayer covenanted to make certain annual payments to trustees upon certain trusts and the trustees, upon the request of the taxpayer, were to advance him sums of money by way of loan with or without interest and without being responsible for loss of monies so advanced. Wrottesley J pointed out that the covenantor could at once borrow "every farthing" of the money, possibly, forever without interest or security.[26] Moreover, should the covenantor loose all of the money after borrowing it, the trustees were in no event to be liable. The effect of the deed was as follows:

> "It seems clear that without a direction by the settlor, of which there is no evidence and which

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23. See Chapter 1, Part 7
24. D'Ambruneniel v IRC (1940) 23 TC 440
25. See Part 4, supra
26. (1940) 23 TC 440 at p446

never need be given [the beneficiary] will never get the income of this so-called trust ... and provided the settlor exercises his right to ask for advances out of what was his own property until it reached the trustees, he has only to ask to have his wish gratified and by that means he controls not only the income but also the capital of the trust. Can a payment to the trustees made in these circumstances and for such purposes be said to be an effective payment whereby the [taxpayer's] income is, or may be diminished, or can it be said to be a charge on his income? It seems to me I cannot say that any such payment is an effective payment anyhow until the [taxpayer] be dead, and what is necessary here is not a payment which only becomes effective if and when the settlor dies without taking the money back. There is, I find, no evidence upon which the Commissioners could find that there was an effective payment. The payments to the trust fund found by the Commissioners as facts are not and do not purport to be such payments."[27]

Another example of an ineffective payment can be found in Lee -v- IRC[28]. The taxpayer here had been, for several years, in the habit of making payments to or for the benefit of his daughter, two sisters of his wife and a niece. In 1935 and 1937 he executed certain deeds by which he covenanted to pay them annual sums which he claimed were deductible in computing his total income for surtax purposes. After executing the deeds, he did not desire that the persons interested should become possessed of the money all at once, so it was arranged that repayments should be made to him and that monies should be expended by him on their behalf from time to time. There were no reliable records of the monies so expended. The Special Commissioners held that, in

28. (1943) 25 TC 485

connection with the sums that had been repaid, there had been no effective payment under the deed. MacNaghten J agreed. He said:

> "I think that where there is an agreement or an arrangement that the covenantee should on receipt of the covenanted amount return it to the covenantor and the covenantee in fact does so, the Special Commissioners were right in holding that no payment had in fact been made."[29]

However, in respect of one of the deeds executed in 1937, the taxpayer covenanted to pay to himself and his wife, as trustees, a certain sum after deduction of tax for seven years (or until the earlier marriage of his niece) if both he and the niece should so long live, to be applied for the maintenance, education or benefit of the niece. By two letters written on the same day as the deed was executed, he instructed his bankers to credit a joint account in the names of himself and his wife with the sums in question each year and the trustees instructed their bankers to credit the taxpayer's account with the equivalent amounts. He made payments for the benefit of the niece from time to time. Here, the Special Commissioners held that the provisions of the deed were complied with and that the sums in question were repaid to the taxpayer as trustee for the niece for her maintenance and education. They accordingly allowed a deduction for the relevant amounts and Macnaghten J accepted that his was correct.

The Crown also argued that the payments were ineffective in Russell -v- IRC[30]. In this case there was a difference of opinion in that Macnaghten J, at first instance held that the payments were indeed ineffective; but that Court of Appeal unanimously disagreed.

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29. pp494-5
30. (1944) 26 TC 242

The taxpayer covenanted to pay to trustees an annuity for each of his three children to be held on protective trust. The trustees were empowered in their absolute discretion to apply the money for the children's maintenance, education or benefit, or to pay it to the child's parent without being concerned to see how it was then applied, or to pay it to the child personally. Certain sums were paid by the trustees to the taxpayer as parent to be applied on the children's behalf. Other sums were paid direct to the children, who paid them immediately to the taxpayer.

The Crown contended that the taxpayer never made an effective payment of any of the annuities, since, although he sent to the trustees a cheque for the relevant amount, the amount so paid was in fact returned to him within one or two days and, therefore, his income was not diminished.

Macnaghten J noted that the taxpayer, when he executed the trust deed, expected that during the minority of his children, the trustees would return the amount of the annuities to him. He had given evidence before the Special Commissioners that he would have been "surprised" if they had not done so since the children would have been at home with him and he was providing for their maintenance.[31]

The judge's conclusion was:

> "The first trust deed provided for a payment of the annuities to the trustees in trust for the three children, who were all, at that date under age, and it authorised the trustees at their discretion to return the money to Mr. Russell 'without being concerned to see to the application thereof'. If,

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31. p251

instead of leaving it to their discretion, the deed had made it obligatory on the trustees to repay the annuities to Mr. Russell without any obligation on their part to see what he did with the money, the deed would on the face of it have appeared to be merely a pretence and a sham.

In my opinion, in view of the fact that the deed was executed by Mr. Russell in the expectation that the trustees would exercise their discretion in his favour and the trustees being aware of his expectation, repaid the annuities to him and thereby freed themselves from any obligation to see what he did with the money. The Special Commissioners ought to have held that by the exchange of cheques Mr. Russell made no effective payment of the annuities or of any part thereof and that his income suffered no dimunition thereby, and the fact that he discharged his legal obligation to maintain his own children has no bearing on the question at issue."[32]

When the case came before the Court of Appeal they ordered it to be remitted to the Special Commissioners for them to inform the Court what were the findings of fact upon the evidence already before them on which they based their conclusion that there were no effective payments by the taxpayer whereby his annual income was diminished in the years in question.

The Supplemental Case disclosed that the Commissioners were influenced, in particular, by the following facts:

1. In each of the years in question the annual sums paid by the taxpayer to the trustees were returned in full to him either by the trustees or his sons.

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32. pp254-5

2. Although the trustees, in returning the sums, were not acting under an arrangement that they should do so, nevertheless the trustee who gave evidence thought that the taxpayer would have been surprised had he not received all the money back. The taxpayer, according to his own evidence, would have been surprised in such an event.

3. The sons, in returning to the taxpayer the whole of the monies paid to them by the trustees were acting under an agreement that the taxpayer should take care of the monies for them, and there was no evidence that the sons had interested themselves in the taxpayer's treatment of the monies.

4. The sums returned to the taxpayer were paid into the taxpayer's private bank account.

5. The taxpayer did not invest these monies or place them to a separate account.

6. The taxpayer kept virtually no detailed account of the monies.

The judgement of the Court of Appeal was delivered by Luxmoore LJ. He noted that the validity of the deeds was not challenged and that each was a genuine deed. He also noted that the trustees, when purporting to exercise discretions vested in them by the deeds, actually did so.[33] The Court of Appeal came to the conclusion that:

> "It is true, that in respect of monies paid by the trustees to the [taxpayer] during the minority of any beneficiary, the trustees were exonerated from seeing to their application, but this exoneration did not affect the [taxpayer]; as guardian of the

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33. p260

infants he was under legal liability to apply the money for the benefit of the infants and could not be compelled, if he failed so to apply it, to account, either at the suit of the infants by their next friend, or by the infants, respectively, when they attained majority.

There being no attack on the genuineness or bona fides of the deeds, and the Commissioners having found that:

a. The trustees made all the payments to the [taxpayer] for which they were responsible in the exercise of the powers conferred on them by the deeds, and

b. The monies paid by the trustees to [the sons] were handed over by [the sons], respectively, to the [taxpayer] on an express agreement that he would take care of such monies for them respectively.

It was not, in our judgement, open to the learned judge to come to the conclusion he did. In our opinion, on the findings of the Commissioners, only one result is possible in law, and the learned judge ought to have held that the [taxpayer] was right in his contentions and to have discharged the additional assessments ..."[34]

The facts and finding of this case can be compared with those of two subsequent cases. The first is <u>Hulme Estate Co. Limited -v- IRC</u>[35]. The facts of this case have been given in Chapter 1, Part 7. It was held by the Court of Appeal that the Commissioners were entitled to take the view on the facts that, notwithstanding the creation of the trusts, Sir John

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34. pp260-1
35. (1946) 28 TC 107

Prestige was able to secure that the whole income or assets of the trust would be applied directly or indirectly for this benefit within section 15 FA 1939 and that if, in law, there were persons who might restrain him, they were unlikely to do so. It was further held that it was impossible to lay down, as a rule of law, that monies paid to a father under a trust for maintenance must, for income tax purposes, always be treated as money paid for the father's benefit although on the findings of this particular case, that was the appropriate finding.

The second case is IRC -v- Compton[36]. In 1930 the taxpayer irrevocably covenanted by deed to pay certain monthly sums to trustees for the benefit of his four infant children. For the three relevant years, the only trustees were the taxpayer and his wife. In those years, the taxpayer paid certain sums, which were considerably in excess of the net amount payable under the deed, direct to various third parties in payment of bills in respect of the maintenance, education and benefit of the children. In 1943, on the advice of the taxpayer's accountant, a memorandum was prepared and signed by the taxpayer and his wife as trustees, in which it was declared that the portion of the payments actually made by the taxpayer for the benefit of his children as represented the payments due to be made under the deed, were appropriated in discharge of his obligations under the deed. The Revenue contended that the payments which the taxpayer had actually made were not made in discharge of his obligations under the deed and, therefore, the grossed-up equivalent of these sums should not be allowed as a deduction under the provisions of section 20(1)(c) FA 1922 in computing his surtax liability for the three years in question.

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36. (1946) 27 TC 350

It was held that the taxpayer had failed to show that he had actually made the payments covenanted in the deed. At no time had he made any payments under the deed to any one, nor had he made any payments at the behest of the trustees to third parties in fulfilment of his obligations under the deed, for the memorandum was made after he had made the payments to the third parties. Accordingly, no legal appropriation of the payments had taken place and the taxpayer was, therefore, not entitled to deduct the payments in question in computing his surtax liability.

One point that should be made here is that, in the case of covenants made on or after 7th April 1965, because of the provisions of section 683 ICTA 1988, seven year covenants were only effective for reducing basic rate income tax, and not excess liability, unless the covenant came within the exemptions in section 683.[37]

The case of IRC -v- Plumber[38] has already been examined in connection with the question of whether an element of bounty is required to constitute a "settlement".[39] It will be recalled that the consideration received by the taxpayer for the annuity was held by the House of Lords to be valuable and sufficient consideration within section 660 ICTA 1988. The Plumber case concerned a well known and widely marketed scheme known as the "reverse annuities scheme". The particular scheme used in the Plumber case was stopped by what is now section 125 ICTA 1988 which stated that an annuity or other annual payment charged with tax under Schedule D Case III, other than interest, which is made under a liability incurred for consideration in money or monies worth which is not taxable, is not a charge on income for the purposes of

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37. See Part 8, infra
38. (1979) 54 TC 1
39. See Part 2, supra

income tax or corporation tax. There are exemptions for payments made under partnership agreements or transfers of business and maintenance agreements; payments made to a person for surrendering, assigning or releasing an interest in settled property to or in favour of a person having a subsequent interest; annuities granted in the ordinary course of a business of granting annuities; or annuities granted before 30th March 1977 charged on settled property to a life assurance company.

When the original reverse annuity scheme was stopped by what was section 48 FA 1977, a variation was devised taking advantage of the exemption in subsection (3)(b) for payments made to an individual under a liability incurred in consideration of his surrendering, assigning or releasing an interest in settled property to or in favour of a person having a subsequent interest.

This device was not defeated by new legislation; it failed because of the new approach adopted by the Courts in the Ramsay case.[40] In fact, no case involving the variation was ever brought to the High Court; the writer is aware of one case which was argued before the Special Commissioners, in which the Inland Revenue won.

It became clear that the Revenue were treating the Plumber case as one decided on its particular facts in connection with the original scheme, and any variation was a ground for challenge. It became clear also, that any taxpayer who wanted to press his claim would have to do it through the Courts, probably to the House of Lords. It appears that no one taxpayer had enough money at stake to make this worthwhile and, even where one particular company which had sold the scheme and had a large number of clients who had implemented the original scheme, Counsel advised that the arrangements would fail in the

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40. W.T Ramsay v IRC (1981) 54 TC 101, see Chapter 11

Courts, so a test case was pointless. In fact, the Special Investigations Section agreed informally that, if a taxpayer conceded and paid the tax demanded the appeal would technically be left open in case anyone did fight a case through the Courts: no one did. It is not clear under what authority the Special Investigation Section agreed to keep the appeals open, but as the concession was in favour of the taxpayer, no one complained.

Section 48 FA 1977 was, in fact, quite severe in its operation, both disallowing the reverse annuity as a charge on the taxpayer's income and preventing the taxpayer from deducting tax at the basic rate when paying it.

PART 6

SETTLEMENTS WHERE SETTLOR RETAINS AN INTEREST

Retention of Interest

The Legislature were quick to see the potential for tax avoidance by means of arrangements whereby a taxpayer settles property for the purported benefit of others, but in which he retained an interest or obtained a benefit. Accordingly, legislation was introduced in 1938 to counter such devices.

Provisions originally contained in section 38(3) and (4) FA 1938 are now in section 673 ICTA 1988. Like subsection 38(1) and (2) FA 1938[1] subsections (3) and (4) of that section have stood the test of time very well.

Section 673 (1) ICTA 1988, provides:-

> "If and so long as the settlor has an interest in any income arising under what property comprised in a settlement (wherever made), any income so arising during the life of the settlor in any year of assessment shall, to the extent to which it is not distributed, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year and not as the income of any other person except that-
>
> Provided that:-
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> (a) if and so long as that interest is an interest neither in the whole of the income arising under the settlement nor in the whole of the property comprised in the settlement, the

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1. See Part 4, supra

amount of income to be treated as the income of the settlor by virtue of this subsection shall be such part of the income which, but for this paragraph, would be so treated as is proportionate to the extent of that interest; and

(b) where it is shown that any of the income which is not distributed in any year of assessment consists of income which falls to be treated as the income of the settlor for that year by virtue of section 671 or 672, that amount shall be deducted from the amount of income which, but for this paragraph, would be treated as his for that year by virtue of this subsection."

Subsection (2) says:-

"Subject to subsection (3) below, the settlor shall, for the purpose of subsection (1) above, be deemed to have an interest in the income arising under or property comprised in the settlement if any income or property which may at any time arise under or be comprised in that settlement is, or will or may become, payable to or applicable for the benefit of the settlor or the wife or husband of the settlor in any circumstances whatsoever."

The provisions of subsection (3) are:

"The settlor shall not be deemed to have an interest in any income arising under or property comprised in a settlement:-

(a) if and so long as that income or property cannot become payable or applicable as aforesaid except in the event of:-

(i) the bankruptcy of some person who is or may become beneficially entitled to that income or property; or

(ii) any assignment of or charge on that income or property being made or given by some such person; or

(iii) in the case of a marriage settlement, the death of both the parties to the marriage and of all or any of the children of the marriage; or

(iv) the death under the age of 25 or some lower age of some person who would be beneficially entitled to that income or property on attaining that age; or

(b) if and so long as some person is alive and under the age of 25 during his life that income or property cannot become payable or applicable as aforesaid except in the event of that person becoming bankrupt or assigning or charging his interest in that income or property."

A number of cases have shown how widely drafted this provision is. The earliest case was IRC -v- Gaunt[2]. The facts were that, by a settlement dated 10th March 1938, the taxpayer settled upon trustees £100 to invest £98 in purchasing 98 deferred shares on £1 each in a company. The trustees were directed to accumulated and invest the income of the trust funds during the taxpayer's lifetime and, after his death, to hold the fund on such trusts as he should appoint by his Will. It was declared that neither the taxpayer nor his wife should benefit from the trust during his lifetime but the taxpayer was empowered

2. (1941) 24 TC 69

(with the consent of certain persons) to appoint during his lifetime new trusts provided that the powers should not be exercisable in favour of himself or his wife.

It was decided by Lawrence J that, under the terms of the power enabling the taxpayer to appoint new trusts during his lifetime, he was able, for example, by appointing a trust of a discretionary nature with himself as one of the beneficiaries, to secure for himself such a benefit as would bring the settlement within section 38[3]. This point was not dealt with in the Court of Appeal, which decided the case on other grounds.

In the following year, Lawrence J decided another case giving a wide construction to the section: IRC -v- Tennant.[4]

The taxpayer executed a deed of settlement by which she assigned to trustees two policies on her life to be held on trust for a bank absolutely subject to certain charges. However, she retained the power to revoke the trusts with the consent of the trustees, and to create new trusts in favour of any person except herself. She further covenanted to pay to the trustees each year a sum which, after deduction of income tax, would equal the premiums payable upon the policies. In a document executed shortly afterwards, the taxpayer declared, and the trustees agreed, that the policies and the annuity should be a continuing security for the payment of any money owing by the taxpayer to the bank. The taxpayer's husband died in the following, and the outstanding advances on their joint account were later repaid, but the taxpayer had not exercised her power under the settlement to appoint new trusts.

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3. p72
4. (1942) 24 TC 218

The taxpayer claimed that the covenanted payments were admissible as deductions in computing her total income for surtax purposes. The Crown, however, argued that the taxpayer had power to revoke the settlement and appoint new trusts in favour of her future husband and that, accordingly, she had an interest in income arising under or property comprised in the settlement within the meaning of section 38(3) and (4).

Lawrence J agreed with the Crown's contention.[5]

The Revenue regard this decision as applying:-

a. Where a settlor is not at the material time a party to a subsisting marriage and the terms of the settlement are such that a benefit may be conferred on substantially any person who may become the spouse of the settlor in future; or

b. Where, whether or not the settlor is married, the terms of the settlement are such as to indicate a specific intention that a future spouse of the settlor might be enabled to benefit.[6]

The Revenue do not, however, regard the decision as applying to a person who cannot take relevant benefit during the settlor's life.

Another early case, <u>Barr's Trustees -v- IRC</u>[7] shows how easy it is for a settlor unwittingly to fall within the section, even though it is only in very remote and unintended circumstances that he could benefit.

The facts were that the settlor executed a deed of trust in favour of two grandsons, children of the settlor's son

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5. p220
6. Statement of Practice SP/A30, "Benefit to Settlor's Future Spouse"
7. (1943) 25 TC 72

who had already died. Under the deed, the trustees were directed to hold certain investments for the benefit of the two grandsons and were empowered to provide that the share of the trust estate falling to either beneficiary should be held in trust for such time as the trustees might think desirable, the income to be applied for the use of the beneficiary, and on his death his share would be paid to his issue.

The trustees were further directed, on either of the grandsons attaining the age of 30, to divide the trust estate into equal shares, and to pay over to such grandson, and to the other grandson on his attaining the age of 30, their shares of the trust estate.

The deed provided that, in the event of either grandson dying before the vesting of the trust fund, his issue should take equally amongst them the share which their parent would have taken, had he survived; and that if either grandson should die before the vesting of the trust fund without issue, the share of the deceased should fall to the survivor, or to the issue of the survivor. The fourth purpose of the deed provided that, in the event of both grandsons dying before the time of the vesting of the trust fund, the trust estate should be divided among the heirs of the settlor's son.

The income arising under the settlement was assessed to surtax as income of the settlor by virtue of section 38, on the grounds that, under the fourth purpose of the deed, it was possible, so long as the settlor was alive, for the trust fund to revert to the settlor, who could be the heir of his son.

The Court of Session held that the assessments were valid. Under Scottish Law it was possible, albeit only a remote possibility, that the trust fund could find its way to the settlor under the above provisions.[8]

The next in the line of cases dealing with these provisions was Jenkins -v- IRC[9]. This case has already been dealt with in connection with the meaning of "arrangement" and in relation to settlements for children.[10] However, the Crown also argued that, as regards the assessments for 1937/38, the taxpayer had an interest in the income of the settlements within the meaning of section 38(3) and (4). It was held by both Macnaughten J and the Court of Appeal that, the fact that the dividends received by the trustees might be paid over by them to the taxpayer in partial repayment of his loans, meant that he was a person who must be deemed to have an interest in the income within section 38.

Macnaughten J noted that, under the terms of the settlement, the taxpayer had no interest in the income but he, in fact, obtained the whole of the dividends which the trustees received in respect of their "B" shares, because the trustees used the dividends to reduce the loans of £6,500 which the taxpayer had made to them.[11] He continued:-

> "They thought that was the best course to pursue, notwithstanding that the [taxpayer] had been so good as to lend them the money without interest. One might have thought trustees would have considered it advantageous to their beneficiaries to retain what income they could for their beneficiaries, so long as their creditor was so good as to leave the money in their hands without interest. But they in their absolute discretion thought it better to pay over the dividends to the [taxpayer].

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8. See The Lord President (Normand) at p77
9. (1944) 26 TC 265
10. See Parts 1 and 3, supra
11. p277

Subsection (4) of section 38 provides that the settlor is to be deemed to have an interest in income arising under a settlement, if the income may become payable to him 'in any circumstances whatsoever'. In this case, not only might the income become payable to the settlor, but it was actually paid to him.

In those circumstances, it seems to me that he is a person who must be deemed to have an interest in the income, and that he can properly be assessed to surtax in respect thereof."

The Court of Appeal agreed. Lord Greene MR stated:-

"Now the position when the trustees received the income of [1937/38] was this. As I have pointed out, they could have applied it in any one of the three ways which I have mentioned so far as the language of the settlement is concerned. The one that they chose was the third, namely, the payment off of the loan, or part of it. At the moment before they came to their decision to apply the money in that way, it was, I think, true to say that if they so determined, the money would thereupon have become applicable for the benefit of the settlor. It is not disputed that the repayment of a non-interest bearing loan was for the benefit of the settlor within the meaning of this sub-section. It is, therefore, not necessary to consider what the position would be if the loan had been of a different description. My words must not be taken as expressing any view on that point.

Here are the trustees, therefore, with a sum of income in their hands. If they decide to use it in paying off the loan, it thereby becomes applicable for the benefit of the settlor; and it seems to me that, looking, if one pleases, to the time before they have received the income, it would also be true to say that the income when they received it might become payable to, or applicable for, the benefit of the settlor for the simple reason that they had it in their power to decide to divert the money in that direct and, therefore, in the circumstances that they so decided, it would become payable to the settlor. I say that because I do not wish it to be thought that the fact that actual payment, as took place in this case, would be necessary in order to bring the sub- section into operation. In point of fact, this is an a fortiori case, because the money was in fact paid to the settlor. But the circumstance that the money could always be so paid if the trustees so decided would, in my opinion, have been sufficient to bring the subsection into operation."[12]

The section can, of course, apply even if there has been no attempt to avoid tax. An example of such a situation was the case of Glyn -v- IRC[13].

A deed of resettlement was executed under which a life interest that the taxpayer previously had was surrendered and extinguished and the trust fund was thereafter held by trustees upon such trusts as the taxpayer and his son should from time to time jointly appoint. In default of and subject to any such appointment, the income was to be accumulated until the son died or attained the age of 35 or married, whichever was the earlier. The accumulated income was then to be paid to the son (if then living) at the trustees' discretion, and the capital was to be held upon

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12. pp279-80
13. (1948) 30 TC 321

trust for his son and his descendants. In the relevant years, no appointment had been made by the taxpayer and his son, and the whole of the income of the trust fund was accumulated by the trustees.

Surtax assessments were made on the taxpayer and he admitted that the resettlement constituted a "settlement" and that he was the "settlor" within the meaning of section 38, and that, under the joint power of appointment contained in the resettlement, it would be open to the taxpayer and his son to appoint the income arising from the trust investments to the taxpayer. However, he contended that he did not have an "interest" in the settlement within the meaning of section 38(3) and (4).

Singleton J reluctantly rejected the taxpayers arguments. He noted that it was said by the Inland Revenue that, if reference was made to sub-section (4) and the words that the settlor shall be deemed to have an interest in income arising under a settlement if any income is, or will or may become, payable to the settlor in any circumstances whatsoever, the fact that there was a joint power on the settlor and his son to appoint in regard to the trust fund, meant that the settlor had an interest in that income and that, the income not being distributed, it should be treated as the income of the taxpayer.[14] The judge commented that: "It seems a little hard to me that it should be so". However, he accepted that subsection (4) was "extraordinarily wide".[15] The judge also noted that Counsel for the Crown had accepted that, if the power of appointment was reserved to the son alone, then the settlor would have had no interest whatever in the trust fund. The judge concluded that the taxpayer and his son could jointly appoint the funds, wholly to the son or wholly to the father, or half and half (or indeed in any other proportions). He concluded:-

14. p328
15. p329

> "In those circumstances [Counsel for the Crown] submitted that the natural meaning of the words in sub-section (4) was that the father, the settlor, should be deemed to have an interest in income arising under the settlement, because the income at any time might become payable for his benefit. It could only do so, as far as I can see, by an arrangement between the father and the son; but that is the sort of arrangement which might be made, and which one knows often is made between father and son.
>
> Although I regret having to come to this decision, I think it does fall within the words of subsection (4), and consequently of subsection (3). I cannot see may way out of it. I must give the words their ordinary natural meaning."[16]

When the question of costs was being considered, Singleton J commented that:-

> "This quite clearly was a case in which there was never any attempt whatever to escape tax. It so happens, as I think, it is hit by the last words of subsection (4)[17] rather by accident than by design."

In the following year the House of Lords considered section 38(3) and (4) in Vestey -v- IRC[18]. The facts of this case have already been set out.[19]

One of the grounds on which the Vestey's were assessed to tax was that the lease and the settlement together constituted a "settlement" in which they had an interest within the meaning of section 38(3) and (4). The House

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16. pp329-30
17. ie "in any circumstances whatsoever"
18. (1949) 31 TC 1
19. See Part 1, supra

of Lords, however, held that neither of the Vestey brothers had an interest in the settlement within the terms of subsection (3); and that the power held by them as "authorised persons" to direct investments was of a fiduciary character, and therefore outside the ambit of sub- section (4).

Lord Simmons, for example, considered section 38(3) and (4) and commented that they were couched in "very wide words". However, applying them to the contentions of the parties here in relation to Lord Vestey (Sir Edmund Vestey's position being identical), he analysed the position as follows:-

> "The alleged 'interest' of Lord Vestey upon which Counsel for the Crown rely arises in this way. Under the deed of trust the Paris trustees are bound to invest the rent received by them 'at the direction in writing of the authorised persons or a majority thereof and in the event of an equality of voting by such authorised persons at the trustees discretion' in their names or under their control 'in or upon stocks, funds, shares, securities or other investments of whatever nature and wheresoever ... or upon personal credit or upon loans to any company or companies wheresoever domiciled and with or without security'. The expression 'authorised persons' is defined earlier in the deeds. It means the settlors during their joint lives and the survivor of them during his life and after the death of such survivor the following four persons namely (a) the two eldest of the beneficiaries of 25 years of age and upwards for the time being entitled to share in the fund therein called William's fund but preferring males to females as therein mentioned, and (b) such two persons as Sir Edmund might appoint during his lifetime or by his Will and in default of such appoint Percy Charles Vestey and Ronald Arthur

Vestey and in the case of the death of either of such authorised persons such person as the survivor for the time being should appoint by deed, writing or Will to fill the vacancy, Sir Edmund expressing the opinion that it was advisable to select a member of his family to fill such vacancy provided that the person making such appointment considered such member of the family fit for the position. There is finally a proviso that if the authorised persons, being more than two in number, cannot agree, the trustees are to act on the direction of the majority, but in case of equal voting by the authorised persons they are to exercise their own discretion. I have cited at length this definition of 'authorised persons' for it may well have some bearing in considering what is the nature of the right or power entrusted to them.

The first question here for consideration is, what is the nature of the right to direct investment which is invested in the authorised persons. On behalf of the Crown it is urged that it is not a fiduciary power or right but a right exercisable by the authorised persons for their own benefit, so that they can require the trustees to invest the trust funds by way of loan to themselves or to any company in which they are interested, at any rate of interest, whether or not such an investment is always intended to be for the benefit of the trust estate. It is therefore in this view some kind of beneficial interest albeit a kind, I think, hitherto unknown to the law.

So far as section 38(3) and (4) is concerned, I observe that even if the argument for the Crown so far prevails, it must still be established that by reason for the settlor's right to direct investment, the income or property arising under or comprised in the settlement is 'payable to or applicable for the benefit of the settlor'. I am clearly of the opinion that it is not. I think that these words contemplate an out-and- out parting with the trust property or income by payment to the settlor in money or monies worth; they are as familiar words as any in the conveyancing art. Investment is the very antithesis of this, for it contemplates the retention of something as part of the trust property. I think, therefore, that in any case the claim of the Crown upon this head under section 38(3) and (4) must fail but as I have said, the nature of this right to direct investment is of crucial importance upon section 18 of the Finance Act 1936,[20] also, and this is the moment to pursue it.

My Lords, I cannot bring myself to regard this right as anything but a fiduciary right, and if so, it appears to me to follow that it is not to be regarded as conferring any part of the benefit upon its holders. I do not ignore the surrounding circumstances, upon which so much reliance was placed; I am content to bear in mind what happened after 1921, though such events can have no bearing upon the deed of that year. But if I ask how any Court of Equity would regard this power, it seems to me that the only answer must be that it is a fiduciary power to be exercised with a single eye to the benefit of the beneficiaries. Let me suppose that the authorised persons, who may for this purpose be either the Vestey brothers or those who later answer that description (since the character

20. See Chapter 9

of the power will not vary with those who exercise it) direct the trustees to invest the trust funds by way of loan to themselves at a low rate of interest without security, and that the trustees, regarding such an investment as very precarious, apply to the Court and ask whether they must comply with the direction. In such a case it would, as it appears to me, be an irrelevant plea by the authorised persons that the right to direct investment was merely a part of the scheme for avoiding liability to income tax. The Court can see nothing but a settlement with a wide power of an investment of the trust funds and a mandate to the trustees to invest at the direction of certain persons. Nothing short of the most direct and expressed words would, I think, justify a construction which would enable those who exercise the power of direction to disregard the interests of the beneficiaries. If it is said that such a construction defeats the general intention of the scheme, I would reply that it may be that those who framed it dug a pit for themselves and have assumed a duty where they thought to acquire a right."[21]

He concluded that this power to direct investment was a fiduciary power and that it was not an "interest" within section 38 of the Finance Act 1938.

The other Law Lords came to the same conclusion.

It can therefore be seen that the wide words of the provisions in question caught an innocent taxpayer who had no intention of avoiding tax in Glynn's case but the Vestey's, having entered into a complicated and sophisticated tax avoidance arrangement, managed to steer clear of the Act. The cases show that an unintended and remote possibility of benefit to the settlor can be

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21. pp82-4

caught by section 673, while the well advised can take steps to stay outside the ambit of the section.

Taxpayers who fail to come to terms with the intricacies of trust law can find themselves caught when they thought they had excluded themselves from all benefit. This has been seen in some of the cases above and is also evident from the next case on these provisions: Hannay's Executors -v- IRC.[22] The facts were that, by a deed executed in July 1951, the taxpayer and his wife settled £23,000 on trust until their first child attained 21 years of age, to pay the income to charities selected by the taxpayer, and thereafter to pay out of the income an annuity of £250 by monthly instalments to each child from the age of 21 until the youngest child attained 25 or married, if earlier, and then to distribute a capital sum of £60,000 out of the trust assets among the children, and the remaining assets among selected charities. The first child attained 21 on 16th April 1952, and her annuity was duly paid; the balance of the trust income for 1952/53 being paid to charities nominated by the taxpayer.

The taxpayer was assessed to surtax on the trust income. He admitted liability under section 397 ITA 1952[23] in respect of the annuity, since the eldest child was a minor at the commencement of that year, but claimed that the balance of the income should not be treated as his.

The Court of Session held that the income was not disposed of by the settlement and therefore failed to be paid back to the trustees. The Lord President (Clyde) analysed the terms of the deed and asked whether the income in question was dealt with under one or other of its clauses. He concluded that, on the facts, the income surplus to the trust expenses and the annuities to be paid to the children was not disposed of so far as it

22. (1956) 37 TC 217
23. Now section 663 ICTA 1988, see Part 3, supra

accrued in the period between the day when the first of the settlors children attained 21 and the day when the youngest of them attained 25 or married. Accordingly, the settlor had an interest in that surplus income.[24] The other judges agreed. The position was, therefore, that, effectively the deed was defective in that it did not provide either for the income to be paid to the charities or to be accumulated. These defects caused the taxpayer to be caught what is now section 673 ICTA 1988.

Perhaps encouraged by their successes in such cases as Glynn and Hannay's Executors, the Revenue began to use arguments of much ingenuity to try to catch taxpayers under these provisions. The courts, however, did not always appreciate their efforts, as in IRC -v- Bernstein.[25] The taxpayer settled a fund upon trust to accumulate the income during his lifetime for the benefit of the person or persons eventually entitled to the capital; and after his death as to one-third for any children of his by his future wife then living, and as to two-thirds for his future wife absolutely, but if his future wife died in his lifetime leaving children, for the children living at his death; and if at his death there were no children, for his future wife absolutely, with a gift over if she died before him. He subsequently married the woman in question and they had no children.

The taxpayer was assessed to surtax on the footing that he had an interest in half the property comprised in the settlement within the meaning of what is now section 673 ICTA 1988, in as much as there was a power of advancement in favour of his wife under section 32 of the Trustee Act 1925. The taxpayer contended that the statutory power of advancement was not applicable because the settlement indicated a contrary intention.

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24. p222
25. (1960) 39 TC 391

In the High Court, Danckwerts J described the Crown's contention as a "very long shot".[26] He held that the Crown's long shot missed its mark. He held that, from the way the settlement was drawn, providing for accumulation during the lifetime of the settlor, there was, in his view, an intention that no income should be distributed before the taxpayer's death. The trust for accumulation was inconsistent with the power of advancement in section 32 of the Trustee Act 1925.[27]

The Court of Appeal also rejected the Crown's claim on this ground.[28] Danckwerts J also rejected what appears to have been an even longer shot which was, in fact, contrary to the perpetuity laws as they then stood. The Crown argued that the taxpayer's wife might at some point be past the age of child bearing. In that event, any children she had already had would be the only ascertainable persons, other than her sister, who might give their consent and that there might be a situation in which, in certain circumstances, they would be persons who might give their consent to allow for section 32 of the Trustee Act to be operated. Danckwerts J pointed out that, as the rule against perpetuities then stood, a woman is never treated as being incapable of having children, whatever her age. This hopeless argument was not pursued in the Court of Appeal.

As mentioned above, the matter was decided in the Court of Appeal on the question of whether the statutory power of advancement applied, or whether the context excluded it. Lord Evershed MR, like Danckwerts J, appeared to be a little surprised by the Crown's claim. He said:

> "On the face of it, the case is a little startling. No advancement pursuant to section 32 of the Trustee Act has ever purported to have been made, and we have been informed by [Counsel for the taxpayer]

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26. p395
27. p397
28. infra

> that at some date after the claim first arose, by an appropriate instrument - which obviously it would be competent for the parties to execute - the trusts of the settlement have been varied so as henceforth to exclude any possibility of advancement to the [taxpayer's wife] ... . I do appreciate that those responsible might well take the view that by instruments of this general nature it might be possible for persons of means to provide, as the phrase goes, for a "rolling up" of the income, yet thereafter to make the resultant capital available to a substantial extent by way of advancement to the settlors wife and thus to avoid what otherwise might have been a liability to substantial taxes. As it is, the variation which has been made has shown that in this case, at any rate, that is no longer in any circumstances possible."[29]

Lord Evershed MR agreed with Danckwerts J that the statutory power of advancement did not apply in this case.[30]

Harman LJ, too, was unimpressed by the Crown's argument. For example, he referred to the Crown's concession that the statutory power of maintenance in section 31 of the Trustee Act was over-ridden by the expressed trust to accumulate and that:

> "The Gilbertian position is thus reached that, though the children of this union may not be maintained out of income, they may be advanced out of capital. Well, when one reaches that conclusion it is time to draw the foot back before you slip into the pond of absurdity."[31]

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29. p399
30. p408
31. p404

Donovan LJ agreed, even though he acknowledged that the intention of the taxpayer was presumably to remove some of his income from the surtax net. In fact, he said that, given that this must have been the taxpayer's intention, it is unlikely that the taxpayer would want anything in the deed to produce the opposite result. Looking at the document itself, he said that the one reasonable explanation for its rather unusual features was that the taxpayer had an intention to save surtax. Accordingly, his view was that the document itself raised a presumption that the settlor wanted no power of advancement in it. He did not, of course, base his conclusion on these comments, but agreed with the reasons put forward by the other two judges for dismissing the Crown's claims.[32]

The Crown again tried to fix the taxpayer with a liability under these provisions by virtue of an accidental and remote possibility that he might benefit in Muir -v- IRC.[33] Again, the Crown failed.

Under a settlement made by the taxpayer in 1947, the income of the trust fund arising during an appointed period was declared to be applicable for the benefit of all or any one or more of the beneficiaries as the trustees might from time to time think fit. The trustees were empowered to capitalise income by, inter alia, applying it in paying premiums on any policy of assurance in which a beneficiary had a beneficial interest and they also had a power to appoint capital to or in trust for any of the beneficiaries. In 1952, the trustees purported to appoint the entire capital on trusts identical in all material respects with the original trusts, excluding the power to capitalise income. In 1953 the taxpayer made a substantial addition to the trust fund.

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32. See pp405-6
33. (1966) 43 TC 367

The taxpayer was assessed to surtax in respect of the income arising under the settlement. The Crown contended that, for reasons which are not relevant here, the trusts of income were void for uncertainty, so that the income was held on a resulting trust for the taxpayer. Alternatively, it was contended that, since it was thought during the relevant years that there might be a resulting trust for the taxpayer, what was then section 405 ITA 1952[34] applied to the undistributed income. Finally, the Crown contended that the purported release of the power of capitalisation in 1952 was void, and that section 405 applied because income might, under that power, be applied in paying premiums on a policy in which both a beneficiary under the settlement and the taxpayer had beneficial interests.

At first instance, Pennycuick J dismissed the Crown's first two contentions but agreed with their third argument. On the first point he found that, on the construction of the settlement, it was not void for uncertainty. On the second point, he acknowledged that section 405 was in "very wide terms" but, he said, he thought that it must be confined to cases where income or property "were or may become payable to or applicable for the benefit of the settlor" either under the trusts of the settlement itself or under some collateral arrangement having legal force such as that in the Jenkins case.[35] He concluded:

> "I do not think that the section can apply merely by reason that there is a current doubt as to the construction of an income trust, and that upon one alternative construction the trust would be void. The true position there is that, according to whichever is the true construction of the income trust, it is either valid or void. If it is valid,

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34. Now section 673 ICTA 1988
35. Jenkins v IRC (1944) 26 TC 265, supra

the settlor has no interest at all. If it is void the settlor is absolutely entitled under the resulting trusts. Pending judicial decision, it may not be known which is the true construction, but the existence of the doubt cannot upon any fair construction of the section bring the income within it as being income which in certain circumstances may be payable to the settlor."[36]

On the Crown's third point, however, Pennycuick J held that the 1952 deed was ineffectual to extinguish the powers to capitalise and that the trustees had power to apply income towards the payment of premiums on any policy in which, under any other settlement, a beneficiary has any beneficial interest. He said:

"Unfortunately, under such a settlement the settlor might also have an interest in the policy kept up by payment of the premiums upon it. To take the simple and realistic example suggested by [Counsel for the Crown], the trustees, in performance of their duties under the settlement, might apply income towards the payment of premiums under a policy comprised in another settlement under the terms of which the trust funds, including the policy, are held in trust for one of the settlor's grandchildren contingently upon attaining the the age of 21, with a default trust for the settlor."[37]

He, therefore, held that section 405 applied but he did so "regretfully". He commented:

"I say 'regretfully' because, like many others who have had to apply this section, I find it distasteful to fix a taxpayer with surtax liability

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36. p381
37. p384

by reason of a remote and accidental interest of this kind. But it is well established that the section must be strictly construed and applied and I can see no escape from the conclusion ..."[38]

The Court of Appeal, on the other hand, dismissed all three of the Crown's arguments. On the first two points Harman LJ, with whom Diplock and Winn LJJ agreed, was of the same opinion as Pennycuick J's. However, on the third point, Harman LJ held that the 1952 appointment was not ineffective in releasing the power to capitalise.[39] He did, however, say that, if the 1952 deed had been ineffective, the Crown's argument, which Harman LJ described as a "far fetched notion" would have succeeded because section 405(2) provided that the settlor was to be treated as having an interest if any income may become payable for this benefit "in any circumstances whatsoever".

In contrast, the transactions in the next case were such that few people can have any complaints that they were caught by section 405 ITA 1952. The case was IRC -v- Wachtel[40]. On 4th April 1960, the taxpayer settled a fund of £1,000, with provision for further additions, on trusts for the benefit of his children.

On the following day, the trustees agreed to purchase the whole issued share capital of an investment company, Ebor Investments Limited, for £7,690. The purchase price was advanced to the trustees by a bank by way of overdraft on current account, on condition that the taxpayer should guarantee the overdraft and deposit with the bank a sum sufficient to cover it. It was agreed between the taxpayer and the bank that the interest chargeable on the overdraft should be limited to 1% per annum and that the taxpayers deposit should carry no interest.

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38. Ibid
39. p391
40. (1970) 46 TC 543

The bank also stipulated that the income of the trust should be applied to reduce its indebtedness and that the taxpayer's deposit could be reduced accordingly. Subsequently, sums representing dividends from the investment company were paid into the trustees' current account and equivalent sums were withdrawn from the taxpayer's deposit account. In June 1962, Saul Wachtel Limited, a company wholly owned by the taxpayer and his wife, was substituted for him as the guarantor of the overdraft and opened a deposit account with the bank in replacement of the taxpayer's deposit account. Following this, the trustee's overdraft and the deposit account of the company continued to be reduced by the payment into the trustee's current account of dividends from the investment company.

The taxpayer was assessed to surtax for the relevant years on the footing that, inter alia, the income of the trustees for those years fell to be treated as his income under section 405. The taxpayer claimed that the arrangements with the bank did not form part of any settlement within the definition in section 411(2)[41]; alternatively, if those arrangements did form part of a settlement, that he was not the settlor of any sum beyond the original £1,000 and that he had no interest in the income arising under the settlement within section 405(2).

Goff J held that there was an "arrangement" amounting to a "settlement" within section 411(2), consisting of the deed of settlement of 4th April 1960, the arrangement between the taxpayer and the bank, and the arrangement by the trustees with the bank.[42] He further held that the taxpayer was a "settlor", and the settlor of the whole fund in that it could not have been provided without his assistance. The trustees were able to borrow the

41. Now section 681(4) ICTA 1988
42. P554

necessary funds to buy the shares virtually free of interest because, and only because, the taxpayer deposited his money and agreed not to take any interest on it (the last point being considered by the judge to be "fundamental")[43].

The judge then went on to consider whether, by virtue of section 405(2), the taxpayer had an interest in the income. He said that the point was whether the payments by the trustees to the bank were payments indirectly for the benefit of the taxpayer or, more accurately, whether the income was indirectly applicable for his benefit. Goff J said that, apart from authority, he was of the view that the payments were for the taxpayer's benefit, since they entitled him to withdraw an equivalent amount of his frozen capital.[44] Turning to authority,[45] Goff J derived "great assistance" from the Jenkins case[46].

In the circumstances, the decision in this case is hardly surprising.

The statutory definitions of "settlor" and "settlement" were considered in the context of section 673 ICTA 1988 in the case of Mills -v- IRC,[47] which is considered in Part 1 of this Chapter.

It can be seem from the above cases that on the whole section 673, which has been on the statute books for over 50 years, has been mostly successful in countering the avoidance devices at which it was aimed.[48] It has required very little amendment during the half century of its life, although one defect will be considered below. However, the section, in order to anticipate all of the

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43. p555
44. pp555-6
45. p556
46. Jenkins v IRC (1944) 26 TC 265, supra
47. (1974) 49 TC 367
48. It has been seen, supra, that the Vestey family escaped, they have proved to be a hard family to pin down; see Chapter 9.

methods which the ingenuity of taxpayers may generate to get round its terms, is couched in wide and all embracing terms which, inevitably, have caught some "innocent" taxpayers, ie, those who have had no thought of avoiding tax.

Nevertheless, although the section, as with most of the other sections dealt with in this Chapter, is wide in its ambit, the language in which it is worded is fairly specific and, once the sometimes complicated language is mastered, and the case law fully appreciated, more often than not the situation is clear. Inevitably there are some difficult areas, as some of the cases examined in this Part have shown, but, in practice, most "innocent" taxpayers caught by this, and the other income tax settlement provisions, have been caught because they, or their advisers, have not grasped adequately the meaning of the relevant provisions. The only real exception to this comment is section 677, which is considered in Part 7 of this Chapter.

This was, however, one major hole in section 38(3) and (4) FA 1938. A fundamental point relating to these provisions was decided against the Crown in Lord Herbert -v- IRC[49]. The defect in the legislation exposed by this case was so great that amending legislation was immediately introduced in section 20 FA 1943.[50]

The facts of the case were that the taxpayer and his father were interested in certain property as tenant for life (the father) and tenant in tail in remainder (the taxpayer). They entered into a settlement of the relevant property. It was admitted that the terms of the settlement were such that the taxpayer might become beneficially entitled to income arising under the

49. (1943) 25 TC 93
50. Section 679 ICTA 1988
51. See Part 4, supra

settlement within section 38(2) FA 1938;[51] and that the taxpayer had an interest in the income arising under the settlement which had not been distributed within the meaning of section 38(3). However, assessments to income tax on the taxpayer as "settlor" by reference to section 38 in respect of the income arising under the settlement were held invalid by Macnaughten J on the grounds that the Revenue had no power to chose which of two settlors should be assessed under section 38 and that, since before the settlement was made the taxpayer had no interest in the income arising from the property during his father's lifetime, he could not, during the father's lifetime, be assessed as settlor under section 38 in respect of the income arising under the settlement. The judge said:

> "The ... settlement admittedly contains provisions which bring it within sub-section (2) of section 38, and the [taxpayer] is admittedly a settlor. But the [taxpayer] is not the only settlor. His father is also a settlor; and the point raised by [Counsel for the taxpayer] on this appeal is that in the circumstances, no assessment can be made upon Lord Herbert in respect of the income from the property comprised in the settlement for the following reasons. The settlement provides that the income 'shall be treated as the income of the settlor and not as the income of any other person'. Lord Pembroke[52] is admittedly a 'settlor' and, therefore, the income must be treated as his income and not as the income of any other person: Lord Herbert is another person and, therefore the income cannot be treated as his. If Lord Pembroke were assessed, the same argument could be raised. If there is no flaw in the argument and the words of the section are imperative, as they seem to be, the result is that where there is more

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52. The taxpayer's father.

than one settlor the provisions of the section become inapplicable.

In view of the fact that the expression 'settlement' in this section includes any disposition, trust, covenant, agreement or arrangement, and the expression 'settlor' in relation to a settlement means any person by whom the settlement was made, it would seem probable that in many of the settlements that come within this section there must be more than one settlor. But the Act does not prescribe what is to happen when there is more than one settlor and it seems that the question has never yet come up for decision. It is not suggested that all the settlors can be assessed in respect of all the income. That, indeed, would seem to be an extravagant proposition. Nor is it suggested by the Crown that the income should be distributed between them. ...

The interpretation of the section put forward on behalf of the [Crown] was that where there are two or more settlors the Crown has the option to assess any one of the settlors to the exclusion of the other, and that, in the case of an

assessment to income tax - and the assessments in question on this appeal were assessments to income tax - the option must be exercised by the local Inspector of Taxes and that there was no right of appeal by the taxpayer against the Inspector's choice. In the case of any assessment to surtax the option would lie with the Special Commissioners. I find myself unable to accept that interpretation. It seems to be fantastic to suppose that Parliament has conferred upon Inspector's of Taxes, or even upon the Special Commissioners, a choice as to whether A, or B, should be liable to income tax or surtax, as the case might be."[53]

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53. pp98-99

Section 20 FA 1943[54] was enacted to meet the difficulty disclosed by this decision. The section was designed to provide machinery for apportioning settled property and settled income amongst the settlors where there are more than one.

The section stated that, where there is more than one settlor, each of them is deemed to be the sole settlor and the settled property and settled income comprised in the settlement is limited to that provided directly or indirectly by him.

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54. Now section 679 ICTA 1988

Discretionary Power for the Benefit of the Settlor

It has been noted above that section 21 FA 1958 amended section 404 ITA 1952 in connection with revocable settlements.[55] The FA 1958 also introduced another anti-avoidance provision relating to settlements, and that provision is now section 674 ICTA 1988. The legislation has remained intact since 1958 and has generated few disputes, yet it appears to have been successful in stopping the narrow range of abuses at which it was aimed.

Section 22 FA 1958 was not introduced until the Finance Bill debates were at an advanced stage. This section was introduced because it was recognised that there were settlements under which there had not been an effective alienation of money from the settlor but which were beyond the reach of section 404 ITA 1952, even as extended by section 21 FA 1958. For example, a discretionary power in the settlement whereby someone could apply the income or property for the benefit of the settlor or his spouse was still not within section 404; for instance, a settlement whereby neither the settlor nor his wife could become beneficially entitled to any part of the settled funds but where those funds could, at the discretion of the trustees, be applied, say, in reduction of an overdraft of the wife. Section 22 was designed to cover this type of case.

Section 22 applies where the terms of a settlement are such that any one has power (with or without the consent of anyone else) to apply all or any part of the settlement income or property for the benefit of the settlor or the settlor's spouse. It also applies if the power is to secure the application of the settlement property or income to or for the benefit of the settlor

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55. See Part 4, supra

or the settlor's spouse. In each case, the power in question is a power exercised at the discretion of the person in question. The effect of section 22 is that, if all the settlement income is subject to this discretionary power, all of it has to be treated as the settlors income; but if only a part of the income or property is subject to the discretionary power, a corresponding part of the income has to be treated as the settlor's.

These provisions apply, for example, if the settlor's spouse is a member of the class among whom the income or the trust property can be distributed at the discretion of the trustees or someone else.

Section 22 contained a provision to the effect that, if the power cannot be exercised within six years from the time the settlement income arises or from the time a particular asset first becomes comprised in the settlement, then, so long as the power remains unexercisable, the section did not apply.

So as not to make the provisions of the section retrospective, it was stated that, in the case of a settlement made before 9th July 1958, any income arising under the settlement is not caught if:

(a) no power by reason of which it would fall to be treated as the income of the settlor has been exercised after 8th July 1958, or is or can be exercisable after 5th April 1959, or such later date as the Board may in a particular case allow; and

(b) neither the settlor nor the settlor's spouse has received or is entitled to any consideration or benefit in connection with the fulfilment of the condition in (a) above.

There is a further limitation whereby the settlor is not deemed to have an interest in the income or the property of the settlement in the circumstances which are now set out in section 673(3)[56].

In the light the case of IRC -v- Tennant[57] the Inland Revenue issued a Statement of Practice[58] relating to benefits to a settlor's future spouse for the purpose of this section. The statement, issued on 18th June 1979, reads:

> "The settlements legislation in TA 1970, part XVI,[59] includes provisions which may be applied to any settlement where the spouse or any possible future spouse of a settlor may be able to benefit from the income or capital of the settlement in any circumstances whatsoever. In relation to the concept of 'possible future spouse' the Board of Inland Revenue have considered the scope of the decision reached in the case of IRC -v- Tennant (24 TC 215) and they take the view that that decision applies:
>
> (a) where, although a settlor is not at the material time a party to a subsisting marriage, the terms of the settlement are such that a benefit may be conferred on substantially any person who may become the wife or husband of the settlor in future, or
>
> (b) where, whether or not the settlor is married, the terms of the settlement are such as to indicate a specific intention that a future wife or husband of the settlor may be enabled to benefit."

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56. See Part 5, supra
57. (1942) 211 TC 215, see Part 5, supra
58. SP/A30
59. Now Part XV ICTA 1988

As noted in Part 5 of this Chapter, the Revenue do not regard the Tenant case as applying to a person who cannot become entitled to a benefit during the settlor's life.

With this section, as with the ones examined in other Parts of this Chapter, it is important to establish what constitutes the settlement, because the power mentioned in section 674 must be within the settlement itself. Cases such as Wolfson,[60] are therefore relevant here.

60. Wolfson v IRC (1949) 31 TC 141, see Part 1, supra

Other Settlements Where Settlor Retains an Interest

Section 109 FA 1989 introduced an new section into the ICTA 1988 relating to settlements in which the settlor retains an interest: section 674A ICTA 1988.

Deeds of covenant for children (other than unmarried infants) were very popular, for example, in the case of children at university, where the child's personal allowance was still available. A repayment of the tax credit was thereby obtained. Section 36 FA 1988 introduced section 347A ICTA 1988, as has been mentioned above, put a stop to this.

Taxpayers quickly appreciated that they could achieve the same end by setting up a trust into which they paid the funds they would previously have paid over under a covenant. The funds would then be distributed to the child by the trustees. Such a trust was not effective for higher rate income tax because of section 683 ICTA 1988[61] but the child did obtain the repayment of the basic rate.

Section 109 put a stop to this device by deeming the income paid out to the child to be the income of the parent.

There are certain exceptions to this deeming provision,[62] the most important of which is:

> "income from property of which the settlor has divested himself absolutely by the settlement."[63]

Accordingly, if the settlor or his spouse cannot have any of the settled property or the income arising from it returned to them, the section will not apply. It must

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61. See Part 8, infra
62. See Section 674A(1) ICTA 1988
63. Section 674A(1)(d) Ibid

not be possible for the settled property, or any property derived from it, to be payable to or applicable for the benefit of the settlor or his spouse "in any circumstances whatsoever".[64]

This section has effect in relation to all income arising under a settlement made on or after 14 March 1989 and, where a settlement was made before that date, in relation to income arising on or after 6 April 1990.[65]

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64. Sections 674 A(3) and 685(1) Ibid
65. Section 674A(5) ibid

Disallowance of Deduction of Payments By Settlor

Section 39 FA 1938, now section 676 ICTA 1988 states that where, by virtue or in consequence of any settlement to which the section applies, the settlor pays directly or indirectly to the trustees of the settlement any sums which would, but for sub-section (1), be allowable as deductions in computing his total income for that year, those sums are not to be allowed to the extent to which the aggregate amount falls within the amount of income arising under the settlement in that year which has not been distributed.

This provision is aimed at settlements constituted by the payment of annual sums by the settlor, by which, for tax purposes, his total income would be diminished. It is not aimed at settlements constituted by the transfer of capital sums to the trustees. Usually the type of settlement to which these provisions applies is a deed of covenant to pay annual sums to trustees but this is not necessarily the case, as the case of Pay below shows. In Pay's case, it took the form of payment of annual interest under a charge by the settlor of the settlor's own property, which property the settlor herself had settled on trustees.

Where the section applies, the annual payments by which the settlor's income is diminished are, to the extent to which they are undistributed, not to be treated as having that effect and, accordingly, the total income of the settlor, to that extent is not regarded for tax purposes as having been reduced by those payments. In other words, the payments made by the settlor, to that extent, are completely ignored for tax purposes.

The operation of the section can be seen in IRC -v- Pay[66]. The facts were that, on 30th June 1950, the

66. (1955) 36 TC 109

taxpayer settled the sum of £60,000 on her grandson and, in certain events, for certain other persons, and, before the date of the execution of the settlement, she paid the £60,000 to the trustees. On 3rd July 1950, she created a registered charge on the property in consideration of an advance to her by the trustees of the settlement (herself and her brother) of an equivalent sum of £60,000. Under the terms of the charge, interest was payable at the rate of 5% per annum. The principal and interest, however, was not to constitute a debt due from, or to be recoverable against, her or her executors or administrators personally, although it would presumably have been open to the trustees in the event of non-payment, to seek other remedies such as the appointment of a receiver. These transactions were carried out by an exchange of cheques. The settlor first drew a cheque for £60,000 on her private bank account in favour of herself and her brother as trustees of the settlement; and a few days later, the brother, as trustee, signed a cheque for £60,000 in her favour, by way of an advance to her, which was secured by a charge. She in turn executed a charge on the property in question. It is important to note that, under the terms of the charge, the settlor was to remain in occupation and to continue the management of the property charged.

The settlor made payments of interest under the charge to the trustees who applied some of it towards the maintenance of the infant grandson. There was, accordingly, an accumulation by the trustees of a substantial portion of the interest payments.

If the case was caught by section 39 FA 1938, the settlor would not be entitled to any deduction from her total income for surtax purposes of the accumulations, i.e., the undistributed portion of the trust income.

It was contended by the Crown that the whole transaction was a settlement in that it was an "arrangement". It was held by Danckwerts J that, not only the settlement proper by which the settlor transferred the sum of £60,000 to the trustees, but in addition, the charge and the payments of the sums of £60,000 all formed one scheme designed to carry out the purpose of the taxpayer. Although the settlement proper in the first instance was effected by the payment of £60,000, sums paid by the settlor to the trustees were the interest payments made by her under the charge of her property. The charge was part of the "settlement" and the payments were made under it "by virtue or in consequence of" the settlement. Once the view was taken that the charge was part of the "settlement", it became obvious in the view of Danckwerts J, that the payments of interest were made, if not "by reason of" the settlement, but at any rate "in consequence of" the settlement. Accordingly, the judge pointed out, the taxpayer had paid the interest because it was a charge on her property, but she paid it, not because she happened to own the property, but because there was a charge for the amount of the interest on it; and there was this charge because the taxpayer created it, and the creation of the charge was part of the arrangement which constituted the settlement.

Since these provisions were introduced in 1938, there have, in all material respects, remained unaltered although their importance has been diminished by section 683 ICTA 1988[67] and the provisions relating to accumulation settlements for infant unmarried children in section 664 ibid.[68]

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67. See Part 8, infra
68. See Part 3, supra

PART 7

CAPITAL SUMS PAID TO THE SETTLOR

The next provision to consider was first introduced as section 40 FA 1938 and is now section 677 ICTA 1988. As will be seen below, this section has been amended and supplemented, particularly to fill a gap exposed by the Potts case.[1] However, the bulk of the section has remained unaltered since 1938 which is surprising considering that it is a badly drafted provision which has come in for some particular scathing criticism from the Courts, particularly the House of Lords. Some of the comments that have been made about the section include the following. In Potts' Executors -v- IRC[1], Lord MacDermott said that the section seemed "capable of involving straightforward transactions to such a considerable extent that a decision which may encourage the substitution of something better need not be a matter for regret".[2] Lord Evershed in IRC -v- De Vigier, said that "the pit dug by the legislature in enacting [section 451] has been wide enough to catch the unwary innocent."[3] In IRC -v- Bates, Russell LJ referred to the section as "monstrous" a comment with which Lord Reid in the House of Lords agreed,[4] Lord Reid himself declaring that the provisions were "wholly unjust" and that "the draftsman has chosen such a complicated method that he has obviously failed to realise the absurd results to which it leads in all but the simplest cases - and I think in almost every case where the trust income has to be accumulated"[5]. Lord Morris talked of the "unsatisfactory state" of the provisions[6] and Lord Wilberforce referred to the "grave defects" of the section[7]. Perhaps the most damming comment came from Lord Reid who said;

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1. Potts' Executors v IRC (1951) 32 TC 211
2. p236
3. (1964) 42 TC 24 at p35
4. (1964) 44 TC 255 at p261
5. Ibid
6. p265
7. pp271-2

"This case may well afford ammunition to the body of opinion which holds that redrafting of the Income Tax Act ought to be taken out of the hands of those at present responsible."[8]

These criticisms are amply shown by the fact that, of the first four cases decided under these provisions, in one, Potts, a tax avoider escaped liability; and in the other three, De Vigier, Bates and McCrone, a completely innocent taxpayer was caught by the section.

Yet, despite the unsatisfactory state of the section and the criticisms made against it by the Judges, the Revenue and the Legislature have been totally insensitive to the appalling state of the provisions and have left them on the statute book for over fifty years as a trap for the unwary and as, in some cases, a minor inconvenience for the well-advised tax avoider.

Lord Reid explained the mischief of the section in the Bates case. He said:

"The provisions were first enacted in 1938. The mischief against which they were directed appears to have been some taxpayers, intending to avoid paying surtax, transferred to trustees of settlements shares in companies controlled by them; they then borrowed money from the trustees, who used the dividends on these shares to make the loans. In that way the settlors got possession of the income from the shares which they had settled in the form of capital payments which did not attract surtax. And if the trustees were complacent, the settlors might never repay these 'loans'. The reason why companies were brought in appears to have been that some settlors had devised rather more elaborate

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8. p265

schemes. The settlor might form a company, controlled by him, to which he transferred assets yielding income. He would then put the whole, or the greater part, of the shares of that company in the settlement, and then he would cause that company to lend him a whole or a part of its income, thereby diminishing the dividends which would have otherwise have gone to the settlement trustees. He would not repay those loans during his lifetime, and in that way he would receive and enjoy the income of the assets which he had transferred to the company without being liable to pay surtax in respect of it."[9]

The schemes employed by taxpayers before section 40 FA 1938 was introduced were, in fact, not restricted to transfers to trustees of shares. A settlor might, for example, transfer other types of capital to trustees with a direction that the income should be accumulated, the accumulations being paid by the trustees to the settlor in the shape of loans which were normally not intended to be repaid. What the beneficiary of the settlement had was not the trust income but merely a right to recover a debt from the settlor, a right which was normally never enforced.

As a variation on the settlement of shares, a settlor might, for example, settle, say, £1,000, the trustees being given a direction that the income should be accumulated during the settlors lifetime. At the same time, the settlor formed a company to which he sold assets for, say, £100,000. The settlor then loaned £99,000 to the trustees in order to enable them to purchase the shares of the new company. The trustees, with the £100,000 trust capital plus the £99,000 advanced to them, purchased the shares in the company. This money

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9. IRC v Bates (1964) 44 TC 225 at pp259-60. It should be noted, however, that loans by close companies to participators are now covered by section 419 ICTA 1988, see Chapter 1, Part 3.

found its way back into the pocket of the settlor, because the company, on receiving the £100,000 from the trustees in the settlement, paid it back to the settlor as the purchase price of the assets, which the company acquired from him. The company paid dividends out of the income from the assets which it had purchased and these dividends were paid to the trustees of the settlement, who are the holders of the shares. The trustees handed over the money they received by way of dividends to the settlor in gradual repayment of the advance of £99,000 which he had made to them. The repayments to the settlor by the trustees were in the nature of repayments of capital and the settlor accordingly did not become liable to tax on them.

Another device was for a settlor to transfer capital to trustees of the settlement which he had established, but, instead of making an advance to the trustees to enable them to acquire the assets in which he himself was interested, the settlor sold these assets direct to the trustees at a considerable over-value, so that there was no need to form a company, as in the previous scheme. The trustees paid the purchase price for these assets in instalments spread over a period of years.

The trust income derived from the trust capital transferred to the trustees was then applied towards payment of the instalments of the purchase price of the assets, which the settlor had sold to the trustees.

This type of scheme was counted by section 40 which provided that, where capital sums are paid by the trustees directly or indirectly to the settlor in a particular year of assessment, to the extent to which such of those capital payments fall within the income derived in that year from the settlement, that income is to be regarded as the income of the said law. After various amendments, the wording of section 677 ICTA 1988 is now:

> "1. Any capital sum paid directly or indirectly in any relevant year of assessment by the trustees of the settlement to which this section applies to the settlor shall -
>
> (a) to the extent to which the amount of that sum falls within the amount of income available up to the end of that year, be treated for all purposes of the Income Tax Acts as the income of the settlor for that year;
>
> (b) to the extent to which the amount of that sum is not by virtue of this subsection treated as his income for that year and falls within the amount of the income available up to the end of the next following year, be treated for the purposes aforesaid as the income of the settlor for the next following year;
>
> and so on for each subsequent year up to the maximum of ten subsequent years, taking the reference in paragraph (b) to the year mentioned in paragraph (a) as a reference to that and any other year before the subsequent year in question."

Payments of capital sums to the spouse of the settlor are also caught.[10] Capital sums paid by a company connected with the settlement are now caught by section 678.

The term "capital sum" is defined by section 677(9) as meaning:

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10. Section 677(9) ICTA 1988

"(i) any sum paid by way of loan or repayment of a loan; and

(ii) any other sum paid otherwise than as income, being the sum which is not paid for full consideration in money or money's worth,

but does not include any sum which could not have become payable to the settlor except in one of the events specified in the proviso to section 673(3)"[11].

Section 677(10) provides:

"For the purposes of this section they shall be treated as a capital sum paid to the settlor by the trustees of the settlement any sum which -

(a) is paid by them to a third party at the settlor's direction or by virtue of the assignment by him of his right to receive it where the direction or assignment was given or made on or after 6 April 1981; or

(b) is otherwise paid or applied by them for the benefit of the settlor,

and which would not apart from this subsection be treated as a capital sum paid to him."

References to sums paid to the settlor include, not only references to the settlor's spouse, but also to the settlor (or the settlor's spouse) jointly with another person. The definition "capital sum" set out above represents a considerable extension of the scope of the definition by section 42 FA 1981, which, inter alia, blocked the loophole in the Potts case.[12]

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11. See Part 6, supra
12. Potts' Executors v IRC (1950) 32 TC 211, infra

The amount of "income available" up to the end of the year is basically the aggregate of two amounts, namely,

(i) the trust income for the particular year insofar as it has not been distributed; and

(ii) the trust income for previous years which likewise has not been distributed.

Having arrived at the total of the undistributed income for the current and any previous years, it is necessary to make certain deductions in order to arrive at the amount of the available income. These deductions are set out in section 677(2). The operation of the carry forward rules was considered in the Bates case[13].

The first case on section 40 was Potts' Executors -v- IRC[14]. The facts were that, in 1939, the settlor settled a sum of money on his infant grandchildren. The settlor was governing director of a company and, in the following month the trustees of the settlement invested trust monies in the purchase, from the settlor, of all but one of the shares of that company. The company was admittedly a "body corporate connected with the settlement" within section 41(4)(e) FA 1938, so that sums paid by the company to the settlor would have been treated as having been paid by the trustees of the settlement so as to bring section 40 into operation.

For many years prior to the settlement, and even after the settlement, the settlor had an arrangement with the company whereby the sums payable to him as directors fees and expenses were credited to an account; whereas various payments which the settlor himself had to make, for example, for charitable subscriptions and surtax, were paid by the company on his behalf and debited to this account. On 6th April 1939 the account showed a debit

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13. IRC v Bates (1964) 44 TC 255, infra
14. (1950) 32 TC 211

balance, which was substantially increased during the year to 5th April 1940 mainly by reason of large payments on account of surtax on the settlor's behalf. The debit balance was paid off in December 1940. Additional assessments to surtax were made on the taxpayers as the settlor's executors for the years 1939/40 and 1940/41 on the grounds that the payments to third parties debited to the account constituted loans to him and were therefore capital sums within the definition in section 40(5)(a) FA 1938, and fell to be treated as income of the settlor by virtue of sub-sections (1) and (3).

Judicial opinion was split on this issue. The two Special Commissioners, the three members of the Court of Appeal, and Lord Morton, in the House of Lords, all held in favour of the Crown; whereas Singleton J, in the High Court, and four members of the House of Lords, all held for the taxpayer.

As the wording of the legislation has changed since 1938, it is just as well to consider the wording of section 40 as it then stood. Subsection (1) stated, so far as relevant:

> "Any capital sum paid directly or indirectly in any relevant year of assessment by the trustees of the settlement to which this section applies to the settlor shall -
>
> (a) to the extent to which the amount of that sum falls within the amount of the income available up to the end of that year, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year; ... "

Subsection (3) stated:

> "For the purpose of this section, any capital sum paid to the settlor in any year of assessment by any body corporate connected with the settlement in that year shall be treated as having been paid by the trustees of the settlement in that year."

The expression "capital sum" was defined in subsection (5)(a) as meaning:

> "(i) any sum paid by way of loan or repayment of a loan; and
>
> (ii) any other sum paid otherwise than as income, being a sum which is not paid for full consideration in money or money's worth; ... "

Singleton J considered that the results of subsection (3) was that, when there is a company connected with a settlement, section 40 is brought into operation if a capital sum is paid to the settlor by the company. In this case, unless it could be shown that there was a payment of a capital sum by the company to Mr. Potts, the Crown's case must fail. The judge observed that the Commissioners described the payments as "in substance merely a convenient method which avoided the necessity of the company paying to Mr. Potts and Mr. Potts then paying the Commissioners of Inland Revenue [the surtax due from Mr. Potts]." The judge said:

> "I do not regard the payments of surtax, or other payments to third parties through the current account, as payments made to the settlor. In making payments of this kind, the company was carrying out an old practice, and a practice which existed long

before the settlement came into existence. It was not making payments to the settlor."[15]

The Court of Appeal unanimously came to the opposite conclusion.

Sir Raymond Evershed MR, with whom Somervell and Denning LJJ agreed, was of the opinion that the Crown were right in saying that "paid to the settlor" in sub-section (3) must in its context be read as meaning "paid directly or indirectly to the settlor". The Master of the Rolls said that his first impression was the other way but, having considered the context, he agreed with the Crown that direct and indirect payments are both species of the genus "payments to the settlor". In other words, he said, the phrase "paid to the settlor" is one capable in itself of covering both direct and indirect payments.[16]

In the House of Lords, Lord Simonds agreed that the words "directly or indirectly", which occur in sub-section (1) were to be read into subsection (3)[17]. Nevertheless, he found for the taxpayer rather than the Crown.

The question was whether the sums with which the settlor was debited in the current account with the company were capital sums paid directly or indirectly by the company to him.

Lord Simonds noted that the Special Commissions had held that the sums in question were "sums paid by way of loan", and that they had said that the payments by the company to the Revenue for surtax were in substance merely a convenient method which avoided the necessity of the company paying to the settlor and the settlor then paying the Revenue. To this, Lord Simonds said:

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15. p217
16. pp221-2
17. p226

"There are, I think, sections in Revenue Acts which justify a reference to the substance of a transaction. But there is danger in forgetting the words used by Lord Tomalin in the Duke of Westminster's case[18] ...

The question is not what the transactions between the settlor and the company in substance were but whether they fell within the fair meaning of the section."[19]

Referring to subsection (3), he said that he had to be satisfied that, according to the fair meaning of the words, the sums in question were sums paid by way of loan to the settlor directly or indirectly by the company. He did not think it mattered whether the words "directly or indirectly" qualified the payment or the receipt. He did not doubt that in certain context money paid at A's request to B could be properly described as "paid to A". But he said that this was not the way a taxing statute was to be read. He said:

"I am not, in the construction of such a statute, entitled to say that because the legal or business result is the same whether on the one hand I borrow money from the company and with it make certain payments, or on the other hand the company at my request makes certain payments on my implied promised to repay, therefore it is immaterial what words are in the statute if that result is attained."[20]

He concluded that, on the ordinary fair meaning of the words, the company did not pay any sums to the settlor by way of loans. He said that it would be as inapt to say that the company paid the settlors sums by way of loan

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18. See Chapter 11
19. p227
20. pp227-8

when he was in debit on the account as to say that he paid the company sums by way of loan when he was in credit.

Lord Simonds concluded:

> "It was finally urged by learned counsel for the [Crown] that, if this appeal is allowed, an easy way of evading tax will be open to the taxpayer. This is an argument which is of no weight whatever. The question is what is the fair meaning of the words in the Taxes Act."[21]

Lord Normand also found for the taxpayer. He rejected the Crown's submission that payments made by the settlor's requests, were capital sums paid indirectly to the settlor as loans. He said that the relevant words were apt to cover payments made as loans to third parties through whom the payment reaches the settlor himself, but they were not apt to cover payments made to third parties who are not accountable to the settlor and are entitled to retain the sums as their own monies. He said that the terms of a taxing Act are not to be enlarged by reasoning that the same final result is achieved as by a loan made to the settlor followed by a payment made by him to the third party. He too referred to Lord Tomlin in the Duke of Westminster case[22]. He continued:

> "It would be inconsistent with this principle [i.e. that stated by Lord Tomlin] to accept the contention that the words should be extended to any payment made by the settlor's request to a third party which produces a pecuniary benefit to the settlor equivalent to the sum paid. It was said, however,

21. p228 Lord Simonds obviously meant "avoiding" rather than "evading".
22. p229

that a payment made by the settlor's request to an agent or other person accountable to him is in law a payment made directly to the settlor and, therefore that the word 'indirectly' must have a wider significance than I have assigned to it. This is, with respect, to beg the question. In a taxing Act designed to prevent tax evasion by effecting with liability to tax sums paid to a settlor otherwise than as income it was obviously necessary to provide for the case when persons accountable to the settlor are interposed between the payer and the settlor for the purpose of disguising the transaction. That is a satisfactory explanation for the use of the words 'directly or indirectly'. There is therefore no reason for extending the meaning of 'indirectly' so as to include payments to third parties which the settlor has an interest to make whether in discharge of his legal liabilities or in furtherance of charities favoured by him. If that had been the intention other words would have been added."[23]

Lord Normand therefore held that payments made by the settlor's request to third parties were not payments made directly or indirectly to him. Having made that finding he said that it was not strictly necessary to consider whether they were payments made by way of loans but, in view of the argument that had been addressed to the House, he stated his opinion. He said that there was a real distinction between the loan to A to enable him to pay his creditors and a payment to A's creditors made for the purpose of discharging his debts. He said:

"All the controversial payments in the present case appear as items in a current account described as a directors account. It is a fair inference that the payments, whether to the settlor himself or to third

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23. pp229-30

parties, were deemed by the company to be authorised by the power in the Memorandum of Association to make advances to directors and customers and generally to act as bankers for customers and others. Nevertheless, the account is not a banker's account with its customer. For example, the payments with which the settlor is credited are not loans to the company, as are the payments into the bank when the customers' account is not overdrawn; nor were any of the payments made for the purpose of granting credit required by the settlor, who had at all times liquid resources ready to pay all that he owed to the company. I therefore think that the payments in question were not payments by way of loans as that word is understood in common parlance and as it is used in section 40."[24]

He concluded his judgement by commenting:

"Courts of law are not concerned with extrinsic circumstances, such as that the provisions of section 40 as I have construed them are of little value because they may easily be evaded by those who have the will to evade them, or that persons who contract genuine loans and receive repayment of genuine loans without any purpose of evasion and without in fact evading any liability to tax are as likely to be taxed under section 40 as persons who contrive elaborate schemes of pretended loans for the purpose of evasion."[25]

Lord Oaksey, in a short judgement, also held for the taxpayer.

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24. p230
25. p231. Again, references to "evasion" are obviously meant as references to "avoidance".

The fourth Judge who held for the taxpayer was Lord MacDermott. His analysis of the payments were similar to that of Lords Simonds and Normand.[26]

At the end of his judgement, he referred to the Crown's comment that to find for the taxpayer would make section 40 so easy to circumvent that it would be useless for its purposes. He commented:

> "That purpose, doubtless, was to prevent or discourage certain forms of tax evasion. But the section attempts this in a manner which may work great harm to innocent people, as by inflicting tax on the grossed up amount of a loan so temporary that it might only be to until the banks opened, or of a loan genuinely borrowed and as genuinely repaid to the settlor. Tax evasion often places the draftsmen in great difficulty and it may not always be possible to avoid hurting the guiltless. But section 40 seems capable of involving straight-forward transactions to such a considerable extent that a decision which may encourage the substitution of something better need not be a matter for regret."[27]

Section 42 FA 1981 introduced subsection (9) into section 451 ICTA 1970.[28]. It reverses the Pott's Executors decision in relation to any direction given or assignment made or any capital sum paid to the settlor after 5th April 1981.

The next case to be considered by the Courts on these provisions was one in which a completely innocent taxpayer, carrying out a sensible and reasonable transaction, had a very large surtax liability imposed when, had the taxpayer been minded to avoid the

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26. See p236
27. ibid
28. Now section 677(10) which is set out supra

application of the section, it would have been very easy to do so. Every Judge who considered the case, expressed regret that he was forced to find for the Crown. The case IRC -v- De Vigier[29].

The taxpayer's wife was a trustee of a settlement executed by the taxpayer in favour of his children. The trust fund included shares in a company. In September and October 1957, the taxpayer's wife advanced £7,000 to the trustees to enable them to acquire further shares in the company. In May and August 1958, the trustees repaid to her £2,500 and £4,500 respectively out of the income of the trust. The taxpayer was assessed to surtax on the footing that the sums so paid to his wife were paid by way of repayment of loans, and were therefore "capital sums" within the meaning of what was then section 408 ITA 1952. The taxpayer contended that the sums made available by his wife to the trustees were not loans. However, all of the courts up to and including the House of Lords held that the payments by the trustees to the taxpayer's wife were repayments of a loan.

In the Court of Appeal, Russell LJ noted that the taxpayer had maintained that the proper inference to be drawn from the facts was that the arrangement did not involve a contract of loan, but was properly described as merely a placing of her own money by the taxpayer's wife to the credit of the trust account in reliance upon such rights as equity might confer upon her as a result. Russell LJ disagreed, saying that, in his view, the trustees needed money to buy shares and that they might have borrowed from a bank, but, instead it was arranged that they would borrow from the taxpayer's wife.[30] The payments by the wife to trustees had to be regarded in the ordinary sense of the word as loans and, accordingly, the sums paid to her by the trustees were sums paid by way of a repayment of a loan.

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29. (1964) 42 TC 24
30. p33

Russell LJ concluded his judgement by commenting that "the regrettable fiscal consequences must follow" from the above finding. He continued:

> "I say 'regrettable' in this case because I do not detect any device for the avoidance of tax, and it would seem that, under section 405, income of the trust attributable to this loan while it was outstanding would be treated as income of the settlor for tax purposes. Had the money been borrowed by the trustees from the bank on the wife's guarantee, she would not have made the loan. Had she simply waited longer for payment for her own shares, and paid for the other shares acquired direct to the vendor or to the issuing company, she would not have made a loan. If she had been the sole trustee, I would not think it could have been described as a loan. In truth, the provision in section 408 is a stop-gap against possible evasions of section 407.[31] As is not uncommon in taxing statutes, the pit (to change the metaphor) dug by the Legislature, is perhaps inevitably, wide enough to catch the unwary innocent, and I think that that has happened here to the settlor and his wife."

In a similar vein, Donovan LJ commented that he did not know why it was considered necessary to press the full rigor of section 408 against the taxpayer. He accepted that the Inland Revenue have no express discretion in the matter, but the wide terms of section 5(1) ITA 1952[32] have, in the past been treated by the Revenue as sufficient.[33]

In fact, it seems that the Revenue had no statutory power to alleviate the hardship caused by the section in this case. This was the view of Lord Reid[34] but, of course,

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31. Section 407 ITA 1952, now section 676 ICTA 1988
32. Now section 1(1) TMA 1970
33. p34
34. p35

there are many examples of Extra Statutory Concessions and it would have been equitable for the Revenue to grant concessionary relief to a completely innocent taxpayer such as the one in this case, as well as being a useful public relations move as compared with their determination to apply the Act to a taxpayer who had no intention to avoid tax.

Lord Reid restricted himself to agreeing that the taxpayer's appeal must fail and that there was no suggestion that the taxpayer or his wife was trying to avoid tax and he noted that "the transaction which has attracted tax liability was one which would never suggest that possibility to any one unless he was familiar with income tax law."[35] A similar comment was made by Lord Upjohn who said:

> "It would surprise anyone not expert in income tax matters to learn that this seemingly sensible capital transaction, obviously designed to overcome the temporary lack of cash in the trustee's bank account, has in fact attracted an additional assessment of surtax upon the [taxpayer] in the sum of £12,174, that being the grossed up sum which, after the deduction of income tax at the standard rate for the year, would amount to £7,000."[36]

Lord Reid's other comment sounded a warning to trustees. He noted:

> "I realise that if legislation is to be effective to forestall attempts at evasion it must often be drafted in terms so wide that it can apply to a variety of quite innocent transactions. So one could only say that it is very unwise for anyone unfamiliar with income tax law to depart from the beaten paths of trust administration in any case

35. ibid
36. p39

where the settlement involves or provides for accumulation of income, without first obtaining an opinion from Counsel experienced in income tax matters."[37]

To this it can be commented that the transaction, referred to by Lord Upjohn as a "sensible capital transaction" was not, to any great extent, departing from the beaten paths of trust administration, and it would be a grave indictment of this section if it interfered with the proper administration of trust affairs to such an extent that trustees had to refer to Tax Counsel at every turn.

Lord Evershed shared the regret expressed by Russell and Donovan LJJ at being forced to find for the Crown in this case.[38] He also made the valid comment that, had the taxpayer's wife had it in mind to avoid the pit dug by the Legislature, she could easily have done so but, in her innocence, she had taken action which unfortunately brought her within the ambit of the section.

Lord Pearce said that there is an inclination to limit the application of section 408 to the cases which it was primarily intended to catch, and to exclude cases like the present one where its application creates unfairness. But, he said, how can that be done without drawing some technical and artificial line which would defeat the whole intention of the section. He made the point that, if the operation of the section is excluded simply because the transaction in question was a nebulous and casual one, or because, as was the case, the trustees had no actual power to borrow, then every person wishing to avoid this section could do so by making his transaction nebulous and casual or by lending to a settlement which had no power to borrow. He said that the section was not intended to have so limited an application.[39]

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37. p35
38. ibid
39. p37

On the point that the trustee did not have power to borrow, Lord Pearce commented:

> "I cannot accept [Counsel for the taxpayer's] argument that 'a loan' must be a loan that is properly made within the powers of the persons concerned, or that no loan exists or should be implied where equity will regulate the rights of the persons making and receiving the advance and will impose some more limited right of repayment. Equity can only thus regulate the rights on the basis of some agreement, express or implied, to repay. Otherwise Equity would treat this payment as a gift by the mother to her children. Where the circumstances of a payment clearly indicate an intention by all concerned that there should be repayment, the Court can properly infer that the money was lent. The precise legal rights of the persons concerned as between one another do not destroy the nature of the transaction and make it cease to be a loan."[40]

The section next came under fire from the Courts in IRC -v- Bates[41] The facts were that the taxpayer was a director of a company. In 1948 and 1950 he settled shares in the company on trusts for the benefit of his children. No income arose from the shares before 1953/54 and the income for the years 1953/54, 1954/55 and 1955/56 was £3,610, £3,158 and £3,201 respectively, all of which was accumulated. In April of each of the years 1950 to 1954 the company paid sums in the region of £8,000 to £10,000 to the taxpayer or, when his current account at his bank was overdrawn, to his bank for his credit. In particular, it paid him £9,100 on 5th April 1954. These sums were debited to the taxpayer's current account with the company, which, in consequence, until June 1954 was overdrawn each year for most of the company's accounting

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40. ibid
41. (1966) 44 TC 225

year to 31st March to the approximate extent of the sum debited in the preceding April, but was brought into credit each year by a cheque from the taxpayer shortly before 31st March.

The taxpayer was assessed to surtax for the years 1953/54 to 1955/56 on the basis that the sums paid to him by the company in 1953/54 were capital sums paid by a body corporate connected with the settlement and, under section 408 ITA 1952, the grossed up equivalent failed to be treated as his income to the extent of the undistributed income of the settlements.

The taxpayer appealed contending that the sums paid by the company were not "capital sums" within the meaning of section 408; that "relevant year" in section 408(2)(a)[42] was, but "relevant year of assessment" in section 408(1)[43] was not, to be construed by reference to section 408(7)[44], with the result that, after deduction under section 408(2)(a) capital sum of £8,586 paid to the taxpayer on 4th April 1952, there was within the meaning of section 408 no "income available up to the end of" 1953/54, 1954/55 or 1955/56. It was further contended that the capital sum paid on 4th April 1952 could not be taken into account because the company was not shown to have been a body corporate connected with the settlement in 1951/52.

Although Plowman J found in favour of the taxpayer, the Court of Appeal allowed the Crown's appeal despite the by now customary expressions of regret. Indeed, Russell LJ said:

> "I would be content myself to give the taxpayer every possible chance to get out of this section if he can."[45]

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42. Now section 677(2)(b) ICTA 1988
43. Now section 677(1) ibid
44. Now section 677(9) ibid
45. p252

When the question of whether leave should be given for an appeal to the House of Lords, Counsel for the taxpayer pointed out, quite correctly, that a man who has the prudence to take advice before acting can avoid the operation of the section; its only the person who carries on in a perfectly straightforward fashion who gets caught by the section.[46]

The House of Lords dismissed the taxpayer's appeal and the Law Lords, once again, voiced severe criticisms of the section.

Lord Reid noted:

> "The case against the [taxpayer] is that section 408 requires that the sum of £9,100 shall be treated as the income of the [taxpayer] to the extent therein provided. The section requires that any loan to the settlor by 'any body corporate connected with the settlement' shall be treated as having been paid by the trustees of the settlement and the definition in section 411(4)[47] of 'body corporate connected with the settlement' is so wide that in my opinion it must be held to include this company although there was in fact no connection whatever between the company and the settlement beyond the fact that the settlement trustees held some shares of the company, and the [taxpayer] had no intention of gaining any tax advantage and in fact gained none by taking this loan from the company."[48]

He called this a "startling proposition" but one which he had to uphold. He later said that section 411(4) was so widely drawn as to be a trap for the innocent but this did not entitle a Court to attribute to any of its

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46. ibid
47. See now section 681(5) ICTA 1988
48. p258

provisions a strained or unnatural meaning so as to make it impotent in those cases where tax avoidance is attempted.[49]

Referring to the section in general, Lord Reid noted that, as the Pott's case had shown, in at least one respect it was too narrow; and in other respects it is too wide.[50] He said that its provisions suffered from "two glaring defects". The first was that they imposed heavy liabilities in the case of many kinds of ordinary and innocent transactions "which no laymen and indeed few lawyers not familiar with this section would ever imagine could be caught in this way - in short, they are a trap". Secondly, the provisions are framed in such a way that their plain meaning in many cases leads to a result which could be called "monstrous". He pointed out that normally when the Courts construe a statute, they are attempting to discover the intention of Parliament from the words used in the act. But here, he said, it was obvious that Parliament could never have intended some of the results which were inescapable if certain of the provisions of the section were not to be disregarded. But the Courts could not apply a statutory provision in one way in cases where it creates injustice and in a different way in cases where it serves to defeat attempts to avoid tax.

Lord Reid considered the computational of difficulties inherent in the provisions. He noted that section 408(3) enacted that a loan to the settlor by a company connected with the settlement in the year in which it was made must be treated as having been made by the trustees of the settlement in that year. Accordingly, the £9,100 must be treated as having being paid by the trustees to the taxpayer on the last day of 1953/54, although the trustees did not, in fact, have such a sum available.

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49. p260
50. p260

Subsection (1) then provided that the payment, to the extent that there was undistributed income, should be treated as the income of the settlor for that year. He pointed out that this clearly meant that the taxpayer must pay both *income tax and surtax on it* but the taxpayer here had only been issued with an assessment to surtax. Counsel for the Crown admitted that it had been the practice not to demand income tax in these cases because that would be wholly unjust and involve double taxation. Lord Reid noted that the Crown were unable to suggest any construction of the words of the section which would justify this concession.[51]

Lord Reid then continued:

> "The next point is the extent to which the loan is to regarded as the settlor's income in any year. Sub-section (1)(a) deals with the first year, 1953/54. For that year the assessment is £3,607; that can be reconciled with the words of the Act. But for the next year the assessment of £3,165 has been arrived at by a method which bears no relation to the method prescribed by the Act. That is admitted, and again the reason is given that to follow the prescribed method would lead to injustice and double taxation. The draftsman has chosen such a complicated method that he has obviously failed to realise the absurd results to which it leads in all but the simplest cases - and, I think, in almost every case where the trust income has to be accumulated; so the Inland Revenue have taken it on themselves to disregard the statute and substitute a method which they think fair and, if I understood Counsel rightly, in accord with the spirit of the Act. I can, I hope, explain the difference in this way. Suppose loans of £20,000 are made by the connected company in year one, which is the first in which the trustees receive income. That, after

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51. pp261-2

making the calculations in sub-section (2)(b) and (e), is £3,000. That £3,000 is added to the settlor's income for year one. It is the calculation directed for year two which gives rise to the absurdity. Suppose the trust income in year two to be £2,000, then the 'available income' up to the end of year two is the sum of the incomes of years one and two, i.e. £5,000, because there was a direction to accumulate. And if in year three there is a trust income of £3,000 the 'income available' at the end of that year is the sum of the incomes for years one, two and three, i.e. £8,000. In year two £5,000 will be treated as the income of the settlor and in year three £8,000 will be treated as his income, so, although the trust income for the three years was only £8,000 in all, the settlor's income for those three years will be regarding as increased by £3,000 plus £5,000 plus £8,000 i.e. £16,000, or double the whole trust income. It is not surprising that Russell LJ called this 'monstrous' and that the Inland Revenue refuse to apply sub-section (2) as it stands and have devised a scheme which appears to avoid this particular injustice. But the fact that the Inland Revenue have chosen to assess for a smaller sum than the terms of the section would appear to justify does not entitle us to hold that the assessment is bad."

Lord Reid then noted that, whereas section 408(2)(a) refers to a sum paid "in any relevant years" section 408(1) refers to a sum paid "in any relevant year of assessment". He pointed out that it was argued that, although 1951/52 was a "relevant year", it was not "a relevant year of assessment", because, on the facts, there could have been no assessment under the section in that year. He continued:

> "It is, of course, an elementary principal of drafting that different expressions should not be used in different places in the same section to express the same meaning. So there is a presumption that these two expressions do not mean the same thing. But that is only a presumption, and if it is applied in this case it leads to an absurd result. So I am forced to the conclusion that this difference of phraseology is only another example of the thoroughly bad draftsmanship of this section."[52]

Lord Reid then drew attention to what he called "the very unsatisfactory state in which the law has been allowed to remain" since the decision of the House of Lords in the Potts case sixteen years earlier. He then finished his judgement by saying:

> "But when [Potts] was decided against the Crown, nothing was done to amend the section. In the present case it appears that in five different years payments were made by the company for the purpose of discharging the [taxpayer's] debt to his bank. In three cases these payments were made direct to the bank, and Potts' case shows that they were not caught by section 408. But it so happened that in the other two years the payments were made by cheques drawn in favour of the [taxpayer] and not in favour of the bank. It is this fortuitous circumstance alone that it was brought the [taxpayer] within the scope of section 408 and imposed on him tax liability for several thousands of pounds. This case may well afford ammunition to that body of opinion which holds that re-drafting of the Income Tax Act ought to be taken out of the hands of those at present responsible."[53]

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52. p262
53. pp262-3

Lord Morris also regretted the fact that the provisions had been allowed to remain in "an unsatisfactory state".[54]

On the question of whether the loans were capital sums, Lord Guest commented:

> "It was argued for the [taxpayer] that the expression 'being a sum which is not paid for full consideration in money or money's worth' qualified, not only the opening words of paragraph (2) but also the whole of paragraph (1) so that the section would read 'any sum paid by way of loan or repayment of a loan, being the sum which is not paid for full consideration in money or money's worth'. In my view, this is not a tenable construction and it involves a contradiction of terms. A loan in made in respect of an obligation to repay and could not by its very sense be 'for full consideration in money or money's worth.' A obligation to repay is not 'money or money's worth'. Next it was suggested these sums were not loans but were payments passing in the course of a running account between the company and the [taxpayer]. Even if they were, the sums were, in my opinion nonetheless loans. I pose the rhetorical question - 'If those sums were not loans, what were they?'."[56]

Lord Wilberforce added his voice to the other Law Lords in criticising the section. He said that, in several respects, there were "grave defects" in section 408(2), particularly with regard to the aggregation of income, as particularly explained by Lord Reid and Lord Guest. He said that these defects were "over-ripe for correction". He concluded:

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54. p265
55. In section 408(7) ITA 1952
56. pp265-6

> "The Crown has very fairly not taken advantage of these deficiencies which might indeed lead to exorbitant surtax claims but, in matters of taxation, administrative moderation, though not to be discouraged, is, except in the short-term, no real substitute for legislative clarity and precision."[57]

Despite these severe criticisms of the section by House of Lords, it is forty years since the deficiencies of the section were first exposed in the Potts case and the provisions are still on the statute book.

It is interesting to note an exchange that took place in the House of Commons following the House of Lords decision in the Bates case. Mr. More asked the Chancellor of the Exchequer what steps he would take to correct the apparent injustice of the present law in view of the observations of the House of Lords in the Bates case. The Financial Secretary of the Treasury, Mr. Nial McDermott said that the observations of the House of Lords were being considered. Mr. More then replied:

> "Does not the Chancellor think that this is something of a scandal? Fifteen years ago attention was drawn by the House of Lords of the unsatisfactory state of the law. In those fifteen years, nothing has been done."

Mr. McDermott was either completely naive or totally unaware of the true position when he replied:

> "I am not prepared to accept the Honourable Gentleman's strictures, but it is perhaps better that I reserve comment until our consideration of those observations is completed."

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57. p272

This drew the following comment from Margaret Thatcher:

> "While the Financial Secretary is considering this case, would he also consider whether he should publish the basis upon which the Inland Revenue has been invoking these sections and the basis on which it has left them alone? He will recollect that it has not invoked sections 408 and 411 on all occasions."

Mr. McDermott again reply with a comment which showed his apparent total ignorance of the true position:

> "Again, I do not accept what the Honourable Lady says. There are different interpretations of this section which have been advocated by various people and the Inland Revenue has never sought to interpret the section in the way in which some people have suggested it can and should be and criticise the section consequently."[58]

It is apparent that Mr. McDermott, and those who were advising him, had not analysed the section or the judgements of the House of Lords in the Bates case, unless his was a not untypical evasive answer from a politician. Needless to say, the "consideration" of the observations of the House of Lords in the Bates case did not lead to the much needed overhaul or abolition of the section.

Three months after the House of Lords decision in the Bates case, the Court of Session decided the case of McCrone -v- IRC[59]. In 1946 the taxpayer executed a settlement in favour of his three daughters, with power to the trustees to accumulate income. In 1958, at the taxpayer's suggestion, the trustees advanced to him

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58. Hansard Volume 739, No 128, Col 1258, March 1967
59. (1967) 44 TC 142

£45,000 at a rate of interest of 6%, out of the accumulated income. The advance was satisfied by the transfer to the taxpayer of securities valued at £45,100, the balance of £100 being refunded by him. The advance was secured by a bond on a farm belonging to the taxpayer and it was repaid in November 1964.

The taxpayer was assessed to surtax for 1958/59 on the sum of £45,000, grossed up at the standard rate of income tax, as being the sum paid to him by way of loan within section 408. The taxpayer argued that the transfer of securities was not a payment of a capital sum within section 408; and, alternatively, that the trustees motive was investment of trust funds and therefore the payment to him was not by way of loan. He also contended that a secured loan was not a loan for the purposes of section 408(7). The Court of Session dismissed each of these contentions.

That the Revenue sought to apply the full rigour of the section in this case was undoubtedly correct from a strict statutory point of view, but the facts of the case suggest that such treatment was totally inequitable. The Stated Case of the Commissioners shows that, at the relevant time, the taxpayer was borrowing from his bank at 6%, so that the rate of interest payable by him to the trustees was the same as that which he was paying to the bank. The trustees could not get that rate of interest on gilt-edged securities and the trustees regarded the transaction simply as an investment of trust funds, and it was admitted on behalf of the Revenue that, from the point of view of the trustees, this was what it was.[60]

On the question of whether there was a "capital sum", it was clear on the facts that the arrangements did provide for a loan of £45,000 and that the trustees, in order to

60. p144

fulfil their obligation to lend to the taxpayer, transferred to him securities of the relevant amount.[61]

The argument that "loan" referred only to an unsecured loan was, of course, a hopeless point. The Lord President (Clyde) commented:

> "I can see no warrant in this section for this contention. If Parliament, for some inscrutable reason, had intended to exclude from the preview of the section secured loans, a qualification to that effect would have been necessary in the Act. I can find none."[62]

At this point, mention should be made of the case of IRV -v- Wachtel[63], which has been considered above in connection with section 673 ICTA 1988.[64] The taxpayer was also assessed, on an alternative basis, under section 408 ITA 1952. The Special Commissioners, however, held that the trustees had not paid the taxpayer any capital sum, so that section 408 did not apply. Goff J agreed, following the Potts case. The payments by the trustees in reducing their overdraft were capital payments, but they were not made directly or indirectly to the settlor within section 408.

Counsel for the taxpayer had relied on the theory of accountability set out by Lord Normand and Lord Oaksey in the Potts case.[65] Goff J accepted that the bank was not in law accountable to the taxpayer here but he said that this did not prevent the loans from being paid either directly or indirectly to him. Indeed, he pointed out that Lord Normand had said[66] that the fact that payment

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61. See, for example, The Lord President (Clyde) at p147 and Lord Gutherin at pp148-9
62. p147
63. (1970) 46 TC 543
64. See Part 6, supra
65. Supra
66. 32 TC at p229

to an agent or person accountable is in law a direct payment is no reason for reading "indirectly" in any wider sense. Goff J then continued:

> "When, however, the expression is applied not only to 'payment' but to 'application for the benefit of', the words have, I think, a wider significance. Paying the settlor's bills could well be a payment to a person not accountable, yet it would be directly or indirectly for the benefit of the settlor though it would not be a payment indirectly to him."[67]

He therefore held that the Special Commissioners finding that section 408 did not apply, was correct.

The final case to consider is Piratin -v- IRC[68].

In 1967, the taxpayer and his wife each made identical discretionary settlements and the taxpayer transferred to the trustees of his settlement shares in a close company, SPL Limited. In 1967 and 1968, the taxpayer maintained a running account with SPL, paying in a total of £21,300 and withdrawing a total of £20,000. In November 1968, the trustees of both settlements placed trust monies on deposit with Oceanic Credit Corporation Limited, another close company. On 11th November 1968, the taxpayer and his wife each placed personal monies on deposit with Oceanic. On 30th March 1972, the taxpayer and his wife directed that the sums held in their names by Oceanic be transferred to Burton Finance Company Limited where the monies were again held on deposit in their respective names. On 30th June 1972, the trustees of each settlement withdrew their deposits from Oceanic.

During the years 1967/68 to 1972/73 inclusive, the trustees of each settlement used the income of the funds

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67. p559
68. (1981) 54 TC 730

to pay the premiums on whole life assurance policies on the life of their respective settlors. In addition, the trustees of the wife's settlement used the income to pay the premiums on a five year term policy on the life of the wife.

The taxpayer was assessed to surtax under what was then section 451 ICTA 1970 on the grounds that the withdrawals from the running account with SPL and the transfer from Oceanic to Burton constituted repayment of loans directly or indirectly to the taxpayer and his wife by bodies corporate connected with the settlements and, also, that the premiums on the life assurance policies were not expenses of the trustees to be deducted in estimating the income of the settlements available for distribution.

The question of the running account was referred to as the "SPL issue", and the transfers from Oceanic to Burton as the "Oceanic issue".

Slade J found for the Crown on the SPL issue, applying the Bates case; and for the taxpayer on the Oceanic issue after referring to the accountability question raised in the Potts and Wachtel cases. He also held that the assurance premiums were not expenses of the trustees properly chargeable to income in the absence of any express provision in the settlements, but this third finding is not considered further here.

Slade J first dealt with the Oceanic issue. He recited in detail a number of the crucial facts. It was common ground that, as from the date of the payment by Oceanic to Burton, Burton held over £14,000 to the order of the taxpayer and over £22,000 to the order of his wife, and that these sums were "available to them on demand". He noted that the Crown did not contend that, in paying the sums to Burton, Oceanic gave it specific instructions *that it should transmit those* sums to the taxpayer and his wife. Slade J said that, if such instructions had been given, the payments must have constituted "payments to" them within the section.[69] The Crown also did not contend that, upon receipt of the sums, Burton held them as agent, trustee or nominee for the taxpayer and his wife. Accordingly, it was common ground that, upon receipt of the monies from Oceanic, Burton became both the legal and beneficial owner of those sums, but immediately upon receipt and at all subsequent times, Burton was under a contractual obligation to the taxpayer and his wife to pay them the equivalent sums on demand. The Crown submitted that these circumstances were sufficient to support the contention that, by virtue of the payment by Oceanic to Burton, the sums were "paid indirectly" to the taxpayer and his wife. Slade J formulated the question in the following way:

> "If A has paid a sum of money direct to B, can the sum properly be said to have been "paid indirectly" by A to C within the meaning of section 451, solely because B on receipt of the money was under a contractual obligation to C to pay an equivalent sum to him on demand?"

The judge considered that there was clear guidance on this issue in the Potts case.

Slade J referred to the views of Lord Simonds in the Potts case on payments made "indirectly"[70]. Slade J then commented:

> "In the present case, the monies received by Burton were received by it for its own use and benefit, even though it was subject to the contractual obligation to which I have referred. It is not

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69. p747
70. supra

suggested that the settlors had power to control the use or disposition of these monies in any way; all that they had were their personal contractual rights. If, therefore the opinion of Lord Simonds as the force of the phrase 'or indirectly' was correct and of general application, the Crown's contention in the present context must be ill founded."[71]

He then referred to the statements of Lord Normand and Lord Oaksey on the question of accountability. Slade J concluded from these statements that:

"One thus finds both Lord Normand and Lord Oaksey expressing the opinion in the Potts case that a sum cannot be said to be 'paid indirectly' to the settlor within the section, unless it is paid into the hands of someone accountable to him. It is common ground that the word 'accountable' in an English law sense is not apt to describe the position of a person who is under a mere contractual obligation, such as that owed by Burton to the two settlors. ... It follows that, if the opinions of Lord Normand and Lord Oaksey as to the force of the phrase 'or indirectly' in the context of the section were correct and of general application, the Crown in the present case must fail on the Oceanic issue."[72]

On this issue, Slade J concluded:

"It may be added that, as [Counsel for the taxpayer] pointed out, this is for practical purposes a penal subsection. As will appear from a later part of this judgement[73], even when it is applied according to the fair meaning of the words used, it is still in my view capable of producing some results very

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71. p748
72. p749
73. In relation to the SPL issue.

harsh to the taxpayer. If the Legislature had intended to provide that in certain circumstances monies should be deemed to have been paid to a settlor, even though in fact nothing had been paid to him, the Act could have made express provision for this. It is, I think, quite apparent from what Lord Normand, Lord Oaksey and Lord Simonds said in the Potts case that they would not have regarded the payments in question in the present case as having been paid 'directly or indirectly' to the settlor within the meaning of the subsection. Even if the opinion of Lord Simonds was expressed obiter, the opinions of all three of their Lordships are entitled to great respect. I have not been convinced that they were incorrect. Goff J, in the Wachtel case ... having referred to what he described as Lord Normand's and Lord Oaksey's theory of accountability, expressly applied this theory and concluded that the fact that the bank in that case was not in law accountable to the settlor prevented the loans from being paid either directly or indirectly to him. I likewise propose to follow Lord Normand and Lord Oaksey, which means that on the Oceanic issue the appeal must succeed."[74]

Turning the SPL issue, Counsel for the taxpayer pointed out that, if section 451(1) applied, where capital sums have been paid to a settlor in the course of operating the running account, then on the facts of cases such as the present one, where the settlor has been putting money into a company and then taking it out, a literal application of the section would result in the amount of the loan repayments to him being deemed to be a figure far in excess of the income of the trust or of the company concerned. He also pointed out that, in the present case, during the first year of assessment in

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74. p751

question, the taxpayer actually put more into the company than he drew out of it. Accordingly, the result of a literal application of the wording of section 451(1) would be that, every time the settlor paid money into the company and then withdrew it, his potential liability to tax under section 451(1) would be multiplied - a liability which could extend for many years to come, having regard to the words "and so on" at the end of the sub- section. Counsel for the taxpayer submitted that Parliament could not have intended such an unjust and capricious result and suggested that the problem could be solved in construing the words "capital sum" in the context of the sub-section as referring merely to the balance at the end of the relevant year of assessment.

Slade J said that he had some sympathy with the submission but that he could not accept it. The plain words of the sub-section did not allow such treatment. He said that a Court would be justified in reading into the sub-section a mitigating qualification as a matter of construction, only if it was fully satisfied as to the nature of the qualification which Parliament must have intended.[75] The mere fact that a provision may be thought by the Court to produce an injustice does not, in his view, entitle it to re-write the provision in the course of interpretation. He therefore concluded:

> "With some regret, therefore, I must reject [Counsel for the taxpayer's] submission that the payments to [the taxpayer] by SPL fall to be treated any differently because they were payments made in the course of the operation of a running account."

Some, but by no means all, of the problems with section 677 were dealt with in 1981. Section 42 FA 1981 amended what was then section 451 ICTA 1970. The amendment blocking the loop-hole exposed in the Potts case and

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75. p754

Piratin has already been mentioned. Following section 42, a capital sum is attributed to income of the settlement in the year in which the capital sum is paid and in subsequent years up to a maximum of ten years. A capital sum constituted by a loan to the settlor will not be caught in years of assessment after that in which the settlor repays the loan. Another amendment gives the settlor credit for any basic rate or additional rate tax charged in respect of the amount treated as his income.

Section 42 FA 1981 inserted a new section, section 451A ICTA 1970[76] replacing section 451(4) in relation to a capital sum paid to the settlor after 5th April 1981. This section says that, the settlor will be treated as having received a capital sum within section 451, where a company which is connected with the settlement pays a capital sum to the settlor within five years before or after receiving an associated payment from the settlement. Loans repaid within 12 months will be exempt provided that the total period of credit for all loans over a five years period does not exceed 12 months.

Despite the changes relating to capital sums paid by a body corporate connected with the settlement, there is still plenty of scope for innocent taxpayers to be caught. For example, a settlor who has a running account with a company could fall within section 678 if the settlement lends money to company.

It is nothing short of a disgrace that this appallingly badly drafted legislation has been left on the statute books so long after it flaws were exposed and so severly criticised by the House of Lords. The 1981 amendments went some way to patching up these provisions but the fact remains that innocent taxpayers will continue to be caught, whereas those taxpayers who can pick their way through the tangled language of the sections and plan

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76. Now section 678 ICTA 1988

their transactions accordingly, will often be able to escape the clutches of the legislation.

Legislation drafted in this way should have no place on the statute books.

PART 8

EXCESS LIABILITY OF THE SETTLOR IN CERTAIN CASES

The immunity provided by section 20(1)(a) FA 1922 to settlements of income for a period which are capable of exceeding six years was partially restricted by section 28 FA 1946. This section provided that payments were not to be deductible by the settlor for surtax purposes unless, under the deed, the payments:

(1) were made to an individual for his own use; or

(2) were applicable for the benefit of one or more individuals named in the deed; or

(3) were applicable for the benefit of a child or children of an individual named in the deed,

and even in these cases, not if the individual or child, as the case may be, was in the service of the grantor or accustomed to act as his solicitor or agent. This provision therefore superseded the decision in Duke of Westminster -v- IRC[1].

This section, on consolidation, became section 415 ITA 1952. This section was amended by section 12 FA 1965 and by section 23 FA 1966, in each case in respect of settlements made after 6th April 1965. On the 1970 consolidation, the provisions relating to settlements made on or after 10th April 1946 (the date when section 28 FA 1946 came into operation) but before 7th April 1965 were re- enacted in section 458 ICTA 1970.[2] The provisions relating to settlements made after 6th April 1965 became section 457 ICTA 1970.[3]

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1. (1935) 19 TC 510, see Chapter 11
2. Now section 684 ICTA 1988
3. Now section 683 ibid

For a case concerning the question whether a new compound settlement had been created as a result of a second deed executed after 10th April 1946, so that the relevant settlement was one made after that date, see the case of Scott -v- IRC[4].

Section 684 ICTA 1988 now states:

"(1) Where, during the life of the settlor, income arising under a settlement made before 7th April 1965, but after 9th April 1946, is, under the settlement and in the events that occur, payable to or applicable for the benefit of any person other than the settlor, then, unless under the settlement and in the said events, the income either -

(a) is payable to an individual for his own use, or

(b) is applicable for the benefit of an individual named in that behalf in the settlement or of two or more individuals so named; or

(c) is applicable for the benefit of a child or children of an individual named in that behalf in the settlement; or

(d) is income from property of which the settlor has divested himself absolutely by the settlement; or

(e) is income which, by virtue of some provision of the Income Tax Acts not contained in [Chapter IV Part XV ICTA

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4. (1957) 37 TC 486, see Part 4, supra

1988], is to be treated for the purposes of those Acts as income of the settlor;

the income shall, for the purposes of excess liability, be treated as the income of the settlor and not as the income of any other person.

(2) In subsection (1) above 'excess liability' means the excess of liability to income tax over what it would be if all income tax were charged at the basic rate to the exclusion of any higher rates.

(3) The exceptions provided for by paragraphs (a), (b) and (c) of subsection (1) above shall not apply where the named individual or individuals or, in the case of paragraph (c) either the named individual or the child or any of the children in question, is in the service of the settlor or accustomed to act as the solicitor of agent of the settlor."

Section 685 sets out circumstances in which a settlor shall not be deemed to have divested himself of property for the purposes of section 684. It says:

"(1) ...*the* settlor *shall* not *be* deemed *to* have divested himself absolutely of any property if that property or any derived property is, or will or may become in any circumstances whatsoever, payable to or applicable for the benefit of the settlor or, in the case of a settlement made after 6 April 1965, the wife or husband of the settlor"[5]

"(2) .....the settlor shall not be deemed not to have divested himself absolutely of any property by reason only that the property or any derived property may become payable to or applicable for the benefit of the settlor, or, in the case of a settlement made after 6 April 1965, the wife or husband or the settlor in the event of -

(a) the bankruptcy of some person who is or may become beneficially entitled to the property or any of the derived property; or

(b) an assignment or charge on the property or any of the income derived property being made or given by some such person; or

(c) in the case of a marriage settlement, the death of both parties to the marriage and of all or any of the children of the marriage; or

(d) the death under the age of 25 or some lower age of some person who would be beneficially entitled to the property or the derived property on attaining that age."

Compare section 683.[6]

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5. The reference to settlements made after 6 April 1965, relates to settlements now within section 683 ICTA 1988 which is also subject to the provisions of section 685 ibid.
6. infra

Section 458 was considered in Vandervell -v- IRC[7]. The taxpayer controlled a private manufacturing company with an issued capital of £1,055,500 divided into four classes of shares. There were 600,000 ordinary shares of 5 shillings each, and all but two of these were owned by the taxpayer, and these shares gave him control of the company, including dividend control. There were also 100,000 A ordinary shares of 5 shillings each, 2,600,0000 B ordinary shares of 5 shillings each and 230,000 5% cumulative preference shares of £1 each. The B ordinary shares were held as to 20% by the taxpayer, and as to 80% by a trustee company. Nearly all the preference shares were held by four insurance companies. The trustee company was a private company with the principal object of acting as a trustee, and its 100 shares of £1 each were held almost equally by three persons who were the taxpayer's advisers and friends, and the three shareholders were also the directors of the trustee company. The principal function of the company was to act as trustee of a settlement which the taxpayer had made in favour of his children in 1949.

In 1958 the taxpayer became interested in an appeal made by the Royal College of Surgeons for the founding of a chair of pharmacology. At the time the 100 A ordinary shares were registered in the name of a bank as trustee of the deeds securing annual payments to the taxpayer's former wife. The deed entitled the taxpayer, with his former wife's consent, to substitute other security and for some time negotiations had been going on for that to be done. The purpose of these negotiations was to ease the estate duty position that would occur on the taxpayer's death, and to that end, to float the manufacturing company as a public company at some time.

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7. (1966) 43 TC 519

On 29th December 1958, there was a meeting between the taxpayer, one of his advisers and the Appeals Secretary of the Royal College of Surgeons as to how the £150,000 required for the founding of the Chair of Pharmacology should be provided. The taxpayer's advisers suggested that the taxpayer should transfer the 100,000 A ordinary shares, and that dividends therefrom to provide the £150,000 should be declared. The taxpayer agreed to this suggestion, and left the matter to the adviser to arrange. On 5th November 1958, a deed was executed, substituting the sum of £25,000 for the 100,000 A ordinary shares as security for the annual payments to the taxpayer's former wife, and by that deed the bank declared that it held the shares in trust for the taxpayer absolutely.

On the following day the taxpayer's adviser having formed the view that a public floating would be complicated if the 100,000 A ordinary shares were given outright, arranged that the College should give the trustee company an option to purchase the shares back within five years for £5,000. On 14th November 1958, the taxpayer wrote a letter to his adviser stating, "I have decided to give to the College the 100,000 A shares ... which have been released ... in exchange for the £25,000." The letter went on to request the adviser to arrange for the transfer of the shares to the college. On 19th November a transfer deed for the 100,000 A shares was executed in blank and it and the option deed were handed to the Appeals Secretary of the College. On 25th November the transfer deed was sealed by the College and also the option deed, and on the following day these documents were returned to the taxpayer's advisers. The adviser put the option deed in his private safe. In October 1961, the trustee company exercised its option, and paid the College £5,000 for the shares. In 1958/59 dividends to a total of £162,500 were declared on the shares and received by the college, and in 1959/60, a dividend of £87,500 was paid.

It was contended on behalf of the taxpayer that he had divested himself absolutely of all interest in the 100,000 A shares, and that he had done so before the dividends were paid. In support of this contention it was argued that the letter of 14th November 1958, from the taxpayer to his adviser, operated as an equitable assignment of the taxpayer's beneficial interest in the shares; alternatively that the taxpayer parted with all interest by procuring the option to be given to the trustee company, either beneficially or in its capacity as trustee of the children's settlement of 1949 so that, in the latter case, a presumption of advancement of the children arose. It was further contended that the grant of the option by the College was an independent voluntary act by the College, dealing with the shares as its own unencumbered property.

On the other hand, it was contended on behalf of the Crown that the taxpayer had not divested himself of all interest in the shares in that, by section 53(1)(c) of the Law of Property Act 1925, he could transfer the beneficial interest only in writing, and the letter of 14th November 1958 was not addressed to the bank in whose name the shares stood, nor to the College, but to an agent of the taxpayer. It was also contended that, if there had been a transfer of all interest in the shares to the College, the latter then held the shares as a bare trustee for the taxpayer.

Before Plowman J, it was also contended that any possibility of the proceeds of the shares becoming applicable for the benefit of the taxpayer within section 415(2) ITA 1952[8], was so remote as to be de minimis. The judge held that there was no room for the de minimis principal to operate in relation to section 415(2); and that the sums of £163,500 and £87,500 fell to be treated as the taxpayer's income for the years in question. He pointed out that the letter of 14th November 1958 was not

8. Now section 685 ICTA 1988

addressed to the bank nor to the College; it was addressed to the taxpayer's adviser. It was, in the circumstances of the case, not an equitable assignment of the shares.

As regards the option, Plowman J said that, at the time the option was given and at the time when the dividends in question were paid, it had not been decided what the ultimate fate of the option was to be. The option was really in cold storage until a decision was taken as to what was ultimately to happen to it. The result in law was that the option was held by the trustee company on a resulting trust for the taxpayer, whether the taxpayer wanted it for himself or not.

This left the de minimis point. The Judge said that it did not arise because, if the taxpayer had not in fact divested himself absolutely by the settlement from the property comprised in the settlement, the deeming provisions in section 415(2) did not arise. As there was a resulting trust of the option, the taxpayer could not have divested himself of the property comprised in the settlement absolutely and, therefore, it was not necessary to look beyond section 415(1)(d).[9] In any case, if section 415(2) was relevant, the language of the subsection, which included the words "may become, payable to him or applicable for his benefit in any circumstances whatsoever", was wide enough to include the negligible possibility that the proceeds of the shares would become applicable for the benefit of the taxpayer.

The taxpayer's appeal was dismissed by the Court of Appeal. Willmer LJ commented:

> "It was an integral part of the transaction - which it is agreed constituted a "settlement" within the meaning of section 411 of the Income Tax Act 1952 -

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9. Now section 684(1)(d) Ibid

that when the 100,000 A ordinary shares were transferred to the Royal College of Surgeons an option to repurchase them within five years was reserved to the trustee company. This in my judgement represented something subtracted from Mr. Vandervell's gift to the Royal College. I reject as wholly unrealistic the argument founded on the suggestion that it was the Royal College that gave the option to the trustee company. The true view that it was Mr. Vandervell who, as an integral part of the transaction, caused the benefit of the option to be vested in the trustee company. The trustee company gave no consideration but took as volunteers. This on well established principals gave rise to a rebuttable presumption that they held the benefit of the option on a resulting trust in favour of Mr. Vandervell. To my mind the only real question in the case is whether Mr. Vandervell has succeeded in rebutting this presumption, so that he can truly say that he 'has divested himself absolutely' of the property in the shares. Only so can he avoid being caught by section 415(1)(d) of the Act."[10]

Willmer LJ said that it was abundantly clear that the taxpayer personally never formed any intention at all. His intentions must be taken as that of his adviser, to whom he had given carte blanche, and who was himself a director of the trustee company. He said that it was quite impossible to contend that the presumption a resulting trust in favour of the taxpayer was rebutted.[11]

In the House of Lords, the Crown again won but, this time, only by a majority of three to two. The majority

10. pp544-5
11. p546

view was epitomised by Lord Upjohn. He said that there were two points to be considered. The first was that whether, notwithstanding the plain expressed intention of the taxpayer, the absence of writing prevented any equitable or beneficial interest in the shares passing to the College, so that, contrary to his wishes and understanding, the College remained a bare trustee for him. He said that this depended entirely upon the true construction of section 53(1)(c) of the Law of Property Act 1925. Lord Upjohn said that this section was directed to cases where dealings with the equitable estate were divorced from the legal estate. To hold the contrary would make assignments unnecessarily complicated; if there had to be assignments in expressed terms of both legal and equitable interests, that would make the section more productive of injustice than the supposed evils it was intended to prevent.

All five Law Lords were in agreement on the section 53(1)(c) point; it was on the second point that there was a difference of opinion. This second point was whether there was a resulting trust. Lord Upjohn said that this question was whether the trustee company held the option beneficially or as a trustee and, if the latter, upon what trusts. He said it was a very difficult matter to decide what was the proper inference to draw from the known facts.

There were three possibilities, namely:

(1) That the trustee company was intended to take as trustee for the children's settlement.

(2) That the trustee company should take beneficially, the taxpayer relying on his three friends and his advisers, the directors and holders of all the shares in the trustee company, to carry out his

wishes, which from time to time should be intimated to them in the way of a gentleman's agreement, but having no power at law to enforce them.

(3) The trustee company should hold as trustee upon such trusts as he or the trustee company should from time to time declare.

Regarding the first possibility, it had been faintly argued that there was a trust for the children's settlement, but Lord Upjohn could see no ground for it. It was the choice between possibilities (2) and (3) that caused difficulty.

What influenced Lord Upjohn in the end was that, throughout the correspondence in 1961, the taxpayer's advisers had been contending that the trustee company took the shares as trustees; and this was conceded before Plowman J. It was not suggested that the trustee company took it otherwise than on trust. The question was really one of inference from primary facts but, having regard to the way in which the matter had developed, Lord Upjohn was reluctant to differ from the lower courts. Accordingly, Lord Upjohn agreed with the conclusion of the Court of Appeal and Plowman J that the trustee company should hold on such intended trusts as might thereafter be declared.

Lord Pearce and Lord Wilberforce agreed with Lord Upjohn. Lords Donovan and Reid dissented because, in their view, the facts did not clearly establish a resulting trust.

Turning to the provisions now in section 683 ICTA 1988,they apply to settlements made on or after 6th April 1965 and rise out of amendments made to section 415 ITA 1952 by section 12 FA 1965 and section 23 FA 1966.

Subsection (1) now reads:

"Where, during the life of the settlor, income arising under a settlement made on or after 7th April 1965 is, under the settlement and in the events that occur, payable to or applicable for the benefit of any person other than the settlor, then, unless, under the settlement and in the said events, the income either -

(a) consists of annual payments made under a partnership agreement to or for the benefit a former member, or the widow or dependents of a deceased former member, of the partnership, being payments made under a liability incurred for full consideration, or

(b) is excluded by subsection (3), (6) or (9) below;[12] or

(c) is the income arising under a settlement made by one party to a marriage by way of provision for the other after the dissolution or annulment of the marriage, or while they are separated under an order of a court or under a separation agreement or in such circumstances that the separation is likely to be permanent, being income payable to or applicable for the benefit of that other party; or

(d) is the income from property of which the settlor has divested himself absolutely by the settlement; or

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12. Relating to covenanted payments to charity, annual payments made in connection with the acquisition of a business and annual payments to a former member of a partnership, or the widow or dependent of a former member.

(e) is income which, by virtue of some provision of the Income Tax Acts not contained in [Chapter IV of Part XV, ICTA 1988], is to be treated for the purposes of those Acts as the income of the settlor;

the income shall, for the purposes of excess liability, be treated as the income of the settlor and not as the income of any other person".

Subsection (2) states:

"In subsection (1) above 'excess liability' means the excess of liability to income tax over what it would be if all income tax were charged at the basic rate to the exclusion of any higher rate."

It can be seen that there are important differences in wording between this section and section 684. Furthermore, for the purposes of section 683, the settlor is not deemed to have divested himself absolutely of any property if that property or income from it is, or will or may become payable to or applicable for the benefit of the settlor's spouse.[13]

Reference is made above to an exception from the section 683 charge in relation to annual payments made under a partnership agreement to or for the benefit of a former partner or his widow or dependents. This was an amendment made by section 23 FA 1966. Another exemption mentioned above was introduced in 1966 and that is the one relating to annual payments made in connection with the acquisition of the whole or part of a business.

Except to the extent specified in sections 683 and 684, covenants were not effective for excess tax purposes, but, as far as basic rate tax is concerned, the

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13. Section 685(1) ICTA 1988

covenantor would be allowed a basic rate tax deduction, subject, of course, to the other anti-avoidance provisions dealt with above, in particular, the restrictions now contained in section 347A ICTA 1988.

It only remains to consider two relatively recent cases on section 683. The first is Ang -v- Parrish.[14] By two deeds of covenant, the taxpayer and his wife covenanted to pay certain sums in favour of their parents. The payments were made after deduction of tax at the basic rate under section 52 ICTA 1970.[15] The Revenue claimed that the sums paid under the covenants was, by virtue of section 454 ICTA 1970 "income arising under a settlement"[16] and that, accordingly, it was investment income within section 32(3) FA 1971 and fell to be included as such in the taxpayer's total income for the purposes of excess liability under what was then section 457.

The taxpayer appealed contending that, since for the purposes of section 457, the covenanted payments fell to be added back to his total income after having been deducted from it, there was, in effect, no deduction of the covenanted payments from his earned income and the payments remained as part of his earned income for the purposes of excess liability under section 457. The question whether the income was earned income or investment income was important then because, of course, the investment income surcharge applied to investment income.

Walton J held that, to ascertain the amount of the taxpayer's total income for the purposes of excess liability pursuant to section 457, it was necessary to add back the payments which had been made under the deeds

14. [1980[
] STC 341
15. Now section 348 ICTA 1988
16. See now section 681(1) ibid

of covenant. The payments were "income arising under a settlement" within section 454 and, accordingly, were "investment income" within section 32(3) FA 1971. It followed, therefore, that the payments, when added back to the taxpayer's total income by virtue of section 457, formed part of his investment income.

Walton J said that:

> "The whole question is whether what started out as part of the taxpayer's earned income was, for tax purposes, transmuted into investment income by the provisions of section 457 of the 1970 Act."[17]

Counsel for the taxpayer argued that, if the philosophy behind section 457 is examined, the sole extent of its operation is to cut at the root of the principal of deduction so that, in substance, there is simply no deduction. Accordingly, for the purposes of excess liability, the taxpayer's income remains of precisely the same nature as it was before.

Walton J considered the judgements of the House of Lords in Coathew Investments Limited -v- IRC[18] and said that the majority view was that the process was to deduct and add back not just to deny a deduction. Walton J came to the conclusion that this was the correct approach. He said:

> "I think the fallacy which underlies Counsel's valiant attempts to argue for the contrary approach for the taxpayer lies in the fact that the two economically equivalent sums, the sums paid by the taxpayer pursuant to the deeds of covenant and the income arising under the settlement, are not of the same nature. One can test this very simply by

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17. p344
18. (1966) 43 TC 301

imagining that some Finance Act imposed a tax on income arising under a settlement, without otherwise altering the law. It would then be quite clear that what would be added to the taxpayer's income at the end of the day would be the settlement income less the amount of the special tax."[19]

The other case to be considered is Watson -v- Holland[20]. This was a case which turned on the construction of the settlements in question and on the rule in Lassence -v- Tierney[21]. As in the Vandervell case, it was a question of whether there was a resulting trust in favour of the settlor so that section 457 ICTA 1970 applied.

The rule in Lassence -v- Tierney is that:

> "If you find an absolute gift to a legatee in the first instance, and the trusts are engrafted or imposed on that absolute interest which fail, either from lapse or invalidity or any other reason, then the absolute gift takes effect so far as the trusts have failed to the exclusion of the residuary legatee or next of kin as the case may be."[22]

If this rule applied there would be no resulting trust in this case but, if the rule did not apply to this settlement, there would have been a resulting trust and section 457 would have caught the settlor.

The facts were that the settlor made two irrevocable settlements in favour of his children. These settlements were virtually identical and, in each case, the trusts for the particular child's benefit were not exhaustive and the principal beneficiary had no right to capital. A clause in each settlement, which was expressly made subject "to all the trusts herein before declared",

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19. p348
20. [1984] STC 372
21. (1849) 1 Mac & G 551
22. per Lord Davey in Hancock v Watson [1902] AC 14 at p22

required the trust fund and the income of it to be held in trust "for the settlor's children other than the [principal beneficiary] ..... and so that each such other child's share shall be held on the same trusts and subject to the same powers and provisions" as those set out in favour of the principal beneficiary. It was also provided that the settlor and his wife were to receive no benefit from the settlement in any way whatsoever.

The Revenue raised assessments under section 457 in respect of the income arising under the settlements on the ground that there was a resulting trust in favour of the taxpayer in each case. The taxpayer appealed contending that the section did not apply because, under each settlement, the principal beneficiary had an absolute gift on to which were engrafted trusts which failed, with the result that the absolute gift took effect so far as the trusts failed to the exclusion of the resulting trust for the taxpayer.

Peter Gibson J held that the language of the relevant clause of the settlement was unambiguously that of an absolute gift, an outright disposition of the entirety of both capital and income of the trust fund, and the inconsistent referential trusts relating to "each such other child's share" which followed were reconcilable with it by the application of the rule in Lassence -v- Tierney. Accordingly, there was no resulting trust of capital or income of the trust fund and, accordingly, section 457 did not apply.

Finally, it should be noted that section 108 FA 1989 altered one aspect of the provisions dealt with in this Part with effect from 6 April 1990, the date when the system of independent taxation of husband and wife comes into operation.

It has been explained above that section 683 and 684 ICTA 1988 do not operate, inter alia, in respect of income from property of which the settlor has divested himself absolutely.[23] Section 685(1) states that a settlor shall not be deemed to have divested himself absolutely of any property if it is, or will or may become, in any circumstances whatsoever, payable to or applicable for the benefit of the settlor or where the settlement has been made after 6 April 1965, the settlor's spouse.

Section 685 has been amended by section 108 FA 1989 so as not to conflict with the new system of independent taxation.

Accordingly, for 1990/91 and subsequent years of assessment, the amended section 685 states that references to a settlement in section 683[24] to a settlement do not include references to an outright gift by one spouse to the other of property from which income arises, unless:

(a) the gift does not carry a right to the whole of that income; or

(b) the property given is wholly or substantially a right to income without the underlying capital.[25]

An example of a situation within (a) would be where a husband transfers land to his wife but retains the right to the rent from it. A paragraph (b) situation would be where, for example, a husband transferred an annuity to his wife.

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23. Sections 683(1)(d) and 684(1)(d) ICTA 1988
24. As explained above, income payable to the settlor's spouse in the case of pre 7 April 1965 settlements does not cause section 684 to operate.
25. Section 685 (4A) ICTA 1988

The amended section 685 also provides that a gift is not an outright gift for the purposes of the above rules if it is subject to conditions, or if the property, or property derived from it, or income arising from it, is, or will, or may become, in any circumstances whatsoever, payable to, or applicable for the benefit of the donor spouse.[26]

Although these are very wide words, the Financial Secretary to the Treasury stated in Standing Committee, that section 108 would not be applied to a voluntary return to the donor spouse of property by the donee spouse.

26. Section 685(4B) ibid

CHAPTER 3

TRANSACTIONS INVOLVING LAND

Introduction

Land values increased substantially in the 1960's and 1970's. These decades also saw high income and corporation tax rates and the introduction of tax on capital gains. Many taxpayers therefore stood to make very large profits on the sale of their land, much of which would disappear in tax. Accordingly, tax avoidance schemes to prevent the payment of large amounts of tax on the considerable profits to be obtained from the disposal or exploitation of land were fairly widespread.

To make matters worse for taxpayers, there were also various attempts to tax the development value of land, culminating in Development Land Tax on 1976.

Another interesting development saw the growth of investment in woodlands as a tax shelter for wealthy individuals.

These matters are examined in this Chapter. Capital gains tax avoidance is considered separately in Chapter 8.

Artificial Transactions in Land

The subject of "Stock Stripping" has already been examined.[1] It has been seen that earlier legislation in sections 21-26 FA 1960 and sections 23-25 FA 1962 had not proved to be a satisfactory code in that dealers in the land who had the foresight to take appropriate professional advice could often avoid being caught; whereas innocent taxpayers could find themselves enmeshed in these complex provisions.

As has already been noted, section 32 FA 1969 replaced these provisions, apart from one part of section 25 FA 1960 and part of section 25 FA 1962. Section 32 is now section 776 ICTA 1988.

The Chancellor, in his 1969 Budget speech, said:

> "The Finance Bill contains provisions to counter tax avoidance in three fields. The first relates to the profits arising from land, where the provisions of sections 21 to 26 of the Finance Act 1960 have been found to be inadequate to deal with some ingenious schemes for avoiding a charge on dealing although it is abundantly clear that dealing has in fact taken place."[2]

The legislation introduction in 1969 was extremely widely drawn and, as will be seen, incorporated a number of confusing and unclear features. The Legislature appear to have reacted to the failure of the earlier, more specific provisions, and went too far the other way. Also, unlike some of the earlier sections, the 1969 provisions were aimed solely at transactions involving land, not other assets.

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1. See Chapter 1
2. Hansard, Col 1012, 15 April 1969

When the original legislation was introduced in 1969, one commentator. D.C. Potter, a person well used to dealing with complex tax legislation declared that:

> "The section seems, in parts, designed to terrorise by its obscurity."[3]

The wording is wide enough to provide hidden traps for the innocent. For example, even if a taxpayer is aware that there is this anti-avoidance provision relating to land, he may be blissfully ignorant of the fact that he can be caught if he sells a majority shareholding in a company.

An example of a simple arrangement that succeeded but which would now be caught by section 776 was the subject of the case of <u>Williams v Davies</u>.[4]

The two taxpayers had been engaged in dealing in and developing land for many years. They each purchased half of three plots of land. If they had sold these plots, any profit would undoubtedly have been subject to income tax. In an attempt to ensure that the profits would be treated as capital, in the month following acquisition, the plots were given to the taxpayers' wives. A few days later, the wives, acting on advice from their husbands, sold the plots to a land development company of which their husbands were the only directors and shareholders. Two years later the process was repeated with other land. The whole plan had been arranged by the taxpayers even before they had purchased the plots in the first place, although it was found by the Commissioners that the gifts to the wives were genuine (for example, the proceeds from the sales to the development company were reinvested for the benefit of the wives; not their husbands).

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3. [1969] BTR 202 at p206
4. (1945) 26 TC 371

The Revenue assessed the taxpayers under Sch D Case 1 on the basis that the taxpayers themselves were dealing in the land and, alternatively, under Case VI in respect of "wife's profits from transactions in land."

Wrottesley J upheld the decision of the Commissioners that the wives were not carrying on a trade and that the profits they received were capital.

The judge acknowledged that the husbands, by means of their prearranged plan, had avoided the income tax that would have arisen if they had made the profit themselves, but rejected the Crown's argument that, given that the whole plan was contrived by the husbands, and looking at the transactions as a whole, it was impossible to say that no trade was carried on by the husbands.[5]

The taxpayers and their wives therefore avoided income tax. The arrangements would now, however, clearly be covered by section 776 and the capital sums received by the wives would be subject to income tax under Case VI.

A more artificial arrangement that succeeded because it was implemented before section 32 was introduced, but which would now be caught was used in IRC v Pratt.[6] The transactions in this case were implemented in 1964 and 1965 and were attacked by the Crown, unsuccessfully, under what was then sections 412 Income Tax Act 1952.[7]

The facts were that the taxpayers were directors and shareholders in a UK company. The company sold land to a Bahamian company following negotiations with an arm's length purchaser, one Mr Lucas.[8] There was an understanding between Mr Lucas and the taxpayers that, if

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5. See pp377-8
6. (1982) 57 TC 1
7. Now section 739 ICTA 1988, see Chapter 9
8. The Bahamian company was one of Mr Lucas' vehicles.

planning permission for development were obtained, the taxpayers would benefit from the consequent increase in the value of the land.

In order to ensure that any such increase should accrue to the taxpayers as capital rather than as income, they implemented an artificial avoidance scheme, the details of which are considered in Chapter 9. For present purposes, however, it should be noted that the increase in the value of the land due to the planning permission accrued to discretionary settlements of which the beneficiaries included the taxpayers and Mr Lucas.

In the absence of legislation such as is now contained in section 776, the Crown were restricted to seeking to attach an income tax liability to the taxpayers in respect of the income earned by the settlement trustees from the investment of the capital sums received from the land under section 412 ITA 1952. Why they failed is analysed in Chapter 9.

The need for anti-avoidance legislation to catch capital sums derived from land by such schemes as that used in Pratt was becoming increasingly apparent to the Revenue through the 1960s.

As will be seen below, the legislation was eventually introduced in the Finance Act of 1969, which contained a number of wide ranging and powerful anti-avoidance provisions.

Another example of transactions that would have been caught by section 32 FA 1969, had the section then been in operation, are the arrangements implemented by the taxpayer in Ransom v Higgs.[9] The facts of this case are considered in connection with "Stock stripping"[10] and

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9. (1974) 50 TC 1
10. See Chapter 1

"The Substance Doctrine"[11]. Lord Wilberforce categorised the transactions as follows:

> "The appeals relate to operations of 'stock-stripping', the design of which is to take properties held as trading stock which are ripe for development, to arrange for their development at a profit, and to convert the profits into a capital asset by turning them into the purchase price for other assets. Thus the recipient of the profits, who is not the developer, gets them in a tax-free form."[12]

Later he said that:

> "if schemes such as these succeed in taking trading stock profits - by a stripping process - outside the net, the remedy, as in the case of dividend-stripping, lies in legislation. Indeed, if one asks for a description of what this scheme is, if it is not trade, the answer is to be found in the Finance Act 1969, section 32 - a section passed eight years after these transactions and so too late to catch them. It is (I take my words directly from the section) an artificial transaction in land by which land held as trading stock is disposed of by an arrangement or scheme which enables a gain to be realised by an indirect method by a person who is a party to or concerned in the scheme. The fact that it can - indeed can only - be so described seems to me to confirm that this case is not one of trading."[12A]

It should be noted that Lord Wilberforce was, in fact, incorrect in saying that "artificial" was taken directly

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11. See Chapter 11
12. p87
12A. p91

from the words of the section; that word appears nowhere in the section itself, being only in the heading.[13] The word was dropped from the heading on the 1988 consolidation.

Following the section's introduction it was not used very much by the Revenue. The section was drafted in such wide terms that it must have acted as a deterrent to taxpayers contemplating schemes such as those used in Pratt, so the Revenue did not have to use it too often. Also, inspectors preferred to attack transactions under Sch D Case I. In later years, however, the section has come to be used frequently as a weapon by the Revenue and the deficiencies of the section have gradually come to light.

Not the least of the difficulties is the complicated language in which the section is drafted. Buckley LJ, a judge used to dealing with complex tax legislation, said of what was then section 488:

> "Section 488 of the 1970 Act is, like so many sections in Taxing Acts, one the length and complexity of which tends to obscure its meaning and effect. Notwithstanding that section 488(1) affords a clear indication of the purpose which the section is designed to serve, viz to prevent the avoidance of tax by persons concerned with land or the development of land, I confess that I first travelled through the section finding very little light on the journey to aid my understanding of it."[14]

The cases that have been decided on section 776 have, in some areas, only increased the difficulties thrown up by the wording of the section.

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13. Of what was then section 488 ICTA 1970
14. Yuill v Wilson (1980) 52 TC 674 at p693

The section states:

"(1) This section is enacted to prevent the avoidance of tax by persons concerned with land or the development of land.

(2) This section applies wherever -

(a) land, or any property deriving its value from land is acquired with the sole or main object of realising a gain from disposing of the land; or

(b) land is held as trading stock; or

(c) land is developed with the sole or main object of realising a gain from disposing of the land when developed.

any gain of a capital nature is obtained from the disposal of the land -

(i) by the person acquiring, holding or developing the land, or by any connected person, or

(ii) where any arrangement or scheme is effected as respects the land which enables a gain to be realised by any indirect method, or by any series of transactions, by any person who is party to, or concerned in, the arrangement or scheme;

and this subsection applies whether any such person obtains the gain for himself or for any other person.

Subsection (4) should also be noted. It runs;

"(4) For the purposes of this section -

(a) land is disposed of if, by any one or more transactions, or by any arrangement or scheme, whether concerning the land or property deriving its value from the land, the property in the land, or control over the land, is effectually disposed of; and

(b) references in subsection (2) above to the acquisition or development of property with the sole or main object of realising the gain from disposing of the land shall be construed accordingly."

The wide impact of these provisions is broadened still further by section 777(2) and (3) which state:

"(2) In applying [section 777] account shall be taken of any method, however indirect, by which -

(a) any property or right is transferred or transmitted; or

(b) the value of any property or right is enhanced or diminished;

and accordingly the occasion of the transfer or transmission of any property or right, however indirect, and the occasion when the value of any property or right is enhanced, may be an occasion when, under [section 777], tax becomes chargeable.

(3) Subsection (2) above applies in particular -

(a) to sales, contracts and other transactions made otherwise than for full consideration or for more than full consideration; and

(b) to any method by which any property or right, is transferred or transmitted by assigning share capital or other rights in a company or any partnership or interest in settled property; and

(c) to the creation of any option or consent or embargo affecting the disposition of any property or right, and to the consideration given for the option, or for the giving of the consent or the release of the embargo; and

(d) to the disposal of any property or right on the winding up, dissolution or termination of any company, partnership or trust."

The language of the section, then, is very wide. As always happens when such broad anti-avoidance provisions are enacted, taxpayers can find themselves unwittingly within the boundaries of the provisions; yet they are not so all-embracing that an enterprising and well-advised taxpayer cannot, on occasion, find a way around the section. Having said that, section 776, when it has been used, has generally been effective.

Two cases that demonstrate the operation of the section as noted in the previous paragraph are the Chilcott and Page v Lowther cases.

<u>Chilcott v IRC</u>[15] involved a "Bradman" scheme[16] of characteristic complexity. It was similar to the scheme used in the Williams case[17] which there was attacked under section 703 ICTA 1988.

Reduced to its bare bones, the facts were that the taxpayers owed the shares in a property dealing company ("Kolinol") which owned land which it had acquired for £30,000. The company agreed to sell the land for £1.9 million to Minet Holdings Ltd to be satisfied by the issue of 506,666 Minet shares.

On the same day, the taxpayers transferred their shares in Kolinol to Trafalgar House Developments Holdings Ltd for £1,233,235. This sum was satisfied by the transfer

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15. (1981) 55 TC 446
16. A scheme marketed by Mr Godfrey Bradman, at one time a well-known purveyor of pre-packaged tax schemes.
17. <u>Williams v IRC</u> (1980) 54 TC 257, see Chapter 1

of 328,863 Minet shares (part of the holding issued to Kolinol earlier in the day). The taxpayers had thus realised a gain in the form of shares which had been derived from the land and which represented part of the proceeds of sale of the land by Kolinol.

They were assessed under section 776 on the basis that the £1,233,235 which they had received in the form of the Minet shares represented gains of a capital nature obtained by them from the disposal of land by Kolinol and that the transactions constituted an arrangement "as respects the land" within section 776(2)(ii).

However, in the High Court, Vinelott J held that the taxpayers escaped liability under section 776(10) which says that no liability arises on the disposal of shares in a company which holds the land as trading stock provided the land is disposed of in the normal course of trade. This exclusion does not apply if there is a scheme or arrangement enabling a gain to be achieved by indirect means. Vinelott J held that the transaction whereby the taxpayers received the Minet shares from Trafalgar House in consideration of the sale of their Kolinol shares was not such a scheme or arrangement.

Vinelott J noted that the Crown had submitted that the transaction fell within subsection (2)(i) because of subsection (4). As the share agreement was conditional on the completion of the land agreement, both agreements were parts of an "arrangement or scheme" within subsection (4). This arrangement, it was argued, was one concerning the Kolinol shares, being "property deriving its value from land" within subsection (13)(b)(i), and that, by the arrangement, the property in the land or control over it was disposed of by Kolinol to Minet. Accordingly, it was argued, the gain of a capital nature which was obtained by the taxpayers from the sale of their Kolinol shares must be treated for the purposes of subsection (4) as a gain obtained by them from the disposal of the land by Kolinol.[18]

Vinelott J said that the process by which the transaction was brought within sub-paragraph (i) also brought it within the exception in subsection (10). He continued:

> "If the gain obtained by the taxpayers on the disposal of their shares is to be treated as obtained from the disposal of the land because the sale of the shares was part of an arrangement or scheme by which the property in the land or control over it was disposed of by the person holding land (Kolinol), then it must I think follow that the disposal of the shares must also be treated as a disposal of shares in a company which at the material time held the land as trading stock within subsection10"[19]

18. p471
19. pp471-2

On the section 776(2)(ii) point, the Special Commissioners found that the transactions:

> "constituted a two-fold arrangement whereby: (1) the taxpayers procured the transfer by Kolinol of its land (trading stock) to Minet Holdings for £1.9 million, which Kolinol received (at noon on 16 February) in the form of 506,660 Minet Holdings shares, and which represents proceeds of sale and a revenue profit of £1.1 million, allowing for approximately £800,000 potential tax; (2) the four shareholders then (at 2.30 pm on 16 February) transferred to THD Holdings their Kolinol shares (now enhanced by Kolinol's profits) for £1,233,235, which they received (between 16 and 19 February) in the form of 328,266 of the 506,660 Minet Holdings shares, thereby receiving their gain in the form of part of Kolinol's proceeds which were derived from or substituted for the land."

The Commissioners held that the arrangement was one "as respects the land" which enabled a gain to be realised by an indirect method within section 776(2)(ii).

Vinelott J disagreed, He said that the only capital gain obtained by anybody was the capital gain obtained by the taxpayers, either when the share agreement became unconditional, or possibly when it was completed by the transfer of the Kolinol shares so that the taxpayers became contractually entitled to the consideration payable by Trafalgar House Developments Holdings. He said:

"It is true that, by virtue of subsection (4), subsection (2) applies as if a capital gain had been obtained by the taxpayers from the disposal of the land by Kolinol, but it does not follow that the arrangement or scheme must be treated as if a capital gain in fact obtained directly from the sale of the shares had been obtained or realised indirectly from the sale of the land. It seems to me immaterial in the context of subparagraph (i) that there was an unenforceable understanding that [Trafalgar House Developments] Holdings would purchase from Kolinol sufficient of the rights to allotment of the Minet shares to enable it to satisfy the purchase price due to the taxpayers by renunciation of allotments to them. That was an indirect method by which they obtained shares of Minet in satisfaction of the capital gain they had obtained on the sale of their shares. It was not in my judgment an indirect method which enabled the taxpayers to realise a gain on the sale of the Kolinol shares."[20]

Counsel for the taxpayers had also argued that subsection (1) imposes a condition additional to those in subsection (2)(i) and (ii) and that a case might fall within subsection (2)(i) or (ii) and outside the exemption in subsection (10), but still be excluded from the charge to tax imposed by the section because it did not contain the necessary element of tax avoidance.

Vinelott J rejected this as not being consistent with the approach of the House of Lords in Yuill v Wilson.[21] Lord Russell had considered that subsection (1) described the mischief of the section and Viscount Dilhorne referred to subsection (2) as "defining the scope of the section." Vinelott Dilhorne had said that he thought that subsection (1) did not add a further condition limiting the scope of

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20. pp472-3
21. (1980) 52 TC 655, infra

the section. Vinelott J therefore agreed with the Crown that subsection (1) "is of the nature of a preamble stating the mischief at which the section is aimed."[22]

The judge then referred to the sidenote "Artificial transactions in land" which, on the 1988 consolidation, was changed to "Transactions in land: taxation of capital gains." The judge referred to the decision of the House of Lords in DPP v Schildkamp[23] where it was said that there is no rule which prohibits a court from looking at the side-note as a guide to the scope of the section although it was a "poor guide" which will "very rarely" throw light on the intention of Parliament. However, in the case of section 488 ICTA 1970, Vinelott J said that subsection (1) is framed in "very wide and indefinite terms". The question of what is tax avoidance was one on which a wide variety of views are possible. That being so, he said that "the side-note is in this case not only a permissible but also I think a useful guide throwing further light on the mischief aimed at."[24]

He said, reading subsection (2) in the light of subsection (1) and the sidenote, the intention to be inferred is to impose tax when, by an artificial transaction, a gain realised by a dealer or developer "is transmitted into a form which is not assessable to income or corporation tax." He considered that this approach was supported by subsection (10) which:

> "makes it clear that section 488 is not to apply to a simple sale of shares in a company holding land as trading stock if the land is sold in the ordinary course of its trade at full value (so that it falls to be brought into the company's computation of

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22. p474
23. [1971] AC 1
24. pp474-5

gains) and if the sale of the shares is not allied to some artificial arrangement or scheme of the kind described in subparagraph (ii)."[25]

The next case to examine, and one in which the words of Vinelott J in Chilcott were considered is Page v Lowther.[26]

Trustees of a settlement held certain land which they wished to develop. It appears that they did not wish to suffer income tax under Sch D, Case 1 and so they implemented the following transactions with a view to paying tax at only CGT rates on their profits.

The trustees granted a 99 year lease of the land to an unconnected development company in return for a rent. The development company was, in fact, Trafalgar House Developments Ltd, a company in the same group as the company involved in the Chilcott development. It was a term of the lease that the development company would erect dwellings on the land and, when a dwelling was completed, the company would grant an underlease to the occupier under which the occupier would pay a "premium" to the trustees. This premium was calculated in accordance with a formula and was a proportion of the amount which the company would get from the development.

The Crown submitted that the words of section 488(2) ICTA 1970[27] covered the case in that the land was developed with the sole or main object of realising a gain from disposing of the land when developed. It was developed by Trafalgar and a gain of a capital nature was obtained by the trustees from the disposal of the land, namely, from the disposals effected by the underleases. An

25. p475
26. (1983) 57 TC 199
27. Now section 776(2) ICTA 1988

arrangement was effected as regards the land, it was argued, (ie the arrangement effected by the lease), which enabled a gain to be realised by the trustees, who were parties to the arrangement.

On the other hand, the taxpayer put forward an argument based on subsection (1) and he also referred to the side-heading, the heading of Part XVII of ICTA 1970, in which section 488 appeared (ie "Tax Avoidance"), and to Vinelott J's words in Chilcott. The taxpayer argued that the trustees were not dealers or developers and there was nothing artificial about the transactions that they entered into.

At first instance, Warner J said that section 488 had to be interpreted in the light of the purpose of the section as stated in subsection (1). He did not, however, consider that that entitled him to treat the words of subsection (2), which he thought were clear, as ambiguous. What constitutes tax avoidance is "very much a matter of opinion" and it would, he said:

> "be dangerous in the extreme for a judge to take it upon himself to modify the meaning of words in subsection (2)....according to his own conception of what does and does not constitute tax avoidance."[28]

In any case, the judge said that the transactions entered into by the trustees here may have resulted in the avoidance of tax by them, albeit perhaps unwittingly. The premiums paid by the underlessees, in part to the trustees and in part to Trafalgar, reflected both the value of the trustees' land and the value of the development carried out by Trafalgar. The lease "was susceptible of producing the result that they shared in the profit resulting from the development, a profit that would normally be taxable under Case 1 of Schedule D."[29]

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28. p208
29. ibid

In the Court of Appeal, Slade LJ, with whom Waller and Robert Goff LJJ agreed, followed Warner J's approach to the interaction of subsections (1) and (2).[30]

The Court of Appeal had been urged by the taxpayer to have regard to the Plummer case[31] where the House of Lords had said that, if a completely literal reading of the words in a taxing statute would extend its application beyond that which Parliament can reasonably be supposed to have intended, but a more restricted interpretation would limit its application in a manner more likely to represent such an intention, then it may be legitimate to adopt the narrow interpretation if the words used fairly admit of such a meaning as to give effect to that purpose.

However, Slade LJ had no doubt that, even having full regard to the sidenote and subsection (1), the lease was an "arrangement" within the meaning of subsection (2). He noted that, in contrast to section 487(1) ICTA 1970,[32] in section 488 it was not specifically provided that a condition for the application of subsection (2)(ii) should be that the main object, or one of the main objects, of the arrangement was the avoidance of tax.[33]

Subsection (1) and the sidenote do not impose any such condition precedent to the application of the section. Slade LJ referred to the wording of subsection (5)(b)[34] which read:

> "any number of transactions may be regarded as constituting a single arrangement or scheme if a common purpose can be discerned in them, or if there is other sufficient evidence of a common purpose."

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30. pp214-5
31. IRC v Plummer (1979) 54 TC 1, see Chapter 2 and 11
32. Now section 775 ICTA 1988, see Chapter 1
33. p215
34. Now subsection 776(5)(b) ICTA 1988

Slade LJ said that the subsection did not state, nor could it be implied, that the common purpose must be that of avoiding tax. It is enough if that purpose is enabling a gain to be realised by a person who is a party to the arrangement. He said:

> "The wording of subsection (2) does not permit the presence or absence of the motive of avoiding tax to be a relevant consideration."[35]

Slade LJ then turned to the taxpayer's second submission, that no gain of a capital nature had been obtained by the trustees from the relevant disposal of the land within the meaning of subsection (2). He agreed with Warner J that the execution of each underlease was not merely an occasion when the trustees received extra payments according to the formula in the lease; each underlease was the first occasion on which the trustees' entitlement to such a payment arose as against the person who was actually going to pay them.[36]

On the general approach to the interpretation of the section he said:

> "While subsection (1) may be regarded as being of the nature of a preamble, stating in general terms the nature of the mischief at which the section is aimed, its wording is not, in my opinion, nearly sufficiently clear to enable the Court to give a construction to subsection (2) which would enable the trustees to escape the net of taxation under section 488 in the present case. If it had expressly limited the operation of the section to transactions specifically designed to avoid tax, the position might have been quite different.

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35. p215
36. p216

As to the side note, I must accept that, on my construction of the section the side note reading "Artificial transactions in land" may, in some cases, be somewhat misleading. Indeed I would accept that the transactions involved in the present case cannot on the evidence fairly be described as artificial."[37]

It appears to have been accepted by Slade LJ that the trustees would have fallen outside the section if they had simply sold the land with no stipulations as to development, but, without appreciating the fiscal consequences and, as Slade LJ conceded, for good commercial reasons, they tied their profit to the development.[38] In other words, they simply structured their deal incorrectly. They could, it seems, have escaped the section by selling for a capital sum payable in instalments based informally, perhaps, on the anticipated completion dates of the various stages of the development. By linking their payments to the profit obtained from the land when developed, they strayed within the boundaries of the section.

With reference to subsection (5)(b), which was considered in this case, this subsection is a further example of the unusual language of the section. It refers to "a common purpose" being "discerned" and then says that there will also be a single arrangement "if there is other sufficient evidence of a common purpose". The draftsman unfortunately omitted to explain quite how this common purpose might conceivably be discerned except by "sufficient evidence". Not unexpectedly, the Revenue have never gone to court arguing for the existence of a common purpose relying on mere discernment rather than "sufficient evidence".

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37. p217
38. ibid

In such an important anti-avoidance provision, such sloppy and nonsensical drafting is inexcusable.

Another example of the wide wording of the section can be seen in the requirement that there is a "disposal" of the "land".

The term "land" includes buildings and any estate or interest in land or buildings[39], and "property deriving its value from land" includes:

> "(i) any shareholding in a company, or any partnership interest, or any interest in settled property, deriving its value directly or indirectly from land, and
> (ii) any option, consent or embargo affecting the disposition of land."[40]

As regards "disposal", this includes "the disposal of any property or right on the winding up, dissolution or termination of any company, partnership or trust."[41] Furthermore, land is treated as disposed of if, by one or more transactions, or by any arrangement or scheme, the property in the land is "effectually" disposed of.[42]

Accordingly, a taxpayer who enters into into involved arrangements by which he indirectly but effectually disposes of land, should not be surprised if he is caught by the section. An example of this is <u>Winterton v Edwards</u>.[43] The shareholding in a company, Lyon Group Ltd was held as to 90½% by a Mr Lyon and as to 4½% and 5% by Messrs Winterton and Byfield respectively. In 1969 and 1970, Mr Lyon purchased two parcels of land which he proposed to sell at a profit to the company.

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39. Section 776(13)(a) ICTA 988
40. Section 776(13)(b) ibid
41. Section 777(3)(d) ibid
42. Section 776(4)(a) ibid
43. (1979) 52 TC 655

He agreed with Winterton and Byfield, the taxpayers, that the company's facilities would be used to enhance the values of the two parcels of land, but that he would pay for these himself and the taxpayers would receive a 4½% and 5% share respectively in the two ventures. Mr. Lyon signed letters confirming that 4½% adn 5% of his interest in the land were held by him in trust for the taxpayers absolutely. The land was disposed of to the company by means of a "Bradman" tax avoidance scheme. The taxpayers were not parties to any of the documentation, in which Mr Lyons was expressed to sell as beneficial owner.

The taxpayers were assessed under section 488 and these assessments were upheld in the High Court. Slade J accepted that they were not parties to the various transactions, but he said that they were "concerned in" the transactions within section 488(2)(ii)[44] by virtue of their interests in the proceeds of sale.[45]

What Slade J was in effect saying was that persons who have no intention of realising a gain within section 488 can still be caught by the section if they are concerned in an arrangement, implemented by someone who did have such an intention, under which that land is disposed of.

Another manifestation of the width the Legislature was determined to build into the section can be seen in section 776(8) which reads:

> "If all or any part of the gain accruing to any person is derived from value, or an opportunity to realising a gain, provided directly or indirectly by some other person, whether or not put at the disposal of the first mentioned person, subsection (3)(b) of this section shall apply to the gain, or that part of it, with the substitution of that other person for the person by whom the gain was realised."

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44. Now section 776(2)(ii) ICTA 1988
45. p669

In other words, if Mr X directly or indirectly provides Mr Y with the opportunity of realising a gain, Mr X can be liable under the section.

This sounds reasonable enough, but the subsection does not indicate what rights Mr X must have in the land before he can be said to have transferred the "opportunity" to Mr Y. This question has been partially answered by the courts and it is now clear that Mr X need not have the legal capacity to transfer the opportunity to Mr Y to be caught by subsection (8).

The case in which this was decided was Yuill v Wilson.[46] The facts of this case were basically that the taxpayer and his family trust held a controlling interest in Cecil M Yuill Ltd. The company sold two parcels of land to two UK companies connected with the taxpayer. The taxpayer set up a Guernsey trust which, in turn, set up two Guernsey companies, Ceville Ltd and Mayville Ltd. Ceville and Mayville purchased the two parcels of land from the UK companies at prices which fully reflected the undeveloped market value of the land.

The following year, the Guernsey trustees sold Ceville and Mayville to Valnord Investments Ltd, another Guernsey company, which was owned by an unconnected overseas trust. This trust had apparently been set up by an overseas settlor for overseas beneficiaries, and the taxpayer and his family were not among the class of beneficiaries.

Shortly after the sale, planning permission was obtained to develop the land, and Cecil M Yuill Ltd purchased both parcels of land from Ceville and Mayville for a substantial sum but on contingently deferred terms.

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46. (1980) 52 TC 674

The taxpayer was assessed under section 488 ICTA 1970, on the gains made by Ceville and Mayville. It was held that, by virtue of his powers over the companies and the family trust, the taxpayer had provided Ceville and Mayville with the opportunity of making gains within which is now section 776(8) ICTA 1988.

It was held that Ceville and Mayville were clearly within the section but no tax could be obtained from them because they were outside the jurisdiction of the UK courts. The Inland Revenue therefore had to try to attach a liability to the taxpayer under subsection (8).

The question therefore arose as to what rights a person must have in the land before he can be treated as having transferred the rights, or provided an opportunity, to another. Buckley LJ, in the Court of Appeal expressed his views on this as follows:

> "If A has the legal capacity to transfer an opportunity to make a gain and in exercise of that capacity does transfer that opportunity to B by his own act, he does so directly. If in the exercise of his own capacity to do so he transfers or transmits the opportunity to B with the knowledge or expectation that the opportunity will consequently pass from B to C without any further act on A's part, he may be said to provide C with the opportunity indirectly. If he lacks the legal capacity to transfer the opportunity by his own act to anyone but is in a position by persuasion to procedure B, who has the opportunity, to transfer it to C, can A properly be said in this way to provide C with that opportunity indirectly?
>
> Bearing in mind the purpose of section 488 as stated in subsection (1), I think this question should be answered affirmatively. The possession of the legal

capacity to transfer the opportunity is not, it seems to me, essential for the fulfilment of subsection (8)."[47]

The decision of the Court of Appeal was upheld on the subsection (8) point by the House of Lords.

The decision on subsection (8) does, then, raise a fundament point: by their application of subsection (8), the courts were effectively piercing the corporate veil. The taxpayer did not own the land, he did not avoid any tax; the UK companies owned the land which they disposed of at market value. He was caught, basically, because he pulled the strings throughout the arrangement.[48]

The taxpayer actually won, in the House of Lords, in this case.[49] The reason related to the deferred contingent consideration on the sale by Ceville and Mayville. A substantial part of the consideration was payable in the event of nationalisation or compulsory purchase of the land within five years. The House of Lords held that the only gains realised by Ceville and Mayville in the relevant year of assessment arose from the proportion of the purchase consideration unconditionally put at the disposal of Ceville and Mayville at the time of the contracts. This gave rise to a small loss in Ceville and a small gain in Mayville.

Viscount Dilhorne, however, did point out that the taxpayer would become liable to tax under section 488 in future years as each instalment of the purchase price became payable on demand to Ceville and Mayville.[50]

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47. p698
48. The subject of "Piercing the Corporate Veil" is examined in Chapter 12.
49. Although his victory was only temporary, see <u>Yuill v Fletcher</u> [1984] STC 401, infra
50. p713

In view of what was said in the later cases of Chilcott[51] and Page v Lowther[52] about the presence or absence of a tax avoidance motive, it is interesting to compare what was said on the subject in this case.

In the Court of Appeal, Buckley LJ said:

> "If the transaction is one in which there is no element of tax avoidance, the section may well not be applicable on account of section 488(i); but that cannot be said of the present case. So the section will not necessarily apply where the land in respect of which a capital gain has been realised was acquired by the person who has realised that gain, or some predecessor of his, at market value, but the fact of acquisition at market value will not exclude the possibility of the section applying. The section will, in my judgment, apply to any case falling within the language of section 488(2) where there is an element of tax avoidance.
>
> There is no specific finding in clear terms in the case to the effect that any of the transactions was carried out with a view to tax avoidance..... It is, I think, manifest..... that the commissioners formed the view that the transactions were not straightforward commercial transactions, but that they were entered into for an ulterior motive, namely tax avoidance."[53]

Goff LJ was of the same mind, he said that the section was:

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51. Chilcott v IRC (1981) 55 TC 446, supra
52. (1983) 57 TC 199, infra
53. pp694-5

"governed by subsection (1), which expressly provides that it is enacted to prevent the avoidance of tax by persons concerned with land or the development of land. Unless the facts bring the case within those words, which are clear and unambiguous and present no problems, the section does not apply at all and one has no occasion to look any further."[54]

Eveleigh LJ agreed with both judgments.

This point was not specifically dealt with in the House of Lords, which is a shame because the approach of the Court of Appeal was clear and logical and fully respected the clear words of subsection (1), which was specifically made a full and effective part of the section; rather than treating the words in subsection (1) as being in the nature of a mere preamble, which they are not.

It is submitted that the approach taken here by the Court of Appeal is fairer and is to be preferred to the rule subsequently established in Chilcott and Page v Lowther.

The taxpayer's victory in Yuill v Wilson was shortlived because he was subsequently held to be liable when the land was neither nationalised nor compulsory purchased and the instalments were fully released to Ceville and Mayville.

In <u>Yuill v Fletcher</u>[55] the taxpayer argued that he could only be assessed in the year of assessment in which the gain was realised on the basis that it would then have been possible to value Ceville and Mayville's rights under the contracts, and that those rights could have been sold at a price close to the valuation at that time. He conceded that he was liable to tax under subsection (8) but contended that the whole of the gains realised by

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54. p704
55. [1984] STC 401

Ceville and Mayville were capable of computation in the original year of assessment by reference to the value of their rights at that time, that the rights were "money's worth" within the meaning of section 489(13) ICTA 1970, that the gains, which under section 488(3) ibid were "chargeable to tax.....for the chargeable period in which the gain was realised", should have been assessed to tax for that year only and not for any other year.

The two provisions relied on by the taxpayer are as follows. Section 488(3) ICTA 1970 is now section 776(3) ICTA 1988 which says:

> "Where this section applies, the whole of any such gain shall for all the purposes of the Tax Acts be treated -
>
> (a) as being income which arises when the gain is realised; and which constituted profits or gains chargeable to tax under Case VI of Schedule D for the chargeable period in which the gain is realised; and
>
> (b) subject the the following provisions of this section, as being income of the person by whom the gain is realised."

Section 489(13) has been redesignated section 777(13) ICTA 1988 which runs:

> "For the purposes of [section 776] -
>
> 'capital amount' means any amount, in money or money's worth, which, apart from [section 776], does not fall to be included in any computation of income for the purposes of the Tax Acts.....
>
> and for the said purposes any amount in money or

money's worth shall not be regarded as having become receivable by some person until that person can effectively enjoy or dispose of it."

At first instance, Walton J held that the sale of the land by Ceville and Mayville was a sale for money and not for money's worth, although payment of part of the purchase price was deferred. The House of Lords in Yuill v Wilson had, he said, laid down the principle that the gains were realised only when the balance of the purchase price could effectively be enjoyed or disposed of by Ceville and Mayville and was no longer subject to any contingency or restriction.

The Court of Appeal rejected the taxpayer's appeal. The appeal judges agreed that a gain was "realised" within the meaning of section 488(3) only when it could effectively be enjoyed or disposed of, The gains were therefore realised here by Ceville and Mayville only as and when the instalment became repayable to them on demand and not by reference to the companies' original contractual rights, even if there was a market for those contractual rights, for the contracts for sale were for money and not for money's worth.

Reference should also be made to a case already considered: Winterton v Edwards.[56] In this case, Slade J held that, under the terms of the relevant documents, the taxpayers could demand immediate payment of their shares in the proceeds. Accordingly, the year in which the gain was made was the year in which they were taxable under section 488 and not later when they actually received the sums of money.

Another case in which it was held that the taxpayer had provided an opportunity of realising a gain was Sugarwhite v Budd[57]. The taxpayer purchased a property in the UK

56. (1979) 52 TC 655
57. [1988] STC 533

for £20,000 and, a few days leter, through arrangements made by a solicitor, he contracted to sell the property to Mediera Investment Properties Ltd, which had an address in the Bahamas. The contract allowed Madeira to subsell or nominate another purchaser. When the sale was completed the taxpayer executed a transfer of the property to a third party for £33,500, of which £25,000 was paid to the taxpayer, £1,000 to Mareria, £6,500 to Coleridge Securities Ltd and £600 to Ground Securities Ltd. Coleridge and Ground also had addresses in the Bahamas.

The Revenue assessed the taxpayer to income tax on the gains accruing to the Bahamian companies under section 488 ICTA 1970. The Special Commissioner found that the taxpayer was an active party to the arrangements whereby the property was sold to the third party, with his share of the gross profit being fixed at £5,000 and the balance being diverted, with his consent, to the Bahamian companies. The Commissioner determined that, in the absence of evidence to the contrary from the taxpayer, the gains transmitted to the Bahamian companies must be assumed to have been of a capital nature and that the transaction was therefore within section 488. The taxpayer appealed, contending that the Bahamian companies were parties to a joint trading adventure and, accordingly, that the sum paid to each of them was not of a capital nature.

Vinelott J and the Court of Appeal both rejected the taxpayers contention which was not backed up by sufficient evidence to enable the courts to interfere with the Commissioner's finding.

Another way in which the section has a wide operation is in its international application. It has already been seen that a UK resident can be caught if he provides an opportunity to non-UK companies (through transactions at market value) to make a gain.[58] The same result would have arisen if the overseas entity had been a trust or individual.

In fact, it is even wider than this. It has already been noted that, by virtue of section 777(13) ICTA 1988 "capital amount" means "any amount, in money or money's worth, which, apart from [section 776], does not fall to be included in any computation of income for the purposes of the Tax Acts...." The word "capital" is to be construed accordingly.

This appears to mean that (subject to any double taxation agreement) the section would catch a trading disposal made by an overseas entity, because, although, assuming it did not relate to a trade carried on within the UK,[59] would not be included in any computation of income for the purposes of the Tax Acts, and the word "capital" would be deemed to cover the profits.

If this interpretation is correct, a UK resident would be caught if, for example, he directly or indirectly provides, say, an overseas company with the opportunity of making a gain within section 776(5)(a), and the company trades in land in the UK.

The section applies to both UK residents and non-resident if all or part of the land is situated in the UK.[60] Some, but by no means all, double tax agreements will prevent a non-resident suffering a charge under the section.

Many agreements grant exemption in wide terms. For example, it is commonly provided that "profits of an enterprise of one of the States shall be taxable only in

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58. Yuill v Wilson, supra
59. Or, in the case of a company, through a branch or agency here.
60. Section 776(14) ICTA 1958

that State unless the enterprise carries on business in that State through a permanent establishment situated therein." This is a wide and unqualified exemption which would probably cover a section 776 liability. In any case, even if it would be argued - which, it is submitted, it cannot - that the above Article does not exempt a section 776 charge, it would be excluded if the agreement contained the common "sweeping-up" Article, which says that "items of income of a resident of one of the States, being income of a class or from sources not expressly mentioned in the foregoing Articles of this Convention shall be taxable only in that State."[61]

Some agreements are not so comprehensive. The one with Jersey, for instance, merely exempts from UK tax the "industrial or commercial profits of a Jersey enterprise"[62]. There is no "sweeping up" Article. In these circumstances, it is doubtful whether the narrow "industrial or commercial profits" Article would be sufficient to exclude a section 776 charge.

What is more, even if a comprehensive double tax agreement does exempt the overseas entity from liability under the section, Yuill v Wilson and Yuill v Fletcher have shown that the Inland Revenue may well be able to attach a liability to a UK resident who has provided the opportunity of making the gain to the overseas entity.

Further difficulties arise in computing the gain chargeable under section 776.

The first potential complication is provided by section 776(6) which states that:

"such method of computing a gain shall be adopted as

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61. That is, the country of the taxpayer's residence
62. Article 3(2)

is just and reasonable in the circumstances, taking into account the value of what is obtained for disposing of the land, and allowing only such expenses as are attributable to the land disposed of..."

There are special provisions applicable to cases where a freehold is acquired and the reversion is retained on a disposal, and where there have been certain premiums on lease.[63]

A further "just and reasonable" factor is introduced by section 777(6)(a) which states that "any expenditure or receipt or consideration or other amount may be apportioned by such method as is just and reasonable in the circumstances."

These provisions are not particularly precise and can give rise to confusion in particular cases.

Section 776(7) has the potential for adding to the confusion. It says that section 776(2)(c)[64]:

> "shall not apply to so much of any gain as is fairly attributable to the period, if any, before the intention to develop the land was formed, and which would not fall under [section 776(2)(a) or(b)]; and in applying this subsection account shall be taken of the treatment under Case 1 of Schedule D of a person who appropriates land as trading stock."

The first part of this subsection, in particular, propounds an especially difficult test to apply. It can be a question leading to immense problems in deciding (and proving) when the relevant intention was formed.

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63. Section 776(6)(a) and (b) ICTA 1988
64. Which refers to land being developed with the sole or main object of realising a gain from disposing of the land when developed.

Even if the time the intention to develop was formed can be established with any precision (unlikely in many cases), there is then the problems of deciding how much of the gain "is fairly attributable" to the period before that intention was formed. Taxpayers have the right to expect greater clarity in such important anti-avoidance legislation.

An example will give an indication of some of the potential problems. A trader owns an office which is a capital asset of his business. It becomes surplus to his requirements, so he seeks and obtains planning permission to demolish the office and build houses which he will then sell off. Assuming the Inland Revenue assesses him under section 776 rather than Sch D Case I,[65] what value is "fairly attributable" to the period before the intention to develop arose. Is it, for example, the current use value of the office; the current use value plus hope value; the value with planning permission; or some other basis? This will presumably depend on the exact moment the intention to develop was formed. It cannot be assumed that this was when (or before) he sought planning permission because he might intend to obtain planning permission and sell the land without developing it. On the other hand, he may have formed an intention to develop years before the planning application was submitted. These matters are likely to be difficult to tie down.

The second part of subsection (7) can also cause problems. Appropriations to trading stock are normally treated as taking place at market value[66], which is the price the asset might reasonably fetch in the open market.[67] This will be relevant both for calculating the capital gain, subject to CGT, and the base cost for

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65. They could assess him to both, in the alternative
66. Section 122 CGTA 1979
67. Section 150, ibid

section 776 purposes. Again, what is market value in this context? Presumably, if the land has no planning permission granted in respect of it, but has hope value, that value has to be added.

It can be seen that both subsection (6) and (7) refer to matters being taken into account. This is unfortunately imprecise, in that the wording does not explain how, or what extent, the relevant matters are to taken into account. For example, in subsection (7), account is to be taken of the Sch D Case I treatment of a person who appropriates land as trading stock. In other words, that Case I treatment need not necessarily be carried through exactly when considering section 776; it merely has to be taken into account.

The Inland Revenue are given wide powers to obtain information by section 778 ICTA 1988, which enables an Inspector to require "any person" to furnish him "with such particulars as the Board or the Inspector think necessary for the purposes of" section 776.

The particulars which can be demanded "include" particulars

(a) as to transactions or arrangements with respect to which the person in question was acting on behalf of others;

(b) as to transactions or arrangements which, in the opinion of the Board or the Inspector, should properly be investigated for the purposes of section 776; and

(c) as to whether the person to whom the notice is given "has taken or is taking any, and if so what, part in any, and if so what, transactions or arrangements of a description specified in the notice."

Section 788(3) contains certain exemptions for solicitors.

It should be noted that these powers are very wide indeed and enable the Revenue to ask questions not related to specific transactions or arrangements.

The width of these powers has been demonstrated in Essex v IRC[68]. In this case, the Revenue served on the plaintiffs notices under what is now section 778, requiring them to give certain specified particulars where they had, (a) either acted on their own behalf or on behalf of some other person in connection with any transaction or operation within certain specified categories, or (b) acted on behalf of a person by way of introducing, instructing or employing some other person in connection with transactions or operations within the specified categories.

The actual wording of the notice shows that the Revenue were on what is colloquially known as a "fishing expedition". The specified categories of transactions and operations were:

> "(A) Any contract, conveyance, lease, declaration of trust, or other transaction or operation whereby any legal, equitable or other interest in land situated in the United Kingdom passed to or from a person or persons, one or more of whom was not resident in the United Kingdom. (B) Any option agreement or assignment of the benefit of such an agreement relating to land in the United Kingdom where one or more of the parties to the agreement or assignment was not resident in the United Kingdom. (C) Any transaction or operation or any combination of transactions or operations whereby a benefit arose or might arise to a person resident in the United

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68. [1980] STC 378

Kingdom if any one of such transaction or operations was of the type mentioned in A or B."

The specified particulars were:

"(a) The name and address of the persons specified in A, B or C above. (b) Where any person specified in (a) was acting for some other person or persons, the name and address of each such other person. (c) Particulars of the transaction or operation. (d) Where particulars of a transaction or operation are given in answer to (c) above, as being a transaction or operation falling within (C) above, give the name and address of the person who obtained or might obtain the benefit, and the nature of the benefit or possible benefit. (e) The name and address of any person introduced, instructed or employed to or one behalf of any person specified in (A),(B) or (C)."

The plaintiffs sought a declaration that the notices were void contending that, since the notices required particulars of unidentified transactions or arrangements, section 778(2)(c) was the only paragraph under which the Revenue could have issued them; that they were outside the powers conferred on the Revenue by that subsection[69]; and that the notices were worded with such obscurity and width of language that they were inordinately burdensome and oppressive.

It was not disputed that the particulars sought by the inspector were those which he bona fide thought necessary for the purposes on section.[70]

Slade J and the Court of Appeal both rejected the plaintiffs' claims.

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69. Because that paragraph only covers the question of whether the addressee has taken part in transactions or arrangements of the specified description.
70. See p382 per Brightman LJ

On the section 778(2) point it was held that the subsection was a corrollary to the power given under subsection (1) to require any person to furnish the Revenue with such particulars as the Revenue think necessary for the purposes of section 776. Subsection (2) defines the duty of the recipient of the notice, including the duty under paragraph (c) to furnish "particulars" as to whether or not he had taken part in transactions or arrangements of a specified character. The word "particulars" in that context fell to be construed as synonymous with "information" and was not limited to details of specific transactions or arrangements. Accordingly, the power conferred on the Board or the inspector by section 778(1) was wide enough to authorise them to require information not related to specific transactions or arrangements.[71]

It was also held that the fact that certain terms in the notices were not precisely defined did not render the notices void for, although an unintelligible notice might be effectively no notice at all, and a notice might be objected to on the ground of oppression, the precision required in a taxing statute was not necessary in a statutory notice, which did no more than require the recipient to answer to the best of his information, knowledge and belief; and there was no evidence that the plaintiffs found the notices either unintelligible or oppressive.[72]

It is therefore, clear that the Revenue have extremely wide powers to obtain information under section 778.

Section 776 does provide a clearance procedure in subsection (11). It is however, one of the least used clearance procedures in the current major anti-avoidance provisions. Applications under, for example, sections

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71. See Brightman LJ at pp383-4
72. Ibid

704 ICTA 1988 and 267(3)(A) ICTA 1970, section 88 CGTA 1979, the demerger and company purchase of own shares legislation, to name some of the main ones, are regular features of tax practise in the legal and accountancy fields; but very few applications are made under section 776.

One of the problems is that such applications are not dealt with by a department manned by specialists, but by the local Inspector of Taxes. Few Inspectors have an adequate understanding of the section and many advisers feel that, if the potential application of the section is nor brought to the Inspector's attention, there is a good chance that he will either not realise the section has any relevance, or prefer to challenge the transaction, if at all, under Sch D Case I.

Some Inspectors also appear to feel that the fact that a section 776 application has been submitted shows that the taxpayer is likely to be involved in tax avoidance. Compared to applications under other clearance sections, a higher proportion of section 776 applications appear to be refused.

The use of the mental element in the section is worthy of note. Two of the categories of transaction within section 776(2), namely those mentioned in (a) and (c) operate by reference to a "sole or main object" test. This imports a subjective criterion.

With respect to transactions involving land, the Revenue in many cases find it relatively easy to discharge the burden of proof imposed on them to establish the necessary motive. Few people these days acquire land without at least the hope that it will increase in value and even fewer develop land without that hope. The question then becomes whether the "sole or main object" is to realise a gain by the disposal of the land thus acquired/developed. In cases other than those involving a person's main residence,[73] the answer will normally be "yes".

It should also be noted that a person can be caught even if the object of disposing of a gain is not his if, for example, he is "concerned in" a scheme in which someone else has the required motive, as in Winterton v Edwards.[74]

Paragraph (b) of section 776(2), where land is held as trading stock, is not subject to the "sole or main object" test or any other mental criterion; it applies automatically. This can operate harshly in some cases. Take, for example, a person who owns a majority holding of shares in a company which owns land as trading stock, the value of which is reflected in the shares. He may have held the shares for many years and he decides to sell them to a purchaser in a bona fide commercial transaction. The section will apply to the gain he makes.

On the section as a whole it can be said, in conclusion, that it has been drafted in very wide terms, the full ambit of which is not appreciated by all professional advisers and Inspectors of Taxes. It has been seen that the wide and sometimes imprecise language can lead to confusion or, at least, uncertainty and, as is inevitable with such broad provisions, there is the danger that innocent taxpayers will be caught. However, this danger is much less then with a section such as section 677 ICTA 1988[75]; and the sophisticated tax avoider has had less success in circumventing section 778 than many of the other anti-avoidance sections.

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73. Which is covered by a specific exemption - see section 776(9) ICTA 1988.
74. Supra
75. See Chapter 2

Nevertheless, there is a valid case to be made for the imprecisions and uncertainties in the drafting of these provisions to be eliminated, but there seems little prospect of this happening at the present time.

Land Sold and Leased Back: Limitation on Tax Reliefs

In his 1964 Budget, the then Chancellor outlined a scheme involving the sale and leaseback of land which he intended to stop. He said that the provision he was to introduce related "to a new and serious form of tax avoidance, involving the use of leasing devices." He continued:

> "One device is for a trader who owns business premises to lease them for a long period to a dealing concern in consideration of a premium which is not taxable and to take a lease back from the dealer. In the first few years of the leaseback he pays excessive rents sufficient to recoup the dealer for the premiums. The rent is deductible by the trader for tax purposes but, although the rent constitutes a trading receipt of the dealer, he is able to set against it the countervailing diminution in value of the lease, so that little tax is payable. The Revenue suffers a loss. The lease can be determined prematurely and the device repeated with the same property."

The main factor generating such devices was that, following the end of the Second World War, land values increased substantially and so considerable value accrued, but it was locked into the land. Sale and leaseback transactions were a way of using that value for the benefit of the owner's trade. There was the additional benefit before 6th April 1965 that, when the land was sold for a capital sum, that capital sum was not taxable and, even after the introduction of capital gains tax (and corporation tax on the capital gains on companies) the tax on the capital sum was less than the tax on the business's profits which would be reduced by the rental payments.

There was also the incentive to manipulate the sums involved in the transactions so that the trader selling the land received a higher capital sum (tax free before 6th April 1965) and paid higher rental payments (deductible from trading profits).

Before the introduction of specific provisions aimed at these devices the Revenue had to attack the deductibility of the rental payments under other provisions, either by claiming that they were capital rather than income, or that they were not incurred wholly and exclusively for the purposes of the trade.[76]

The provision introduced in 1964 was section 19 FA 1964. This section survives in all material respects unchanged as section 779 ICTA 1988. It is a long and detailed section which has successfully stopped most of the abuses at which it was aimed and has not generated any court cases.

The section is in addition to the normal requirements for a deduction for tax purposes, namely, that the payments must not be capital and that they must be wholly and exclusively incurred for the purposes of the trade under section 74(a) ICTA 1988. The basic effect of section 19 FA 1964 was to disallow a deduction for sums in excess of a commercial rent.

It is not necessary to examine section 779 in detail here but a general description of its operation will be sufficient.

Where, after 14th April 1964, land or an estate or an interest in land is transferred and, as a result of a lease or other transaction affecting any estate or

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76. See, for example, IRC -v- Land Securities Investment Trust Limited (1969) 45 TC 495 and Littlewoods Mail Order Stores -v- IRC (1969) 45 TC 519.

interest in the land, the transferor, or a person associated with him, becomes liable at the time of the transfer or later to pay any rent, the section applies to all rent due under the lease from the transferor or his associates.

If there is a transfer of an estate or an interest in land and, as a result, the transferor, or any person associated with him, is liable to make a payment other than rent under a lease, for which tax relief is available (for example, a rentcharge), the section applies to all such payments under the rent charge or other transaction due from the transferor or his associates. For this purpose there is included the granting of a lease or other transaction involving the creation of a new estate or interest in the land and the section also includes the transfer of the lessee's interest under a lease by surrender or forfeiture of the lease, but will not include transactions which consist exclusively of the transfer of the lessee's interest under a lease at a commercial rent.

Relief for tax purposes, which takes the form of a reduction in respect of the rent paid, is not to exceed the commercial rent of the land for the period for which the payment is made. If there is a restriction of the rent in this way, the disallowed portion can be carried forward as if it had been paid in the subsequent period. Where a deduction is allowable in respect of a premium,[77] the premium is treated as paid for the same period as for the purposes of what are now sections 34 to 38 ICTA 1988.

The restrictions in section 779 apply not only to the calculation of profits of a trade, profession or vocation under Schedule D Case I or II, but also to the computation of tax under Schedule A, Schedule D Case VI, management expenses under sections 75 and 76 ICTA 1988,

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77. Under the provisions in sections 22-24 FA 1963, now sections 34-38 ICTA 1988, infra

Schedule E expenses under section 198 ICTA 1988, and, prior to the abolition of tax on profits arising from woodlands, in computing such profits.

This provision, on the whole, has been successful in tackling the scheme at which it was aimed and, due to the fact that it is so specific and well targeted, it is rare for it to be a problem for innocent taxpayers. The one practical problem is the difficulty of establishing a commercial rent. This obviously depends on the evidence of appropriate professionals which, in this field, can vary widely from person to person. It is, however, difficult to see how the legislation could be made more specific to deal with this problem.

The provision itself is, therefore, a reasonable and relatively effective piece of legislation although, in the light of the Land Securities and the Littlewoods Mail Order Stores cases, in most cases a deduction for excess rents would be disallowed under normal principals anyway.

Land Sold and Leased Back: Taxation of Consideration Received

Following the introduction of what became section 779 in 1964, the Revenue relied on that section plus the general rules highlighted in the Land Securities and Littlewoods Mail Order Stores cases for a number of years. They then turned their attention to what they perceived to be another abuse of the rules, namely, the situation where a trader sold, for a capital sum, the remainder of an old lease to an institution, which was prepared to lease the premises back to the trader at the current market rent for the remainder of the original term. The Revenue considered this an unjustified method of obtaining capital at the expense of a reduction in taxable profits.

It seems that such schemes were encouraged by the substantial increases in rental values in the 1960's and 1970's which resulted in the commercial rent for the premises in question being often higher than the fixed rent payable by the trader.

Matters were brought to a head when, on 16th June 1971, apparently at the instigation of the taxpayers, it was reported in the Press that a claim to have the increased rent payable by Austin Reid Limited was disallowed by the Special Commissioners. The company had entered into a sale and leaseback transaction and the rent was not in excess of the commercial rate. This decision caused some concern and it was announced that legislation would be introduced in the next Finance Act, retrospective to 27th June 1971 to cover these schemes.

The legislation was contained in section 80 FA 1972, a section that has survived to the present day despite the fact that it is not very well drafted and, in many cases, is easy to circumvent. The section is now section 780 ICTA 1988.

Unlike section 779, instead of restricting still further the deductibility of the rent, section 780 subjects to income tax part of the capital sum received for the sale of the original lease. It is not necessary to examine the detailed provisions of this section; a brief outline of the way the section works will be sufficient for present purposes.

Section 780 operates where the original lease has not more than 50 years to run and the original lessee assigns this lease to another person, or surrenders it to the landlord, for a consideration which would, apart from section 780, be taxed as capital in the hands of the lessee. The lessee must be assigned or granted a new lease of the whole or any part of the land which was the subject of the original lease for a term not exceeding 15 years. Where the above conditions apply, a proportion of the capital sum received by the lessee is treated as income. This proportion is calculated by a formula, namely, $\frac{16 - N}{15}$, where N is the term of the new lease expressed in years.

Section 780 only operates if the new lease covers at least some of the land which was the subject of the original lease. Therefore, if the sale of an original lease is followed with a new lease of other premises, even if they are next door to the original premises, section 780 cannot operate.

Certain other obvious loopholes are, however, stopped by section 780. For example, a lessee who varies the terms of the original lease by agreeing with the landlord that the landlord will receive a consideration and the lessee will pay an increased rent, is treated as having surrendered the original lease and been granted a new one. Another potential loophole is covered by including, in the definition of a new lease, a lease to a partner or associate of the lessee, or to an associate of his partner.

Lease Premiums

In 1963, provisions were introduced to deal with a situation where a landlord attempts to replace highly taxed rental income with a capital payment received in return for the grant of a lease and the payment of a rent at below market rates. These provisions, sections 22-24 FA 1963, countered these schemes by treating a portion of the premium received for the grant of a lease of 50 years or less as additional rent, taxable under Schedule A. These provisions are now sections 34-38 ICTA 1988.

Section 34 states that, where a premium is paid under a lease which does not exceed 50 years, that part of the premium that is treated as income in the hands of the landlord is the amount of a premium reduced by 1/50th for each complete period of 12 months (other than the first) comprised in the term of the lease.

As section 34 does not apply to lump sums payable on an assignment of a lease, it would be easy to avoid section 34 by granting a lease to a connected person and for that connected person to assign the lease to the proposed tenant for a capital sum. This obvious avoidance device is covered by section 35. The section operates if a lease for 50 years or less is granted and the landlord could have demanded a premium or a larger premium than the one he negotiated, if he had been acting at arms length.

Section 35 is interesting in that it contains an almost useless clearance procedure. Section 35(3) states:

> "If there is submitted to the Inspector, by the grantor or any assignor or assignee of the lease, a statement showing whether or not a charge to tax arises or may arise under this section and, if so, the amount on which the charge arises or may arise,

then, if the Inspector is satisfied as to the accuracy of the statement, he shall certify the accuracy thereof."

An Inspector, of course, will not be trained in the rather specialised field of valuing leases so it is hard to think how he could possibly be satisfied as to the accuracy of the statement made to him.

<u>Section 36</u> covers another obvious device that could have been used to get round the main section 34 charge. Rather than grant a lease at a premium, a land owner could sell his land and buy it back at what would have been the end of the lease for a lower figure. The difference between the sale and purchase considerations would be the premium he would have taken had he granted a lease.

Section 36 says that, where land is sold with a provision that it shall be reconveyed at a future date to the vendor or to a connected person, an income tax charge is imposed on the vendor equal to the amount, if any, by which the sale price exceeds the reconveyanced price, reduced (if it cannot be reconveyed for at least two years after the sale), by 1/50th for each complete year (other than the first) in the period between the date of the sale and the date of reconveyance.

Again, it would have been easy to avoid this provision by a person selling the land with a right to have a long lease granted for a premium less than the sale consideration, or for no premium but at a nominal rent. Section 36 counters this device by stating that the lease is treated as a reconveyance at a price equal to the premium plus the value of the right to receive a conveyance of the reversion immediately after the lease begins to run. In order that commercial sale and lease back transactions are not affected by this anti-avoidance provision, there is an exemption where the lease is granted and begins to run within one month of the sale.

See section 38 for rules for ascertaining the duration of leases. This section covers a number of obvious potential avoidance devices aimed at securing a premature termination of a lease which, on its surface, would fall outside the above provisions.

Section 37 provides that an intermediate landlord who pays a premium to a head landlord and the head landlord incurs an income tax charge under sections 34-36, the intermediate landlord becomes entitled to a deduction equal to the chargeable amount of the premium. This was originally exploited by taxpayers who manufactured a premium by a sale with a right to reconveyance where, because of accumulated losses, no tax was payable on the taxable portion of the premium but an allowable deduction was generated under section 37. This device was countered by section 32 FA 1978[78] which withdrew the relief in such situations where there has been a sale with a right to reconveyance.

Section 80(6) ICTA 1970 gave a taxpayer the right to elect that, where a premium was payable by instalments, instead of suffering an income tax charge on the relevant fraction of the premium, the whole of each instalment would be taxable but only in the year in which it was payable. This election was exploited by schemes which deferred the liability to income tax on the premium until many years have elapsed while, at the same time, the current value of the premium was crystallised in other ways.

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78. Now section 87 ICTA 1988

Accordingly, section 81 FA 1972 amended section 80(6) ICTA 1970 so that, what is now section 34(8) ICTA 1988, reads:-

> "Where an amount by reference to which a person is chargeable to tax by virtue of this section is payable by instalments ('the tax instalments'), the tax chargeable by reference to that amount may, if he satisfies the Board that he would otherwise suffer undue hardship, be paid at his option by such instalments as the Board may allow over a period not exceeding eight years and ending not later than the time at which the last of the tax instalments is payable."

Finally reference should be made to the case of Banning -v- Wright,[79] where a payment to a landlord as part of a settlement of a breach of the terms of a lease constituted a payment for a variation of the lease.

See also section 14 FA 1962 in relation to short term capital gains and the acquisition and disposal of shares in land owning companies.[80]

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79. (1972) 48 TC 421
80. See Chapter 8

Development Land Tax

The FA 1976 introduced DLT as a separate tax on the development value of land. It superseded development gains tax which was introduced by the FA 1974 which was, not a separate tax, but part of the capital gains tax regime. Development gains tax was not on the statute books for long enough to make a real impact and it is not necessary to deal with the tax in any detail here. It is sufficient to say that the basis of the tax was that, on a disposal, the gain was split into the development element, which was subject to income or corporation tax, and the remainder of the gain, which was subject to CGT in the normal way. There was also a first lettings charge whereby, when a building was first let or occupied to a material extent after development had taken place, a person who had an interest in the property was deemed to have made a disposal of it for the purposes of CGT and development gains tax.

The legislation did contain two anti-avoidance provisions aimed at schemes for disposing of land indirectly by, for example, disposing of shares in a land owning company,[81] and disposing of an interest in a land owning settlement.[82]

Development gains tax was not the first attempt to tax gains from land separately from other gains as part of wider land policy by Labour Governments. Previous attempts were the 100% development charge in 1947, and the 40% betterment levy in 1967. It should be pointed out that, although development gains tax was introduced by a Labour Government, the Labour Party adopted and introduced the provisions originally put forward by the Conservative Party prior to their General Election defeat in 1974.

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81. Section 41 FA 1974
82. Section 42 ibid

DLT, which came into operation in 1976 was again a creature of the Labour Party and was again tied to wider land policy, being intended to be part of the community land scheme which, in fact, never came into operation.

The tax lasted until 1985 when it was abolished in that year's Finance Act. During its life it had become easy to avoid, low yielding and expensive to collect. In may respects, DLT became a voluntary tax for those who took appropriate professional advice.

DLT was originally levied at a rate of 80%, with a reduced rate of 66.67% on the first £150,000 of development value. It was intended that, once the community land scheme got under way the rate of DLT was to be raised to 100%. As mentioned above, however, the community land scheme never came into operation and, in 1979 the annual exemption was increased from £10,000 to £50,000 and the rates were reduced to a single rate of 60%. In 1984, the annual exemption was raised from £50,000 to £75,000.

Even at these high values, the return on DLT was extremely low.

It was estimated by Malcolm Grant, now a professor of planning law at London University, in an article in the Journal of Planning and Environment Law[83] that, given a tax rate of 60% on development values, the annual yield should have been £600m.[84] In fact, the net yields of DLT were as follows:-

1979 £13.1m
1980 £26.3m
1981 £26.9m
1982 £38.3m

83. (1986) p4 and p92
84. Ibid p11

It is also necessary to take into account the high administrative cost of collecting DLT. Grant discloses that, for example, in 1980/81, the cost of the DLT office itself was £1.39m, but the total administrative cost of the tax came to £4.9m.[85] The cost/yield ratio of DLT was the highest for any tax. In 1979/80 it was 12.8%, in 1980/81 it was 13.4% and in 1981/82 it was 11.6%. This compares with around 7% for income tax (except Schedule E which is about 1.5%), CGT at around 2.5%, corporation tax at under 1% and CTT/inheritance tax at around 3.5%. It was also pointed out by Grant that written-off assessments were surprisingly high, averaging over 5% of assessments and as high as 9% of net receipts in 1981/82.[86]

This low yield was due partly to the structure of the tax, with a range of exemptions and fairly beneficial bases of calculation, but, more importantly, to the fruitful planning and avoidance methods adopted by taxpayers and their advisers, particularly before the advent of the "new approach" in the Ramsay case.[87] Although, as the Bowater[88] case has subsequently shown, the "new approach" did not have such a major affect on DLT as was originally thought.

The anti-avoidance legislation relating to DLT was never very successful in preventing avoidance, as can be seen from the following analysis. Some of the schemes set out below were outlined in Professor Grant's article but, it should be noted, these examples were supplied to Professor Grant by the present writer.

The main schemes sought to exploit the annual exemption which, as mentioned above, started at £10,000, was

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85. Ibid p94
86. Ibid
87. W.T Ramsay Ltd v IRC (1981) 54 TC 101 see Chapter 11
88. IRC v Bowater Property Developments Ltd [1988] STC 476, see Chapter 11.

increased to £50,000 in 1979 and was increased still further to £75,000 in 1984. The avoidance devices took advantage of the fact that the exemption was related to the year rather than to particular transactions. Grant notes that the increase in 1979 resulted in a drop in notifications of disposals to the DLT Office from 20,940 in 1980 to 12,155 in 1981.

Most of the schemes which exploited the annual exemption were what became known as "fragmentation" schemes. Indeed, the scheme used in the Bowater case was of this type. There was some anti-avoidance legislation aimed at these schemes but it proved to be utterly useless. The first provision, which imposed only a minor barrier to fragmentation schemes, was produced by a combination of section 5(6) and 12(5) DLTA 1976, which said that the exemption would not be available if the land was acquired from a connected person within 12 months prior to the onward disposal. There was nothing, however, to prevent an option being granted to the ultimate purchaser during that 12 month period.

There were different methods of exploiting the annual exemption for individuals and for companies. However, they all worked on the same principal, namely, that, prior to the disposal to the ultimate purchaser, the ownership of the land would be fragmented by transferring it to an appropriate number of entities which would have their own annual exemption which, when added together, would eliminate the realised development value.

In the case of individuals, ownership was normally fragmented amongst the taxpayer's family using, for example, the inter-spouse exemption and, when it became available in 1980, CGT hold-over relief. Furthermore, in some cases it was possible to fragment ownership when the value of the land was low, at little or no CGT cost, and for planning permission then to be applied for.

Obviously CTT had also to be taken into account in situations other than in transfers between spouses and, again, this potential problem could be avoided by fragmenting ownership when the value of the land was low.

In the case of companies, fragmentation of ownership was a relatively easy matter because the required number of subsidiaries could be established and interests in the land could be transferred to them within the inter-group relief provided for by section 20 DLTA 1976. One large public company is reputed to have saved over £2m DLT by fragmenting its land between some 200 companies set up expressly for the purpose of the scheme.

Given the prevalence of such fragmentation schemes, the loophole was attacked by section 116(2) FA 1980. Given that the abuse was fairly specific and widely known, it is barely credible that Parliament can have introduced such an inadequate anti-avoidance provision. The counteracting legislation stated that the annual exemption would not be available if the disponer acquired his interest within six years prior to his disposal for a consideration of less than full market value as a result of an acquisition from a connected person which disposal was either a part-disposal or a disposal of an interest resulting from the part-disposal.

There were two main ways to side step this section. One of these became known as the "Cascade" scheme. An example of such a scheme would be where the land-owning company sets up a subsidiary, the subsidiary sets up its own subsidiary which, in turn, sets up a further subsidiary of itself, and so on, until there is a chain of subsidiaries sufficient in number to eliminate the realised development value, assuming they all get an annual exemption. The land-owning company would then sell the appropriate portion of the land to the purchaser and give the remaining land to the first of the subsidiaries. The first subsidiary would again sell the appropriate fraction of the land to the purchaser and pass the remaining land down to its subsidiary, and so on, until the whole of the land had been sold to the purchaser.

This scheme was not caught because each subsidiary in turn would not have acquired its land through a part-disposal because its immediate parent company would have transferred to it the whole of the remaining land, which was a complete disposal rather than a part-disposal, and it was also accepted that the disposal from parent to subsidiary was not a disposal arising from a part-disposal. Each subsidiary's sale to the purchaser (or sometimes to an interposed capital loss company to cancel any chargeable gains) would be covered by the annual exemption.

An example of a fragmentation scheme is the one used in the now celebrated Bowater case[89] which is dealt with in detail in Chapter 11.

Another way of getting round the 1980 amendment was by using unconnected group companies. This apparent contradiction in terms was brought about by having two classes of shares. The land-owning company would set up the appropriate number of new subsidiaries, each of which would have a share capital of, say, 24 "A" ordinary shares and 76 "B" ordinary shares. The "A" shares would have one vote per share, the right to the whole of any surplus on a widing up and the right to 90% of any dividend declared other than on preference shares. The "B" shares would have no votes, the right to repayment at par only on a winding up and the right to 10% of any dividend declared by the company in respect of any shares other than preference shares. The new companies would also have 100 preference shares each, which would have no

89. IRC v Bowater Property Developments Ltd [1988] STC 476

votes, the right to repayment at par only and a right to a fixed cumulative preference dividend. When a purchaser was found for the site, the "A" shares and the preference shares would be sold to him before exchange of contracts. The purchaser would then lend each of the new companies enough to buy their respective pieces of land. The companies would then buy the land from the vendor and sell on to the ultimate purchaser, the consideration being the release of the loans. The sale by the vendor to the new companies would be covered by section 20 DLTA 1976 because the vendor would own more than 75% of the "ordinary share capital" because only the "A" shares and the "B" shares would fall within this description. However, section 12(5) would not prevent each of the new companies from being entitled to a annual exemption because the parent and the subsidiaries would not be "connected" in view of the rights attaching to the shares held by the purchaser.

A more straightforward and less ambitious way of exploiting the annual exemption was merely to dispose of the land in two separate years so as to obtain two exemptions. Some schemes, however, sought to phase transactions over a longer period. This was normally done by a developer taking a series of options over a site which would be exercised in stages over a number of years. As the granting of an option did not constitute the disposal of a material interest in the land, DLT liability was postponed until the option was exercised. In order to safeguard both sides to the transaction, it became common to have put and call options so that either the vendor or the purchaser could exercise his option to buy or, as the case may be, sell the land. The DLT Office became increasingly unhappy about the use of put and call options, taking the view that they amounted to an immediately binding contract for the disposal of the land. It is difficult to see how they could establish that the beneficial interest in the land passed by operation of the cross-options but, by 1984, the DLT

Office had made it clear that they would challenge cross-options and that they would seek to recover DLT in respect of all past transactions which had used cross-options, except where they had already given clearance or an assessment had been raised and agreed. Following Furniss -v- Dawson,[90] even unilateral options were challenged by the DLT Office. In practice, however, it was normally possible to structure unilateral options and, in many cases, cross-options, to minimise the risk of a successful challenge, even under Furniss -v- Dawson. It was often possible to show a commercial reason for an option and, in any case, if the options were structured properly, they could not be challenged successfully without the Courts recharacterising the transactions.[91]

Options were also used initially in a more artificial way by taking advantage of the fact that the abandonment of an option did not constitute the disposal of an interest in land by virtue of section 8(2) DLTA 1976. The landowner would grant to, say, a subsidiary company an option to buy the land for a sum which would cover the relevant base value, plus expenses plus the annual exemption. The party being granted the option would agree to pay a sum which was the difference between the market value of the land and the purchase price payable on the exercise of the option. The land would be transferred, subject to the option, to the purchaser in consideration of the payment of a sum approximately equal to the amount payable for the land on the exercise of the option. The purchaser would agree to pay a sum, which when added to the amount paid for the land, would equal the market value of the land, to the option holder at the end of the option period of the option had not been exercised. In due course, the option period would elapse without the option being exercised and the

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90. (1984) 55 TC 324, see Chapter 11
91. As to the extent to which this was permissible, see Chapter 11

purchaser would pay the agreed sum to the option-holder. That sum would then be transferred from the option-holder to the vendor in satisfaction of the debt arising on the granting of the option. The purchaser would have paid the market value of the land, partly for the land itself and partly for the abandonment of the option. Such an artificial scheme as this became unworkable following the Ramsay case.[92]

In fact, the "new approach" tended to diminish greatly the use of even the more straightforward fragmentation schemes because of the climate of uncertainty surrounding the application of the Ramsay principal. The uncertainty was not finally settled until the Bowater case was decided by the House of Lords several years after DLT was abolished.[93]

As well as this uncertainty, the Inland Revenue also had other lines of attack. For example, if a fragmentation scheme was not set up properly, the Revenue sometime argued that the various joint owners following the fragmentation were acting in partnership in selling the land on to the purchaser. The Revenue were not successful in using this argument, however, if the transactions were set up properly.

One useful method of avoiding DLT, which was accepted as effective by the DLT Office related to the inter-action of DLT with other taxes. A typical scheme would be for land held by an investment company to be disposed of to a land dealing company and then appropriated to trading stock. That would trigger a corporation tax charge which could then be set against a subsequent DLT liability when the land was sold outside the group. If that corporation tax charge was then sheltered by, for example, losses brought forward or by a capital allowances scheme

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92. W.T Ramsay Ltd v IRC (1981) 54 TC 101, see Chapter 11
93. See Chapter 11

generated first year allowances, the reduction in the DLT liability would remain.

Given the prevalence of DLT avoidance schemes, it is noteable there was very little actual anti-avoidance legislation. The two main reasons appear to be that, firstly, DLT did not remain on the statute books for long enough for a comprehensive collection of anti-avoidance provisions to be drafted in response to the schemes and, secondly, and probably more importantly, the "new approach" and the uncertainties that came with it arose in the middle years of the DLT era and, particularly in the early years of the Ramsey principal, it was thought by many to have a much wider application than it eventually turned out to have.

However, there were a few anti-avoidance provisions. Section 5(6) and section 12(4), as subsequently amended by section 116 FA 1980, have already been mentioned. There are two other minor avoidance provisions that can be mentioned. <u>Section 21 DLTA 1976</u> was similar to section 278 ICTA 1970 in connection with corporation tax on capital gains.[94] It applied where a company left a group within six years following the acquisition of land from another group company. The operation of section 21 was slightly different from section 278 because, whereas under section 21 the departing company is treated as having sold the land and reacquired it on the date it leaves the group; under section 278 the disposal and reacquisition is deemed to take place when the departing company acquired the asset. The object of section 21, as with section 278, was to ensure that the group relief provisions were not used to avoid DLT on a transfer outside the group by transferring the asset within the group and then selling the transferee company to the outside purchaser.

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94. See Chapter 8

Section 44 DLTA 1976 was a provision to prevent long leases being masqueraded as short leases so as to establish a much lower value. Basically, if there was a provision under which the term of a lease could be extended at the option of the tenant, the lease was assumed to be for the maximum term possible under the particular option arrangements in question. Brief mention can also be made of section 40 DLTA 1976 under which 50% (reduced to 40% by the FA 1984) had to be deducted from consideration payable in respect of development land to vendors whose usual place of abode was outside the UK. This was to prevent foreign vendors from failing to account for the DLT for which they might be liable. The money deducted was payable to the Inland Revenue on account of the potential DLT of the vendor. In fact, in 1984, this requirement was extended to all land and not just development land.[95] This change, which had effect from 6th August 1984, could have caused major problems as it was not restricted to development land.

Purchasers who failed to make the required deduction would have to pay the required amount to the Inland Revenue out of their own resources. There was, however, a clearance procedure under which, if the DLT Office were satisfied that the disposal would not give rise to DLT, they would authorise the purchaser to make no deduction. As it turned out, the amendment made by section 121 FA 1984 did not cause many major problems due to the abolition of DLT in 1985.

An interesting case in which a company tried to avoid DLT by exploiting the rules relating to the commencement of a project of material development was R -v- IRC, ex parte Harrow London Borough Council[96].

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95. Section 121 FA 1984
96. [1983] STC 246

Under section 2(1) DLTA 1976, the start of a "project of material development" operated as the deemed disposal of an interest in the land giving rise to a charge to DLT. However, by section 18, DLT was not chargeable on the commencement of such a project if this was within three years of the acquisition of the land and it could be shown that no significant amount of development value would have been realised had the project been commenced immediately after the acquisition. The other provision of relevance to this case is section 39(1) which stated that, where an interest in land was disposed of to certain types of local authority or exempt body having compulsory acquisition powers, that authority or body should make a deduction from the consideration payable on account of the DLT due in respect of that disposal.

The facts were that a development company, Peerage Properties Limited, purchased land in the London Borough of Harrow. Subsequently, the Council made a compulsory purchase order on the land which was later confirmed by the Secretary of State. Meanwhile, two planning permissions were granted for the development of houses and flats on the land. Peerage submitted to the DLT Office a notice of commencement of a project of material development which was stated to comprise a number of dwellings and flats and to have commenced with the digging of foundation trenches to two buildings and the laying of ducted copper water pipes in an through the foundation with the necessary stop-cocks to accept internal service. A few days later the Council served Peerage with a notice to treat and a notice of entry and took possession of the land.

The Council, being entitled to the benefit of any DLT payable under section 39, claimed that its acquisition of the land from Peerage amounted to a disposal of the land by Peerage and that Peerage should be assessed to DLT on the basis that no project of material development had been started. The Council contended that a project of material development involved an intention that it should be carried out to completion and that Peerage, when carrying out the works in question, had no such intention and that the works should not therefore constitute a "specified operation" within the meaning the Act. The Board of Inland Revenue took the view that it would not be proper for them to proceed on the basis that a developer's notice of the start of a project must reflect an intention to carry it out and a reasonable expectation of his being able to complete it, and that the works undertaken by Peerage amounted to a "specified operation" within the Act. Accordingly, they ruled that an assessment to DLT should not be made on Peerage. The Council applied for judicial review of the Inland Revenue's decision, seeking a declaration that the Revenue had erred in law in not making an assessment.

In the Queen's Bench Division, Stephen Brown J held that, for the purposes of the DLT Act, a project of material development could not be taken as having commenced on the carrying out of works alleged to constitute "specified operations" unless, when carrying out the works, the developer concerned had the intention to carry out the project. On the evidence before him, he held that the works alleged by Peerage to be "specified operations" were, in reality, colourable operations undertaken solely for the purpose of attempting to avoid the incidence of DLT. He held that, in arriving at his decision, the Board of Inland Revenue deliberately chose not to question Peerage's notice at the start of the project and, by doing so, had failed to consider the only question which it should have considered, namely, whether in fact the project of material development had been begun. In the circumstances, it could not be said that the Board's decision not to assess Peerage was based on an objective assessment of the known facts of the case. The Board had misdirected itself in law and had based its decision on extraneous considerations. The judge said:

"Having regard to the evidence, which can only be described as overwhelming, pointing to the minor works alleged by the developers to be 'specified operations' as being in reality colourable operations, undertaken solely for the purposes of attempting to avoid the incidence of Development Land Tax, rather than the start of an actual 'project of material development', I find myself driven to the conclusion that the Board's decision was based on considerations of policy and administrative expediency and not on an objective assessment of the known facts of the case."[97]

The result of this case was that a taxpayer could not establish the commencement of a project of material development by carrying out minor operations on the land with no intention of carrying through the development to its completion.

An attempt to fragment ownership within a trust failed in the case of IRC -v- Matthews Executors.[98] A testator created a settlement, appointing the taxpayers as his trustees and executors with power to realise, administer, manage and divide the assets of his estate as if they were the beneficial owners and directed them to divide the residue of his estate equally among 12 charities. When the testator died, his estate included land with development potential. The taxpayers took steps to dispose of this land but, before a contract was concluded, they decided that they would treat the land as having been allocated equally among the beneficiaries and that they would enter into a contract of sale only as agents of the beneficiaries. The taxpayers did not inform the beneficiaries of their decision to allocate the land to them until after the contract of sale had

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97. p288
98. [1984] STC 386

become unconditional. The taxpayers were assessed to DLT in respect of the disposal of the land. They appealed, and the Special Commissioners decided that the rights of the beneficiaries to the land crystallised immediately on the taxpayers decision to allocate the land to them and that the disposal was therefore made by the beneficiaries jointly, and not by the taxpayers.

On appeal by the Crown, the Court of Session held that, on a proper construction of the trust provisions, it was the duty of the trustees to realise the estate and to divide the proceeds of disposal of the residiary estate in cash among the residiary beneficiaries. The power to allow any beneficiary to take over any asset was contrary to the requirements of that duty. Accordingly, under the provisions of the trust, the trustees had no power to deal with the assets of the estate of the testator by taking a decision which irrevocably conferred on the residiary beneficiaries the exclusive right to direct how the land should be dealt with. It followed that, immediately, before the disposal of the land, the land was not held on trust for the beneficiaries absolutely as against the trustees and, accordingly, the appeal was allowed. The Lord President (Emslie) said that the decision by the trustees "was clearly a device, having as its single objective, the mitigation of any tax liability on disposal of the land."[99]

Before a body of anti-avoidance provisions and cases on DLT avoidance could be built up, the tax was abolished in 1985. Malcolm Grant[100] sets out five reasons which were advanced by the Government for the abolition of DLT, namely:

1. It was expensive to collect.

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99. p391
100. Op cit pp4-5

2. It was a clog on the supply of land for development, particularly for house building, and its abolition fell within the Government's deregulation objectives.

3. It had a distortive effect on the market.

4. It was set at an unfair and discriminatory rate compared to corporation tax.

5. Its raison d'etre as a special tax on development values no longer existed when the Government had brought inflation under control.

Malcolm Grant continued:

> "For the Chancellor, the abolition of DLT was nothing more than the removal of a highly technical, unpopular and little understood tax. Removing it will provide a substantial boost to the house building and construction industry at a net annual cost to the Exchequer of no more than £50m. But the reality is far more complex. The impact on planning and the land development process is likely to be substantial. DLT was always far more than a simple taxation instrument; it was at the outset an instrument of land policy, and even though that role disappeared with the repeal of the community land scheme, the tax continued to have a marked influence on land development. It played a large part in moulding the present patterns of land supply and the servicing of land for development; it influenced land assembly for private development and the disposal of land by public bodies. It affected the choice between redevelopment and relocation for commercial and industrial firms, and it helped underwrite planning gain and private sector funding of off-site infrastructure."[100]

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100. op cit pp4-5

One final point to make regarding the prevalence of DLT avoidance schemes before the enthusiasm of the taxpayers and their advisers was dampened by the Ramsay case, is that the widely drafted anti-avoidance section 776[101] and 703[102] did not apply to DLT.

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101. Supra
102. See Chapter 1

Woodlands

Prior to the 1988 Budget, investment in woodlands was an ideal way for high taxpayers to shelter some of their taxable income. The effect of the tax regime that existed up until the 1988 changes was that woodlands could be created out of income, with tax relief at an individuals top rates of tax, and they could often be sold with no income or capital gains tax being paid. The tax advantages were also available to companies. In the case of individuals, there are also inheritance tax reliefs available to the owners of woodlands.

Successive Governments for a long time recognised the need to encourage the planting of woodlands, and the tax rules were kept in a state which made woodlands an attractive investment, particularly when coupled with the available cash grants. However, in the late 1970's and in the 1980's, investment in woodlands became increasingly exploited by high earners and the tax benefits began to have a distoring affect on the type of woodlands being grown. Nature and environmental groups argued that plantations were being established in ecologically sensitive areas and planted without regard to the environment. The way the tax reliefs were structured, they argued, led to a bias towards the planting of fast growing coniferous tree species at the expensive of slower growing pine trees and broad-leaved species. In the end, the Government bowed to this pressure and replaced the advantageous tax regime with an enhanced system of forestry planting grants.

Prior to the changes, the occupation of woodlands in the UK managed on a commercial basis with a view to the realisation of profit was taxed under Schedule B. The charge under Schedule B fell on the occupier (whether owner or tenant) on the assessable value of his occupation. The assessable value was an amount equal to one-third of the woodland's annual value. The annual value was the rent which might reasonably be expected on a letting from year to year if the tenant undertook to pay all usual tenant's rates and taxes, and the landlord undertook to bear the costs of the repairs and insurance and the other expenses necessary for maintaining the woodlands in a state to command that rent. This annual value was determined on the basis that the land was let in its natural and unimproved state, namely, without regard to the actual timber growing on it.

However, the occupier could elect to be assessed under Schedule D on the profits from the exploitation of the woodlands. This election had effect for the year of assessment to which it related and for all future years, so long as the woodlands were occupied by the person making the election. The election was irrecoverable. The election provided an opportunity for income and corporation tax planning. When the woodlands were immature or otherwise unprofitable, the occupier could elect for taxation under Schedule D because of the deductibility of revenue expenditure and the availability of capital allowances on such things as machinery and plant, forestry buildings, etc.

When the woodlands reached maturity, taxation under Schedule B was normally preferable, as the assessable value for schedule B purposes was likely to be much less than the profits assessable under Schedule D. As mentioned above, an election for taxation under Schedule D was irrevocable. However, on a change of ownership, the basis of taxation for the new owner automatically reverted to Schedule B (unless and until an election was made for taxation under Schedule D by the new owner). Accordingly, when the woodlands reached maturity, the change of ownership could be engineered so that Schedule B would apply. This could be done by, for example, transferring the land to a relative, a trust or a company set up by an individual owner, or a fellow group company of a corporate owner.

Once Schedule B applied no further tax was payable on the sale proceeds of the timber or on grants received.

The main tax sheltering opportunities arose under the use of Schedule D. This basis was normally appropriate for new woodlands, for example, if land was to be planted for the first time or re-planted after a timber harvest. The expenditure on clearing, fencing, drainage, road, etc., if the land had been used for woodlands before, was likely to be a revenue rather than a capital expense. In the case of both new and existing woodlands, revenue expenses could be numerous and would include:

(a) purchase of trees, fertilisers, weed killers, etc.;

(b) wages;

(c) rents, rates and insurance;

(d) repairs, depreciation and other overhead expenses.

In addition, capital allowances would be available which, at one time, were as high as 100% in the first year on machinery and plant and, even when the capital allowances rates had been cut, machinery and plant still qualified for an annual writing down allowance at 25%.

The only income in the first years was likely to be grants, so losses were regularly incurred which could be off-set against an individual's other income for the same year or for the following year or, alternatively, carried back three years if a new trade was established (which was deemed to happen if an election for Schedule D was made). A company could set the loss against other profits of the year in question or the previous year, if the trade was carried on in that year.

In addition to these income and corporation tax benefits, the disposal of timber, whether standing, felled or cut, was exempt for capital gains tax purposes if Schedule B applied. The land itself was not exempt. Also, the sale of growing timber was exempt whether Schedule B or D applied. Under Schedule D, if the trees were separated from the land, any receipts from their disposal would be treated as income subject to income or corporation tax.

Where the owner was an individual, there were a number of reliefs that applied to woodlands forming part of his estate. For example, there was a deferment of inheritance tax on death whereby the inheritance could be deferred until the timber was subsequently disposed of. Business property relief and, in some case, agricultural property relief was also available.

The rules governing the taxation of woodlands were such that, at each stage in their development, woodlands could potentially be used as a tax planning tool.

In the early years, they were attractive for companies and individuals with taxable profits and income. As noted above, by electing for a taxation under Schedule D, the deductibility of revenue expenses and the availability of capital allowances, coupled with the lack of income, normally created losses. The cost of the underlying land would not be allowable for tax purposes but the interest incurred on a loan for buying it was often allowable as a business expense.

In the middle years, when the timber was growing, there would often be no income from the woodlands and expenditure would be low and restricted to such things as insurance and fence maintenance. However, the value of the timber would be increasing and this increase in value would not be subject to CGT. For this reason, woodlands at this stage in their development, were often attractive to pension funds and life assurance companies.

When the time came for the timber to be harvested, as mentioned above, the income arising would be tax free if matters could be engineered so that Schedule B could be applied.

In addition to these basic tax planning opportunities, a number of more sophisticated schemes were based on the tax rules relating to woodlands. For example, these rules could be used by directors of family companies to produce worthwhile tax advantages in the medium term, say, ten years. If a company was cash-rich and the director was fairly young, the following scheme could represent a very tax efficient investment, providing benefits, not only to the director, but also to the company. The company would purchase bare land suitable aforestation. This could be acquired relatively cheaply. The company would grant a "planting" lease of the land to the director. The lease could be at a market rent but this would normally be very low indeed because such planting leases had little value. The company paid additional remuneration to the director which was used to fund the planting of trees on the land. The director, electing for taxation under Schedule D, incurred considerable expenses as mentioned above, producing a loss which could be set against his other income.

There was an additional advantage in that the additional remuneration reduced the company's taxable profits. The overall affect of these first steps was that profit taxable in the hands of the company had been converted into an allowable loss in the hands of the director and, at the same time, the money had been put into a good investment. As a subsidiary point, the additional remuneration often allowed larger pension contributions to be made for the director.

After, say, eight or ten years, the land would be covered with valuable trees which could be sold tax free to, say, the company. The company, as a new owner, would be taxable under Schedule B and would harvest the trees and not pay tax on the profit, paying tax only on the assessable value of the land. Alternatively, the woodlands could be sold to a pension fund.

When the exploitation of forestry in this was began to get out of hand and the pressure from conservation, nature and environmental groups grew, Government bowed to this pressure and changed the rules with effect from 15th March 1988. The change was made quite simply and effectively. Without having to introduce wide-ranging and complicated anti-avoidance provisions, the Government immediately put an end to the worst excesses of both individual and corporate taxpayers who had previously used woodlands as a convenient tax shelter.

The matter was dealt with simply by removing commercial woodlands from the scope of income tax and corporation tax altogether so that the expenditure for the cost of planting and maintaining the trees was not allowed as a tax deduction against other income, and the proceeds from the sale of the trees was not charged to tax.

This change was achieved by abolishing Schedule B altogether as from 6th April 1988 and, subject to certain transitional provisions, the right of occupiers of commercial woodlands to elect to be assessed under Schedule D ceased to have effect on 15th March 1988. Existing occupiers of commercial woodlands who had elected for schedule D as at 15th March 1988 were allowed to continue to get tax relief for the net expenditure they incurred in relation to those woodlands until the end of the transitional period of 5th April 1993.[103]

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103. Section 65 and Sch 6 FA 1988

The removal of the tax benefits was made in tandem with an increase in the forestry grants available. It was estimated that the change in the tax rules would increase tax revenues at the end of the transitional period, by over £10m a year.[104]

104. Inland Revenue Press Release, 15 March 1988

CHAPTER 4

THE EXPLOITATION OF LOSSES

Restrictions on Right of Set-off

Parliament first stepped in to take action against abuses of the rules relating to trading losses in 1960. At that time, there were two particular areas causing them concern, namely, the activities of "hobby" farmers, and the exploitation of a particular relief in the early years of a trade.

In the Budget speech of 1960, the Chancellor, Mr. Heathcoat Amory, set out his concerns and intentions in the following way:-

> "My next proposal concerns losses in farming and certain other activities. As the Committee know, attention has been focussed lately on the continuous losses incurred by some so-called hobby farmers. As the law stands, the Revenue suffers by having to repay the tax on other income equivalent to the loss and the Royal Commission on Income Tax[1] advised that action should be taken.
>
> I propose that loss relief in respect of farming losses - or indeed any other trading losses - shall be admitted only if the activities are carried on 'on a commercial basis and with a reasonable expectation of profit'. I am sure this is fair. It will not adversely affect genuine farming at all. I believe in fact that the genuine farming activities carried on by those who also have other occupations in many cases bring benefit to the farming industry.

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1. The Royal Commission on the Taxation of Profits and Income, whose Final Report was published in 1955 (Cmd 9474).

This new provision will operate for loss claims for the year 1960/61 and subsequent years. My proposal will, therefore, give those who may be affected notice of the basis for dealing with loss claims in respect of the income tax year that starts on Wednesday. They will be able, if they are so minded, to start at once to put their affairs on to a commercial basis, and if they can show the General Commissioners next April that they have done so they should not be adversely affected by the new provisions.

With the foregoing proposal about losses, I associate another. There is in the Income Tax Code (section 142 of the Income Tax Act 1952) another provision which enables a loss in one trade to be set against the profits of another trade carried on by the same person. Section 142 has, I regret to say, been used for tax avoidance purposes. Because of the special rules for assessment in the early years it is possible for a loss incurred at the outset of a new business to be set against the profits of another business two or nearly three times over, a possibility extremely painful to me. The needs which section 142 was designed to meet have since been met by other provisions for the relief of losses either by set off against income of the year of loss or by carry forward. I therefore propose to repeal section 142."

It will be noted that the Chancellor commented that the Royal Commission on Income Tax had advised that action should be taken. Although the Royal Commission, having examined the evidence placed before them by the Board of Inland Revenue, came to the conclusion that "the complaints against the losses of the hobby farmer are probably exaggerated", the Royal Commission did recommend that the law should be amended by inserting a reference to farming being carried on on a commercial basis and with a view to the realisation of profits.[2]

The Royal Commission noted that, to put the problem in perspective, the Revenue had disclosed that, in 1954, farming loss claims of individuals and firms amounted to £10.75m, compared with loss claims of individuals and firms engaged in profit making activities other than farming of £3.45m. The loss claims of companies engaged in ordinary trading activities amounted to £20m. However, the commission did not think that these figures warranted any clear deductions adverse to the hobby farmer. Their reasons for saying this were:

> "First, the figure of the hobby farmer merges into that of the spare-time farmer and spare-time farmers are a composite class embracing the country landowner with a home farm and the local trader (cattle dealer, butcher, blacksmith, agricultural merchant), as well as the hobby farmer proper. Even so, the whole class is only a small section of the agricultural community.
>
> Secondly, there can be no doubt that the increased output that has been achieved by the farming industry in recent years, despite a decreased employment of labour, is due to large scale mechanisation. This means that a proportion of losses claimed may well be due to the capital allowances instituted in 1945 and do not necessarily represent a permanent level of loss. Lastly, even large losses for hobby farmers do not warrant the inference that there is deliberate loss or indifference to loss, considering how much of them may be due to inexperience or lack of aptitude on the one hand or to experiment with new methods and techniques on the other."

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2. Farming Losses are discussed in paragraphs 489-497 of the Final Report (Cmd 9474).

The Commission concluded that, examining the activities of spare time farming in view of the general economy, they did not think that the verdict was an adverse one. As they said:

> "Credit would have to be given for certain valuable pioneering - the introduction of methods and techniques derived from industry or business, a readiness to take advantage of scientific advances, and to make the capital available to support such experiments."

The change recommended by the Royal Commission which was taken up by the Chancellor in 1960, was not likely, in the view of the Royal Commission:

> "To bring about any considerable change in the present position, or markedly to reduce the volume of loss claims in respect of farming. But it will be of considerable assistance to the Revenue in putting out of court claims in respect of farming activities which can be seen clearly to lack commercial inspiration and to be nothing more than hobbies or private amenities."

The ensuing legislation was contained in <u>section 20 FA 1960</u>.[3] The section restricted relief under what was then section 341 ITA 1952[4] to cases where it could be shown that the trade or profession was being carried on for the year of assessment on a commercial basis and with a view to the realisation of profits. The section stated that the fact that a trade was being carried on at any time so as to afford a reasonable expectation of profit would be conclusive evidence that it was then being carried on

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3. Now section 384 ICTA 1988
4. Now section 380 Ibid

with a view to the realisation of profits.

The second change made in 1960 was to withdraw relief under section 142 ITA 1952. Under this section, losses incurred in a trade or business could be set off against the profits made in another. By 1960, section 142 was being widely used as a instrument of tax avoidance in conjunction with the commencement provisions in section 128 ITA 1952.[5] The provisions of section 128 worked in the same way as section 61 ICTA 1988 and, by starting a new trade and making a loss in the first year, that loss could effectively be used up to three times, and that multiplied loss could be set against the profits of an existing trade. This particular form of avoidance was stopped by abolishing section 142 relief altogether for accounting periods ending after 5th April 1960.[6]

In passing, it can be noted that the problem of the exploitation of the commencement and cessation provisions is something that is still confronting the Government and the Revenue some thirty years later.

It soon became apparent that section 20 FA 1960 did not go far enough and further action was taken against the losses of hobby farmers in 1967.

A lot of the problems could be traced to section 124 ITA 1952[7] which then, as now, stated that all farming and market gardening in the United Kingdom shall be treated as the carrying on of a trade. Accordingly, the cultivation of land was classed as a trade even though no real trading took place. The Government were content to treat farming as if it were trading, but treating farming losses as trading losses led to abuses which Parliament tried to counter in 1960 and 1967.

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5. The predecessor to section 61 ICTA 1988
6. Section 20(8) FA 1960
7. Now section 53 ICTA 1988

Section 20 FA 1960 was not specifically directed against farming, although farming was its main target. Other vocational activities and hobbies were also within its ambit. The problem with section 20 FA 1960 was that, if the hobby farmer had the intention of making a profit he was entitled to his tax relief, regardless of the fact that he made heavy losses and of the fact that the possibility of actually making a profit was remote. The short-comings of section 20 FA 1960, to a certain extent, dealt with by section 22 FA 1967.[8]

Section 22, unlike the 1960 provisions, were confined to farmers and market gardeners. The section denied the right to set off losses and capital allowances against total income under section 341 ITA 1952[9], or, in the case of companies, section 58(2) ITA 1952. Section 22 operated if, in each of the five previous years, a loss (computed without regard to capital allowances) was incurred. The section contained two possible escape routes. The first was that the section did not apply where the farm or market garden formed part of, and was ancilliary to, a larger trading undertaking. Secondly, the section did not apply where the taxpayer could show that, in the year following the five year period, the whole of his farming or market gardening activities were of such a nature, and were carried on in such a way, as would have justified a reasonable expection of future profits if they had been undertaken by a competent farmer or market gardener. The taxpayer also had to show that, if such a competent person had in fact undertaken the activities in the five prior years, he could not reasonably have expected the activities to have become profitable until after the end of the sixth year.

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8. Now section 397 ICTA 1988
9. Now section 380 ibid

Section 22 FA 1967[10] did not apply to restrict relief in the first five years of trading; although relief could be denied if the taxpayer fell foul of the wider provisions of section 20 FA 1960.[11]

There are corresponding rules for corporation tax in section 393 ICTA 1988.

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10. Section 397 ibid operates in a similar way
11. Section 384 ibid

Change in Ownership of Company

The next major anti-avoidance provision concerning trading losses was enacted in 1969. The FA 1969 was notable for a number of very widely drafted anti-avoidance provisions. As well as section 30 FA 1969, which is the section under consideration here, sections 31 to 33 also contained wide anti-avoidance legislation. Section 31 to 33 introduced the enactments which later became sections 775[12] and 776[13] ICTA 1988 and they also contained an amendment to section 739 ICTA 1988.[14]

The need for this section can be traced back to 1954. The provisions that became section 343 ICTA 1988 were introduced in that year to prevent tax being avoided by artificial discontinuances of companies. As will be seen below, the legislature inadvertently created a market in tax loss companies. The problem was that trading losses could be transferred to a new company which could be sold to a purchaser which could use those losses by ensuring that future profits arose in the acquired company so that the accumulated losses could be used to reduce or eliminate those profits.

Section 30 FA 1969 was introduced to curb the worst abuses while, at the same time, allowing genuine sales of loss-making companies to continue. It did this by targeting two particular abuses. One was where the transferred company's trade was altered significantly after the transfer, and the other was where the transferred company's trade had been run down to such an extent that its activities were negligible and were subsequently increased under the new ownership. In this way, the legislature tried to ensure that the cumulative losses and the future profits were incurred in the same trade.

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12. See Chapter 1
13. See Chapter 3
14. See Chapter 9

What is now <u>section 768 ICTA 1988</u> states, in subsection (1):

"If -

(a) within any period of three years there is both a change in the ownership of the company and (either earlier or later in that period, or at the same time) a major change in the nature or conduct of the trade carried on by the company, or

(b) at any time after the scale of the activities in a trade carried on by a company has become small or negligible, and before any considerable revival of the trade, there is a change in the ownership of the company,

no relief shall be given under section 393 by setting a loss incurred by the company in an accounting period beginning before the change of ownership against any income or other profits of an accounting period ending after the change of ownership."

Subsection (4) is also worthy of mention here. It states:

"In subsection (1) above 'major change in the nature or conduct of a trade' includes -

(a) a major change in the type of property dealt in, or services or facilities provided, in the trade; or

(b) a major change in customers, outlets or markets of the trade;

and this section applies even if the change is the result of a gradual process which began outside the period of three years mentioned in subsection (1)(a) above."

Rules for ascertaining a change in the ownership of a company are set out in section 769 ICTA 1988. The first three subsections of that section run as follows:-

"(1) For the purposes of section 768, there is a change in the ownership of a company -

(a) if a single person acquires more than half the ordinary share capital of the company; or

(b) if two or more persons each acquire a holding of 5% or more of the ordinary share capital of the company, and those holdings together amount to more than half the ordinary share capital of the company; or

(c) if two or more persons each acquire a holding of the ordinary share capital of the company, and the holdings together amount to more than half the ordinary share capital of the company but disregarding a holding of less than 5% unless it is an addition to an existing holding and the two holdings together amount to 5% or more of the ordinary share capital of the company.

(2) In applying subsection (1) above -

(a) the circumstances at any two points of time with not more than three years between them may be compared and a holder at the later time may be regarded as having acquired whatever he did not hold at the earlier time, irrespective of what he has acquired or disposed of in between;

(b) to allow for any issue of shares or other reorganisation of capital, the comparison may be made in terms of percentage holdings of the total ordinary share capital at the respective times, so that a person whose percentage holding is greater at the later time may be regarded as having acquired a percentage holding equal to the increase;

(c) to decide for the purposes of subsection (1)(b) or (c) above if any person has acquired a holding of at least 5%, or a holding which makes at least 5% when added to an existing holding, acquisitions by, and holdings of, two or more persons who are connected persons within the meaning of section 839 shall be aggregated as if they were acquisitions by, and holdings of, one and the same person;

(d) any acquisition of shares under the will or on the intestacy of a deceased person and, if it is shown that the gift is unsolicited and made without regard to the provisions of section 768, any gift of shares, shall be left out of account.

(3) Where, because persons, whether company members or not, possess extraordinary rights or powers under the articles of association or under any other document regulating the company, ownership of the ordinary share capital may not be an appropriate test of whether there has been a major change in a persons for whose benefit the losses may ultimately enure, then, in considering whether there has been a change in

the ownership of the company for the purposes of sections 768, holdings of all kinds of share capital, including preference shares, or of any particular category of share capital, or voting power, or any other special kind of power, may be taken into account instead of ordinary share capital."

It can be seen that the section is drafted very widely and is capable of catching a large number of transactions, many of which are not of the type the original section was brought in to stop. The wording is so wide-ranging that it is very difficult for taxpayers to be sure that losses of a company being transferred will be available for future use, even in situations which are bona fide commercial company transfers. The situation is virtually always covered by very full warranties and indemnities.

The wording of subsection (3) is particularly wide and uncertain. It is clear that the object of the section is to stop taxpayers circumventing section 768 by manipulating the rights attaching to shares. However, the wording of subsection (3) is very vague even by the standards of modern anti-avoidance legislation. Going though the sub-section, there are a number of features that are not adequately dealt with. For example, no explanation is made of what "extraordinary rights or powers" are. This is not a term of art or a recognised term of company law. The concept of such rights or powers rendering the ownership of the ordinary share capital inappropriate is left tantilisingly vague. Later there is a reference to "any other special kind of power" and it is not explained how this relates, if at all, to the "extraordinary rights or powers" referred to earlier. Finally, the reference to "holdings of all kinds of share capital" opens the section up very widely indeed. It is very difficult for advisers to guide taxpayers on the precise nature of the Revenue's powers under this subsection.

Reference should also be made to section 769(2)(a) from which it can be seen that the Inland Revenue can chose any two points with not more than three years between them to make the comparison in applying the change of ownership tests. Thus, the potential for catching innocent transactions is greatly increased.

It should be noted that the major change in the nature or conduct of trade can take place either before or after the change of ownership. If the section had been drafted to apply only to major changes in the trade after the change of ownership, it would have been possible for the old owners and the new owners of the company to arrange for the trade to be altered before the change in ownership. However, by seeking to catch such devices, many innocent situations have thereby been potentially been brought within the ambit of the section. For example, a company may try something new by way of its business activities and, the new venture might fail miserably thereby giving rise to trading losses. If the company is then sold and the new owners tried to develop the new activities of the company, they could find themselves caught by section 768 and unable to use the accumulated losses. It is noticeable that section 768(4) gives examples of situations falling within the definition "major change in the nature or conduct of the trade", namely:

"(a) a major change in the type of property dealt in, or services or facilities provided, in the trade; or

(b) a major change in customers, outlets or markets of the trade."

The subsection then goes on to state that "this section applies even if the change is the result of a gradual process which began outside the period of three years mentioned in subsection (1)(a) above".

These are just the sort of changes, taken on a commercial basis, that can lead a company to accumulate losses and for the existing owners of that company to seek to off-load the company which had failed in its new business venture. There is in the section no bona fide commercial transaction exemption, so losses incurred after a genuine change in direction of the company could well be unavailable to any new owners of the company who sought to breathe new life into it.

Furthermore, there is no indication when the "gradual process" is to be deemed to start and end. The certainty of the three year period is, to a certain extent, nullified by this reference to the "gradual process". The Revenue can take any two points in the three year limit and if there is a major change when those two points are compared, even if those changes built up over many years outside the three year period, the section could apply. A company could develop new lines and seek new customers and try very hard to make the new activities profitable. If the company's hard work comes to nothing, it seems harsh that those losses cannot be used by anyone else willing to take over the company.

There has been to date only one case on section 768, namely, <u>Willis -v- Peeters Picture Frames Limited</u>.[15] The taxpayer company carried on the business of manufacturing and selling picture frames and mouldings. On 21st May 1976, it was taken over by Mouldings Limited, the parent of a group of companies operating in the same field. By that date, the taxpayer company had incurred trading losses of £87,000. Over the next three years the taxpayer company continued, as a subsidiary of Mouldings

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15. [1983] STC 453

Limited, to manufacture the same type of goods but altered its method of sales and marketing. Prior to the takeover, the taxpayer company had sold its products entirely on the open market, principally to wholesalers and to a much lesser extent, to retailers and the general public, negotiating the price directly with the customers. After the takeover, on the other hand, it increasingly sold its products to distribution companies within Mouldings Limited's group so that, by the end of the third year, 92% of its sales were to the group, at a price equal to cost price plus 10%. The sales were still at a wholesale level and the group's distribution companies only purchased goods from the taxpayer company to fill specific orders, many of which were placed by customers who had previously dealt with the taxpayer company directly. The Inspector of Taxes refused the taxpayer company's claim to carry forward its losses under section 393 ICTA 1988, contending that, following the change in ownership, there had been "a major change in the customers outlets or markets" for the goods within section 768(4)(b) and, accordingly, there had been a "major change in the nature or conduct of [its] trade" within section 768(1)(a).

The Special Commissioners allowed the taxpayer company's claim, holding that there had been no significant change in the conduct of its trade. This finding was upheld by the Northern Ireland Court of Appeal. The Court ruled that the question whether the change in the conduct of the taxpayer company's trade was "major" within section 768(1) was a question of fact and degree for the Commissioners and it could not be said that, on the evidence before them, the Commissioners were bound to find that the change was "major".

Gibson LJ made the following observation about the construction of the phrase "major change in the conduct of the trade":

> "Whether there has been a change in the conduct of the trade clearly imports a qualitative test because one is looking for a different type of conduct. Where the difference in conduct is claimed to be a difference in the manner of the disposal of the taxpayer company's goods, it is clearly not sufficient to satisfy the definition if there is merely a change in the number or identity of customers or outlets, or if the proportion of goods distributed through each is changed. But in judging whether the change is major, a different criterion should be applied. The obvious contrast is between changes which are major and those which are minor; that is to say it is a question of degree, or a quantitative matter. I would ask the question: is the change of greater or lesser importance when considering the taxpayer company's method of trading?"[16]

Lord Lowry CJ commented:

> "The word 'major' in the context could be regarded as verging on the colloquial; it is also rather vague in meaning. The primary adjectival meaning (derived from the comparative of the Latin adjective 'magnus') is 'greater' as in 'the major part', and the word is not found with the indefinite article in the Oxford English Dictionary except in contrast with the word 'minor'."[17]

Further guidance can be found in a case dealing, not with section 768, but with similar words in the now-repealed stock relief legislation. The case was Purchase -v- Tesco Stores Limited[18]. In 1977, Tesco, the supermarket chain, decided to cease giving trading stamps and, instead, to reduce its prices coupled with a sales

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16. pp460-1
17. p462
18. [1984] STC 304

promotion campaign called "Operation Checkout". This campaign was very successful and resulted in a very large increase in turnover which necessitated a corresponding increase in the amount of stock which the company held. At the beginning of the accounting period ended 25th February 1978, the value of the company's trading stock was £84m, while at the end of that period, it was £121m. The company claimed stock relief in respect of that accounting period on a sum of over £33m. The Inspector of Taxes allowed the claim in the reduced sum of £16.5m on the grounds that there had been a major alteration in the conduct of the company's trade which had resulted in an exceptional increase in its trading stock during the accounting period and that, therefore, the increase in stock fell to be valued at a notional opening figure in accordance with paragraph 23(3), Schedule 5, FA 1976.

The company agreed that Operation Checkout constituted an alteration in the conduct of its trade and that it had resulted in an increase in the company's trading stock. The Special Commissioners, in fact, decided that, for there to be a "major alteration" in the conduct of the company's trade, the alteration had to be of such a fundamental kind that the closing stock no longer bore an identifiable relationship to the opening stock, that the difference between the opening and closing stock had to be not just a quantitative difference but a difference in kind and that, in assessing that difference, the effects of the alteration need not be taken into account. On this basis, the Commissioners found that the alteration in the conduct of the company's trade was not a "major" one. The Crown appealed.

In the High Court, Warner J held that the Commissioners had misdirected themselves. He said that the epithets "major" and "exceptional" were ordinary English words and should be treated as such. The test for each of them was quantitative and not merely qualitative. "Major" imported something more than "significant" and less than "fundamental" and a major alteration in the conduct of a company's trade need not therefore be a major alteration in the nature or scope of that trade.

Further, in deciding the case, one of the factors which the Commissioners ought to have taken into account was the effect of the change, which would have assisted them in deciding whether or not the alteration was a major one.[19]

Although the stock relief legislation was dealing with a different subject matter from section 768, the similarity of the language used suggests that the guidance given in this case will be of some use in interpreting the language in 768. Certainly Warner J in this case was assisted by what the Northern Ireland Court of Appeal had said in the Peeters Picture Frames case.[20] To a lesser extent, other cases on this stock relief provision may also be of some use, such as <u>DIK Transmissions (Dundee) Limited -v- IRC</u>[21] and <u>Pobjoy Mint Limited -v- Lane</u>.[22]

Moving from the particular to the general, a number of more fundamental points can be made. As the section has been on the statute books for thirty years, taxpayers and their advisers have become accustomed to the section. The fact remains that the section does represent a statutory piercing of the corporate veil in that the company has suffered losses but is prevented from obtaining relief for those losses against future profits in the same trade merely because of a change of shareholders. On the one hand, the company is treated as the taxpayer and then, the integrity of that entity is compromised by changes in the ownership of that entity.

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19. See pp318 and 320
20. See pp316 and 318
21. [1980] STC 724
22. [1984] STC 327

Admittedly, the activities of taxpayers who engaged in artificial tax avoidance schemes prompted the Legislature to introduce very wide ranging anti-avoidance legislation which impeeds many bona fide commercial transactions. Unfortunately for the businessman who does not engage in artificial tax avoidance, the Legislature decided to take action at a time, in 1969, when they appeared to be particularly in favour of wide-ranging and general anti-avoidance provisions and the Parliamentary draftsman at that time were in the habit of using very imprecise and, in some cases, loose language.

The three main anti-avoidance provisions introduced in 1969, sections 768, 775 and 776 ICTA 1970, particularly 768 and 776, are prominent in that category of fierce anti-avoidance provisions which impose unfortunate restrictions on genuine commercial transactions.

This is not to say that the draftsmen who prepared the Finance Act 1969 were any less proficient than their brethren of earlier or later years, because, the nature of their drafting is determined by instructions they are given by the Legislature. The Legislature, controlled by a particularly vigorous Labour Party at that time, appear to have taken the view that the use of tax losses by a taxable entity that may later make profits, fell into the category of "tax avoidance". However, a company that was very heavily taxed in those years when it made profits, might reasonably expect appropriate relief if it suffered losses. A company might for many years make highly tax profits and then, by branching off into a new area, suffer heavy losses. It is inequitable that there can be, in many situations, no relief for genuine commercial losses. On the other hand, section 768 obviously did not put an end to the sale of tax loss companies as can be seen from the enormous increase in the market for such companies in the 1970's before the Ramsay case[23] dampened

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23. W.T Ramsay Ltd v IRC (1981) 54 TC 101, see Chapter 11

the fervour of the tax avoiders. In fact, even the Ramsay case did not kill the market in tax loss companies completely, which market began to expand gradually as the Courts narrowed down the ambit of the Ramsay doctrine and removed a great deal of the uncertainty surrounding that doctrine. This was despite the published Revenue view that, in their view, purchased tax losses would be within the Ramsay principal. This view was shown to be incorrect in the Shepherd -v- Lyntress case.[24]

Finally, it should be noted that there is a very similar provision preventing the carry forward of ACT where there has been a change of ownership in the company: section 245 ICTA 1988. There is, in fact, greater justification for this provision than for section 768 in that, in order to carry forward ACT, it is not necessary for the company to carry on the same trade as before or, indeed, any trade at all. Without section 245 a company could acquire another with surplus ACT and inject into that company a profitable business to mop up the surplus ACT.

Section 245 does not, however, prevent a company with surplus ACT acquiring a new business to produce taxable profits because, as mentioned above, there is no need for the same trade to be carried on throughout.

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24. Shepherd v Lyntress Ltd [1989] STC 617 see Chapter 8

Dealings in Commodity Futures

It is fairly common these days for anti-avoidance legislation to be made retrospective to the date of a ministerial announcement or Inland Revenue Press Release. Section 31 FA 1978[25] was different in that it was a truly retrospective provision aimed at a specific scheme which Dennis Healey, the Chancellor at the time, found particularly provocative. The Government announced its intention to stop the schemes in December 1977 but the legislation was made effective from 6th April 1976. What the Chancellor appeared to find particularly irritating was the fact that the scheme was highly artificial and widely publicised. Having said that, it was neither the most artificial nor the most widely publicised scheme available at the time.

The scheme at which the section was aimed was marketed under a number of descriptions such as the "commodity carry-over scheme", the "commodity straddle" and the "butterfly straddle". These schemes were all, however, based on the same basic principal. An individual would enter into a partnership with a company, normally a non-resident one, and a partnership would commence a partnership in commodity futures. The partnership activities would invariably realise a loss in one period and a gain in the next by use of deals which would "straddle" the end of the fiscal year.

In the first of the two years, the individual's share of loss would be, perhaps, 90%. At the beginning of the second year, he would resign from the partnership and be repaid his original capital contribution which would inevitably approximate to his share of the loss in the

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25. Now section 399(2)-(4) ICTA 1988

first year. The company would then realise the gain in a non-taxable form. The individual would, by this means, have obtained a loss which he could set-off against his other income under what is now section 380 ICTA 1988 but he would pay no tax on the repayment of his capital contribution.

The section uses a "sole or main benefit" test by operating where "a scheme has been effected or arrangements have been made (whether by the partnership agreement or otherwise) such that the sole or main benefit that might be expected to accrue to [the individual] from his interest in the partnership was the obtaining of a reduction in tax liability by means of such relief."[26]

The section has been successful in stopping the highly artificial schemes at which it was aimed and, in practice, it infringes relatively little on genuine commercial arrangements. For example, it has no operation where the partnership does not contain a corporate partner.

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26. Namely under sections 380, 381 or 393(2) ibid

Group Relief

There are four main provisions aimed at preventing the exploitation of group relief whereby losses of one group company can be set against the profits of another group company (there being corresponding provisions for members of a consortium): section 402 ICTA 1988 et seq. The four anti-avoidance provisions are as follows:-

1. Section 413(7)-(10) and Schedule 18 ICTA 1988. These provisions prevent shares being manipulated in order that artificial groups can be created between companies which have no real connection.

2. Section 410 ICTA 1988. This section is aimed at temporary groups being created specifically with a view to the exploitation of the group relief rules.

3. Section 409 ICTA 1988. These provisions deal with the situation where a company joins or leaves a group and provides for the apportionment of profits.

4. Dual resident companies.[27]

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27. This subject is examined in Chapter 9 and is not considered further in this Chapter.

Group Relief: Qualifications for Entitlement

Prior to 6th March 1973, group relief was available if one of the companies owned 75% or more of the ordinary share capital of the other company or a third company owned 75% or more of the share capital of each of them. Consortium relief was given if 75% or more of a company's ordinary share capital was owned by the consortium or 90% of its ordinary share capital was owned by a holding company which, in turn, was owned by a consortium.[28]

Ordinary share capital is defined in section 832(1) ICTA 1988 as meaning "all the issued share capital (by whatever name called) of the company, other than capital the holders whereof have a right to a dividend at a fixed rate, but have no other right to share in the profits of the company."

Because of this definition, it was easy to exploit the group relief provisions in situations in which the relief would not otherwise be available by creating artificial groups. For example, a parent company, A, could have a subsidiary, B, in which it held 100% of its ordinary shares. It could be arranged for B to issue preference shares carrying no votes and only minimal participation rights, and for sufficient of these shares to be issued to another company, C, to ensure that 75% of the "ordinary share capital" of B was held by C so that group relief would be available between B and C.

Similar arrangements have also been used to avoid corporation tax on capital gains and development land tax. However, in the context of group relief, the legislature decided to take action in 1973 and section 28 and Schedule 12, FA 1973,[29] which operated as from 6th March 1973, laid down two additional tests which must be

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28. Sections 258 and 532(1) ICTA 1970, now section 402 and 838(1) ICTA 1988.
29. Now section 413(7)-(10) and Sch 18 ICTA 1988

fulfilled before group relief is available. These are that the parent company must be beneficially entitled to not less than 75% (or, as the case may be, 90%) of any profits available for distribution to equity holders of the subsidiary company; and the parent company must be beneficially entitled to not less than 75% (or, as the case may be, 90%) of any assets of the subsidiary company available for distribution to its equity holders on a winding-up.

In determining the share of a member in a consortium, it is enacted that the share, in an accounting period, is to be whichever is the lowest of the following percentages:

(a) the percentage of the ordinary share capital of the surrendering or claimant company which is beneficially owned by the member;

(b) the percentage to which that member is beneficially entitled of any profits available for distribution to equity holders of the surrendering or claimant company; and

(c) the percentage to which that member would be beneficially entitled of any assets of the surrendering or claimant company available for distribution to its equity holders on a winding-up.

If any of the above percentages have fluctuated in the accounting period in question, the average percentage over the period shall be taken for these purposes.

It is not necessary here to examine these provisions in any greater detail except to point out that they are, perhaps inevitably by the nature of their subject matter, fairly detailed, containing a large number of definitions, necessary for the operation of the provisions.

On the whole, these provisions tackle successfully the abuses at which they were aimed and, in practice, they infringe relatively little on genuine commercial transactions. The provisions are sufficiently precise and clear for taxpayers, assuming they are adequately advised, to be able to steer clear of the legislation if they are carrying out genuine commercial transactions; and the provisions are sufficiently comprehensive to make it very difficult for taxpayers to create artificial groups for the purposes of exploiting group relief. Unfortunately, the same cannot be said of the next provision to be considered.

Arrangements for the Creation of Temporary Groups

Another way the group relief provisions used to be exploited was by setting up groups on a temporary basis. Again, the legislature took action in 1973 and the relevant anti-avoidance provisions were contained in section 29 FA 1973.[30] Unlike section 28, the legislation has been drafted in wide and imprecise terms and the provisions present a constant hazard in a great many genuine commercial transactions.

In view of the discussion of the section below, it is useful to set out subsection (1) in its entirety. The subsection states:

> "If, apart from this section, two companies ('the first company' and 'the second company') would be treated as members of the same group of companies and -
>
> (a) in an accounting period, one of the two companies has trading losses or other amounts eligible for relief from corporation tax which it would, apart from this section, be entitled to surrender by way of group relief; and
>
> (b) arrangements are in existence by virtue of which, at some time during or after the expiry of that accounting period -
>
> (i) the first company or any successor of it could cease to be a member of the same group of companies as the second company and could become a member of the same group of companies as a third company, or

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30. Now section 410 ICTA 1988

(ii) any person has or could obtain, or any persons together have or could obtain, control of the first company but not of the second, or

(iii) a third company could begin to carry on the whole or any part of a trade which, at any time in that accounting period, is carried on by the first company and could do so either as a successor of the first company or as a successor of another company which is not a third company but which, at some time during or after the expiry of that accounting period, has begun to carry on the whole or any part of that trade,

then for the purposes of this Chapter[31], the first company shall be treated on and after 6th March 1973 as not being a member of the same group of companies as the second company."

Subsections (2) and (3) contain similar provisions relating to consortia.

Subsection (4) states:

"In this section 'third company' means the company which, apart from any provision made by or under such arrangements as are specified in paragraph (b) of either subsection (1) or subsection (2) above, is not a member of the same group of companies as the first company, or, as the case may be, the trading company or holding company to which subsection (2) above applies."

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31. Chapter IV, Part 8, ICTA 1988, "Group Relief".

The term "control" is defined in accordance with section 840 ICTA 1988, which states that control:

> "in relation to a body corporate, means the power of a person to secure -
>
> (a) by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or
>
> (b) by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,
>
> that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person ... "

This legislation obviously revolves on the meaning of "arrangements". There has been a great deal of uncertainty over the meaning of this term, particularly given the very wide interpretation of that word in other contexts by the Courts. The prime example, which has been examined in detail above, is the meaning of the word "arrangement" in the income tax settlement legislation.[32]

The Inland Revenue issued a Statement of Practice in 1980[33] in which they set out their views on various matters arising from what was then section 29 FA 1973. The Statement of Practice makes it clear that the Revenue's view is that an arrangement may exist even though it is not enforceable.[34]

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32. See Chapter 2
33. SP5/80
34. Para 4 ibid

The Statement of Practice sets out a number of points relating to the sale of a company, namely:

"5. ... Inspectors do not normally find arrangements in existence in the case of a straightforward sale of a company before the date of the acceptance (subject to contract or on a similar conditional basis) of the offer unless there is some unusual feature about the negotiations. Equally, unless there are some exceptional circumstances, the genuine offer made to the public at large of shares of a business does not bring arrangements into existence.

6. When the sale of a subsidiary company or similar transaction in shares requires the approval of the shareholders, it is considered that no arrangement will come into existence until that approval has been given, or the company's officers are aware that it will be given.

7. Where a potential vendor is actively negotiating with a prospective purchaser, the mere fact that it does not pursue alternative offers would not be regarded as bringing an arrangement into existence. However, an offer to a particular potential purchaser, which by common understanding is allowed to remain open for an appreciable period, thus enabling that potential purchaser to chose his moment during that period to create a bargain, could be regarded as akin to the grant to that potential purchaser of an option. If there was such an understanding in existence that the offer should be kept open (which would normally be after the offer was formally made but might in some circumstances be before) the Inspector may contend that an arrangement came into existence at the time this understanding was reached.

8. In general, the fact that negotiations have broken down is a strong indication that they did not reach a stage which brought arrangements into existence."

In relation to company reconstructions, the Statement of Practice states:

"9. In the case of a company reconstruction under [section 427 Companies Act 1985] it will not be contended that arrangements exist before the directors of the company are assured that the scheme has the support of the requisite majority of shareholders. Usually this assurance will not exist until the necessary resolution is formally passed at the shareholders' meeting but exceptionally it may be obtained earlier. For example, where a relatively small group of shareholders command the relevant voting power, the directors may be aware of their intentions from the time that the proposed scheme is first mooted.

10. In cases where shareholder approval is required by the rules of the Stock Exchange, the Board will not contend that arrangements exist until the Stock Exchange have confirmed that it will not require approval or that the transaction is known by the directors to have the support of the requisite majority of the shareholders."

Paragraph 11 states that group relief could not be denied between a group parent and a subsidiary for no other reason than that the intermediate company would be a person having control of the subsidiary but not of the parent. This point is examined further below.

It is not considered that a mortgage of shares in a subsidiary amounts to an arrangement, but a default in meeting the terms of the mortgage is capable of bringing an arrangement into existence.[35]

In paragraph 19, the Statement of Practice states:

> "It is not practicable for Inspector's to provide an opinion as to the consequences of projected actions within a group. Where, however, a particular course of action has been taken, the facts may be placed before the Inspector immediately for his opinion as to the consequences."

It is difficult to see why a taxpayer would want to raise the matter before an Inspector in this way. If the Inspector takes the view that there have been "arrangements", it would be too late for the taxpayer to do anything about it; on the other hand, if the taxpayer thinks that arrangements might have come into existence, he will often not want to draw the Inspector's attention to the possible application of section 410. There may be situations, however, where future planning depends on having the Inspector's confirmation that group relief is available.

Section 410 has been considered in two cases, one of which was heard by the House of Lords, but there are still areas of uncertainty about this legislation.

The first of the cases was Pilkington -v- IRC[36]. The facts were that a company called Manchester Liners Limited was part of a shipping group proposing to invest in a new ship. However, the capital allowances to be derived from such investment were more than the group could use.

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35. Para 12, ibid
36. (1982) 55 TC 705

Pilkington Brothers Limited, which was unconnected with the Manchester Liners Group, had large available profits. With a view to securing to Pilkington's the benefits of the excess allowances, Manchester Liners entered into a scheme with Pilkington's, designed to bring Pilkington's into the same group for group relief purposes as a Manchester Liners group company (Golden Cross Line Limited) which would order the ship, and so entitle Pilkington's to use Golden Cross Line's allowances.

Pilkington's had two wholly-owned dormant subsidiaries called Hello TV Limited and Villamoor Limited. Golden Cross Line Limited was a wholly owned subsidiary of Manchester Liners and its main object was to undertake all or any of the trades of a carrier by sea. Hello TV amended its objects so as to become an investment holding company. Villamoor amended its objects similarly and also its Articles of Association so as to re-designate its two issued shares, held by Pilkington's, as "A" shares and two more ordinary shares, which were afterwards issued for cash to Manchester Liners, as "B" shares. Golden Cross Line also amended its Articles. No changes were made to the Memorandum or Articles of Association of Pilkington's or Manchester Liners. On 30th September 1974, Manchester Liners agreed to sell half the issued share capital of Golden Cross Line to Hello TV and half to Villamoor. The result was that, although Pilkington's retained 100% of the issued share capital of Hello TV and continued to control it, the 50/50 split of the issued share capital of Villamoor between Pilkington's and Manchester Liners meant that neither Pilkington's nor Manchester Liners controlled or could control Villamoor; and, similarly, the 50/50 split of the issued share capital of Golden Cross Line between Hello TV and Villamoor meant that neither Hello TV nor Villamoor controlled or could control Golden Cross Lines.

Also, on 30th September 1974, Golden Cross Line entered into an agreement with shipbuilders for the construction of a ship. On 31st December 1974, Pilkington's entered into an agreement with Golden Cross Line, whereby Golden Cross Line would claim capital allowances so as to produce, over a period available losses not exceeding £13m for companies in the Pilkington group and such companies would pay Manchester Liners 87½% of the corporation tax thereby saved.

It was common ground that, as a result of the scheme, Pilkington's and Golden Cross Line satisfied all the requirements of sections 258 and 259 ICTA 1970,[37] and the further requirements of section 28 FA 1973,[38] and that Pilkington's was entitled to group relief in respect of capital allowances surrendered to it by Golden Cross Line unless what was then section 29(1)(b)(ii) FA 1973[39] applied.

Before the Special Commissioners, the Crown contended that there were, within section 29(1)(b), "arrangements" in existence by virtue of which, at some time during or after the expiry of the relevant accounting period, persons who together had or could obtain control of the first company but not of the second because, taking Golden Cross Line as the first company and Pilkington's as the second:

(1) Pilkington's and Manchester Liners together had control of Golden Cross Line but did not together have control and could not together obtain control of Pilkington's; and

(2) (assuming that the person or persons having control or the ability to obtain control for the purposes of section 29(1)(b)(ii) had to be third parties and not

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37. Now section 402 and 403, ICTA 1988
38. Now section 413(7)-(10) ibid, supra
39. Now section 410(1)(b)(ii), ibid, supra

the first and second companies themselves) the shareholders of Pilkington's and Manchester Liners together had control over Golden Cross Line but did not together have and could not together obtain control of Pilkington's.

The Special Commissioners accepted both contentions and dismissed the appeal.

On the company's appeal to the High Court, Nourse J held that section 29(1)(b)(ii) contemplates that the person or persons there referred to is or are a third party or third parties distinct from the first or second companies; and that the "arrangements" must be "things or measures" which are combined or disposed for a particular purpose and so could not embrace the Articles of Association of Pilkington's, which had been in existence before and had not been altered by the scheme.

Counsel for the taxpayer accepted that the dealings with the share capital of Villamoor and Golden Cross Line and the material amendments to the Memoranda and Articles of those two companies and Hello TV were part of the "arrangements" contemplated by section 29(1)(b). However, he submitted that the Articles of Pilkingtons were not part of the arrangements; they had been in existence for very many years and the scheme did not require and did not involve any amendments to them. The taxpayer argued that the Articles could not be part of the arrangements within the section, particularly when it is borne in mind that the shareholders were not party to the scheme and in all probability knew nothing about it, at all events until after it had been implemented.

On the other hand, the Crown argued that all section 29 required the judge to do was to ask what arrangements were in existence at the material time. The Crown also urged the judge to adopt a wide interpretation of the provisions along the lines advocated by Lord Reid in the Greenberg case[40] and Lord Wilberforce in the Joiner case.[41] Counsel for the Crown submitted that the observations of those Law Lords applied to any legislation which mounted a wide and general attack on tax avoidance and that the section in question was of that nature. Nourse J disagreed. He said:

> "I have no hesitation in rejecting that argument which, if correct, would be the thin edge of a substantial wedge. I find it impossible to read the words of Lord Wilberforce, or of Lord Reid before him, as having been intended to go further than to prescribe an approach to the legislation which was there under consideration.
>
> In the circumstances, I approach the interpretation of sections 28-33[42] by the traditional route which has to be followed in the construction of a tax in statute. I think that means that, just as the taxpayer has the benefit of doubts or ambiguities in deciding whether a tax has been imposed upon him, so does he has that benefit in deciding whether a relief which was formally available to him has been restricted."[43]

On the question of what were the arrangements contemplated by section 29(1)(b) in the present case, the judge started from the position that "arrangements" meant arrangements of any kind, whether in writing or not, and whether or not having contractual force and effect. However, that is not to say that anything, which in isolation or in another context could be described as arrangements, were necessarily arrangements for the purposes of section 29. In his view, they had to be

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40. <u>Greenberg v IRC</u> (1971) 47 TC 240, see Chapter 1
41. <u>IRC v Joiner</u> (1975) 50 TC 449, see Chapter 1
42. <u>FA 1973</u>
43. p726

arrangements by virtue of which both the control of the first company is had and the control of the second is lacking.

Nourse J considered that the general approach to the meaning of "arrangements" must be dictated by a passage in the speech of Lord Wilberforce in the Plumber case[44] which is quoted above, in relation to the definition of "settlement" in section 681(4) ICTA 1988.[45] As noted above, Lord Wilberforce had said:

> "But it still becomes necessary to inquire what is the scope of the words 'settlement' and 'settlor' and of the words which are included in 'settlement' in the context in which they appear. If it appears, on the one hand, that a completely literal reading of the relevant words would so widely extend the reach of the section that no agreement of whatever character fell outside it, but that, on the other hand, a legislative purpose can be discerned of a more limited character which Parliament can reasonably be supposed to have intended, and that the words used fairly admit of such a meaning as to give effect to that purpose, it would be legitimate, indeed necessary, for the Courts to adopt such a meaning."[46]

Nourse J, however, did not feel that he had to search for a limited legislative purpose because, in his view, the question could be decided on no more than the ordinary meaning of the words. On that basis, the judge analysed the meaning of the word in the light of the facts of the present case as follows:

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44. <u>IRC v Plummer</u> (1979) 54 TC 1
45. See Chapter 2
46. 54 TC 1 at p42

"The material dictionary meanings of 'arrangement' are: A structure or combination of things for a purpose; a disposition of measures for a particular purpose. Both those definitions require that the individual elements of an arrangement should be combined or disposed for a particular purpose, and I do not think that, unless there is a context to the contrary, that requirement is displaced by the use of the plural as opposed to the singular. All that that adds is the possibility that there may be more than one combination of things or more than one disposition of measures. But without a context it would, as it seems to me, be unnatural to read the plural as dispensing with the need for some unifying link between each of the combinations or dispositions. I therefore construe this provision in the expectation that it is intended to refer to things or measures which are combined or disposed for a particular purpose. On that footing, it is at the least difficult, and in my view impossible, to see how it can include the Articles of Association of Pilkington Brothers, whose nature and effect remain unchanged throughout and cannot in any ordinary sense to said to have been things or measures which are combined or disposed with the provisions of the scheme. The unifying link is just not there. That point seems to me to be emphasised by a consideration of the fact that the shareholders of Pilkington Brothers, who are the persons between whom the Articles have effect as the arrangements for the governments of the company, were not parties to the scheme. It was said on behalf of the Crown that the shareholders were 'brought into the arrangements' by the Board of Pilkington Brothers, alternatively that they 'were as much bound by the arrangements' (those were the Special Commissioners' words) as the company itself but vague concepts of that kind are not really an aid to statutory construction."[47]

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47. p727

The judge then pointed out the anomalous position that would arise if the Crown was right. Taking the common situation of a parent company, A, with a wholly owned subsidiary, B, which company in turn had a wholly owned subsidiary, C; the bottom company, C, could not surrender its losses to the top company, A. The reason is that, for the purposes of section 29(1), C is the first company and A is the second company. B is a person who has control of C (by virtue of C's Articles of Association), but not of A. Counsel for the Crown accepted that this was an inevitable result of his argument, but he said that it was open to the three companies to take "simple and inoffensive steps to remedy the position".[48]

The Crown's appeal went straight to the House of Lords where the decision of Nourse J was reversed. It was held, by a majority of three to two, that the Articles of Pilkington's were "arrangements ... in existence" for the purposes of section 29(1)(b)(ii) and, accordingly, taking Pilkington's as the first company and Golden Cross Line as the second, arrangements were in existence by virtue of which the shareholders of Pilkington's had control of Pilkington's but not of Golden Cross Line.

The Law Lords who dissented were Lords Wilberforce and Russell. They both agreed with the reasoning of Nourse J.

Lord Wilberforce pointed out that the shareholders of Pilkington's had no part in the arrangements made in 1974, they were not consulted and they did not agree to them. Lord Wilberforce did not think that the Court could add to the arrangements "those made (we do not know when, but probably they were spread over years as each shareholder acquired his shares) by which these shareholders were able, ultimately to control the taxpayer company, arrangements which had nothing to do

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48. pp727-8

with the creation of the group structure?" Lord Wilberforce did not think so. In his view, the subsection was directed to arrangements for setting up the group structure in 1974 and to no other arrangements.[49]

As to the Crown's argument that, in as much as the 1974 arrangements were built on an existing structure (that of Pilkington's as it was) with shareholders and directors having powers defined by Articles, that brought whatever arrangements had been made and subsisted, in order to maintain that structure, into that existing arrangement, Lord Wilberforce said:

> "But this fails, to my mind, to get over the fundamental difficulty. It does not explain how, or when, the shareholders of the taxpayer company, a fluctuating body of probably several thousand, are said to have entered into arrangements which in 1974 had the result of setting up the group. If one asks, as the Crown invited us to ask, whether the shareholders 'arrangement' was a sine qua non of the scheme, the answer is plainly no."[50]

In a similar vein, Lord Russell said that "arrangements" could not be taken to include the Memorandum and Articles of Association of Pilkingtons. He said:

> "The grouping scheme in the present case in no way involved the internal structure of the taxpayer company, nor did it concern in any way those who at the time of the scheme (or thereafter) might be shareholders in the taxpayer company. Who those persons (shareholders) were, and the internal structure of the taxpayer company as an 'arrangement'

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49. pp730-1
50. ibid

were matters of total irrelevance to the complicated arrangements involved in the grouping scheme and to the existence of the resultant intended group. I am persuaded that the reference to 'arrangements' is properly to be regarded as extending to something - the internal structure of the taxpayer company - so totally irrelevant to the group situation which otherwise exists and which section 29(1)(b) is designed to narrow in stated circumstances."[51]

It is submitted that the approach of Nourse of J and Lords Wilberforce and Russell is the logical and sensible interpretation of the section and more in keeping with the intention of Parliament when one considers the type of scheme against which the section was aimed. This interpretation also avoids the difficulties over the A, B and C company structure mentioned above, difficulties which Lord Bridge did not seem to think existed but on which his judgement appears to be defective.

The main judgement for the majority in the House of Lords was given by Lord Bridge, Lord Fraser gave a brief judgement agreeing with him and Lord Brandon also agreed.

Lord Fraser, in his brief judgement, attached importance to the fact that the question to which section 29(1)(b) directs attention is whether arrangements "are in existence", and not whether such arrangements came into existence or were entered into for the purpose of setting up the group structure. He said that, in his view, it was immaterial that the voting control of Pilkington's was with its shareholders before the present question relating to the group structure arose.[52]

Lord Fraser admitted that this construction could not be regarded as "an obvious construction". He also said that

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51. p733
52. p731

the result to which the paragraph led him "does not seem to me so surprising or inconvenient as to suggest that it ought to be construed in some more restricted way." The inference from these words is that Lord Fraser accepted that the result to which he came was, to a certain extent at least, "surprising" and "inconvenient".

Lord Bridge examined the situation in rather more detail. He referred to the decision of Nourse J and said that he came to the opposite conclusion for three reasons.

The first was that the definition of "arrangements" as meaning arrangements of any kind persuaded him against imposing any limitation on the ordinary meaning of the word unless forcibly driven to do so by the context. He did not develop this point, which is unfortunate because the essence of the approach taken by Nourse J and Lords Wilberforce and Russell was that the context did force the Courts to put a limitation on the ordinary meaning of the words.

Secondly, Lord Bridge examined in detail the language of the provision and noted that the arrangements to be considered are such as "are in existence". He said that this meant that it mattered not when they came into existence. He noted that, when the draftsmen of the 1973 Act wished to distinguish arrangements which "come into existence" after a given date from those which "are in existence" on that date, he did so; as in paragraph 10(2), Schedule 12. He then pointed to the phrase "by virtue of which", which he said directed attention to the effect of the arrangements and not to their purpose.

He said that the consideration of over-riding significance was that the whole sentence was concerned with those arrangements which determined the control of both companies whose entitlement to be treated as members of the same group was in issue. To construe "arrangements" as excluding those arrangements which regulate the conduct of the affairs of either of the companies in accordance with the wishes of its controlling shareholders, negated the plain meaning of the statutory wording. He also said that he attached no significance to the fact that the shareholders in the taxpayer company were not "parties" to the scheme devised to enable the taxpayer company to acquire a claim to group relief, in the sense that they, as shareholders, as distinct from the Board of Directors, carried on the management of the company and participated in the planning and negotiation of the scheme.[53] As Lord Bridge was prompted by this interpretation to look at the effect rather than the purpose of the scheme, this last observation is not surprising.

His third reason for rejecting the decision of Nourse J was that the legislature must have intended to introduce a requirement, in addition to those introduced by section 28 FA 1973, that the two companies claiming membership of the same group should be under the same control. He said that the narrow construction of "arrangements" adopted by Nourse J would have, what he called, the "startling consequence" that the only kind of scheme setting up a group of companies for the purpose of obtaining group relief which would be liable to disqualification under section 29(1)(b)(ii) would be a scheme specifically designed to embody the very disqualifying features at which the provision was directed.[54] Is Lord Bridge here saying that the provision should catch arrangements embodying features other than those at which the provision is directed? If so, this seems a strange construction and, in fact, a strong argument for using a narrower construction.

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53. pp737-8
54. p738

Finally, Lord Bridge turned to consider the position of a chain of companies. He said:

> "We are asked to consider companies A, B and C where B is the wholly owned subsidiary of A and C is the wholly owned subsidiary of B. Here, if company C surrenders a claim to relief to company A, says [Counsel for the taxpayer] on the Crown's argument, company A cannot claim group relief because, by virtue of the arrangements inherent in the group structure, company B is a person who has control of company C but not of company A.
>
> It seems to me powerfully arguable that, in applying section 29(1)(b)(ii) to the facts posited, company B is a person who can be ignored. In exercising control of company C, company B must act as instructed by company A. Thus, the 'person or persons together' in accordance with whose wishes the affairs of company C are conducted are those who control company A. From this it would follow, applying definition of 'control' in section 532 of the Taxes Act [1970],[55] that the only "person or persons together' who control company C are the same as those who control company A."[56]

This analysis must be wrong and, before Nourse J, even the Counsel for the Crown acknowledged that there would be the anomaly arising from their arguments that group relief would not be available between company C and company A.

In view of the fact that it is very common indeed to have several layers of subsidiaries in groups, the very wide interpretation given by Lord Bridge to section 29 would have far reaching effects. Luckily, to avoid

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55. Now section 838 ICTA 1988
56. p739

complications, the Inland Revenue do not restrict group relief solely because there is a chain of subsidiaries. The Revenue's practice is set out in Statement of Practice SP5/80 and, although this was issued before the Pilkington case, the Revenue have not changed their practice in the light of Lord Bridge's analysis, apparently appreciating the absurd results that would thereby ensue. It is unthinkable that the Legislature could have intended such a ridiculous situation, given the fact that chains of companies are so common in group structures in the UK.

Lord Bridge's analysis also pierces the corporate veil in an important way in that he is saying that it is the shareholders in the parent company, rather than the parent company itself, who controlled the subsidiaries. This is undermining the very existence of corporate entities and separate legal persons and, it is submitted, is plainly wrong. The subject of piercing the corporate veil is considered in Chapter 12.

The second case on section 29, which also has some unsatisfactory features, is <u>Irving -v- Tesco Stores (Holdings) Limited</u>.[57] This case concerned a more complicated structure than that used in the Pilkington case.

The facts were that the taxpayer company entered into a scheme whereby a subsidiary, Tesco Stores Limited, would, for £75, acquire 75% of the ordinary share capital of a company in the Shell Group, Rebron Limited, for which a ship was to be built by a Japanese contractor. The object of the scheme was to enable the taxpayer company to claim the benefit of capital allowances on expenditure incurred by Rebron on the acquisition of the ship in return for a payment of 87½% of the corporation tax saved.

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57. [1982] STC 881

The Articles of Association of Rebron were amended to provide for a share capital of £102 divided into 50 A ordinary shares, 50 B ordinary shares and 2 C deferred shares. There were to be only two votes in general meeting, the A and B shareholders each having one vote. On a resolution to remove a director, however, the Chairman of the meeting, who was to be an A shareholder, had a casting vote. Of the A shares, 49 were held by Tesco Stores Limited or its nominees. The remaining A share, which had been taken up on the incorporation of Rebron by a Mr. Wydra, an employee of Tesco Stores' solicitors, had been transferred by an instrument of transfer by Mr. Wydra to the Chairman of the taxpayer company, a Mr. Porter, as nominee for Tesco Stores Limited, for a consideration of £1, but there was no evidence that it had been paid for, by or on behalf of Mr. Porter. Of the B shares, 25 were held indirectly by Tesco Stores Limited, through its one-half interest in another company which held all the B shares, the other half of which was held by two companies, one of which was controlled by the banker to the Shell Group. The two C shares, which it was agreed were not ordinary share capital, were held by Shell International Petroleum Limited, a member of the Shell Group. If Mr. Wydra's one A share had been effectively transferred to Mr. Porter, Tesco Stores Limited would have held 75% of the ordinary share capital of Rebron but, if it had not, Tesco Stores Limited would have held only 74%. In order that Shell should be able to represent to the Japanese construction company that Rebron was a subsidiary of Shell Group, it was envisaged that Shell should be able to appoint a majority of the members of the Board of Rebron. The method adopted was as follows.

There were to be 9 directors, 2 appointed by the holders of the A shares, 2 appointed by the holders of the B shares and 5 appointed by resolution passed by a majority of the holders of the A and B shares but subject to the approval of the holders of the B shares.

The chairman of the meeting of the Board was to be an A director who was to have a casting vote. By Article 11(e) of Rebron's Articles of Association, it was provided:

> "If at any meeting of the directors a resolution shall be proposed which shall be supported by both the A directors but shall be opposed by a C director, the A director shall on that resolution have such number of additional votes (if any) as may be necessary to ensure that the resolution is passed."

In the event, no C directors were appointed.

Claims for group relief were refused. On appeal by the taxpayer company the Crown insisted on strict proof that Tesco Stores Limited held the 75% of the ordinary share capital of Rebron required by section 258(5) ICTA 1970[58] to qualify for group relief. It was contended that it had not been proved that the agreed consideration of £1 had been paid by or on behalf of Mr. Porter for the one share transferred to him by Mr. Wydra and the beneficial interest in the share had therefore not passed to him as nominee for Tesco Stores Limited. The Crown further contended that Rebron was not to be treated as a member of the same group as Tesco Stores Limited by virtue of section 29(1)(b)(ii) since arrangements existed by which the taxpayer had control of Tesco Stores Limited but not of Rebron. Control, as defined by section 534 ICTA 1970,[59] meant control by the Board of Directors or by the shareholders in general meeting and, as a result of the power of the C shareholders to frustrate the appointment of C directors, the taxpayer company, which controlled only the A shares, did not control the Board or control the company in general meeting since the A shareholders could not dictate company policy against the B shareholders.

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58. Now section 413(3) ICTA 1988
59. Now section 840 ibid

The taxpayer company contended that Tesco Stores Limited held 75 % of the Ordinary share capital of Rebron since the beneficial ownership of the share transferred by Mr. Wydra to Mr. Porter as nominee for Tesco Stores Limited had passed on the execution of the instrument of transfer; and that, although there was deadlock between the A shareholders and the B shareholders in general meeting of the company, in the case of the vast majority of resolutions, for the purposes of section 29(1), control of the affairs of the company by the Board of Directors was sufficient and that, in view of the fact that no C directors had been appointed, the A directors had a majority by virtue of the Chairman's casting vote, and, in any event, by virtue of Article 11(e) and the power of the A shareholders to secure the removal of the C directors, the A directors control the Board of Rebron.

The Special Commissioners allowed the taxpayer company's appeal on the grounds (1) that it could be inferred from the evidence that the £1 had been paid by or on behalf of Tesco Stores Limited for the share transferred by Mr. Wydra to Mr. Porter and therefore Tesco Stores Limited held 75 % of the ordinary share capital of Rebron; and (2) that, as no C directors had been appointed, the A directors had control of the Board of Rebron. The Crown appealed to the High Court.

In the High Court, Walton J held that Mr. Porter did hold his one share on trust for Tesco Stores Limited beneficially. He held that, if the £1 was not paid by or on behalf of Tesco Stores Limited, it was not paid by anyone else. There was no suggestion that anyone else was involved in the acquisition of Mr. Wydra's share. He said that, Mr. Wydra's completion of the stock transfer form must be regarded as an offer to sell the share, either to Mr. Porter or conceivably to anyone who was willing to pay the £1. That offer was accepted by Mr. Porter presenting the transfer for registration, if not before. Accordingly, there was a contract in existence between Mr. Wydra and Mr. Porter under which Mr. Wydra agreed to sell the share to Mr. Porter for £1 on the understanding that the £1 would be paid within a reasonable time. It was not and, so far as the evidence went, it never had been. Walton J said that this possibly would enable Mr. Wydra to have the whole transaction set aside on the ground of total failure of consideration but he had not taken that course.

This first finding was not concerned with the matter of real relevance to the present discussion of section 29 but it is worth mentioning because is shows a remarkable failure on the part of the parties who were trying to secure tax savings of £1.4m, in that they did not bother to obtain, or at least present to the Special Commissions, adequate evidence that the £1 relating to a share that was essential to the group structure under consideration, had ever been paid.

Walton J, in a characteristically colourful manner said, that:

> "In a matter of this magnitude I would have expected the taxpayer, on whom the onus of discharging the assessments rested, to come armed with proper proof of the necessary steps in their chain of allegations, which they most certainly did not. It may be that at the end of the day they have scraped home on this point by the skin of their teeth, but if they had not, I do not see in the slightest why they should not have been left to gnash them in vain."[60]

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60. p905

On the main question, Walton J held that Rebron was not to be treated as a member of the same group as Tesco Stores Limited because, in considering whether relevant "arrangements" were in existence, one must look at the arrangements themselves, not at the extent to which they had been implemented.[61] It was therefore immaterial that no C directors had been appointed. The arrangement at Board level was that the A directors were to be in a minority subject to the power given to them by Article 11(e) to carry through resolutions proposed by them. Since the A directors had no corresponding power in relation to resolutions proposed by the C directors, a resolution carried by the A directors under Article 11(e) could be reversed by a contrary resolution proposed by a C director resulting in a deadlock. That the A shareholders could secure the removal of the C directors had no bearing on the situation, as refusal to appoint another person approved by the C shareholders would be against the arrangements made and could, in the event of prolonged disagreement, result in the winding up of Rebron. As a result, Tesco Stores Limited did not have control of the affairs of Rebron and the taxpayer company controlled Tesco Stores Limited but not Rebron within the meaning of section 29(1) and, accordingly, the taxpayer company was not entitled to claim group relief in relation to the expenditure incurred by Rebron on the construction of the ship.

Although it was not necessary for his decision, Walton J considered whether control by the directors of a company would be sufficient to constitute control for present purposes. As mentioned above, "control" for the purposes of what is now section 413 ICTA 1988 is determined by virtue of the definition in section 840 which means the power to secure that the affairs of the company are conducted in accordance of the wishes of the relevant

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61. p908

person either, by virtue of the votes attaching to shares or "by virtue of any powers conferred by the Articles of Association or other document regulating that or any other body corporate". Walton J referred to Article 80 of Table A, which applied to Rebron.[62] Article 80 read:

> "The business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and registering the company, and may exercise all such powers of the company as are not, by the [Companies Act 1948] or by these regulations, required to be exercised by the company in general meeting, subject, nevertheless, to any of these regulations, to the provisions of the [Companies Act 1948] and to such regulations, being not inconsistent with the aforesaid regulations or provisions, as may be prescribed by the company in general meeting; but no regulation made by the company in general meeting shall invalidate any prior act of the directors which would have been valid if that regulation had not been made."

Walton J concluded that powers equivalent to those contained in Article 80 would be enough to give the directors control.[63] Walton J referred to the case of IRC -v- Lithgows Limited[64], but considered that the Lithgows case was about a different point. However, the relevant provision being considered in that case, section 333(1) ITA 1952 was in very similar terms to section 534 ICTA 1970, and, in the Lithgows case, Lord Guthrie said:

> "The argument was that, in terms of the Articles of Association of both companies, the affairs of the companies were conducted by directors and managers who had power to enter into contracts, including

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62. p910
63. p912
64. (1960) 39 TC 270

contracts of purchase and sales. In each case, it was provided that no regulation made by the company in general meeting should invalidate any prior act of the directors which would have been valid if such regulation or direction had not been made. The argument was that, in terms of these Articles, the control of the company's affairs was in the directors and managers and accordingly could not be in Sir Andrew Macharg.

This argument is, in my opinion, quite unsound. Although directors and managers are given executive powers by the Articles of Association, directors are ultimately subject to the will of the shareholders of the company and expressed in general meetings. It is true that the Articles provide that a prior act of the directors or managers is not invalidated by a subsequent direction of the company, but, as I have pointed out the definition in section 333(1) looks not to any particular incident but to the continuing control of the company's affairs and, on a long term view, there can be no doubt that the control of the company rests in the shareholders."[65]

It is submitted that Lord Guthrie's analysis is much sounder and that Walton J's analysis is wrong.

Finally, there are a number of general points that can be made about section 413(7)-(10).

Section 413 is very wide in its application, particularly as construed by the majority of the House of Lords in the Pilkington case. There are also a number of uncertain and unresolved areas and innocent taxpayers can easily find themselves within the provisions of the section. It

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65. 39 TC 270 at p279

should be noted that taxpayers do not have to have any tax avoidance motive before they are caught by the section. Furthermore, there is no procedure whereby a taxpayer who proposes to enter into a bona fide commercial transaction can obtain clearance from the Inland Revenue that he would not thereby be caught by section 413.

The wording of the section is wide enough to catch accounting periods before 6th March 1973, as long as arrangements have come into existence in an accounting period which ends on or after that date. Furthermore, the wording is wide enough to catch future accounting periods after those arrangements have ceased to exist. However, as disclosed in Statement of Practice SP5/80, the Inland Revenue take a more responsible and reasonable view and only apply the section to the accounting period in which the arrangements come into existence and any later periods in which they remain in existence.

Another area in which the Inland Revenue do not apply the section despite the wide wording of the legislation, is where arrangements exist for the transfer of a company within a group.

Companies Joining or Leaving a Group or Consortium

By virtue of section 409 ICTA 1988, group relief is given only if the surrendering company and the claimant company are members of the same group, or fulfil the conditions for consortium relief, throughout the whole of the surrendering company's accounting period to which the claim relates and throughout the whole of the corresponding accounting period of the claimant company. However, when two companies become or cease to be members of the same group, it is assumed that an accounting period then ends and another one begins for both the claimant and surrendering companies. The losses of the surrendering company and the profits of the claimant company are then apportioned to arrive at the amounts relating to the relevant notional accounting period for which relief is allowable.

Originally, this apportionment was always on a time basis but this allowed the rules to be manipulated by ensuring that, for example, the pattern of expenditure or receipts were such that the amount of relief allowable would be greater than if the two companies had been run without a view to group relief at all. This manipulation was dealt with by section 47(1) FA 1984 which came into operation where an accounting period begins after 7th November 1983 in respect of companies joining or leaving groups after 13th March 1984. This section said that the apportionment under what was then section 262 ICTA 1970 would be on a time basis "except that, if it appears that that method would work unreasonably or unjustly, such other method shall be used as appears just and reasonable".

In relation to groups, but not consortia, where two or more companies join or leave together and they are involved in a group relief claim, there are special rule to ensure that double relief is not given.[66] The rules

66. See section 411 ICTA 1988

were extended to mixed group and consortium relief claims by paragraphs 9 to 13, Schedule 9, FA 1985.

Special rules were introduced for dual resident companies by sections 63 and 64 and Schedule 4, F(No 2)A 1987. The rules relating to dual resident companies are considered in detail in Chapter 9.

Leasing Contracts: Effect on Claims for Losses on Company Reconstructions

The FA 1973 also contained a section, section 30,[67] which prevented sections 28 and 29 being circumvented by a profitable group acquiring plant and machinery on which it could claim first year capital allowances by leasing the plant and machinery out, then arranging for that part of its trade which included the leasing operations being transferred to another group which could use the resulting profits against its losses. For this section to operate there must be "arrangements" whereby the trade will be taken over.

Where such arrangements exist, relief for the losses incurred on the leasing contract are not allowable except against future profits arising from it. For this purpose, each leasing contract to which the "arrangements" apply is looked at separately and the carry forward of losses is only allowed against subsequent profits of that particular contract.

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67. Now section 395 ICTA 1988

Partnerships Involving Companies: Effect of Arrangements for Transferring Relief

As has been seen, sections 28 and 29 FA 1973 were aimed at schemes for creating artificial groups for the purpose of enabling group relief to be available in circumstances in which it would not otherwise be due. Section 30 was aimed at exploiting the availability of capital allowances on plant and machinery in respect of leasing contracts. It was also possible to exploit capital allowances or losses by means of a partnership between companies. These schemes were combated by section 31 FA 1973.[68] The point was that one company could acquire plant and machinery and claim capital allowances on which it would make a loss, but transfer that benefit to another member of the partnership by virtue of the fact that the losses were generated by the operation of the partnership's trade.

Section 31 combated these schemes. The section operates in relation to a company ("the partner company") which is a member of a partnership carrying on a trade if arrangements are in existence (whether as part of the terms of the partnership or otherwise) whereby:

(a) in respect of the partner company's share in the profits or loss for any accounting period of the partnership, another member of the partnership (or any person connected with another member) receives any payment or acquires or enjoys any other benefit in money's worth; or

(b) in respect of the whole or any part of the partner company's share in the loss for any accounting period of the partnership, the partner company (or any person connected with that company) receives any

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68. Now section 116 ICTA 1988

payment or acquires or enjoys any other benefit in money's worth (other than a payment for group relief).

The business of leasing machinery is treated as a trade for these purposes.

Where the above circumstances exist, the partner company is unable to set off its share of any partnership loss against general profits for the relevant period; it cannot set off trading losses or surplus capital allowances arising from the partnership against partnership profits; and it cannot set off payments of ACT against its liability to tax on partnership profits.

Company Reconstructions without Change of Ownership

The provisions now contained in section 343 ICTA 1988 were originally enacted as section 17 FA 1954. Although it is these days more often than not used as a relieving provision, it was originally an anti-avoidance provision. The mischief at which the provisions were aimed was a company ceasing to trade, incurring a substantial loss which it would use by way of terminal loss relief and transferring that trade to an associated company. Enterprising taxpayers, however, began to use the section to create a market in tax loss companies so that, in 1969 Parliament had to step in to try to prevent these abuses.[69]

Section 343 applies where one company ("the predecessor") ceases to carry on a trade and another company ("the successor") begins to carry it on and:

(a) on or at any time within two years after that event, the trade or an interest amounting to not less than three-quarters of it belongs to the same persons as the trade or such an interest belonged at some time within a year before that event; and

(b) the trade, within that period, is not carried on by someone other than a company.

If the section applies, the trade is not treated as discontinued for capital allowances purposes or for claiming terminal loss relief. Any losses of the predecessor are carried forward and may be set off against the future profits of the successor.

Section 42(2) and (3) FA 1986 amended what was then section 252 ICTA 1970. For successions taking place on

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69. By section 30 FA 1969, supra

or after 18th March 1986, losses carried forward are reduced by the extent to which the liabilities of the trade exceed the assets.[70]

By virtue of section 64 F(No 2)A 1987, for successions taking place after 31st March 1987, the section does not apply in relation to capital allowances where the successor is a dual resident company.[71]

Section 343 and its predecessors have been exploited, not only by straightforward successions but by what are commonly called "hive-downs".

The basic structure of a hive down is that a company, which has a business with accummulated losses, transfers that business to a newly-formed subsidiary, for a deferred consideration, which is then sold off to a purchaser thereby preserving, it is hoped, the tax losses for use by the purchaser.[72]

Hive-downs commonly occur where a receiver has been appointed. The receiver is able to get more by disposing of the business as a going concern with the benefit of losses, than by a sale of assets.

Because hive-downs are normally carried out for genuine commercial reasons, particularly in receivership situations, it is, in practise rare for the Revenue to attach them under the "new approach" even if the main object is the preservation of tax losses.[73]

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70. See now section 343(4) ICTA 1988
71. See now section 343 ibid
72. Subject to section 768 ICTA 1988, supra, and the "new approach" infra
73. The possible application of the "new approach" is discussed later in this Chapter and in Chapter 11.

Setting of Companies' ACT Against Subsidiaries Liability

The final provision of FA 1973 to mention is section 33. This section was aimed at schemes for creating temporary or artificial groups to enable relief for ACT to be given.

Section 33 achieved this by adding subsections (9), (10) and (11) to section 92 FA 1972.[74] The main new subsection is now section 240(11) ICTA 1988 which states:

> "Notwithstanding that, apart from this subsection, one company ('the subsidiary company') would at any time, by virtue of subsection (10) above[75], be a subsidiary of another company ('the parent company') for the purposes of this section, the subsidiary company shall not be treated at that time as a subsidiary for those purposes -
>
> (a) if arrangements are in existence by virtue of which any person has or could obtain, or any persons together have or could obtain, control of the subsidiary company but not of the parent company, and
>
> (b) unless the following conditions are also fulfilled, namely -
>
> (i) that the parent company is beneficially entitled to more than 50% of any profits available for distribution to equity holders of the subsidiary company; and
>
> (ii) that the parent company would be beneficially entitled to more than 50% of any assets of the subsidiary company

74. Now section 240(11) and (13) ICTA 1988
75. Which sets out the main conditions for determining whether one company is a subsidiary of another.

available for distribution to its equity holders on a winding up."

Tax Losses and Tax Avoidance

There have been a number of important cases in recent years concerning the extent to which arrangements to exploit tax losses are legitimate commercial transactions, rather than artificial tax avoidance which may, for one reason or another, be ineffective. In Chapter 8, the subject of capital loss companies and also artificial arrangements by companies relating to capital losses are dealt with. Here, a number of other cases relating to revenue losses are considered.

One of the most important cases of recent years relating to tax losses and tax avoidance concerned, not any UK provision, but the general anti-avoidance provision in New Zealand, namely section 99 Income Tax Act 1976.[76] That case was IRC -v- Challenge Corporation Limited[77] This case is examined in detail below[78]. From that analysis it will be seen that the question was whether the general anti-avoidance provision (section 99) over-rode the group relief provisions of section 191 of the Act where a company purchased shares in another company in order to take advantage of the target company's tax losses. The Privy Council (Lord Oliver dissenting) held that section 99 did apply and group relief was not available.

The judgement of the majority was given by Lord Templeman. He pointed out that section 191 was intended to give effect to the reality of group profits and losses.[79] Where one group member makes a profit and another member makes a loss of the same amount, then the reality is that the group has made neither a profit nor a loss and the members of the group should not be liable to

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76. For details of anti-avoidance legislation in New Zealand, see Chapter 10.
77. [1986] STC 548
78. See Chapter 11
79. p552

tax. He pointed out, quite rightly, that section 191 in the circumstances is not an instrument of tax avoidance. However, he then said that in the present case, the Challenge group did not make a loss; the loss was made by the group from which it acquired the target company and, therefore, he said that section 191 would be used as an instrument of tax avoidance which fell foul of section 99.

Although this case concerned provisions of the New Zealand tax code, of relevance to UK law is Lord Templeman's analysis of the inter-action of the two sections. He appeared to accept that, subject to section 99, the assessable income of the Challenge group could be reduced by the amount of the loss sustained by the target company prior to its acquisition.[80] As the UK tax code contains no provision similar to section 99, the inference to be drawn is that tax loss companies can be acquired by UK groups. As will be seen when avoidance of CGT is considered, this has recently been held to be the case with regard to capital losses in the case of Shepherd -v- Lyntress Ltd.[81] In fact, the UK does, of course, have anti-avoidance legislation specifically aimed at stopping the exploitation of group relief, particularly sections 410 and 413(7)-(10) ICTA 1988.

Furthermore, it is submitted that the "Ramsay" principal[82] cannot be used in the same way as section 99 was used in the Challenge case because, as will be seen in Chapter 11, it is now generally accepted by the Courts that the Ramsay principal is not a general anti-avoidance provision but a rule of statutory interpretation.

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80. ibid
81. [1989] STC 617, see Chapters 8 and 11
82. See Chapter 11

Returning to the Challenge case, it will be seen that Lord Templeman, for the first time, sought to draw a distinction between tax mitigation and tax avoidance. In the view of Lord Templeman, it is tax avoidance rather than tax mitigation where income tax is avoided and a tax advantage is derived from an arrangement whereby a taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction.[83] In his view, the Challenge group was involved in tax avoidance by purchasing the tax loss company. He illustrated this[84] by referring to the cases, inter alia of Ramsay,[85] Eilbeck -v- Rawling[86] and Burmah Oil[87]. By way of generalisation, he then said that most tax avoidance involves a pretence. He considered that, in the present case, the Challenge group pretended that they suffered a loss when in truth the loss was sustained by the group from which it acquired the target company. This, in fact, is just not so. There was no pretence about the operations in which the Challenge group were involved. They did not pretend that they had made the loss at all; they merely relied on the specific legislation allowing group relief to be available even though the loss had not been sustained by the target company during the time that it was within the Challenge group.

Lord Templeman then went on to claim that section 99 applies where, as in the Challenge case "the taxpayer alleges that he has achieved the magic result of creating a tax loss by purchasing the tax loss of another taxpayer". On the contrary, the Challenge group was not claiming anything magical; they were merely relying on what appeared to be their right under the New Zealand tax

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83. p555
84. p556
85. W.T Ramsay Ltd v IRC (1981) 54 TC 101
86. Ibid
87. IRC v Burmah Oil Ltd (1982) 54 TC 200

code. There is nothing magical upon relying on a specific statutory relief provided for in detailed terms in the tax code.

As will be seen below,[88] Lord Oliver, not for the first time, took a more realistic and sensible attitude to the scheme than Lord Templeman. He said, for example:

> "To say that, for instance, an election under section 191(5) is valid except where it is made for the purpose of tax avoidance (as defined by section 99) is to emasculate section 191(5), for there can be no other purpose in the election thus contemplated than tax avoidance."[89]

The arrangements in the Challenge case were, after all, much more straightforward than the highly artificial transactions aimed at producing losses in the dividend stripping cases examined in Chapter 1, in connection with which the courts did take a firm line against the schemes.

In an examinations of the courts' attitudes towards loss-producing arrangements, it is interesting to compare the cases of Coates v Arndale Properties Ltd[90] and Reed v Nova Securities Ltd[91]. These cases concerned very similar arrangements, but the taxpayer company lost in the first case, but partly won in the second. These two cases are examined in Chapter 11, from which it can be seen that the scheme used in these cases was implemented to convert a capital loss into a trading loss by using an election under section 274 ICTA 1970.

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88. See Chapter 11
89. p557
90. [1984] STC 637
91. [1985] STC 124

To a large extent, the different results in these two cases turned on the findings of fact by the Commissioners, for which reference should be made to Chapter 11. The question in issue in each case was whether the assets in question were acquired by the transferee company as trading stock. In the Arndale case, it was found that the taxpayer company did not trade and did not have the intention of trading with the assets and so the assets were not acquired as trading stock. The transaction was carried out entirely for tax reasons. On the other hand, in the Nova Securities case, the Commissioners had found that some of the assets were acquired as trading stock.

In respect of those assets, the approach of Lord Templeman in the Nova Securities case is interesting. He said that the "new approach" could not be used by the Revenue when a statutory provision specifically enables a taxpayer to gain a tax advantage. He said:

> "The Revenue cannot complain that [the transferee company] have secured a fiscal advantage by the statutory method presented by section 274 of the 1970 Act and paragraph 1 of Schedule 7 to the 1965 [Finance] Act.[92] The only requirement in these circumstances is that, apart from section 274 considerations, there must be an acquisition by a trading company 'as trading stock'."[93]

Therefore,, if the taxpayer uses the method specifically provided in the legislation to obtain a tax advantage envisaged by the legislation, those advantages will be respected by the courts. As Lord Templeman pointed out:

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92. Now section 122 CGTA 1979
93. [1985] STC 124 at p131

> "the legislature, recognising for the purpose of inflicting tax that group companies do not lead an independent existence, has invented group relief which enables a group of companies to shuffle its losses between members of the group to obtain a tax advantage. The legislature has not extended group relief to allowable losses, but has conferred on a group of companies power to convert an allowable loss into a trading loss which can then be shuffled to secure a tax advantage."[94]

This principle was applied by Vinelott J in Shepherd v Lyntress Ltd.[95]

The final case to consider here is Overseas Containers (Finance) Ltd v Stoker.[96] The facts were that Overseas Containers Ltd ("OCL") carried on the business of owner and operator of container ships. In March 1969, it formed a wholly-owned subsidiary, the taxpayer company, whose objects included the provision of short and medium term finance for the OCL group. In 1967, contracts had been placed for the construction of five container ships in Germany, and OCL entered into loan agreements in deutschmarks with the shipyards to pay for the ships. It was feared that, due to the weakness of sterling, OCL would suffer substantial exchange losses.

It was for this reason that the taxpayer company was formed. The debts were novated to the taxpayer company and the taxpayer company lent OCL equivalent sums in sterling at the current rate of exchange, repayable on the same date as the sums due from the taxpayer. The interest payable by the taxpayer company on the loans from the shipyards was less that the interest the taxpayer company charged on the loan to OCL. A similar

94. Ibid
95. [1989] STC 617, see Chapter 8
96. [1989] STC 364

transaction was entered into in 1969 for the financing of the construction of five more ships.

Subsequently, sterling was devalued and the taxpayer company made a loss of £14.4 million. The taxpayer claimed that this loss was deductible as a revenue loss and should be set against the profits of the OCL group.

The Special Commissioners found that the sole or dominant purpose for the formation of the taxpayer company was to obtain a fiscal benefit, and they held that the transactions were entered into with a view to establishing loss claims which would not have been available had they accrued, in the ordinary course of business, to the OCL group, and that such transactions were not trading transactions.

On appeal by the taxpayer company, Vinelott J, at first instance[97] found for the Crown, agreeing that there was no trade. He said:

> "The only purpose of the interposition of the taxpayer company was to transmute the base metal of an exchange loss on capital account into the pure gold of a revenue loss. A transaction designed to achieve that fiscal alchemy is not a trading transactions."[98]

The interposition of the taxpayer company, he said, served no commercial purpose.

The taxpayer company had argued that the Commissioners should have paid less attention to the purpose for which the taxpayer company was formed, when they should have concentrated on whether the transactions which it entered into were of a commercial character. Vinelott J rejected

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97. [1987] STC 547
98. p587

this, saying that the Commissioners were right to start by identifying the purpose for which the taxpayer company was formed. Once the conversion of exchange losses on capital account into losses on revenue account had been identified as the only purpose for which the taxpayer company was formed, the achievement of that purpose was unaffected by the enlargement of the taxpayer company's activities to include borrowing and lending money in sterling and by the transfer to the taxpayer company of other income which could be set against the exchange losses.[99]

The taxpayer company's appeal to the Court of Appeal was dismissed.[100] Sir Nicolas Browne-Wilkinson V.C, with whom Parker and Russell LJJ agreed, isolated the issues the court had to decide as:

(1) whether it is relevant to take into account a fiscal purpose for which an alleged trading transaction was entered into; and, if so

(2) what is the affect of the existence of such a purpose.[101]

The Vice-Chancellor examined the case law on the meaning of "trade". he noted that Lupton v FA and AB Ltd[102] and Coates v Arndale Properties Ltd[103] established that, in addition to the normal badges of trade, the transactions must have a commercial purpose. In the Lupton and Arndale cases, the sole purpose was to obtain a tax advantage, whereas in Reed v Nova Securities,[104] the House of Lords drew a distinction between the two types

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99. p588
100. [1989] STC 364
101. p369
102. (1971) 47 TC 580, see Chapter 1
103. [1984] STC 637, see Chapter 11
104. [1985] STC 124, see Chapter 11

of transaction and, in the case of one of them, the company could have had a commercial purpose, and so the House of Lords did not disturb the Commissioners' finding that it was a trading transaction, notwithstanding the undoubted fact that the transactions also had the purpose of obtaining a tax advantage. The Vice-Chancellor stated:

> "The key to the cases is that if the taxpayer is shown to have a sole purpose which is not commercial, such purpose is inconsistent with his having a commercial purpose at all."[105]

Applying that test to the present case, the Vice-Chancellor asked whether the relevant purpose was that of the taxpayer company viewed in isolation, or that of the group as a whole. This was a vital distinction because, so far as the taxpayer company was concerned, it enjoyed no tax advantage; the tax advantage accrued to the group as a whole, which could set the losses generated by the taxpayer company against group profits.

The Vice-Chancellor said that he had no doubt that, in a case such as this, regard had to be had both to the overall fiscal purpose of the group, and the impact of the implementation of the scheme on the group.[106] He pointed out that, in the Arndale case, the House of Lords held that the taxpayer company did not acquire the relevant asset as trading stock because the transaction was only entered into as part of the tax scheme of the whole group.[107]

It is submitted that this is correct. Although for company law purposes group companies are strictly

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105. p370
106. Ibid
107. pp370-1

separate, tax law has, in a number of respects, rules which allow group companies to be treated other than as separate entities. Group relief is one of these rules. Accordingly, in matters of group relief, it is legitimate to consider the purpose of the group as a whole where transactions have been implemented within a group with solely a view to the exploitation of the group relief rules.

In the OCL case, the Vice-Chancellor said that, looking at the group as a whole, it was clear that the loan transactions had no commercial justification.[108]

Finally, on the question of losses and tax-avoidance, reference can be made to the subject of "hive-downs", which are mentioned above, and to an exchange of correspondence between the Institute of Chartered Accountants in England and Wales and the Inland Revenue on the subject of the impact of Furniss v Dawson[109] on a number of common transactions. In response to the Institute's letter of 8 July 1985, the Inland Revenue responded on 20 September 1985. The Revenue's letter had this to say on their attitude to hive-downs:

> "This is one of the topics on which it is particularly difficult to see at present where exactly the new approach might apply, if at all. On the face of it, the new approach might have some relevance in cases where little more than the tax losses are being hived down, though even then it would be necessary to demonstrate that there was a composite transaction and the insertion of a 'non-commercial' step in the transaction. However, we would not normally expect the new approach to be relevant in cases where an entire trade, or part trade, together with its related assets and

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108. p373
109. (1984) 55 TC 324, see Chapter 11

liabilities, are hived down with a view to to its being carried on in other hands....."

Following the further restriction of the new approach since 1985[110], it seems that it is unlikely that a hive-down could be susceptible to a successful attack under the "new approach", if the transaction is structured properly.

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110. See Chapter 11

CHAPTER 5

THE EXPLOITATION OF CAPITAL ALLOWANCES

Introduction

It is inevitable that if allowances are given for certain types of capital expenditure, which allowances reduce taxable profits, perhaps producing a loss that can be set against other income, that those taxpayers who are entitled to the allowances would seek to maximise their entitlement; and that other taxpayers, who, in the normal course of their activities, would not qualify for allowances, would seek to alter or extend their activities in order to qualify.

It is equally inevitable that the capital allowance legislation would contain anti-avoidance provisions in an attempt to prevent this exploitation. There is, however, a delicate line to be drawn by the Legislature. Capital allowances are given specifically to encourage investment in particular types of assets where Parliament has decided that extra investment is economically desirable. This could be a general need, such as the need for industrial rejuvenation across the whole spectrum after the Second World War; or, specific, such as the desire to boost the British film industry in the 1970's.

The problem always has been to draft anti-avoidance provisions which allow genuine investment to prosper, but which prevent unwarranted exploitation of the system.

Certain formulae have been used in the capital allowance legislation and have been successful up to a point but, in the 1970's and 1980's, there was a massive increase in artificial schemes, particularly involving the leasing of plant and machinery and also the use of limited partnerships in such specialist areas as investment in films and in oil and gas exploration. Specific legislation was enacted to counter these schemes and also the advent of the "new approach" of the courts to tax avoidance[1] considerably stemmed the tide of avoidance, but it was the gradual withdrawal of initial and first year allowances beginning in 1984[2], that effectively brought an end to widespread avoidance by means of artificial schemes. Even then, some taxpayers switched to investment in enterprise zones where generous allowances remained available;[3] although the extensive avoidance industry build up around capital allowance schemes was largely dismantled.

The exploitation of capital allowances is dealt with in this Chapter in three sections. First, the detailed 1945 anti-avoidance provisions are examined because they formed the basis and the model for much of what came later. Secondly, the modern provisions are considered. The third section deals with the specialised schemes, mostly based around limited partnerships, which concerned such things as films and oil and gas exploration. The major category of capital allowance-based leasing schemes is examined in Chapter 6.

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1. See Chapter 11
2. Section 58 and Sch 12 FA 1984
3. Section 74 and Sch 13 FA 1980

The 1945 Provisions

The capital allowances code introduced by the Income Tax Act 1945 was the first to contain detailed anti-avoidance legislation. These provisions merit examination because some of the concepts they used are still with us today.

Sections 58 and 59 ITA 1945 were intended to give the Inland Revenue a means of countering schemes for obtaining excessive allowances under the ITA itself, or under the scientific research allowances provisions of the FA 1944.

Before the enactment of the ITA 1945, it was possible to obtain an advantage by effecting a transfer at inflated prices; and the Inland Revenue had no power to challenge it, because the whole system of basing wear and tear allowances on original cost was extra statutory. With the calculation of the allowances being put on a statutory basis, the Revenue ensured that it was given statutory protection against possible abuses.

Another factor which strengthened the Revenue's position, but which at the same time provided a loophole, was the introduction of balancing charges.

There were a number of ways in which a sale could be arranged involving an artificial price so that substantial benefits could be conferred on the seller without, at the same time, involving the seller in a balancing charge of corresponding size. It was therefore necessary to look at a sale from both sides, to consider the positions of both seller and buyer, to ensure that neither obtained any undue benefit from the transaction.

Sections 58 and 59 were concerned with three types of artificial transaction but, in each case, there had to be a sale; other disposals were unaffected. The restriction of the sections to sales is understandable, because sales were the main events which gave rise to balancing allowances and, as regards plant and machinery, sales also entitled the purchaser to an initial allowance if he was purchasing the plant for the purposes of his trade.

The first of these artificial transactions is one between parties who were technically at arm's length. The sale would be included with a number of other transactions, with the object of allocating to a specific asset a part of the total consideration which wass different from the price that would have been attached to the asset if the sale had not been part of a larger transaction. A straightforward example would be where a building and plant were sold together with a greater proportion of the total consideration being allocated to the plant than was justified by the respective values of the building and the plant. There would have been an advantage to the buyer as he would have been entitled to a substantial initial allowance on the plant, as against possibly none on the building.

The second of the artificial transactions took place between parties under common control, where it was a simple matter to arrange a price which would give the best overall tax position, taking both parties together.

The third type of transaction could have been either arm's length or connected parties, and was a sale which had only one real object: the obtaining of allowances, or the minimising of balancing charges.

It can be seen that these three types of transaction were all based on a sale price for an asset which did not correspond to its market value. The Act also dealt with a category of transaction where the sale price was not market value, but where the sale wass carried out for proper commercial reasons, so that it could not really be called artificial.

Section 58 ITA 1945 dealt with the question of apportionment when assets were sold as part of a larger transaction. The section tackled two aspects of the matter. The first was that, if an asset was sold together with a number of others, the total proceeds could be allocated to individual assets on "a just apportionment". Secondly, if there were a number of separate sales which really constituted one transaction, they were treated as if one bargain had taken place and the aggregate proceeds were apportioned accordingly, regardless of the separate prices agreed by the parties. The Revenue could therefore disregard any artificial allocation of the sale proceeds and so prevent the obtaining of artificially inflated allowances. The parties could appeal against the apportionment to the Commissioners if they were dissatisfied.

Sales between connected parties and those effected solely to obtain allowances (ie, the second and third types of transaction referred to above) were dealt with by section 59. The scheme of the section was that, if the sale price was not the same as market value, the Revenue could substitute market value for the purpose of calculating allowances and charges, and, in addition, no initial allowances were given to the buyer.

Section 59 applied where either the sale was between connected parties or the sale had as its main object the obtaining of allowances. The former of these two alternatives operated where one party controlled the other or a third party controlled both of them.[4] The definition of "control" corresponded to the one now to be found in section 87(1) CAA 1968, namely, control by way of voting rights, in the case of a limited company and control of over one-half of the assets or income of a partnership.

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4. Section 59(1)(a) ITA 1945

Section 59 applied to sales of assets subject to the wear and tear allowance, obsolescence allowance, a scientific research allowance, or any of the allowances under the ITA 1945.

The section provided a measure of relief in the case of sales between parties under common control.[5] The parties could make a joint election that the general rules of section 59 should be modified so that:

(i) the notional sale price would be the lower of open market value or written-down value;

(ii) the buyer would obtain no initial allowances; and

(iii) any balancing charge which later fell to be levied on the buyer was calculated as if the asset had continued in the ownership of the seller and he had received the allowances up to the date of the second sale.

In other words, the sale would have no effect on the aggregate allowances of the two parties, either at the date of sale or subsequently.

In the case of plant (but not other assets) which was the subject of the transaction within the second or third categories mentioned above, section 59(3), as amended by section 45 FA 1946, provided that no initial allowance was given to the buyer. There were a number of exceptions to this. The main exception applied to a sale between parties under common control, but which was not a transaction the real object of which was the obtaining of allowances. The conditions for the operation of the exemption were that the seller must have received an initial allowance when he purchased the plant, that there

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5. Section 59(4) ibid

was a balancing charge on the seller on the sale to the party under common control and that, on that occasion, the open market value must have been greater than 80% of the original cost.[6] If these conditions were fulfilled, the initial allowance available to the buyer was the lowest of three amounts:

(i) the difference between market value and 80% of the original cost[6] to the seller;

(ii) the initial allowance which the seller obtained when he originally bought the plant; and

(iii) the balancing charge made on the seller.

The third category of scheme mentioned above, was, in fact, dealt with by a "benefit" test. It applied in the case of sales where it appeared that the sole or main benefit which might have been expected to accrue to the parties or any of them from the sale (or from the transaction of which the sale formed part) was the obtaining of allowances.[7] In other words, it did not matter what the intention of the parties was. This is the formula used in the general profits tax and excess profits tax provisions considered in Chapter 1, but the "main benefit" test here, although undoubtedly wide in its scope, was part of a much more specifically targeted provision, and it did not throw up a line of cases in which innocent taxpayers were unduly caught by the test. A major difference between the use of the test here and its use in the profits tax and excess profits tax general anti-avoidance legislation was that here, of course, it was being used in legislation, the object of which was to encourage the investment in certain assets through the granting of tax incentives. Accordingly the thrust of

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6. Reduced to 60% by section 20(3) FA 1949
7. Section 59(1)(b) FA 1945

the legislation was not to prevent the reduction of tax excess the board, but the reduction of tax by the unwarranted exploitation of specific incentives.

The final point to make about section 59 is that it could be applied to a sale that took place at any time, whether before or after 6 April 1946 (the normal commencement date for provisions in the ITA 1945), so that, for example, in relation to sales that took place before 6 April 1946, the Revenue could amend the written-down value as at the end of 1945/46.

However, although an Inspector could revise the written-down value as a starting point for the year 1946/47, he could not disturb the allowances for any earlier year.[8]

Another provision enacted with retrospective effect in 1945 also deserves a mention. The F(No 2) A 1945 introduced important modifications to the provisions relating to what was known as "exceptional depreciation" in section 19 FA 1941, para 3 of Part I of the Seventh Schedule to the F(No 2) A 1939, and those provisions as applied to profits tax by section 43 FA 1941. In accordance with the provisions of section 58 F(No 2)A 1945, the earlier enactments dealing with exceptional depreciation in relation to income tax, profit tax and excess profits tax were treated as having been subject at all times to the modifications contained in the Eight Schedule to the F(No2)A 1945.

The original rule for computing the amount of exceptional depreciation was that the asset in question had to be valued at 31 December 1946 as though it were in a good state of repair. If, at that date, it was not in fact in

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8. Section 59(5) ITA 1945

good repair, and was sold within six years after 31 December 1946, without the repairs having been carried out, at a price which was less than the value put upon the asset for the purposes of determining the exceptional depreciation, the vendor was entitled to claim a modification of his allowances by substituting for the value so ascertained the price realised.

Paragraph 6 of Part I of the Eight Schedule to the F(No2) A 1945, stated that, where the sale was between persons under common control, the purchaser was not permitted to deduct from his profits for profits tax or excess profits tax purposes the cost of making good the disrepair at 31 December 1946 and, furthermore, in the case of plant, if the disrepair was such as to necessitate the replacement of the asset, no deduction from profits was allowed to the purchaser in respect of the wear and tear on the new plant.

These provisions also had effect with respect to sales prior to 31 December 1946 where, at the date of sale, the asset sold was not in a good state of repair.

Part II of the Eight Schedule introduced more general anti-avoidance provisions. These measures applied to sales of buildings or plant and machinery where the sale was between persons under common control, or where it appeared with respect to the sale, or with respect to transactions of which the sale was one, that the sole or main benefit which might have been expected to accrue was the obtaining of any allowance or deduction.

In the case of such sales, the asset in question was treated, for the purpose of computing any exceptional depreciation allowance to the vendor or to the purchaser, as if it had been sold at whichever was the lower of:

(a) the price it would have fetched in the open market; or

(b) its cost to the vendor less any wear and tear and any allowances under the ITA 1945 granted to the vendor.

These provisions were deemed "always to have had effect". It was also specifically provided[9] that any reference in the Schedule to a sale included an exchange of assets; and, where a number of assets were sold together under one bargain, the consideration for the sale was to be apportioned on a just apportionment basis.

It will be seen that the basic structure of the 1945 avoidance provisions has been retained to the present day. Although these measures are potentially very wide in their wording, particularly the sole or main benefit test, they have given rise to surprisingly few disputes. Although the wording of the anti-avoidance measures themselves was relatively wide, they are applied in relation to specific and well-defined situations so that, for example, the problems encountered by the use of the sole or main benefit test in relation to section 35 FA 1941 (as amended by section 33 FA 1944) and section 32 FA 1951[10] did not arise, because taxpayers and their advisers could identify with precision the circumstances in which these anti-avoidance provisions would apply, and the Revenue were less eager to apply the restrictions because they were part of the rules which specifically granted tax incentives: they tended to attack arrangements under the detailed legislation relating to the availability of the incentives than under the general "benefit" test.

However, it was this very feature, the specific targeting of the provisions, that was the main reason why the anti-avoidance provisions based on the 1945 structure were found lacking when the avoidance boom occurred in the 1970's and 1980's.

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9. Para 8 of the Eighth Schedule, F(No2)A 1945
10. See Chapter 1

The Modern Provisions

Section 77 CAA 1968 corresponds with section 78 ITA 1945 and provides for a "just apportionment" where property is sold together with other property. Section 77 provides that all the property which is sold in pursuance of one bargain shall be deemed to be sold together, notwithstanding that separate prices are agreed for separate items or that there are separate sales of separate items of that property.[11] These provisions apply to other sales, insurance, salvage or compensation moneys as they apply in relation to the net proceeds of sale.[12]

For example, in Alfred Wood Ltd v Provan[13] a business of timber merchants and builders merchants was sold for £17,500. This total consideration was apportioned as to £15,850 to the freehold premises, as to £400 to fixed plant and machinery and as to £1,250 to the trade name and moveable assets. The Revenue claimed that more than £400 plus £1,250 should be apportioned to the plant and machinery etc in view of the respective market values of the various assets, with the result that a greater balancing charge should be suffered by the vendors. The General Commissioners found that the open market value of the plant and machinery at the date of sale was £3,783. The Commissioners' apportionment was upheld by both the High Court and the Court of Appeal, and an adjustment was made under what was then section 329 ITA 1952.[14]

The provisions of section 77 also apply in the case of the sale of assets provided for scientific research for the purposes of the scientific research allowances,[15] to the 1971 system of reliefs for plant and machinery[16] and

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11. Section 77(1) CAA 1968
12. Section 77(2) ibid
13. (1967) 44 TC 701
14. See also Fitton v Gilders and Heaton (1955) 36 TC 233
15. Section 95(2) CAA 1968
16. Para 15(4) Sch 8 FA 1971

to the new code of reliefs for mineral extraction.[17]

The rules originally contained in section 79 ITA 1945 are now in section 78 and Schedule 7 CAA 1968. The special provisions in Schedule 7 apply in relation to sales of any property where either -

"(a) the buyer is a body of person over whom the seller has control, or the seller is a body of person over whom the buyer has control, or both the seller and the buyer are bodies of persons and some other person has control over both of them or the buyer and the seller are connected with each other......, or

(b) it appears with respect to the sale, or with respect to transactions of which the sale is one, that the sole or main benefit which, apart from the provisions of [Schedule 7], might have been expected to accrue to the parties or any of them was the obtaining of an allowance or deduction, the obtaining of a greater allowance or deduction or the avoidance or reduction of a charge....."[18]

The provisions of Schedule 7 do not apply to expenditure incurred on the purchase of patent rights after 31 March 1986,[19] to know-how[20] or to plant and machinery acquired after 26 October 1970.[21]

The rules in Schedule 7 follow the format used in section 59 ITA 1945. If the property is sold at a price other

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17. Para 2(1)(2) Sch 13 FA 1986
18. Section 78(1) CAA 1968
19. Section 532(2) ICTA 1988
20. Section 532(5)(b) Ibid see section 387(4)(b) and (6) ICTA 1970
21. Which is subject to separate anti-avoidance provisions, infra

than that which it would have fetched if sold in the open market the capital allowances of the buyer and any balancing adjustment of the seller is calculated by reference to the market value.[22]

As in the 1945 legislation, unless the parties fail the sole or main benefit test, the connected parties (or those under common control) can elect that the asset is treated as sold at the lower of its market value or its written-down value.[23]

There are also, as in the ITA 1945, special rules relating to plant.[24] The wording of these special rules was, in fact, altered in 1954 following the case of Wilsons (Dunblane) Ltd v IRC.[25] The relevant provisions were at the relevant time still contained in section 59(2) and (3) ITA 1945.

The facts were that, on 16 November 1944, Mr Wilson, who carried on a wool spinning business, took his two sons into partnership, bringing into the firm the whole of the business assets. The starting figure in the firm's books for the plant and machinery taken over was £8,000, which was the written-down figure in Mr Wilson's books. The partners elected that the Schedule D, Case I income tax assessments should be computed as if Mr Wilson's trade had been discontinued and a new trade had been set up.

On 16 November 1945, the business was transferred to the taxpayer company, which was owned by the former partners. The price paid by the taxpayer company for the plant and machinery was £17,554, which was its open market value.

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22. Para 2, Sch 7 CAA 1968
23. Para 4, Sch 7 CAA 1968
24. Para 3, ibid
25. (1954) 35 TC 107

The Inland Revenue contended that the sum on which the allowances to the company should be based was only the "limit of recharge" provided for by section 59(2); in this case £8,000.[26]

Although the Special Commissioners decided in favour of the Inland Revenue, the Court of Session held that the Commissioners' decision could not be supported and that the taxpayer company was entitled to allowances based on £17,554.

The Lord President (Cooper) said that the broad effect of the subsequent subsections of section 59 was to secure that, in cases to which subsection (1) applied, the nominal purchase consideration should be disregarded for income tax purposes, and replaced by the market price or, in the case of plant and machinery, by an artificial figure called "the limit of recharge". That, said the Lord President, might be highly intelligible as a scheme, but it remained to consider whether it had been successfully carried into effect by the Legislature.[27]

He said that subsection (2) applied to all property covered by a "sale", but it only applied where the price was other than that which the property would have fetched if sold on the open market. The Lord President held that the modification provided for by section 59 did not apply because, by virtue of the way the section was drafted, where, as here, the sale took place at market value, the machinery of the section could not take effect.[28]

This defect in the wording of the section was cured by section 23(b) FA 1954.[29]

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26. See now para 3(4), Sch 7, CAA 1968
27. p117
28. pp117-8
29. The amended wording has been carried through to para 3(1), Sch 7, CAA 1968

The effect of these provisions is extended to cover transfers of the relevant interest in industrial buildings otherwise than by way of sale by section 76 FA 1981. This section applies where the transfer takes place after 10 March 1981.[30] Such a transfer must be treated as if it were a sale at market value, so as to bring Schedule 7, CAA 1968 into operation in respect of it. Before the enactment of this section it was possible to avoid a balancing charge on the sale of an industrial building by the owner giving it to a connected person and for the connected person to make the sale. This avoidance device is no longer effective because of this provision.

These provisions are extended to qualifying hotels and buildings in enterprise zones.[31]

Plant and machinery purchased after 26 October 1970 is subject to its own anti-avoidance rule in paragraph 3, Schedule 8, FA 1971. These rules are wider than those already considered. These rules are aimed at preventing the availability of a first year allowance in certain circumstances. Since first year allowances were abolished generally with effect from 1 April 1986,[32] the importance of these rules has diminished, although they are still relevant in respect of writing down allowances and balancing adjustments.

The paragraph states that, in certain circumstances, a first year allowance was not available, or if already made, was withdrawn, and writing down allowances and future balancing adjustments of the purchaser are based on the lower of the disposal value brought into account under section 44 FA 1971 and cost. In other words, there

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30. Unless the transfer is pursuant to a contract made before that date, section 76(5) FA 1981
31. Section 76(4) FA 1981
32. Section 58 and Schedule 12 FA 1984

is disregard so much as exceeds the vendor's original cost.

There are three circumstances in which these provisions operate:

(1) where the vendor and purchaser are connected within the terms of section 839 ICTA 1988; or

(2) where the plant and machinery continues to be used for the purposes of a trade carried on by the vendor; or

(3) where the "sole or main benefit" test is not satisfied.[33]

Circumstance (1) is self-explanatory, and requires no further analysis. Circumstance (2) is aimed at "sale-and-leaseback" and similar transactions whereby a vendor buys or leases the relevant assets back from the purchaser. In fact, it is even wider than this because the circumstance applies even if the vendor merely uses the equipment, such as under an informal licence.

Circumstance (3) is the sole or main benefit test dating from 1945. Even in the leasing boom in the days of high first year allowances, the Revenue were surprisingly reticent in applying the section. There were admittedly a lot of schemes which could have been looked on as commercially based, but a great many had as one of their main benefits the obtaining of a capital allowance. Based on the case law surrounding the benefit test in the general excess profits tax and profits tax provisions considered in Chapter 1, the Revenue could well have had a lot of success had they applied paragraph 3(1)(c), Schedule 8 more frequently. In practice, it appears that many Inspectors were simply not aware of the width of the

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33. Para 3(1) Sch 8 FA 1971

test. The main difficulty in deciding the extend to which the main benefit test applied was that the generous capital allowances were given specifically to induce investment in plant and machinery by people attracted by the substantial tax benefits that would ensue. The point at which the obtaining of the allowance became the "main" benefit was often difficult to decide.

Schedule 8 contains similar provision to those in paragraph 3(1) which apply in the case of the use of hire-purchase and conditional sale agreements, instead of the lessor purchasing the plant and machinery outright.[34]

Similar restrictions also apply where a person obtains an assignment of the benefit of a contract under which ownership may pass on performance of the contract.[35]

As noted above, paragraph 3 limits writing-down allowances to the lower of the "disposal value" and the vendor's original cost. It is possible that the vendor may too have a "disposal value" because, for example he is a dealer in the plant and machinery who does not hold it as capital. In such cases there is substituted for disposal value the lowest of the following:

(i) the open market value of the plant and machinery at the date of disposal;

(ii) the capital expenditure incurred by the vendor on the provision of the plant and machinery;

(iii) the capital expenditure so incurred by any person who is connected with the vendor.[36]

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34. Para 3(2), Sch 8, CAA 1968
35. Para 3(3) ibid
36. Section 68(4) FA 1972

Section 68 FA 1972 introduced two exceptions to the paragraph 3 restrictions. Section 68(5) and (6) provides that a first year allowance could not be denied by virtue of situations (a) or (b)[37] of sub-paragraphs (1), (2) or (3) of paragraph 3 if the plant and machinery before the sale had not been used for the purposes of a trade by the vendor or any person connected with him. In these circumstances, the first year allowance was restricted to the lowest of the amounts specified in section 68(4) FA 1972.[38] This exception does not, however, apply to the restrictions on writing-down allowances, which restrictions can therefore still bite.

The exception in section 68(7) FA 1972 provides that paragraph 3(1) and 3(2) are totally inapplicable if the plant and machinery had never been used for any purpose before the sale etc and the vendor's business was, or included, the manufacture or supply of equipment of that class, and the sale was effected in the ordinary course of that business.

It should be noted that none of the restrictions in paragraph 3(1) or (2) can apply, and the sole or main benefit test is irrelevant for this second exception.

Mention should also be made of section 68(1) FA 1982. This contains provisions designed to prevent a person who owned machinery before 27 October 1970, but sold it then subsequently repurchased it after 13 June 1972, from becoming entitled to a 100% first year allowance. This provision also applies where a person, who acquired an asset before 27 October 1970, sold it to a purchaser after 13 June 1972, but continued to use it, for example, under a lease-back arrangement. In these circumstances, the 1968 code of allowances app lis, rather than the 1971 code.

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37. Containing the first two circumstances in which the restrictions can apply.
38. Supra

The provisions of paragraph 3 of Schedule 8 were relatively ineffective to curb the exploitation of the capital allowance rules in the numerous leasing schemes that were particularly prevalent in the late 1970's.[39] The reluctance of the Revenue to use the main benefit test, plus the exceptions provided by section 68 FA 1972 meant that first year allowance were rarely denied by paragraph 3, although the Revenue did attack leasing arrangements in other ways, as explained in the next Chapter.

In any case, in 1984, the first year and initial allowances began to be phased out.[40] With this phasing out, there was an obvious temptation for taxpayers to bring forward the dates on which they incurred qualifying expenditure to take advantage of the higher allowances. Accordingly, Schedule 12 to the FA 1984 contained provisions to prevent such avoidance.

These anti-avoidance rules applied to contracts entered into between 14 March 1984 (when the phasing-out began) and 31 March 1986 (after which no first year or initial allowances were available). Expenditure under such contracts was spread over the period commencing with the date of the relevant contract and ending when the contract was fully performed (or, if earlier, 31 March 1987).[41]

Another timing provision which contains an anti-avoidance condition is <u>section 56 FA 1985</u>. This section altered the date on which expenditure is treated as incurred for the purposes of capital allowances from the date when it was "payable" to the date on which the obligation to pay becomes unconditional. This is in line with normal

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39. See Chapter 6
40. Section 58 and Sch 12 FA 1984
41. Paras 5 to 10, Sch 12 ibid

accounting treatment. Where there is a credit period of more than four months, expenditure that is not required to be paid until more than four months have elapsed is deemed to be incurred when it is required to be paid.

In order to prevent expenditure from being accelerated artificially, section 56(5) FA 1985 states that, in any case where:

"(a) under or by virtue of any agreement, an obligation to pay an amount of capital expenditure becomes unconditional on a date earlier than that which accords with normal commercial usage, and

(b) the sole or main benefit which....might have been expected to be contained from the obligation being unconditional on that earlier date is that ..... the expenditure would be taken to be incurred in a chargeable period or its basis period which is earlier than would otherwise have been the case."

the provisions shall not apply which render the relevant date to be that on which the obligation becomes unconditional.

Finally, mention should be made of two anti-avoidance provisions which relate specifically to industrial buildings. The first is section 69 FA 1972. Before the enactment of this section there was a popular arrangement, normally carried out between companies within the same group or between associated persons, to accelerate the write-off on industrial buildings by means of balancing allowances.

The normal pattern would be for the owner of the building to grant a long lease to, say, a company in the same group at a low rent. This would not be a disposal of the relevant interest but would greatly reduce the value of the reversionary interest, which was the relevant interest. This interest would then be sold, perhaps to another group company, or to an unconnected purchaser, at its market value, which would be low as a result of the lease. The original owner would thereby obtain a large balancing allowance.

By virtue of section 69, for transactions after 13 June 1972, the balancing allowance is calculated as if the proceeds of sale of the relevant interest were increased by the amount of premium receivable for the grant of the subordinate interest. Furthermore, where there is no rent, or a rent at less than a commercial rate, payable in respect of the subordinate interest, the net proceeds for the sale of the relevant interest are taken to be what the proceeds would have been if a commercial rent had been payable and the relevant interest had been sold in the open market (with an appropriate increase for any premium paid for the subordinate interest).

These adjustments are made where either:

(1) the person entitled to the relevant interest immediately before the sale, the purchaser of the relevant interest, and the grantee of the subordinate interest, or any two of them, are connected with each other within the terms of section 839 ICTA 1988; or

(2) it appears, with respect to the sale, or to the grant of the subordinate interest, or with respect to transactions including the sale or grant, that the sole or main benefit which might have been expected to accrue to the parties or any of them was the obtaining of the allowance.

There is, in fact, a penal element to this provision in that, where it operates, the residue of expenditure to the purchaser is the same as if the balancing allowance had not been reduced or eliminated. This is not, therefore, merely a counteracting provision, and taxpayers who implement the tainted transactions will find themselves in a worse position than if they had done nothing.

This provision appears to have entirely successful in stopping the specific schemes at which it was aimed without impinging on other, more legitimate transactions. Neither did it have any effect on the straightforward arrangement for avoiding a balancing adjustment where the owner of a freehold industrial building, rather than selling the relevant interest (the freehold), grants a very long lease, thereby not triggering any adjustment. This transaction, and simple variations of it, are not affected by this provision.

The other provision concerning industrial buildings relates to sales after cessation of use for a qualifying purpose. The relevant legislation is contained in section 74 and 75 FA 1981, which amended section 3 CAA 1968, and it applied to sales, and other relevant disposals,[42] taking place after 17 December 1980. No balancing adjustment arises when a building ceases to be used for the purpose of a qualifying trade; but these provisions ensure that such an adjustment will arise on a subsequent sale. This legislation prevents the simple avoidance device of avoiding a balancing charge by ceasing the qualifying use of a building before sale.

The various anti-avoidance provisions dealt with above are currently far less important and prominent than they were a few years ago when there were high first year and initial allowances across the whole range of capital

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42. As set out in section 3(1) CAA 1968

assets, coupled with high individual and corporate tax rates.

Specialised Schemes

The combination of high tax rates and high first year and initial allowances, plus the ability to use losses created by excess allowances against other taxable income, was inevitably going to lead to avoidance schemes seeking to exploit these generous allowances. However, few predicted the scale of this avoidance. It is no exaggeration to say that a whole industry grew up around these schemes involving extremely large amount of money. Most of these schemes, involved the buying and leasing out of plant and machinery (such as transport containers) and they are considered in Chapter 6. The other major category involved a taxpayer entering into a business activity, normally in which he had no previous expertise, as a limited partner. There would be a number of limited partners seeking tax losses plus a general partner who would actually run the business. The partnership would incur expenditure, the investment normally being geared up by financing, thereby attracting substantial capital allowances producing a loss in the early years. These partnerships operated in a number of areas, such as oil and gas exploration and films. One of these categories is examined below. The category dealt with is that concerning film schemes. This type of scheme has been chosen for three reasons.

1. Film schemes were very popular and widely used.

2. They contained most of the features to be found in similar categories.

3. A number of the fundamental principles upon which they were based have been considered by the courts.

There were some films financed as a tax shelter by single corporate taxpayers, but normally the costs of financing a film were too much for a single taxpayer, thus limited partnerships were used to enable a number of taxpayers to pool their resources.

Film schemes were so widespread that, in the later 1970's and early 1980's a high percentage of both UK and overseas films were financed by UK taxpayers and the UK film industry, in particular, saw a period of expansion.

A typical scheme would operate by a specialist film production company actually making the film. The "master" print would then be acquired by the taxpayers' vehicle (such as a limited partnership) before it had been exploited in any way, so that it was still "unused" at that stage. The purchase price would consist of the capital actually invested by the taxpayers plus a further amount, often a high proportion, borrowed from a financial institution. This borrowing was often on a "non-recourse" basis, which meant that repayments of capital were only due out of the funds generated from the exploitation of the film; and not from the other resources of the taxpayers.

The taxpayers' vehicle would then seek to exploit the film. In practice, this usually meant granting distribution rights to a distribution company which would market the film in the normal way.

Sometimes, the taxpayers would come in before the film was made and would finance the making of the film directly; and at other times they would come in after the film had been made and simply purchase the "master" for a price which reflected the production costs.

The main factor giving rise to all of this activity in

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43. SP 9/79 "Expenditure on producing films and similar assets (FA 1971 s41)"

the film industry was a Statement of Practice issued by the Inland Revenue on 19 August 1979.[43] This Statement announced that the Inland Revenue had reviewed the position regarding the tax treatment of film production expenses and agreed that such expenses could qualify for capital allowances. The Statement said:

> "In future therefore, capital allowance claims for film production expenditure will be accepted, provided the master-print of the film can properly be regarded as a capital asset in the business. In practice a master-print would be regarded as meeting this condition if it is retained by the production company and has an anticipated potential life of not less than two years".

The Revenue accepted that the whole of the film production expenditure qualified for 100% first year allowances because the asset resulting from that expenditure, the master-print, was "plant". The Revenue cited the case of McVeigh v Arthur Sanderson and Sons Ltd[44] for their view that capital allowances were due in such circumstances.

The Revenue cannot have foreseen the size of the exploitation of capital allowances on films purely for reasons of tax sheltering. As well as the sheer volume of tax sheltering, they were particularly irritated by a number of features of many film schemes whereby taxpayers would borrow a high proportion of the funds required, often on a non-recourse basis, and obtain capital allowances far in excess of the taxpayers' own funds injected into the project. The Revenue also disliked the limited partnership structure whereby taxpayers would generate trading losses (by means of the capital allowances) far in excess of their capital risk.

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44. (1969) 45 TC 273

Somewhat surprisingly, this was their first line of attack in the courts on film schemes which, not surprisingly, they lost.[45]

As well as attacking film schemes through the courts, the Revenue sought, and obtained, a change in the law. Accordingly, section 72 FA 1982 was enacted.[45A] This section restricted the availability of capital allowances and set down rules for spreading the availability of tax deductions for production costs.

The section stated that expenditure incurred on or after 10 March 1982 on the production or acquisition of a master-negative of a film, which is not a "qualifying film", shall be treated as revenue expenditure and not as capital expenditure qualifying for capital allowances.[46]

The section contained transitional rules under which capital allowances were retained for a period in respect of "qualifying films" which basically were British films which qualified for what is known as the "Eady" levy under the Film Levy Finance Act 1981, plus certain British television films.[46A] Capital allowances remained available in the case of such films where the relevant expenditure was incurred on or before 31 March 1984 where, either that expenditure was incurred pursuant to a contract entered into before 10 March 1982[47] or, if the contract was entered into after that date and the expenditure was incurred "by a person who carries on a trade or business which consists of or includes the exploitation of films,"[48] and the value of the film was

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45. Infra
45A. As regards individuals, section 70 FA 1980 (see Chapter 6) in many cases prevented capital allowances being set against other income.
46. Section 72(1) FA 1982
46A. See now the Films Act 1985
47. Expenditure on non-qualifying films also remained subject to the capital allowance regime if the contract was entered into before this date.
48. Section 72(7)(a) FA 1982

expected to be realisable over a period of not less that two years.[49]

In the case of non-qualifying films, not only was expenditure on the production of films treated as revenue expenditure, it was spread over a "relevant period" in computing trading profits. Under this spreading provision, the expenditure was not written off as soon as it was incurred, but over such a period as was "just and reasonable" having regard to, in effect, the income-providing life of the film.[50] Section 62 FA 1984 inserted two new subsections into section 72 FA 1982[51] providing for an alternative "cost recovery" method.[52]

The spreading rules do not apply to the profits of a trade in which the film is held as trading stock.[53]

As a result of these statutory changes, investment in films ceased to be a viable tax shelter for taxpayers outside the film industry. The Revenue, however, were faced with the fact that many millions of pounds had been invested in films under the old capital allowance regime and they were faced with a substantial loss of tax revenue. They therefore sought to attack such schemes in the courts.

In the light of the vast scale of tax sheltering through film investment prior to the 1982 changes, a challenge through the courts was only to be expected; however, the challenge, when it came, was a surprisingly weak one and the courts up to and including the House of Lords unanimously rejected it. The case in question was <u>Reed v Young</u>.[54] In this case the Revenue attacked the limited

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49. Section 72(7)(b) ibid
50. Section 72(3) and (4) ibid. See Statement of Practice SP 2/83
51. Subsections (4A) and (4B)
52. See Statement of Practice SP2/85 for an explanation of this method.
53. Section 72(5) FA 1982
54. [1986] STC 285

partnership structure which, as mentioned above, was a feature of most of the schemes.

The taxpayer was a limited partner in "Monday Films (3)". The partnership agreement provided: (1) that the limited partners should receive 95% of the profits and bear 95% of the losses pro rata to the amount of capital which they had contributed; (2) that any profits or losses to which the limited partners were not entitled should be credited to the general partner; and (3) that, by virtue of clause 8 of the agreement, the limited partners should bear losses to the full extent of their interests in the partnership and, where their interests were insufficient to meet the amount of their losses in full, any balance was to be debited to them and carried forward against their entitlement to future profits and against all future capital contributions for which they might be liable. In the year 1977/78, when the taxpayer's capital contribution to the partnership stood at £10,068, the partnership made losses and her share of 95% of those losses amounted to £41,423. The taxpayer claimed that she was entitled to set-off those losses against her income for tax purposes but the Revenue disallowed her claim on the ground that she loss she had "sustained" within section 168 ICTA 1970[55] was limited to the amount of capital contributed by her. The Revenue argued that she could not "sustain" a loss for which she was not liable and that clause 8 clearly limited the amount of her loss as well as her liability and, accordingly, the loss she "sustained" was limited to the amount of her capital contribution. The Special Commissioners upheld the taxpayer's claim.

The Revenue's appeal was rejected at each stage. It should be noted that the Ramsay case[56] was cited by

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55. Now section 380 ICTA 1988
56. W.T Ramsay Ltd v IRC (1981) 54 TC 101 see Chapter 11

counsel in the High Court but was not referred to in the judgment of Nourse J[57] and it was not relied on in the higher courts.

The Crown's arguments were, according to Nourse J, based on a "fundamental confusion".[58] In the House of Lords, Lord Oliver, with whom the other Law Lords agreed, was of the same opinion.[59]

Nourse J clearly and succinctly exposed the basic flaw in the Revenue's argument in the following passage:

> "It is important to distinguish between the capital of a partnership, a fixed sum, on the one hand and its assets, which may vary from day to day and included everything belonging to the firm having any money value, on the other; see generally Lindley,[60] at p442. Equally important is the distinction between the assets of a partnership and its profits for a given period. That distinction is self-evident, but I agree with counsel for the taxpayer that it is necessary to state it in order to detect the fundamental confusion which underlies the arguments of the Crown in this case. That confusion is between the losses of a partnership for a given period on the one hand and its liabilities or, as the statutory language has it, its debts and obligations on the other. The two things are entirely different. A loss, like a profit, is an accounting measure of the firm's performance over a given period. Liabilities, like assets, vary from day to day. Just as you do not make a profit by acquiring an asset, so you do not sustain a loss by incurring a liability.

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57. [1984] STC 38
58. Ibid, p 57
59. [1986] STC 285 at p290
60. "Lindley on the Law of Partnership" 14 edition (1979)

It has long been settled that partnership income is taxed on an artificial basis. The partnership is treated as an entity distinct from the partners. There must then be an apportionment of the income between the partners so as to arrive at each individual's liability.....

If the taxpayer had been a partner in an ordinary partnership, there could be no doubt that she would have been entitled to set off the whole of the £41,423 under section 168. Why should her position be any different merely because her liability to discharge the debts and obligations of the firm is limited to the amount of capital contributed by her? I am unable to see any rational basis for the suggested difference. The incurring of the loss bears no necessary relationship to the discharge of the debts and the obligations of the firm, far less to their discharge out of capital."[61]

Counsel for the Crown also relied on the proviso to clause 8 of the partnership agreement namely:

"Provided Always that no Limited Partner shall be liable for the debts or obligations of the Partnership beyond the amount of capital contributed by him."

It was submitted that, although this proviso refers to a limitation on the liability for the debts and obligations of the firm, it nevertheless carried the clear implication that a ceiling was to be placed on losses as well. Not surprisingly, Nourse J said:

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61. [1984] STC 38 at pp57-8

"There is nothing at all in this point. I think that the proviso was inserted.... to make it clear that the limitation of the limited partners' liability was to exist as a matter of contract between them and the general partner, and not merely as a shield against creditors of the firm."[62]

The judge also said that clause 8 did no more than state expressly what would otherwise implicit in the relationship between the general and limited partners and its effect was that losses not covered by the limited partners' interest in the partnership were to be debited against their share of profits and capital contributions in subsequent years.[63]

The judgment of Nourse J so clearly exposed the hopeless nature of the Crown's argument that it is surprising that they appealed. This is what they did, however, but they got no further in the Court of Appeal or in the House of Lords that they did before Nourse J.

In the House of Lords, Lord Oliver cited and agreed with the passage from the judgment of Nourse J set out above.[64]

More substantial claims were made by the Revenue in the case of Ensign Tankers (Leasings) Ltd v Stokes.[65] By coincidence, this was heard before Millett J who, before being appointed to the Bench, was Counsel for the taxpayer in the High Court and the Court of Appeal in the Reed v Young case.

The facts of this case were that the taxpayer company was part of the Thomas Tilling group. It had been set up to

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62. Ibid p59
63. Ibid
64. [1986] STC 285 at pp289-90
65. [1989] STC 705

act as a leasing subsidiary so that it could obtain 100% first year allowances on plant leased to third parties, to produce tax losses which could be set against the group's profits.[66]

On the publication of Statement of Practice SP9/79 which, as noted above, disclosed that first year allowances would be available in respect of capital expenditure on the production of films, the taxpayer company became a limited partner in two limited partnerships, "Victory" and "Outland", set up to finance the production and exploitation of two films; "Escape to Victory" and "Outland". In each partnership there were limited partners (including the taxpayer company) plus a general partner which alone was responsible for the conduct and management of the partnership's business.

The partners, in the case of each partnership, contributed a total of 25%[67] of the cost of the film, the balance being borrowed on a non-recourse basis. All the transactions relating to the Victory Partnership took place on 14 July 1980, and those relating to the Outland Partnership all took place on 5 November 1980.

The two partnerships each appointed sole agents to distribute and exploit the films on their behalf. The agents were associated with the US film production companies from whom the master-negatives of the two films were purchased. The general partners were also ultimately owned by the US film production companies.

The taxpayer company claimed first year allowances on its percentage of the capital expenditure on the films under section 41 FA 1971.

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66. Leasing schemes are discussed in Chapter 6
67. 25.5% in the case of the Outland Partnership

The Revenue attacked the taxpayer company's claim on four grounds:

1. The main point was that the two partnerships did not carry on a trade.

2. Secondly, they argued that the films did not "belong" to the partnerships.[68]

3. The third contention was that the partnerships had not "incurred" any expenditure in respect of the films.[69]

4. Finally, the Revenue argued that the "Ramsay" principle applied.[70]

In relation to the fourth contention, it may be noted that Millett J was probably better placed than most other people to consider this matter, having been leading Counsel for the Crown who had put forward the arguments which convinced the House of Lords to adopt the "new approach" in Ramsay itself[71] and Furniss v Dawson.[72]

The Special Commissioners dismissed the taxpayer company's appeal, holding that transactions entered into with fiscal motives as their paramount object were not trading transactions and, consequently, neither partnership could be said to be trading.

Millett J, however, found in favour of the taxpayer company on each point. In the course of his judgment, Millett J gave a very useful analysis of the law in cases where what are claimed to be trading transactions are

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68. See section 41(1)(b) FA 1971
69. See section 41(1)(a) ibid
70. See Chapter 11
71. W.T Ramsay Ltd v IRC (1981) 54 TC 101. It should be noted, however, that the House of Lords, in this case, went further than Peter Millett QC had urged them to go; see Chapter 11
72. (1984) 55 TC 324

undertaken with some sort of fiscal objective.

The judge noted that it had been conceded by the Crown that the relevant question was not whether the taxpayer company was carrying on a trade, but whether the limited partnerships were doing so.[73]

Having referred to the Overseas Containers case,[74] Millett J summarised what he considered to be the law on the subject, as follows:[75]

1. In order to constitute a trade, a transaction must possess not only the outward badges of trade, but also a genuine commercial purpose.

2. If a transaction has a genuine commercial purpose, the presence of a collateral or ulterior purpose to obtain a tax advantage does not "denature" an essentially commercial transaction. If, however, the sole purpose of the transaction is to obtain a fiscal advantage, it is logically impossible to postulate the existence of any commercial purpose.

3. Where both commercial and fiscal purposes are present, it is not a question of which one predominates, but whether the transaction can fairly be described as being in the nature of a trade.

4. The purpose or object of the transaction must not be confused with the motive of the taxpayer. The question is not <u>why</u> he is trading, but <u>whether</u> he is trading.

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73. p762
74. <u>Overseas Containers (Finance) Ltd v Stoker</u> [1989] STC 364, see Chapter 4
75. pp762-4

5. The test is an objective one to be answered by a detailed analysis of the terms and circumstances of the transaction itself.

6. In considering the purpose of a transaction, its component parts must not be regarded separately, but the transaction must be viewed as a whole.

7. If the purpose of a transaction is to make a profit, it does not cease to be a commercial transaction merely because those who engage in it have obtained the necessary finance from persons who are more interested in achieving a fiscal advantage from their investment.

8. Millett J referred to Lupton v FA & AB Ltd in which Lord Morris had said:

"It is manifest that some transaction may be so affected or inspired by fiscal consideration that the shape and character of the transaction is no longer that of a trading transaction. The result will be not that a trading transaction with unusual features is revealed but that there is an arrangement or scheme which cannot fairly be regarded as being a transaction [in the nature of trade]."[76]

Millett J said that, in his judgment, this is the true significance of a fiscal motive. Fiscal considerations naturally affect the taxpayer's evaluation of the financial risks and rewards of a proposed venture and are often the decisive factor in persuading him to enter into it. The judge cited, inter alia, first year allowances and enterprise zones as financial inducements to engage in commercial activities which would be financially unattractive without them. Such motivations, he said,

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76. 47 TC 580 at p620

even if paramount, do not alter the character of the activities in question. A fiscal motive becomes highly relevant if it affects, not just the shape or structure of the transaction, but its commerciality, so that it is no longer a trading transaction, but nothing less will do.

9. Therefore, the question is whether, in the light of all of the relevant circumstances, the transaction is capable of being fairly regarded as a transaction in the nature of trade, or is incapable of being so regarded but merely a device to secure a fiscal advantage.

Applying these principles to the fact of this case as found by the Commissioners, the judge said that there was only one possible answer to the question; were the partnerships trading?[77]

The taxpayer company took part in a tax deferral scheme which involved investing in limited partnerships. Those investments were not trading transactions, they merely provided the finance necessary to enable trading transactions to be entered into. The judge considered the relevant question of law to be:

"Where a partnership enters into a commercial transaction with a view of profit, can it fairly be regarded as carrying on a trade even if (i) it obtained the necessary finance from investors who were primarily motivated by the hope of obtaining a fiscal advantage rather than a commercial profit; and (ii) the transaction itself was deliberately structured in order to secure the fiscal advantage without ceasing to be commercial or jeopardising the prospects of profit?"[78]

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77. p767
78. p768

Millett J said that, in his view, this question had to be answered in the affirmative because neither factor alone, nor both together, could alter the true nature of the transaction. Accordingly, the Commissioners must have misdirected themselves, because the only true and reasonable conclusion from the facts found by them was that the partnerships were trading.

Turning to the challenge based on the word "belong" in section 41 FA 1971, Millett J noted that the Crown had argued that the plant did not "belong" to either partnership because, as soon as one of the partnerships acquired its film it parted with the right to distribute and exploit it in perpetuity, retaining only the "bare" master-negative. Not only was this factually incorrect in connection with one of the films, this argument could not be upheld in any case because, by entering into the various distributorship agreements, the partnerships did not part with the right to exploit the films, but actually exploited them.[79]

The third contention of the Crown, based on the word "incurs", also failed. "To incur", said the judge, meant "to render oneself liable to", and expenditure was incurred by a taxpayer if he had legally committed himself to it. For the purposes of section 41, expenditure was treated as incurred when the sum in question became payable. A borrower who obtains a non-recourse loan incurs no personal liability to replay the lender, but this is irrelevant; section 41 is concerned with the taxpayer's liability to expand borrowed money in the acquisition of plant, not with his liability to replay the lender.[80]

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79. p769
80. Ibid

The final contention of the Crown concerned the "new approach".[81] Millett J said that the transactions in the present case were not merely paper transaction without any commercial purpose or effect, as in Ramsay[82]; nor were they essentially single transactions artificially broken up into separate stages, as in Furniss v Dawson.[83] The transactions were not a single indivisible composite whole.[84]

In the view of Millett J, the question arising from the "new approach" is whether some step in a pre-ordained transaction is so closely connected with the rest that it is to be treated, not as having an independent effect, but as merely an element in a larger whole. If so, then a question of statutory construction arises.[85]

The judge said that he was unable to comprehend how the creation of the two limited partnerships could be treated as a step in some other and larger transaction without any independent effect of its own. The two partnerships put up real funds for real transactions.[86]

This case is considered further in connection with the "new approach" in Chapter 11.

It can be seen that the attempts by the Revenue to defeat the film schemes by non-statutory means have so far failed. On the other hand, section 72 FA 1982 plus the withdrawal of first year allowances has stopped film and other capital allowance-based schemes completely except in very narrow circumstances, such as investment in enterprise zones.

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81. See Chapter 11
82. W.T Ramsay Ltd v IRC (1981) 54 TC 101
83. (1984) 55 TC 324. It is questionable whether, in fact, the Dawson transaction was simply a single transaction artificially broken up into separate stages; see Chapter 11
84. p770
85. p771
86. pp771-2

CHAPTER 6

LEASING SCHEMES

Introduction

The schemes considered in this Chapter fell into two categories. Both categories have been, before counteracting legislation was introduced, packaged and marketed widely, giving rise to a large loss of tax revenue.

The first category of arrangements to be considered will be sales and leasebacks of assets other than land, normally plant and machinery. These schemes were very popular in the early 1960's, prompting legislative action in 1964. This legislation has in fact proved to have been better drafted and less easy to avoid than similar legislation, also enacted in 1964, aimed at sales and leasebacks of land, and is still on the statute books 25 years later.

The second category consists of the leasing arrangements based on capital allowances arising out of the first year allowances available in respect of plant and machinery from 1970 onwards.

Sale and Lease-Back Transactions

Action was taken in 1964 to counter sale and lease-back transactions which had increased rapidly in number in the previous years. The relevant legislation was originally contained in section 17-19 and the Seventh Schedule FA 1964. Section 19[1] concerned land and has already been considered.[2] Section 17 and 18 covered assets other than land and these provisions can now be found in sections 781-5 ICTA 1988.

Section 17 FA 1964[3] concerns a lease[4] of, say, plant whereby a person makes payments which are deductible for income tax purposes under a lease, and then sells his interest under the lease for a capital sum which before this legislation was enacted, would have been tax free. The normal method of achieving this advantage would be for the taxpayer to lease the plant, with the rental payments being loaded into the early years (these payments being normally, in total, equal to the capital cost of the plant, plus interest) with a nominal rent payable for the remainder of the lease. At the end of the high-rental period, the lessee would assign his rights under the lease to a third party for a capital sum possibly leasing it back. This capital sum would effectively reflect the right to use the plant during the remainder of the lease for a nominal rent.

Section 18 FA 1964[5] deals with the situation where a trader who already owns an asset, sells or leases it to another person for a capital sum (ie, sale proceeds or premium) and takes a lease back of the asset, so that he can continue to use it in his trade, paying a rent in excess of a commercial rent, which, before the enactment

1. Now section 779 ICTA 1988
2. See Chapter 3
3. Now section 781 ICTA 1988
4. Defined widely; see section 785 ICTA 1988
5. Now section 782 ICTA 1988

of section 18, would have been deductible for tax purposes. This process was sometimes repeated once the first period of high rents had come to an end.

In both types of scheme, a tax-free capital sum[6] was being obtained in exchange for tax-deductible and artificially high rent payable for a short period.

In examining the counteracting measures, it is more convenient to deal with section 18 (now section 782 ICTA 1985), before section 17 (now section 781 ICTA 1988).

Payments within what is now section 782 ICTA 1988 are those which are allowable by way of deduction in computing the profits or gains or losses of a trade and which are made under a lease of an asset which, at any time before the creation of the lease, was used for the purposes of that trade or of another trade carried on by the person who at that time or later was carrying on the first trade and, when used in this way, was owned by the person carrying on the trade in which it was being used.[7]

The section provides that the deduction allowable in computing the profits or gains or losses of the trade for tax purposes is not to exceed the commercial rent of the asset for the period for which payment was made.[8] It is provided that if part of a payment is not allowed because of the operation of the section, that part may be allowed in computing profits, gains or losses of a subsequent period during which the asset is subject to the lease and is used for the purposes of the trade, the profits or gains of which are assessable to tax.[9] This means that if the total rents over the whole working life of the asset do not exceed the total market rents, full relief

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6. These were the days before the introduction of capital gains tax by the FA 1965.
7. Section 782(1) ibid
8. Section 782(2) ibid
9. Section 782(3) ibid

will eventually be obtained, as long as the asset is used for all of its working life; but the relief will not be loaded into the early years.

It can be seen that the section is concerned with the computation of liability to tax of the person making the payments of rent and has the effect of restricting the allowable deduction obtained by him in computing the profits or gains of his trade to a sum which can be regarded as the commercial rent for the assets.

The term "commercial rent" means the rent which might at the relevant time be expected to be paid under a lease of the asset for the remainder of the anticipated normal working life of the asset, being a rent payable at uniform intervals and at a uniform rate which would afford a reasonable return for its market value at the relevant time having regard to the terms and conditions of the lease.[10] If the asset is used at the same time partly for the purposes of the trade, and partly for other purposes, then the commercial rent is to be determined by reference to what would be paid for such as partial use of the asset.[11]

Therefore, if a person uses plant for the purposes of his trade but then disposes of it to another person for a capital sum and then leases it back for a rent which exceeds the commercial rate, taking due account of its anticipated normal working life, he will not be allowed to deduct the full rent, but only that part which can be said to be the proper commercial rent for the asset. It was not uncommon, prior to 14 April 1964, to find that the trader reacquired the asset for a negligible consideration at the expiration of the lease. But for

10. Section 782(6) ibid
11. Section 782(7) ibid

section 782, he would obtain an allowance, by way of rent, of a sum equal to what is, for all practical purposes, the full cost of the asset. The person making the acquisition of the asset and entering into the lease in favour of the trader would normally have paid tax on the rent received by him but might have had capital allowances which were, for all practical purposes, equal to (and might, because of the investment allowance, be in excess of) the actual cost of the asset.

Section 782 is therefore designed to prevent this kind of avoidance from the point of view of the person paying the abnormal rent. This section is narrower than the sale and lease-back provisions relating to capital allowances in paragraph 3 Schedule 8 1971 which are dealt with in Chapter 5. In particular, section 782 does not apply where the equipment was previously used by a connected person. When what is now section 782 was originally put before Parliament as clause 17 of the Finance Bill 1964, it did cover the situation where the asset was used by an associate, but this was dropped before the provisions were enacted as section 18 FA 1964.

Section 781 is complementary to section 782 but, as noted above, does not apply to payments covered by section 782. Where a payment is not within section 782 and a tax deduction[12] is allowable in respect of a payment under a lease and, before or after the time when the payment is made, the person who made the payment (or, in certain circumstances, his associate) has obtained or obtains a capital sum in respect of the lessee's interest in the lease, the person obtaining that sum is charged under Schedule D, Case VI, for the chargeable period in which the sum is obtained, with tax on the amount of the

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12. Within the categories set out in section 781(4) ibid

payment in respect of which tax relief is so allowed.[13] The total amount on which a person is assessed by reference to the capital sum is not, however, to exceed the amount of that capital sum.[14]

Therefore, if a trader acquires plant for use in his trade under a lease, the rent for which is abnormally high and probably equal to the capital cost of the asset in the early years but is only a nominal sum thereafter, it is likely that section 782 would apply and there would be effectively a spreading of the proper commercial rent for use of the asset over its normal working life. If, however, a trader, having leased back the asset, does so for a proper commercial rent, the case will not fall within section 782 but, if he then disposes of his interest in the lease for a capital sum, he will be charged under Schedule D, Case VI on it under section 781. The trader will have obtained a deduction for the rent in computing his profits and he is assessed under Case VI on an amount equal to the allowances given for the rent not exceeding the amount of the capital sum.

Section 781 also applies where the lessor's interest in the lease, or any other interest in the asset, has belonged to an associate[15] of the person who made the payment, and the associate has obtained a capital sum in respect of that interest.[16] This would apply, for example, where one group company leases an asset to another group company and then sells the asset subject to the lease for a capital sum.

The ambit of section 781 is broadened by section 783. This section states that section 781 covers sums obtained

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13. Section 781(1) ibid
14. Section 781(2) ibid
15. As defined in section 783(10) ibid
16. Section 781(1)(b) ibid

on a surrender of rights to the lessor, or on an assignment of a lease, or on the creation of a sublease or any other interest of the lease.[17] Section 781 is also extended to any insurance money's payable in respect of the asset, so far as payable to the owner of the interest in the asset.[18]

References in section 781 to a sum obtained in respect of the lessee's interest also include references to sums representing money or money's worth obtained by the person entitled to the interest by a transaction or series of transactions disposing of the asset, or of an interest in it and, in particular, transactions which comprise arrangements under which the rights of the lessee are merged with the rights of the lessor, or with any other rights as regards the asset, so far as the money or money's worth so obtained is attributable to the rights of the lessee.[19]

To conclude, it should be noted that the provisions of section 17 and 18 FA 1964 have needed no major amendments in their 25 years on the statute books and they remain effective to prevent the abuses at which they were aimed and, unlike the equivalent provisions relating to sales and leasebacks of land,[20] are not easy to circumvent. In fact, sales and leasebacks of assets other than land are these days not common. This is probably due partly to the efficacy of the provisions of section 781-5 ICTA 1988, and partly due to the fact that most assets, other than land, being prone to depreciation, are not attractive as security, stripped of the tax benefits.

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17. Section 783(1)(a) ibid
18. Section 783(1)(b) ibid
19. Section 783(2) ibid
20. Sections 779-80, ibid, see Chapter 3

Capital Allowance-Based Leasing Schemes

A whole tax sheltering industry was built around the first year allowance given in respect of expenditure incurred in the acquisition of plant and machinery. The first year allowance was set at 60% in 1970, rising to 100% in 1972. A full write-off in the first year remained available until first year allowances were phased out, commencing in 1984, with no first year allowances being available at all for expenditure incurred on or after 1 April 1986, or 1 April 1987 where the contract was entered into before 14 March 1984.[21]

The generous capital allowances were exploited extensively by those taxpayers whom the Government had not intended to help by the introduction of the allowances; whereas the capital-intensive industries who should have benefited were often not in a tax-paying situation anyway because of such factors as the availability of stock relief and the general world recession which hit profitability. Relatively few manufacturing companies paid substantial amounts of tax in the 1970's, even ignoring the availability of generous capital allowances; while wealthy individuals and financial and service based companies were presented with the opportunity for a tax-sheltering bonanza.

The basic procedure was simple. A taxpayer with taxable income he wished to shelter would acquire capital assets which he would lease to someone who used them in his trade, and he would obtain 100% first year allowances on those assets. Any income from the assets in that year would be far outweighed by the allowances, so a loss would be incurred which could be set against his other income. Rental income would arise subsequently but it would be spread over a number of years and, even if a

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21. Section 58 and Sch 12, FA 1984

substantial balancing charge later arose on the disposal of the asset, a valuable deferral of tax liability would have been obtained.

A wide range of capital assets were used in leasing schemes. One of the most popular types was the transport container. Not only was there an enormous demand for containers in the 1970's, as nearly all goods transportation was switched into such containers, but they also constituted convenient units, so that a taxpayer could, within reason, acquire as many or as few as he needed to shelter his particular tax liability.

Given the widespread exploitation of the capital allowance system through leasing schemes, it was inevitable that there would be legislation aimed at countering the abuses.

Two early anti-avoidance provisions were considered in Chapter 4, namely section 30 FA 1973[22] and section 31 of that Act.[23] As has been seen, these sections were aimed at specific types of scheme.

The first anti-leasing section to be considered in this Chapter was also restricted to particular circumstances. The section in question is section 41 FA 1976. This section stated that an individual could not set off a loss against his general income if and to the extent that it was referable to a first year allowance in two situations.

The first situation arose out of a scheme which involved a partnership between an individual and a company, which partnership engaged in the trade of leasing plant or machinery. The company would usually be resident outside the UK. There were a number of different schemes, but

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22. Now section 395 ICTA 1988
23. Now section 116 ibid

they all had a similar basic structure. The partnership agreement would provide for perhaps an even split of profits, but the majority of any losses (say, 90%) would accrue to the individual. The leasing trade would commence and the partnership would purchase the necessary plant, thus producing a loss in the relevant year, the bulk of which loss would be used by the individual against his other income. Once this valuable tax advantage had been obtained, the individual, in the following tax year, might dispose of his interest in the partnership to the company for a capital sum which would be approximately the same as the capital contributed to the partnership by the individual. Consequently, the capital sum would not be taxed in his hands.

This scheme was stopped by section 41(1) FA 1976 which stated that the individual could have no set-off against his general income for any loss applicable to a first year allowance made to him in respect of expenditure incurred on the provision of plant and machinery for leasing in the course of trade if:

(a) the trade was carried on by him in partnership with a company; or

(b) a scheme had been effected or arrangements were made with a view to the trade being so carried on.

This provision was successful in stopping the company/individual partnerships which exploited the capital allowance system. This subsection was not restricted to trades carried on with a tax avoidance motive, but purely commercial arrangements involving such partnerships must have been very rare, so this provision is unlikely to have had any real effect on bona fide commercial transactions.

The first limb of section 41 was later effectively superseded by the more general anti-avoidance provisions of section 70 FA 1980.[24]

Section 41(2) FA 1971 denied a set-off against general income by reference to a first year allowance if:

(a) the allowance was made in connection with a trade carried on by an individual in partnership (whether with another individual or a company), or transferred to a connected person or to any other person at less than market value; and

(b) a scheme had been effected or arrangements made such that the sole or main benefit that might have been expected to accrue to him from the transaction under which the expenditure was incurred was the obtaining of a reduction in his tax liability by means of the set-off.

This subsection was aimed at arrangements whereby an individual would take the benefit of the losses but, subsequently, when the leases started to produce rental income, the plant (or the trade itself) was transferred to, say, the individual's wife, who might be paying tax at a much lower rate.

Like the first limb of section 41, the second was successful in stamping out the narrow range of schemes at which it was aimed.

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24. infra

The "Qualifying Purpose" Restrictions

The exploitation of capital allowances continued at an enormous scale throughout the 1970's so that, in 1980, Parliament was forced to impose further restrictions on the availability of first year allowances.

The first limb of these restrictions was contained in section 64 FA 1980 which provided that no first year allowance would be made in respect of expenditure on the provision of plant or machinery for leasing unless it was used only for a "qualifying period" in the "requisite period."[25]

The "requisite period" was four years beginning with the date on which the plant or machinery was first brought into use by the person who incurred the expenditure or, if shorter, his period of ownership.[26] As will be seen below, the FA 1982 extended the "requisite period" to 10 years in respect of certain leases to non-residences.

The lessor's right to a first year allowance therefore depended upon the lessee using the asset for a qualifying purpose for at least the first four, or perhaps ten, years of ownership (unless he ceased to own it before the end of the four/ten year period).

The meaning of "qualifying purpose" was set out in section 64 (as amended by FA 1982). The asset in question was used for a "qualifying purpose" if any of the following applied.

(1) The lessee used it for the purposes of a trade (other than leasing) and he would have been able to claim a first year allowance if he had

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25. Section 64(1) FA 1980
26. Section 64(8) FA 1980, as originally enacted.

purchased the asset himself.[27] In relation to expenditure incurred after 31 March 1986, the lessee had to be in a position to obtain writing down allowances, as opposed to first year allowances (which were, of course, no longer generally available).[28] Thus, the lease could not be to such lessees as local authorities, individuals who used the asset for private purposes, and non-resident traders who did not use the asset for a trade carried on in the UK.

(2) The person who incurred the expenditure used it for "short-term leasing".[29]

(3) The asset was leased to a lessee who used it for short-term leasing and either the lessee was resident in the UK or he used the asset in the course of a trade carried on here.[30]

(4) The person who incurred the expenditure used it for the purposes of a trade other then leasing.[31]

(5) The asset in question was a transport container which was leased in the course of a trade which was carried on by a person who is resident in the UK or who carried on the trade here if, either the trade consisted of or included the operation of ships or aircraft and the container, when not being leased, wass used in connection with the operation of ships or aircraft; or the container wass leased under a succession of leases to unconnected persons.[32]

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27. Section 64(2)(a) ibid, as originally drafted
28. Section 57(4) and para 1 Sch 16 FA 1986
29. Section 64(2)(b) FA 1980. The term "short-term leasing" is defined in section 64(3) and (3A) ibid, subsection (3A) being added by s.70(7)(10) FA 1980
30. Section 64(2)(c) FA 1980
31. Section 64(2)(d) ibid
32. Section 64(7) ibid

(6) The asset was fixed to a building or land leased by the person who incurred the expenditure.[33]

(7) The asset was a vehicle provided wholly or mainly for the use of person in receipt of a mobility allowance.[34]

(8) The asset was a ship or aircraft let on charter in the course of a trade which consisted of, or included operating ships or aircraft and the trader was resident in the UK or carried on his trade here and he is responsible for managing the ship or aircraft throughout the charter period and for defraying general expenses in connection with the ship or aircraft throughout the charter period. Where the expenditure was incurred on or after 10 March 1982, the main object of one of the main objects of the transaction must not have been the obtaining of allowances.[35]

Expenditure to which section 64 FA 1980 applied[36] had to be segregated into a separate pool for capital allowances purposes.[37] This ensured that a balancing adjustment normally arose if all the assets in the pool were disposed of.[38] This became unnecessary when first year allowances were abolished in 1986, for expenditure incurred after 31 March 1986. Where plant and machinery was initially used for a qualifying purpose but ceased to be so used in the requisite period, first year allowances originally

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33. Section 64(ii) ibid
34. Section 64(12) ibid
35. Section 64(5)(6)(6A) ibid section 71 FA 1982
36. Now expenditure to which section 70 FA 1982, infra applies; see section 57(4) and para 2, Sch 16 FA 1986.
37. Section 65 FA 1980
38. A balancing adjustment will not arise in the circumstances mentioned in section 65(5) ibid as amended.

granted were claimed back.[39]

The provisions dealt with above, therefore, greatly restricted the availability of allowances. Section 70 FA 1980 contained further restrictions. This section had the effect that individuals and partnerships had to have set up a full time trade if capital allowances were to be used against general income. These provisions are now contained in section 384(6)-(8) ICTA 1988.

Section 70 stated that an individual (including an individual partner) cannot set off any excess allowances against other income unless:

(a) the trade is carried on for a continuous period of at least six months in, or beginning or ending in the year in which the loss is incurred; and

(b) he devotes substantially the whole of his time to carrying on the trade throughout the year, or if it is set up or permanently discontinued (or both) in that year, for a continuous period of at least six months beginning or ending in that year.

These restrictions stop an individual setting up a part time leasing trade to generate capital allowances. Previously, an individual could set up a leasing trade and spend little of his time in running it, putting the finding of lessees and the management of the leases into the hands of a broker. The individual's involvement was therefore more like an investment than a trade. Most individuals becoming involved in leasing as a pure tax sheltering device were unlikely to be able to devote "substantially the whole" of their time to it.

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39. Section 66 FA 1980, repealed by section 57(4) and para 3, Sch 16 FA 1986 in relation to expenditure incurred after 31 March 1986, subject to section 57(2) and (3) ibid.

These provisions also apply to expenditure incurred by an individual on the provision of an asset which is used in a trade to generate licence fees.[40] This was aimed specifically at film schemes[41] where the film was exploited by the granting of distribution rights in return for a royalty.

The 1980 legislation therefore dealt a severe blow to the leasing industry, particularly removing most opportunities for individuals setting up leasing trades simply as a tax sheltering device.

Further restrictions were to follow in 1982. Section 70 and Schedule 11 FA 1982 concerned writing down allowances. It has been seen above that the 1980 legislation prevented first year allowances being available in many situations. First year allowances might also be denied by paragraph 3, Schedule 8, FA 1971, which is dealt with in Chapter 5. Where first year allowances were denied under the 1970 or 1971 legislation, the writing down allowances were still generous, being 25% per annum on a reducing balance basis. Section 70 FA 1982 reduced the writing down allowance in certain circumstances to 10%, and in others, withdrew it altogether.

The reason for the 1982 legislation was that UK taxpayers were using the 25% writing down allowance to shelter income but the lessees were often resident overseas and using the plant in foreign manufacturing industries. These non-resident lessees were being subsidised (through the level of rents payable under the leases) by the UK Exchequer.

The provisions of section 60 turned out to be effective

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40. See now section 384(7) ICTA 1988
41. See Chapter 5

in stopping most of this foreign leasing business by reducing or eliminating the writing down allowances in connection with the leases in question. Unfortunately, the section had an adverse effect on many genuine commercial leases.

The section operates where plant or machinery is leased to a person who is not resident in the UK and who does not use it for the purposes of a trade carried on here. The section operates in respect of expenditure incurred after 9 March 1982. The section does not apply if the leasing is short-term leasing or, in respect of expenditure incurred after 31 March 1986, it is the leasing of a ship, aircraft or transport container which is used for a qualifying purpose.[42]

The section withdraws writing-down allowances altogether in certain situations, namely:

1. Where there is a period of more than one year between the dates on which any two consecutive payments are due under the lease.

2. Where any payments other than periodical payments are due under the lease, or under any agreement collateral to the lease.

3. Where any of the payments due under the lease or a collateral agreement, expressed as monthly amounts, do not remain constant, ignoring variations due to changes in rates of tax, capital allowances, or inter-bank interest, or in insurance premiums payable to third party insurers.

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42. Section 70(1) FA 1982 as amended by section 57(4)(b), (7)(a) and para 5 Sch 16, FA 1986

4. Where the lease is for a period of over 13 years.

5. Where, at any time, the lessor, or a person connected with him, could become entitled to receive from the lessee, or any other person, a payment, other than a payment of insurance moneys, which is of an amount determined before the expiry of the lease and which is referable to the value of the plant or machinery at or after the expiry of the lease.[43]

Situations 1,2 and 5 prevent various devices whereby regular rental income is reduced below the level of what would otherwise be the available 10% allowance, so as to provide the lessor with excess allowances to shelter other income, with the lessor being entitled at other times to one or more large rental payments[44] to compensate for the low (or nil) rental payments at other times. Situation 3 was aimed at the arrangement where the rental payments increase throughout the period of the lease, starting at a very low level, thereby, again, providing excess allowances for set-off purposes in the early years. Situation 4 prevents the spreading of the rental payments over an uncommercially long period.

These provisions preventing any allowances being claimed were introduced late in the passage of the 1982 Finance Bill through Parliament without any consultation with the leasing industry. The clumsiness of the drafting in presumably due to the undue haste in the preparation of this part of the section. However, despite the drafting complexities, these provisions appear to have been largely successful in stopping abuses, but they have also affected many genuine finance leases. The Equipment

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43. Section 70(4) FA 1980
44. Sometimes known as "balloon" payments

Leasing Association's Annual Report for 1981 shows that its members were involved in £572 million of leases to non-UK lessees in 1981. Following the 1982 legislation this has virtually stopped completely.

There were transitional provisions in section 70 applicable to plant or machinery brought into use before 1 April 1985 and the expenditure was payable under a contract entered into before 9 March 1982, or in certain cases, on or before 31 March 1984.[45]

It can be seen that, by 1982, the availability of capital allowances for tax-sheltering purposes had been very restricted indeed. Virtually all remaining opportunities were removed with the phasing out of first year allowances beginning in 1984.[46] The once flourishing tax-shelter leasing industry is not dead.

The explosion in leasing schemes during the 1970's was perhaps the most striking example of a tax incentive being exploited by taxpayers for whom it was not intended, in ways in which it was not intended to work. Legislative action in 1980 and 1982 was effective in putting a stop to these abuses but not before a very large amount of tax had been sheltered and scheme promoters had made a great deal of money. On the whole, the anti-avoidance legislation was relatively well-targeted and free of obvious loopholes; it was the concept and structure of the original legislation giving the incentives that was flawed.

Although some of the legislation, particularly section 70 FA 1982, has hit genuine leasing arrangements. the "real" commercial leasing industry has thrown off any substantial reliance on tax incentives. In a report

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45. Section 70(10) and (12) FA 1980
46. Section 58 and Sch 12 FA 1984

prepared for the British Branch of the International Fiscal Association entitled "Taxation of Cross-Border Leasing", N.J Prentice points out that the real value of leasing business in 1988, after allowing for inflation was 90% up on 1983 when tax rates were high and first year allowances were available.[47]

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47. Final Draft Version (27 September 1989) p5

CHAPTER 7

BENEFITS FOR DIRECTORS AND EMPLOYEES

Introduction

Directors and employees are taxable under Schedule E on their "emoluments". This term is defined as including all "salaries, fees, wages, perquisites and profits whatsoever."[1] This definition can be found in the Income Tax Act 1842.[2] It was established in the last century, in the case of Tennent v Smith[3] that payments to or benefits provided for employees[4] are only taxable as emoluments if they are money or they can be converted into money.

This principle has constantly been exploited by employers who have found many way to remunerate employees so that the rule in Tennent v Smith does not impose a tax charge. Even if a benefit was caught, the employee was only taxable on the amount of money into which the benefit could be converted, this was often very low. For example, the second hand value of an asset given to an employee would normally be much less than the cost to the employer or the practical value to the employee.[4A]

On the strength of the Tennant v Smith and other decisions along the same lines[5] the practice of providing benefits in a non taxable form[6] grew, particularly where

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1. Section 131(1) ICTA 1988
2. Except that it had the word "or" instead of the word "and".
3. (1892) 3 TC 158
4. Which term, unless otherwise stated on the context so demands, in this Chapter includes directors.

4A. This rule only applies if there is no "salary sacrifice"; Heaton v Bell (1969) 46 TC 211.

5. See also, for example Machon v McLoughlin (1926) 11 TC 83; Ferguson v Noble (1919) 7 TC 176; Cordy v Gordon (1925) 9 TC 304; and Nicoll v Austin (1935) 19 TC 531
6. Or at least in a form that did not give rise to the full tax charge applicable to the equivalent payment.

directors, who by the nature of their office, were usually in a position to influence the decisions of the company as regards benefits; and senior executives, who were in a strong bargaining position, were concerned.

Eventually, Parliament had to step in and introduce legislation specifically to tax certain benefits provided for what were seen as the more privileged category or directors and higher paid employees. This first legislature action occurred in 1948.

In the period since then further restrictions have been imposed to bring other benefits within the tax net and to counter the ingenuity of taxpayers and their advisers in devising new ways to remunerate employees without generating the full tax charge that would attach to an equivalent cash payment.

In this Chapter, the various attempts to prevent the avoidance of tax by the provision of benefits are examined.

The Early Legislation

A. The First Provisions

Although the first main legislative attack on employee benefits occurred in 1948, before dealing with the 1948 provisions, it is worth mentioning section 19 FA 1939. This section was aimed at the practise of companies paying employees expense allowances in lieu of remuneration. Section 19 said that payments in excess of £15 per annum were to be included in the employee's return of remuneration paid. It was then up to the Revenue to take appropriate steps to access any expense allowance that seemed to be excessive. The onus was on the Revenue to prove that the payments were not necessary business expenses. It will be seen that the 1948 provisions went further than this and enacted that expenses to directors and higher paid employees were assessable under Schedule E except to the extent that the employee was able to submit a valid claim in respect of expenses wholly, exclusively and necessarily incurred by him in the performance of his duties. The onus which is thus placed on the employee is notoriously difficult for him to discharge, particularly in view of the very restricted wording of what is now section 198 ICTA 1988 and the inclusion of the word "necessarily". The narrowness of this wording has been established in a long line of cases which it is not necessary to consider here.[7]

The 1948 provisions were contained in sections 38-46 FA 1948. The rules in these sections formed the foundation for many of the provisions now in Chapter II of Part V ICTA 1988. These sections created a distinction that is still in equivalent legislation today: directors and higher paid employee, to whom more onerous provisions

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7. See, for example Ricketts v Colquhoun (1926) 10 TC 118 which is one of what the Final Report of the Royal Commission on the Taxation of Profits and Income referred to as a "symposium of hard cases" (Cmd 9474, para 131)

apply; and other employees who earned at least £2,000 per annum.[8]

One preliminary point that should be made about the 1948 legislation was that it was not introduced to bring in any significant amounts of extra revenue; but to redress what was seen as an unfair distinction between one type of taxpayer and another. During his Budget Speech in 1948, the Chancellor spoke of additional extra revenue of a mere £250,000.[9] The equivalent legislation today is not so much seen as an instrument of redressing the balance between taxpayers, the current £8,500 limit is far too low for this to be the case, but as an instrument for ensuring that all remuneration is taxed in full, no matter what form it is given in, or to whom it is given.

Given that Tennant v Smith was decided in 1892, it may seem strange that the first legislation to address the problem of the perceived abuses was not enacted until over 50 years later. However, the Final Report of the Royal Commission on the Taxation of Profits and Income published in 1955, stated:

> "Up to recent years benefits in kind by way of remuneration were mainly found as an addition to the smaller ranges of wage; represented advantages that were often trivial in value; and had little significance to the total yield of tax. The same considerations do not operate today; partly because so large a part of the wage-earning population has now ascended into the class of income tax payers, partly because the pressure of high rates of taxation on all classes has made the receipt of benefits in kind a possible attraction to every class of wage and salary earner."[10]

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8. Later raised to £5,000 with effect 1975/76 and £7,500 from 1978/79. It is now £8,500; section 23(1) FA 1978, section 167(1)(b) ICTA 1988.
9. H.C Deb Vol 449 col 70
10. Op cit para 212

As noted above, the 1948 legislation operated in the cases of directors and of employees earning more than £2,000 per annum. The Final Report of the Royal Commission dealt with the distinction between those and other classes of wage and salary earners in the context of the 1948 legislation. The Royal Commission considered that directors had been singled out because of "the managerial authority of the board as a whole."[11]

Regarding employees, the Report commented:

> "When we examined representatives of the Board on the point, they suggested that £2,000 a year indicated the salary of a man whom the employer might well be anxious to attract: and since it was of no moment to the employer whether he provided his employee's remuneration in money only or partly in money and partly in kind, the more highly paid employee could be presumed to be the kind of person to whom benefits in kind were specially likely to be offered. We accepted this as the most probable explanation of the discrimination against these employees."[12]

The general scheme of the 1948 legislation is one that has become the standard method adopted in benefits-in-kind legislation. It was that expense allowances and the value of benefits were to be treated as emoluments assessable on the recipient under Schedule E, except that, in the case of expense allowances, the individual employee could claim a deduction from the assessment the expenses he had necessarily incurred in the performance of his duties.

The application of the 1948 legislation was fairly limited. It applied only to expense allowances and

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11. Ibid para 216
12. Ibid

benefits in kind provided free of charge by any company, unincorporated body, partnership or individual. However, the following employers were excluded from the Act:

(i) charitable bodies;

(ii) non-trading entities (except investment-holding bodies);

(iii) local authorities or educational establishments (except to the extent of any trading activities carried on).

The Royal Commission could discover no justification for distinguishing between employers in this way. The Final Report said:

> "Apparently the exemption was based on the impression that such abuses as were taking place were confined to trading concerns. This may well have been so. But, as the whole subject seems to have been approached largely as matter of impression, it seems to us that it would have been safer to follow a more logical line of distinction. After all, the purpose of special legislation about benefits in king is to prevent persons who enjoy the reality of personal income from escaping taxation upon it because it is not received in monetary form or in a form that is convertible into money. It is irrelevant for this purpose that the benefits in kind may be provided out of the resources of charitable bodies rather than trading concerns or that the resources of educational establishments may be tapped to provide them. We recommend the removal of this exemption."[13]

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13. Ibid, para 221

The conclusion of the Royal Commission has to be supported; the distinction drawn by the 1948 legislation was arbitrary and unfairly discriminated between employees, a situation the legislation was specfically introduced to cure.

The first type of recipient covered was "directors". Then, as now, they were included irrespective of the amount of their renumeration. "Director" included:

(a) a single person managing the affairs of a company;

(b) the members of a company whose affairs were managed by the members themselves;

(c) any person in accordance with whose instructions the directors are accustomed to act, unless that person gives the instructions in a purely professional capacity.[14]

The Royal Commission thought it wrong to include all directors in this way. They said in their Final Report:

> "But we think that [the 1948 legislation] goes unreasonably far in treating all directors of trading concerns as if they were equally likely to need special statutory control. In fact a director's relationship to his company varies very much from one case to another. So far as expense allowances and inconvertible benefits go - and what abuses are found must be found mainly in these - it seems to us unreal to treat a part-time director on the same footing as a 'controlling' director or an executive director who gives the whole of his working time to the service of the company concerned."[15]

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14. Compare the current definition in sections 167(5) and 168(8)-(11) ICTA 1988
15. Op cit para 218

They favoured a formula which covered directors who earned at least £2,000 a year plus directors, whatever the size of their remuneration, who were controlling-directors of director-controlled companies.[16]

The current definition goes some way towards this recommendation in that a persons employment is not director's or "higher paid"[17] by reason only of its being employment as a director earning less than £8,500, if he has no "material interest" in the company and either he is a full-time working director, or the company in non-profit-making or established for charitable purposes only.[18] A "material interest" is defined as ownership or control, directly or indirectly, of more than 5% of the company's ordinary share capital by the director or his associates or, in the case of a close company, more that 5% of the distributable income could be apportioned to him or his associates.[19]

The second category of recipient covered by the 1948 legislation consisted of employees whose total remuneration, including expense allowances and the value of assessable benefits, exceeded £2,000 per annum.

The term "employee" included any person who takes part in the management of the affairs of a company but is not a director. This was designed to bring within the scope of the legislation the "fees" paid to individuals as consultants for running the affairs of a company, even though they were called neither directors not employees. Such persons could not probably fall within the definition of "director".[20]

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16. Ibid
17. Although this description has very sensibly now been dropped by section 53 FA 1989, it is retained here for ease of reference.
18. Section 167(5) ICTA 1988
19. Section 168(11) ibid
20. Section 168(8) ibid

As regards the benefits themselves, the legislation was very brief on the subject of expense allowances, it merely directed that "any sum paid in respect of expenses" to a director or higher paid employee was to be treated as an emolument, subject to a valid claim for necessary expenses of the employment. The provisions were not concerned with the reimbursement of expenses. This was the interpretation placed on the corresponding provisions in section 19 FA 1939[21] and confirmed by the Royal Commission in their Final Report.[22] A sum paid in respect of expenses included a sum placed at the disposal of a director or higher-paid employee and disbursed by him. This was intended to cover round sum allowances.

The assessment of benefits in kind was dealt with by sections 39 and 40 FA 1948. They referred to the expense incurred by a company on the provision of "living or other accommodation, of entertainment, of domestic or other services or of other benefits or facilities whatsoever". Section 39 set out certain exceptions to the general charge namely:

(1) Accommodation etc, supplied on the company's business premises to a director or employee were not assessable benefits if they were provided for the individual himself and were used by him solely in the performance of his duties. Excluded from the definition of "business premises" were any premises used wholly or mainly as living accommodation by a director or higher-paid employee.[23] However, if an employee was provided with living accommodation[24] on the company's business premises, this was not treated as an assessable benefit if either;

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21. Supra
22. Op cit para 224
23. Section 45(1) FA 1948
24. Which need not have been used solely in connection with the employee's duties.

(a) the employee was required to occupy the accommodation as a condition of his employment, to enable him properly to perform his duties, and, in addition, the provision of accommodation must have been in accordance with a practice that had been established for at least twenty years and in connection with the particular class of employees concerned; or

(b) the occupation of the accommodation was a condition of employment and it was necessary that the employees of the class concerned and in the trade concerned should reside in the accommodation provided.[25]

These exemptions were to cover such things as the provision of cottages for employees such as farmers and miners.

(2) The provision of meals in a canteen were not an assessable benefit if the canteen was available to staff in general.[26]

(3) The legislation did not apply to benefits provided in the form of death or retirement benefits, which were covered by the FA 1947.[27]

The 1948 legislation, in keeping with all subsequent benefits legislation was not restricted to benefits supplied to the employee himself, but extended to his family, servants, dependants or guests. This covered roughly the same ground as the current "members of his family or household."[28]

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25. Compare section 145(4) ICTA 1988
26. See now section 155(5) ICTA 1988
27. See now section 155(4) ibid
28. Section 154(1)(a) ibid

The legislation had, of course, to tackle the question of valuing the benefits provided. In a straightforward case the employer's actual expenditure was taken, such as the rent paid for accommodation, the cost of food etc. The position was not so clear where the employer transferred assets to the employee or allowed him to use assets which remained in the ownership of the employer. Section 40 FA 1938 contained the rules for ascertaining the value of the benefit in kind in these situations. The general scheme of the section was that, where an asset was transferred outright, the measure of the benefit was the value of the asset as at the date of the transfer and that, where the asset was only lent, the benefit consisted of the annual value of the asset. It will be explained later that this rule was capable of exploitation and had to be changed in 1980.

In view to the fact that these rules later gave rise to widespread avoidance, it is relevant to deal with them in more detail here. Section 40 enacted that, when as asset was merely provided for the employee's use but remained the property of the employer, its actual cost to the employer was ignored and the measure of the benefit accruing to the employee was "the annual value of the use of the asset". This did not apply to premises in respect of which the employer was assessable under Schedule A.[29] If the employer paid a rent or hire charge for the asset then that was the value of the benefit, provided that it was greater than the annual value of the use of the asset. The section contained no indication of the method to be adopted in arriving at the annual value of an asset, leaving the value to be arrived at in accordance with normal commercial principles with refence to the particular asset in question. It might, therefore, have been the normal hire or rent commanded by that type of asset; or, perhaps, the cost of the asset divided by its estimated life.

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29. Infra

Where living accommodation was provided and the employer was assessable under Schedule A in respect of that accommodation, its value was its net annual value, or the rent paid by the employer if greater.

If an asset was transferred outright to an employee, the value of the benefit consisted of the value of the asset at the time of the transfer. If the asset had never been used by the employer or had not depreciated since it was acquired, its value was the actual cost to the company. If, on the other hand, the asset had either been used by the company or had depreciated, its value was taken as at the date of transfer, allowing for its condition and the extent of the depreciation.

The way in which these rules were exploited will be examined below:

It can be seen that the FA 1948 laid the foundations for some of the benefit-in-kind legislation today found in Chapter II Part V ICTA 1988. In the 1960's and 1970's additional benefits were covered and, in 1976, there was a major overhaul of the 1948 and subsequent legislation. Following this overhaul, the years after 1976 saw further amendments to the law to counter the ingenuity of taxpayers. All of these changes are dealt with below.

B. Restrictive Covenants

Two years after the introduction of the 1948 legislation, <u>section 26 FA 1950</u>[30] dealt with another attempt at remunerating a person without giving rise to any Schedule E liability; by way of consideration for entering into restrictive covenants. Although this is not strictly part of the benefits of legislation, it is appropriate to deal with section 26 here because it concerns the same

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30. Now section 313 ICTA 1988

type of operation as that hit at by the benefits provisions: namely, attempts to put money or money's worth into the hand of an employee in a non-taxable form.

Section 26 was retrospective in its operation. This was defended by the Government on the basis that the Chancellor, Sir Stafford Cripps, had given a warning that he might later be forced to take action when he was delivering his Budget speech in 1948. He had said:

> "Before I leave this subject, I will mention one other device which people may be tempted to adopt. That is to dress up what really is remuneration in a non-taxable capital form; for instance, as compensation for loss of office,[31] or as payment in consideration of a restrictive covenant on an individual's employment. Such devices, by which a man aims to evade [sic] paying a fair share of income tax, are intolerable in our present state of affairs, and I must give warning that the position will be closely watched, and that the Government will not hesitate to propose legislation, with retrospective effect, to deal with such devices."

In his 1950 Budget speech, the Chancellor announced:

> "Two years ago, I referred in my Budget speech to the growing avoidance of tax by means of arrangements known as restrictive covenants among others. The form taken by these is that a high executive - it is almost always a high executive - undertakes not to set up in competition. In return, the concern gives him a large sum of money or block of shares which, as the law stands, is not liable to tax. I gave a warning in 1948 that I should not hesitate to introduce retrospective legislation to tax such payments if it became necessary.

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31. Against which no action was taken until 1960, infra

Since then certain glaring instances of such payments have been widely advertised, and I am certain that the public and particularly those employed in the businesses concerned do not think it right that a particular individual should by such a device be able to evade paying his proper share of taxation. The payment of such sums is too entirely contrary to the spirit of the policy of the White Paper on personal incomes, costs and prices, and can only help to break down the otherwise good record of voluntary restraint that has so far been shown in these matters. I propose, therefore, that these benefits shall be chargeable to sur-tax and that the charge shall be retrospective to the year 1949-50 so that payment will have to be made next January on such benefits. In the case of the larger sums this means that over 95 per cent of them will be payable as tax."

Despite the Chancellor's warning in 1948, making this provision retrospective was a great imposition on taxpayers who are entitled to know what the law is at any given time. It is true that this legislation was introduced at a time of austerity and this device, which seems relatively tame by today's standards was, it seems, frowned upon by the ordinary employee,[32] but this was severe legislation imposed on individuals who perhaps were unwise not to heed the warning signs, but who, nevertheless, carried out transactions which were perfectly legal and not taxable at the time. The difference between paying no tax at all (which might here have been the situation when the transaction was carried

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32. Although this brings to mind the comment of the Royal Commission on the Taxation of Profits and Income which said, in relation to the 1948 benefits legislation, that "times of high taxation are apt to produce in the individual the impression that every advantage in which he does not share is itself an abuse." (Final Report, Cmd 9474, para 217). This comment has some relevance here because section 26 was made retrospective in response to pressure from the TUC.

out) and later having imposed retrospectively an effective tax rate of up to 95% if so great that a Government should not move from one position to the other except on the strength of an unequivocal Ministerial statement with prospective effect from the date of the announcement: not a general warning given in a Budget speech.

The reason the effective rate mentioned by the Chancellor was so high was, of course, that the amount received by the employee had to be treated as a net sum which then had to be grossed-up at the standard rate of income tax in determining the amount of sur-tax payable.

During the Committee Stage of the Finance Bill, in response to criticisms of the proposed provision, the Solicitor-General, Sir Frank Soskice, said that, in drafting the relevant legislation, three sets of circumstances would have to be considered:

(1) Covenants entered into before the Chancellor's warning during the 1948 Budget speech. It was intended to exclude these covenants from the charge to sur-tax in relation to payments both before and after the passing of the Act.

(2) Cases entered into before the passing of the Act where tax avoidance was not in mind. The Solicitor-General said that it was not intended to charge sur-tax on payments made as a result of these transactions.

(3) Cases in which avoidance of liability to sur-tax was intended.

The exemptions as they finally appeared in the Act were, however, slightly different. The cases that were exempt were those where:

(a) the undertaking not to compete with the company's business was given on or before 6 April 1948; or

(b) the sum or other consideration for the undertaking was paid or given at or after the time of the retirement of the individual from his office or employment, where the contract was made or reduced to writing on or before 18 April 1950, and where the terms of the contract expressly provided for payment on or after retirement; or

(c) the sum of consideration was paid in accordance with a written contract made or reduced to writing before 18 April 1950, and where the main purpose of the contract was to provide for the transfer of a trade or part of a trade, or the transfer of the controlling interest in a company.

These exemptions were rather narrower than might have been expected in the interests of fairness in a retrospective provision of this nature.

Turning to the section itself, it was enacted to prevent practices that had been increasing in popularity (amongst those who were able to benefit from them, at least), particularly since the publicity given to the schemes by the House of Lords decision in Beak v Robson,[33] which established the rule that a sum paid by a company to a director or employee in return for a covenant not to compete for a certain period, was not an emolument of his office or employment and so not assessable on him under Schedule E.

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33. (1943) 25 TC 33

The facts were that, by an agreement dated 4 October 1937, a company agreed to employ the taxpayer as a manager and director for five years at a salary of £2,000 a year, plus bonuses. By clause 6, the contact was made terminable by either party on six months' notice in writing on or after 30 September 1940. Clause 7 provided for payment of £7,000 to the taxpayer on the execution of the agreement in consideration of his entering into a restrictive covenant contained in clause 8, which provided that, if the agreement should be determined by notice in writing given by him or by any breach by him of the provisions of the agreement, then from such determination or breach, he was not, without the consent of the company, to carry on a competing business within 50 miles of Newcastle-upon-Tyne.

The Revenue argued that there was no real difference between this case and one in which an employee accepted a restriction in his contract but received no separate consideration for it. The House of Lords, however, held that the taxpayer was not assessable to income tax under Schedule E in respect of the sum of £7,000 because it was not a profit arising from his office; it was provided for a separate clause in the contact. The sum of £7,000 was not for performing services, it was for a separate consideration by the director which was to pass after the termination of his employment.[34]

The sum paid by the company was capital and not deductible by the company in computing its profits under Schedule D. This was clearly established in the case of <u>Associated Portland Cement Manufacturers Ltd v Kerr</u>.[35]

The lost revenue by the use of payments for restrictive covenants was the surtax on what would otherwise have

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34. See also <u>Hose v Warwick</u> (1946) 27 TC 459
35. (1946) 27 TC 103

been the taxable salary of the employee. Accordingly, the charge under section 26 was restricted to surtax on the basis that the payment had already effectively suffered income tax in the hands of the company.

The wording of the section was very wide, and the draftsman was obviously trying to cover as many ways of making these payments as possible. If the section was otherwise applicable, it made no difference if the payment was made to someone other than the covenantor; the covenantor, not the actual recipient being assessable to surtax. It was also immaterial whether the covenant was entered into before the covenantor took up his office or employment, while he held it, or after he had left it, provided only that it was given "in connection with his holding thereof." The covenant could have been either absolute or qualified, legally valid or unenforceable, and needed only to have been one "the tenor or effect of which is to restrict him as to his conduct or activities."[36]

The section also applied where valuable consideration other than money was given. Furthermore, where no money was paid immediately but the covenantee undertook to "make over or provide valuable property, rights or advantages", the undertaking itself was not regarded as "valuable consideration", but anything done towards discharging the undertaking was regarded as valuable consideration.[37]

Although the mechanics of the section altered slightly to cater for changes in surtax and income tax, the basic structure of the charge remained the same until 1988 when an overhaul of the section was necessitated by the fact that income tax rates and capital gains tax rates were

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36. See section 313(1) ICTA 1988 prior to its amendment by section 73 FA 1988 and also the new wording substituted by that section, infra
37. See now section 313(4) ICTA 1988

brought into line. The provisions, which had become section 313 ICTA 1988, were greatly amended by section 73 FA 1988 in respect of covenants made after 8 June 1988. Payments made in respect of such covenants are treated as a taxable emolument of the employee and as a deduction in calculating the employer's taxable profits, or as a management expense in the case of an investment company. The reason this charge was made was that some employers were taking advantage of the fact that employees only paid tax at the higher, and not the basic rate, on the consideration for the covenant and were entering into such covenants with employees in lieu of giving then pay increases. The 1988 changes were successful in countering this device.

Sums chargeable under section 313 are specifically exempts from the normal Schedule E charge on retirement or removal from an office or employment under section 148 ICTA 1988[38] by virtue of section 188(1)(b) ibid.

Section 26 FA 1950 in its various manifestations has in practice given rise to very few problems; its target is clear and its wording is wide and, by the nature of its subject matter, it has tended to have no impact on transactions outside its original target area. The one case on the section was concerned with the possible application of the section to inducement payments. This case was Vaughan-Neil v IRC.[39] It concerned a barrister who had an extensive practice in the field of planning law. He was regarded as the top "junior" in his field and was an obvious candidate to become a QC. His prospects at the Bar for further advancement were good. He was approached by the property developers, George Wimpey & Co Ltd, who offered him employment at a salary

38. Infra
39. [1979] STC 644

of £15,000 per annum. Such employment would have meant that the taxpayer would have to give up his practice at the Bar and the future opportunities that went with it. The company offered the taxpayer £40,000 as an inducement. The taxpayer accepted the company's offer and entered into a deed with the company. By that deed, to which a service agreement was annexed, the company covenanted to pay the taxpayer £40,000 as an inducement to him to give up his status as a practising barrister with the consequent loss of his established position and prospects of further distinction arising from his practice at the Bar, and the taxpayer covenanted that "he will cease to practice at the Bar in order to enter into the service agreement."

The taxpayer was assessed to tax in respect of the £40,000 under what was then section 34 ICTA 1970. The Special Commissioners upheld the assessment. The taxpayer appealed contending that, because he could not take up the employment without ceasing to practice, the covenant to cease practice was entirely otiose, that the payment of £40,000 was, therefore, not in respect of the fulfilment of any undertaking within section 34, but in respect of the loss of status and loss of future professional advantage.

Oliver J allowed the taxpayer's appeal, deciding that:

> "the payment was to act as an inducement to the taxpayer to accept the professional and social consequences which flowed from his taking the preferred employment. Counsel for the Crown would argue, I think, that that means that it was a payment for entering into the service agreement, and that that is itself an undertaking restricting the taxpayer from any conduct or activity incompatible with the carrying out of the duties which he was engaged to perform, and therefore an undertaking caught by the section. But whatever restrictions the section, on

its true construction, is aimed at. I cannot read the expression 'as undertaking...... the tenor or effect of which is to restrict him as to his conduct or activities'[40] on embracing the simple undertaking of the very duties which are inherent in and inseparable from the office or employment itself."[41]

The judge concluded that the payment was not one "in respect of" a relevant undertaking by the taxpayer within the section.[42]

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40. In section 34(1) ICTA 1970; now section 313(1) ICTA 1988
41. p656
42. Ibid

Additional Restrictions

The 1960's and the 1970's leading up to the overhaul in 1976, saw further restrictions introduced, bringing further benefits within the Schedule E tax net.

A. Golden Handshakes

In 1960, legislative action was taken for the first time to tax payments on retirement or removal from office or employment, colloquially known as "golden handshakes". In practice, this term covered two distinct types of payment:

(i) ex gratia payments made as a mark of appreciation for the loyalty and devotion a departing employee has shown; and

(ii) compensation payments on loss of office in return for the departing employee relinquishing all claims he might have against his ex-employer, such as actions for unfair dismissal etc.

A body of case law had built up before 1960 establishing the principle that such ex gratia and compensation payments were not taxable under Schedule E as long as, in the particular circumstances of the case, the payments were in no way consideration for past, present, or even future services.[43] Similarly, payments for persuading an employee to accept less favourable conditions of employment sometimes escaped tax.[44]

It has already been seen that, in his 1948 Budget Speech, Sir Stafford Cripps had warned that legislation, possibly

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43. See, for example, Beynon v Thorpe (1926) 14 TC 1; Henley v Murray (1950) 31 TC 351
44. See, for example, Hunter v Dewhurst (1932) 16 TC 605; Duff v Barlow (1941) 23 TC 633; Tilley v Wales (1945) 25 TC 136

with retrospective effect, might have to be introduced to stop the "intolerable" device of dressing up remuneration as compensation for loss of office. Unlike the "device" of using restrictive covenants, no such action was forthcoming during the life of that Government. In any case, if remuneration was only dressed up as compensation or as an ex gratia payment, the courts, not being bound in any way by the form in which the sum was dressed up[45], would have applied the normal Schedule E rules anyway. It was no doubt true, however, that, in practice, a convincing set of circumstances could be manufactured to disguise what was in fact remuneration as compensation or an ex gratia payment, making it difficult, if not impossible, for an Inspector or a court to see the true position.

The problem of ex gratia payments and compensation payments were examined respectively in the second Tucker Committee report[46] and the Final Report of the Royal Commission of the Taxation of Profits and Income.[47] The Royal Commission recommended that both ex gratia and compensation payments should be taxed according to the following formula:

(i) one-quarter of the sum, not exceeding £2,000, should be tax free;

(ii) the taxable part should be charged to tax by top-slicing over five years; and

(iii) ordinary remuneration from the office or employment in the year of receipt should not be taken into account for the purpose of the top-slicing.[48]

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45. On the question as to how far, and in what circumstances, form can prevail over substance, see Chapter 11.
46. Cmd 9063
47. Cmd 9474, see paras 247-251 for a summary of both situations.
48. Ibid, para 252

Legislation followed five years later. Sections 37 and 38 and Schedule 4, FA 1960 operated in respect of payments made on or after 6 April 1960. This legislation was drafted in wide terms and, since 1960, the details of the legislation have altered somewhat, but, in its various forms, the legislation has been successful in bringing within the charge to tax those payments the Legislature had in mind in 1960.

The relevant legislation is now section 148 and 188 and Schedule 11 ICTA 1988. Reference to section 148(2) and (3) shows how wide the net has been thrown.

By subsection (2) the section applies to any payment (not otherwise chargeable to tax) which is made, whether or not in pursuance of a legal obligation, either directly or indirectly in consideration or in consequence of, or otherwise in connection with, the termination of the holding of the office or employment or any change in its functions or emoluments, including any payment in commutation of annual or periodical payments (whether chargeable to tax or not) which would otherwise have been so made.

Subsection (3) states that any payment made to the spouse or any relative or dependant of the employee, shall be treated as made to him, and any valuable consideration other than money shall be treated as a payment of money, equal to the value of that consideration at the date when it is given.

When the original legislation was enacted in 1960, the recommendations of the Royal Commission were largely, but not entirely adopted. Section 38 FA 1960 contained an exemption which was, in fact, £5,000 rather than the £2,000. This was raised to £10,000 in 1978[49] and £25,000

49. Section 24 FA 1978

in 1981.[50] It is now £30,000.[51] Schedule 4 FA 1960 contained rather complicated top-slicing and certain other marginal relief provisions which at various times were varied and simplified.[52]

It is not necessary to deal with the various forms of the relief here except to mention one aspect which called for remedial action in 1986. It arose out of the changes made to what were then sections 187 and 188 and Schedule 8, ICTA 1970 by section 31 FA 1981 and section 43 ICTA 1982. The Inland Revenue and most professional advisers were originally under the impression that the law, as it operated from 6 April 1982 onwards, was that the first £25,000 of ex gratia and compensation payments was exempt; on the next £25,000, the tax was reduced by half; on the next £25,000. the tax was reduced by 25%; and for the excess over £75,000 tax was payable in full. However, the Revenue received legal advice that the band in respect of which tax was reduced by half was not £25,000 in size, but £50,000. This had a knock-on effect in that the band on which tax was reduced by 25% was that between £75,000 and £100,000 (instead of £50,000 to £75,000), and only any excess over £100,000 was taxable in full. On re-examining the legislation with the benefit of hindsight, it appears that this interpretation is correct. Accordingly, in 1986, the legislation was restored to what is was thought to have been all along.[53] Taxpayers who were taxed on the wrong basis were allowed to submit repayment claims. This mix up is explained in an Inland Revenue Press Release issued on 4 June 1986.

The original legislation contained a number of other exemptions or reliefs with which it is not necessary to deal here. For example, section 38 FA 1960 contained a number of specific exemptions which are now contained in

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50. Section 31(1) FA 1981
51. Section 74(1)(3) FA 1988
52. See for example, section 31 FA 1981 and section 43 FA 1982
53. By section 45 FA 1986

section 188 ICTA 1988 and there were certain exemptions in the case of foreign service.[54]

Overall, the "golden handshake" legislation has given rise to few problems over the last 30 years; the target is clear and the legislation widely drafted. Disputes with the Revenue tend to be restricted to questions of fact; namely, whether a particular payment is, in reality, an ex gratia or compensation payment, or whether it relates to past, present or, in some cases, even future services. The Revenue scrutinise with particular care cases where a "golden handshake" is coupled with the receipt of consideration for the sale of shares. They take care to discover whether the "golden handshake" is, in reality, disguised share consideration, in an attempt to reduce the amount liable to capital gains tax and increase the tax-free "golden handshake". Problems with the Revenue in this area can, in practice, be minimised by preparing the ground properly, obtaining bona fide share valuations and keeping adequate documentary evidence of what is going on.

At the end of the day, the verdict of most taxpayers is that, although the wording of the legislation is wide, the exemptions are actually fairly generous and the Revenue normally take a reasonable attitude in applying these provisions. If this legislation is radically altered in the future it is likely to be as a result of a political decision, rather than through any dissatisfaction with the operation or effectiveness of the legislation itself.

B. Living Accommodation

Following "golden handshakes" in 1960, the next benefit in respect of which legislation was enacted was living accommodation provided for an employee by an employer.

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54. These exemptions for foreign service are now restricted, see now section 188 (3) ICTA 1988

The legislation was introduced in 1963 and, as will be seen below, was re-enacted in 1977. The tax charge was found to be far too low as regards more expensive living accommodation, and so a separate and potentially much heavier charge was imposed with effect from 6 April 1984.

The reason why action was taken in 1963 was because of an alteration in another area of the law altogether. Originally, if an employee was allowed to occupy living accommodation provided by his employer, the employee paid income tax in respect of that occupation under Schedule A. The Schedule A charge was abolished in 1963 and, accordingly, employees occupying accommodation provided by their employers would normally have escaped income tax in respect of that occupation altogether. This situation was remedied by section 47 FA 1963 which imposed a charge to income on an amount equal to a notional annual value of the accommodation. In the case of directors and higher-paid employees, an additional charge was imposed in respect of the gross rateable value of the accommodation or, if the employer paid a rent for the accommodation, that rent, if it exceeded the gross rateable value. Directors and higher-paid employees were given a credit for the charge under section 47.[55] This gross rateable value charge was contained in section 63 FA 1976. It will be explained below that this legislation was re-enacted in 1977.

C. Business Entertaining

The abuse of business entertaining was tackled in 1965. This was done, not by imposing a Schedule E charge on the employee, but normally by disallowing a deduction in computing the profits of the employer for Schedule D purposes.

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55. Then contained in section 185 ICTA 1970

The disquiet over the exploitation of business expenses was epitomised by the Chancellor in his 1965 Budget speech. He said:

"Many firms are most scrupulous about business entertainment. But there has been widespread criticism for some years of the habit in some circles of lavish entertainment by businessmen of one another on the pretext that it is necessary to create goodwill to secure a customer. Something which originally began as the hospitable offering of a modest meal to a client at small expense has grown to such a pitch that luxury penthouse flats are kept on business expense accounts, yachts are hired and even Scottish landlords can turn a penny by letting their grouse moors. And provided this is done in the name of business entertainment the taxpayer pays 10 shillings or more in every pound of the cost. No doubt because of this fact, expense account living, as it has come to be called, is often on a scale which is a scandal and is felt to be so not only by the non-business world but by many firms in industry which have a different code of conduct.

In my view the time has come to apply a radical solution to a problem which is not only a fiscal but a social one. I propose that, subject to a limited exception for the entertainment of overseas buyers, expenditure on business entertainment incurred after today should in general be completely disallowed for tax purposes. So far as possible, the disallowance will be made in computing the business profits; this will apply both to entertainment which a business pays for direct and also, for example, to expenditure which is incurred by a director or employee and reimbursed by the employee out of inclusive remuneration, it will be disallowed in computing his liability. I recognise that this general disallowance of business entertainment for tax purposes will not prevent firms from continuing to entertain on a lavish scale if they desire to do so. But at least the rest of the taxpayer community can have the satisfaction of knowing that from now on the businesses in question are paying for it out of their own profits and are not being heavily subsidised by the Exchequer."

The ensuing legislation was contained in section 15 FA 1965 and is now section 577 ICTA 1988. In keeping with the Chancellor's strong words, which did reflect a genuine concern amongst the general public, section 15 was uncompromising in its operation and has been successful in stopping lavish entertainment at the taxpayers' expense. As the section was specifically aimed at a particular and easily defined abuse, it was possible to draft the legislation in wide enough terms to prevent effectively those abuses but without effecting other commercial activities. There have been few complaints about the operation of the section; everyone knew the system was being grossly abused and it was probably appreciated that nothing short of a total ban, subject to an exemption, now repealed, in respect of overseas customers, would be effective to prevent the abuses.

Not surprisingly, "business entertainment" is defined in wide terms as "entertainment (including hospitality of any kind) provided by a person, or by a member of his staff, in connection with a trade carried on by that person, but does not include anything provided by him for bona fide members of his staff unless its provision for them is incidental to its provision also for others."[56]

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56. Section 577(5) ICTA 1988

The section also applies to the provision of gifts, except gifts consisting of an article incorporating "a conspicuous advertisement for the donor", being an article which is not food, drink, tobacco or a token or voucher exchangeable for goods, and the cost of which to the donor, taken together with the cost of any other articles given to the same person in the same year, does not exceed £10.[57] Also, gifts to charity are excluded from the operation or the section.[58]

There the section does apply, no deduction is allowed in computing profits or gains chargeable to tax under Schedule D or Schedule A for the tainted expenses, and they are not allowed as management expenses. Furthermore, any claim for capital allowances in respect of any asset used for business entertainment is disallowed.[59]

The section also states that no deduction for business entertaining expenses shall be made from emoluments chargeable to tax under Schedule E.[60] If an employer reimburses the employee for business expenses, the employer will not obtain a deduction in computing his profits, but the employee can deduct all the expenditure satisfying the normal test in section 198 ICTA 1988 regardless of the restrictions of section 577. On the other hand, if the employee is paid a round sum allowance to cover expenses generally, the employee cannot deduct any entertainment expenses from his taxable emoluments unless they satisfy both the section 198 and 577 tests, but the employer can deduct the expense allowance in computing his profits, subject to the normal requirements in section 74(a) ICTA 1988.[61]

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57. Section 577(8) ibid
58. Section 577(9) ibid
59. Section 577(1)(a)(c) ibid
60. Section 577(1)(b) ibid
61. Section 577(3) ibid

In accordance with the words of the Chancellor in his 1965 Budget speech, the legislation originally contained an exception in the case of the entertainment of overseas customers[62] but this exception was repealed in relation to entertainment provided after 14 March 1988, unless it is provided under a contract entered into before 15 March 1988.[63]

Section 577(10) contains an exception in respect of the provision of anything which it is the person's trade to provide, and which is provided by him in the ordinary course of that trade for payment or, with the object of advertising to the public, gratuitously. This is a narrow exception, as was demonstrated in the case of Fleming v Associated Newspapers Ltd.[64] A journalist who entertained his sources etc, by providing them with meals and drinks was not able to take advantage of this exception: although such entertaining was a common feature of the activities of journalists, the trade in question was producing newspapers, not providing refreshment.

D. Employee Shareholdings

The next major pieces of new benefits legislation was enacted in 1966, 1972, and 1974 and concerned employees being provided with shares or options to acquire shares. This subject is dealt with separately below.

E. Vouchers

Until specific legislation was enacted in 1975, there was some uncertainty over the taxation of vouchers. There was little doubt that they were normally taxable on the

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62. Section 577(2)(6)
63. Section 72 FA 1988
64. (1972) 48 TC 382

basis that they could be converted into money or exchanged for goods, but there was some doubt regarding the measure of the benefit.

The question of vouchers arose in the case of Laider v Perry[65]. Each Christmas since 1949 a company had given vouchers for £10 to each member of staff, regardless of the level of salary. It was found as a fact by the Special Commissioners that the vouchers "were worth not appreciably less than their face value of £10". The vouchers were given because they helped to maintained happiness among the staff which the directors believed was likely to be of advantage to the company. The taxpayer, an employee of the company, received a voucher which he considered to be a pleasant gesture but which he did not expect as of right. He was assessed to income tax on the vouchers received over a number of years, and the assessments were upheld by the House of Lords. The matter at issue in the case was whether, on the facts, the vouchers were assessable at all. It was held that they were because they were given to employees as employees and with a view to benfitting the company; not as personal gifts. For present purposes, it should be noted that the taxpayer was chargeable on the face value of the voucher. On the established principle of convertability, the measure taxable benefit should have been the value of goods for which the voucher could have been exchanged. According to the Commissioners, this was virtually equivalent to its face value.

The uncertainty was cleared up by legislation. Section 36 F(No 2)A 1975 dealt specifically with non-cash vouchers, and section 37 concerned cash vouchers. Subsequently, a new section was added; section 36A[66]

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65. (1965) 42 TC 351
66. Added by section 71(1)(3) FA 1981 with effect from the year 1982/83.

dealing with credit-tokens. These provisions can now be found in sections 141-144 ICTA 1988. It should be noted that these provisions apply to all employees, and not just directors and higher paid employees.

The effect of section 36, F(No 2)A 1975[67] was to treat the employee as having received an emolument equal to the cost of a non-cash voucher. A "non-cash voucher" is defined widely as not including a cash voucher, but subject to that, as meaning:

> "any voucher, stamp or similar document or token capable of being exchanged.... for money, goods or services.... and includes a transport voucher and a cheque voucher".[68]

A "transport voucher" means:

> "any ticket pass or other document or token intended to enable a person to obtain passenger transport services (whether or not in exchange for it)..."[69]

A "cheque voucher" means:

> "a cheque provided for an employee and intended for use by him wholly or mainly for payment for particular goods or services or for goods or services of one or more particular classes....."[70]

Because these words are so wide, any written document which can in any way be exchanged for goods or services is likely to be caught.

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67. Now section 141 ICTA 1988
68. Section 36(4) F(No2)A 1975 as amended by section 44(5) FA 1982, now section 141(7) ICTA 1988
69. Ibid
70. Ibid

When an employee receives a non-cash voucher within the above wide definition the second-hand value of any goods or services for which it is exchanged is ignored and, as noted above, the cost of providing the voucher is taken as the measure of the emolument. This is extended to cover the cost of the money, goods or services for which it can be exchanged.

A non-cash voucher, cash voucher or credit token provided for an employee by his employer is deemed to be provided by reason of his employment.[71]

There is an interesting difference in the wording of the respective definitions of "non-cash voucher" and "transport voucher". As can be seen above, "transport voucher" is defined as including a document intended to enable a person to obtain passenger transport, whether or not in exchange for it; whereas the definition of a "non-cash voucher" refers to a document "capable of being exchanged". This appears to have left some scope for employers to exploit the rules, except where transport vouchers are concerned, to provide benefits for employees who are not higher-paid. For example, an employer could arrange with a clothes shop that employees are to be able to purchase suits on the company's account on presentation of formal identification in the form of a chit which the employee does not actually hand over to the shop. The employee would then be taxable under the normal rules and suffer tax only on the second hand value of the suit.[72] The credit token legislation dealt with below would probably catch such a scheme, however.

Cash vouchers were dealt with by section 37 F(No2)A 1975.[73] The term "cash voucher" means:

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71. Section 36(5)(c) F(No2)A 1975, now section (4)(a) ICTA 1988
72. Directors and higher paid employees would suffer tax on the special rules in Chapter II, Part VI ICTA 1988 infra
73. Now section 143 ICTA 1988

"any voucher stamp or similar document capable of being exchanged..... for a sum of money greater than, equal to or not substantially less than the expense incurred in providing the voucher....."

It does not, however, include any document intended to enable a person to obtain payment of a sum which, if paid to him directly, would not have been chargeable to income tax under Schedule E; or a savings certificate the interest on which is exempt from tax,[74] namely, a National Savings Certificate.

Section 37 stipulated that the employer must deduct tax through the PAYE system on the basis that the employee received an emolument equal to the money for which the voucher was capable of being exchanged.

The rules relating to credit tokens, introduced in 1971[75], were aimed primarily at the use of company credit cards which were being used with increasing frequency to purchase such items as petrol. Section 36A was not, however, restricted to credit cards. The term "credit token" means:

> "a card, token, document or other thing given to a person by another person who undertakes -
>
> (a) that on the production of it (whether or not some other action is also required) he will supply money, goods and services (or any of them) on credit; or
>
> (b) that where, on the production of it to a third party (whether or not some other action is also required) the third party

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74. Section 143(3) ibid
75. Section 36 F(No2)A 1975, inserted by section 71 FA 1981, now section 142 ICTA 1988

supplies money, goods and services (or any of them), he will pay the third party for them....."[76]

The definition obviously covers credit cards, but will also include any token etc which enables an employee to obtain goods on credit.

When an employee uses a credit token to acquire money, goods or services he will be treated as receiving an emolument equal to the expense incurred by the employer, or whoever is providing the credit token.[77] This will normally be the cost of the goods etc he acquires.

These provisions, now contained in section 141-144 ICTA 1988 have been effective in withdrawing any tax advantages through the use of vouchers, credit cards etc by employees. The areas not covered by this legislation were mainly dealt with by the provisions aimed at "suit schemes."[78]

F. Medical Insurance

There is one other provision enacted in 1975 to mention. The payment of premiums in respect of medical insurance had been treated as a taxable emolument in the case of directors and higher-paid employees since 1948.[79] Section 35 F(No2) A 1975 extended this to other employees. This section was re-enacted in a slightly different form as section 68 FA 1976 but this was repealed by section 72 FA 1981, leaving only directors and higher-paid employees taxable in respect of such premiums under the general charging provisions of section 154 ICTA 1988.[80]

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76. See now section 142(4) ICTA 1988
77. Section 142(1) ibid
78. Infra
79. Section 39 FA 1948 supra
80. Subject to the exceptions in section 155(6) ICTA 1988

Sums paid by employers to employees or their families in respect of sick pay are taxable under Schedule E in the case of all employees.[81]

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81. Section 30 FA 1981, now section 149 ICTA 1988

The 1976 Regime and Later Changes

A. The 1976 Legislation

The 1948 legislation regarding directors and higher-paid employees had remained substantially intact until 1976 when the Finance Act of that year made important changes. The 1976 system forms the basis for the present legislation now to be found in Chapter II, Part V, ICTA 1988. It is not intended to give an exhaustive explanation of these provisions; but a number of points of relevance specifically to tax avoidance arrangements should be made here.

The new provisions were contained in sections 60-72 FA 1976 and, as subsequently amended, can now be found in sections 153-168 ICTA 1988.

The 1976 legislation widened the scope of the director and higher-paid employee benefit provisions. Whereas the 1948 provisions applied in respect of benefits provided or expenses incurred by an employer,[82] sections 60 and 61 FA 1976[83] were stated to apply to expenses and benefits received by an employee "by reason of his employment". Furthermore, section 72(3)[84] stated that all sums paid to an employee by his employer in respect of expenses and all benefits provided for an employee, or for members of his family or household, by his employer, are deemed to be paid to or provided for him or them by reason of his employment, except any such payment or provision made by an employer who is an individual as can be shown to have been made in the normal course of his domestic, family or personal relationships. This exception was necessary to ensure that no tax charge arises, for example, where a

82. Section 39 FA 1948
83. Now sections 153 and 154 ICTA 1988
84. Now section 168(3) ibid

father gave, say a birthday present to a member of his family who happened to work for him.

The general charging section was section 61 FA 1976.[85] The scope of this section is very similar to that of sections 39 and 40 FA 1948[86] in that, subject to certain exceptions, it covered "accommodation (other than living accommodation), entertainment, domestic or other services, and other benefits and facilities of whatsoever nature."

It has been established that an employee will be chargeable on the full amount of the benefit, as computed for the purposes of his legislation, even if, had the employee had any say in the matter, he would have spent less.[87] Similarly, it makes no difference if the employer's reason in providing the benefit was, not to benefit the employee, but to produce some benefit to himself.[88]

Special rules apply to certain benefits in Chapter II, Part V ICTA 1988. It is not necessary to deal with them in detail, except to make a few specific points. First there is a general one that the general charging provision plus these special rules, as they have been amended and supplemented over the years, have gradually reduced the range of benefits that can be provided for directors and higher paid employees in a tax efficient manner, and, in addition, a number of particular avoidance devices have been stopped. The situation now is that it is difficult for an employer to provide tax efficient benefits for directors and higher paid employees except to the extent that the tax benefit is given by the legislation itself, either because it is

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85. Now section 154 ICTA 1988
86. Supra
87. See, for example Rendell v Went (1964) 41 TC 641
88. Ibid

covered by a specific exception, such as canteen meals[89] or because the cash equivalent of the benefit is deliberately pitched at a level below the real benefit to the employee. This latter situation now rarely arises as it is the policy of the present Government to bring cash equivalents into line with actual value of the benefits. The one area in which cash equivalents are still significantly below the real value of the benefit is in the case of "company" cars and the provision of private petrol.[90] When the present scheme for taxing cars was introduced in 1976 there was an outcry from the UK car industry that it would be severely damaged if employers ceased to provide employees with cars. Accordingly, the scale of the taxable benefits was very low and, although the sizes of the taxable benefits have risen sharply in the last few years, they are still well below what organisations such as the Automobile Association calculate to be the real benefit of being provided with a car by an employer. It is curious that no restriction has been placed on the type of car that qualifies for the beneficial tax regime; for example, the Japanese and German car industries must have benefited enormously from the UK tax rules over the past 14 years.

The FA 1976 contained the first legislation imposing tax on the provision of loans on beneficial terms by employers for employees. It seems that, when income tax relief for most forms of loan was withdrawn by the FA 1974, the practice grew of employers providing loans to employees either at no interest or at a rate below the commercial rate. This was an attractive benefit because the employee was effectively being "given" the amount of interest he would otherwise have to pay to a third party lender, interest for which, in most cases, he would get no income tax relief.

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89. Section 155(5) ICTA 1988
90. Sections 157-9 ibid

Accordingly, section 66 FA 1976[91] imposed a Schedule E liability on the employee with effect from 6 April 1978. The cash equivalent of the benefit was the amount by which interest at the "official rate" exceeds any interest actually paid by the employee. The "official rate" is specified from time to time by the Treasury by way of Statutory Instrument. There were transitional provisions whereby, for the 1978/79 and 1979/80 tax years, an employee was taxed in respect of loans made after 26 March 1974 and on only half of this amount.[92] The "official rate" is fixed at such a level as to rob loans from employers of most of their attraction.

As one would expect, the beneficial loan provisions are drafted in wide language to prevent the provisions being easily avoided. In particular, "loan" includes any form of credit, and references to making a loan include "arranging, guaranteeing or in any way facilitating a loan."[93]

This wording renders ineffective, for example, a "back-to-back" arrangement that was at one time offered by certain branches of one of the major banks. The arrangement involved the employer depositing a sum of money with the bank, on which deposit the employer would receive no interest. By a completely "separate" transaction, the bank would lend an employee a sum approximately equal to the employer's deposit at a very low rate of interest, say 1%. There would be no documentation linking the employer's deposit and the employee's loan, but it would be understood that the employer would not withdraw the deposit while the employee's loan was outstanding. This scheme fell foul of section 160 ICTA 1988 because the employer was

91. Now section 160 ICTA 1988. There are exceptions in section 161 ibid
92. Section 66(1) and (11)(a) FA 1976
93. Now section 160(5)(a)(c) ICTA 1988

certainly "arranging" and "facilitating" and probably also "guaranteeing" the employees loan.

This is just one example of the way the wording of section 160 has proved to be very effective at preventing employers from providing beneficial loans to employees by indirect means.

The 1976 legislation also imposed an income tax charge when an employee loan is written off by the employer. With effect from 6 April 1976, the amount of the loan written off is treated as an emolument.[94]

B. The Attack on "Suit Schemes"

Prior to 1980, transactions sometimes known as "suit-schemes" became popular as a means of providing assets for directors and higher paid employees at a relatively low tax cost. Although, as the name suggests, suits were often the subject matter of this scheme, it was suitable for a wide range of goods. The common factor they all had was that, although their practical value to the employee was high, their second hand value was low. Consequently, this scheme was used to provide employees with such things as furniture, televisions, hi-fi equipment, kitchen equipment etc.

The scheme relied on the original rules contained in section 63 FA 1976 for calculating the cash equivalent of the benefit. Two rules in particular were relevant:

1. Where the benefit consists in an asset being placed at the employee's disposal, without any transfer in the property in the asset, the cost, and therefore the cash equivalent, of the

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94. Section 66(3) FA 1976, now section 160(2) ICTA 1988

benefit is the "annual value". In the case of assets other than land, the annual value was 10% of the market value of the asset when it was first provided to the employee.[95]

2. Where the benefit consists in the transfer of an asset by an employer, and since the employer acquired it the asset has depreciated, the cost of the benefit is deemed to be the market value of the asset at the time of transfer.[96]

An example will show how these rules were exploited. Assume an employer purchased a piece of furniture at a cost of £1,000 and immediately allowed a higher paid employee to use it. A year later, when the second hand value of the furniture was only £200, it was transferred to the employee. The employee would be treated as receiving an additional emolument of only:

Annual value = £1,000 x 10%	£100
Value at the date of transfer	£200
Total emolument	£300

The assessable emolument was therefore small compared with the value of the asset acquired, and even smaller when compared with the gross salary the employee would have to have been paid so that, after tax, he would have been left with £1,000 to purchase the furniture himself from the shop.

The use of this scheme was becoming so widespread that, in 1980, Parliament were forced to take action. Section 49 FA 1980 amended section 63 FA 1976 by adding a new subsection (3A),[97] giving an alternative basis for

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95. Section 63(4)(5) FA 1976, now section 156(5)(6)(9) ICTA 1988
96. Section 63(3) FA 1976, now section 156(3) ICTA 1988
97. See now section 156(4) ICTA 1988

calculating the cash equivalent when an asset is transferred to an employee; and by increasing the annual value in section 63(5)[98] from 10% to 20%.

The alternative basis in subsection (3A) is to be used where it gives a higher figure than that under the old rules in subsection (3). The alternative basis is as follows. Where an asset has been subject to the annual value rule, on its subsequent transfer to the employee, the cash equivalent will be its value when it is first applied for the employee less any amounts taken into account under the annual value rules.

In the example given above, the 1980 amendments would give rise to the following additional emoluments:

Annual value = £1,000 x 20%		£200
Alternative basis on transfer:		
Value when first provided	£1,000	
Less: amount taxed under the annual value rule	200	
		800
		£1,000

Not surprisingly, "suit schemes" dried up immediately.[99] These simple and sensible amendment prevented the widespread exploitation of the original rules.

C. Living Accommodation

This is another benefit in respect of which action had to be taken after 1976 to bring the deemed emolument more into line with the real value of the benefit to the employee. The need for this action was, not that the rules were being abused, but that the cash equivalent provided for in the legislation was simply too low.

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98. See now section 156(6)(b) ibid
99. The new rules applied to assets provided on or after 6 April 1980

The original charging provisions of section 47 FA 1963 and section 63 FA 1976 are dealt with above. The existing legislation was replaced by substantially similar legislation in 1977. An extra charge in relation to more expensive accommodation was introduced in 1983. These provisions apply to all employees, not just to directors and higher paid employees.

Section 33 FA 1977[100] provided that where living accommodation is provided for a person by reason of his employment, he is treated as receiving emoluments equal to the value to him of the accommodation, less so much as is made good by him.[101] This value is the annual value ascertained under what is now section 837 ICTA 1988, in effect the gross rateable value; unless the employer (or whoever is providing the accommodation) pays a rent which exceeds that value, in which case, that rent is the relevant value.[102]

There are certain exceptions[103] for representative occupation etc. The exceptions are narrow in their scope but the original 1976 rules[104] were even narrower. They were expanded in 1977 following the case of Langley v Appleby[105] and the analysis by Fox J of the previous provisions.

In most cases, the employee will not be able to take advantage of the exceptions but, nevertheless, the charge under section 33 is normally a lot less than would be appropriate by reference to the real benefit enjoyed by the employee, given that gross rateable values are generally much less than open market rents. Accordingly,

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100. Now section 145 ICTA 1988
101. Section 33(1) FA 1977, now section 145(1) ICTA 1988
102. Section 33(2) FA 1977, now section 145(2) ICTA 1988
103. Now contained in section 145(4) ICTA 1988
104. In section 62(5) FA 1976
105. [1976] STC 368

section 21 FA 1983 inserted section 33A into the FA 1977.[106] The new section imposed an additional charge where the cost of providing the living accommodation exceeds £75,000. The employee is deemed to receive an additional emolument equal to an amount found by applying the "official rate" used for beneficial loans to the excess of the cost over £75,000. An example will demonstrate that the new charge produces an additional emolument much more in keeping with the true benefit to the employee.

An employer provides accommodation to an employee at a cost of £175,000, the gross rateable value of which is £1,500. The deemed emolument under what is now section 145 ICTA 1988 would be only £1,500. However, the extra deemed emolument under the provisions now contained in section 146 ICTA 1988, taking an "official rate" of 16.5%, would be:

(£175,000 - 75,000) = £100,000 x 16.5% = £16,500.

Whereas the original charge under section 145 normally gives rise to a deemed emolument that is far too small when compared with the true benefit enjoyed by the employee, the section 146 charge can sometimes go the other way and impose what some might consider to be a penal liability on the employee. The section 146 charge is a very rough and ready one, depending on the extent to which the cost exceeds £75,000 and the "official rate" for the time being. The "official rate", in fact, varies greatly from time to time in response to variations in interest rates generally. For example, the "official rate" rose sharply from 9.5% on 5 August 1988 to 16.5% on 6 November 1989. Section 146 liabilities can alter substantially from year to year. All in all, the section 146 charge can be a real disincentive, in many case, to the provision of accommodation costing a lot more than £75,000 for employees.

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106. Now section 146 ICTA 1988

There is one area where the law is very unclear and where the Inland Revenue take a different view to a strong body of legal opinion. As often large sums are involved, this confusion is most undesirable.

It has been common for many years for an individual who is not domiciled in the UK but who is visiting the UK for a period, perhaps for business reasons, to purchase a property in the UK through a non-resident company, the shares in which are either held by the individual or, alternatively, by a non-resident trust of which he is a beneficiary. This is normally done to ensure that the UK property does not become liable to UK inheritance tax which would otherwise arise if he held the property personally. It is usual for the individual to be neither an employee nor a director of the offshore company. Often, however, it will be, in practice "his" company in that the non-resident directors can be expected to act in accordance with his instructions. Section 168(8) ICTA 1988, which applies to sections 145 and 146,[107] defines the term "director" as including "any person in accordance with whose directions or instructions the directors of the company..... are accustomed to act". Furthermore, section 168(2), which also applied to sections 145 and 146,[108] states that "employment" means "an office or employment the emoluments of which fall to be assessed under Schedule E; and related expressions shall be construed accordingly".

It is presumably for this reason that the Inland Revenue take the view that an individual who can directly or indirectly control the company which provides him with living accommodation is assessable under section 145 and 146. The Revenue's view is apparent from a letter

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107. See sections 145(8) and 146(10) ICTA 1988
108. Ibid

written by Mr T.J Painter of the Inland Revenue to the then President of the Institute of Taxation on 25th January 1989.[109] As mentioned above the Revenue's view is strongly disputed by many lawyers. It is not necessary to rehearse the arguments here: reference should be made to an article by Robert Venables of Counsel in "Taxation" magazine of 16 February 1989,[110] where the arguments are clearly set out. It is submitted that the analysis there set out is sound. The present writer is aware of an eminent tax QC who holds the same views as Venables.

This is obviously a very important matter, and the divergence of opinion makes it impossible for a taxpayer to know where he stands. It would be a simple matter for the legislation to be altered to make the situation clear; but the debate has been raging since at least 1984, when an article appeared in the Law Society Gazette,[111] highlighting the possible problems. There is no reason at all why this confusion should not be clarified by appropriate legislation at the earliest opportunity.

There have been schemes which attempted to place a benefit in the hand of employees by means of options to acquire living accommodation. One such scheme, involving the high street chain, Marks & Spencer, received extensive publicity in the national as well as the professional press. As a result, the Inland Revenue's attitude hardened considerably and such schemes came under increasing pressure. Their popularity waned rapidly under the firmer Revenue line.

In a typical case, a company might have a house worth £100,000. It would grant an employee an option to purchase it for £115,000 between, say, three and seven

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109. See "Taxation" magazine, 6 April 1989 p2
110. p468, "UK Homes of Foreign Domiciliaries"
111. 1st August 1984, p2203

years after the grant of the option. In the days of steeply rising house prices, the employee might be able to purchase the house after, perhaps five years when its value might be £150,000. This, it was argued, would give the employee a tax-free benefit of £35,000 based on the questionable premises that (a) when the option was granted, it was worth very little; and (b) on the purchase of the property, the purchaser acquired the accommodation as option-holder, not as an employee.

Although there were Counsel's opinions supporting this scheme, it could hardly be said to be watertight. In the first place, with a straightforward option as in the example given above, and in an environment of rapidly increasing house prices, the option almost inevitably had a substantial value. The average property speculator might well have looked on such an option as a very good investment.

As for the contention in (b), this was presumably based on <u>Abbott v Philbin, which is dealt with below.</u>
<u>The scheme was not, therefore, without its grey areas. Given the increased Revenue hostility to the scheme following the widespread publicity, the "Ramsay" principle originating in 1981, and the increased tax liabilities in section 33A FA 1977 (which came into operation in 1983), if the scheme failed, it was not surprising that interest in schemes such as this died out.</u>

<u>D. Scholarships</u>

<u>Section 20(1) FA 1983</u> inserted section 62A FA 1976[112] to

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112. See now section 165 ICTA 1988

deal with the gap left by the decision of the House of Lords in Wicks v Firth[113] to the effect that the exemption for scholarship income in section 375 ICTA 1970[114] extended to exempt the scholarship income from being a benefit assessable on a director or higher paid employee, where the recipient was a member of the director or higher-paid employee's family or household. Section 62A FA 1976 effectively prevents large employers setting up "in-house" scholarship schemes for children of employees.

113. [1983] STC 25
114. Now section 331 ICTA 1988

Employee Shareholdings

Of all the benefits legislation, that concerning employee shareholdings has been the most complicated. The situation has been exacerbated by the fact that this has become a politically sensitive subject with different Governments having varying attitudes towards employee share ownership. However, the basic pattern has been that perceived abuses have been attacked by legislation, sometimes involving complicated provisions; but some Governments have wanted to encourage employee share ownership. Accordingly, employees can sometimes acquire shares on beneficial terms, as long as they do it in a way sanctioned by the Government for the time being; but, outside the approved methods, attempts to benefit employees by way of shareholdings involve employers and employees picking their way through a minefield of legislation.

One of the reasons the legislation has become so complicated is that shares, by their very nature, are easy to manipulate and there are a number of ways they can be used to give benefits to employees.

It is sometimes a little difficult to see why shares provoke so much excitement among both the Government and employees where unquoted shares are concerned. Small holdings of shares in unquoted companies are normally not easy to sell and, accordingly, often have little real value. There is always the hope that a company might later obtain a listing, perhaps on the USM, and since 1981, companies have been able to purchase their own shares, but often the benefits of acquiring shares in an unquoted company are more apparent than real.

Nevertheless, it cannot be denied that, for whatever reason, shares have always been considered by employees to be an attractive perk; often no doubt because they like to think that, at least in a small way, the company is partly "theirs".

Interest in shares for employees began to grow in the 1950's and received a boost by a House of Lords decision in 1960. It had long been established that, if an employee is given shares or allowed to subscribe for them at an undervalue, he will be treated as receiving a taxable emolument equal to the amount by which the value of the shares exceeds the price he pays (if any). This was clear from the House of Lords decision in Weight v Salmon.[115] However, in the 1950's, employers began to use options to get round this problem, on the basis that, if an employee is given an option to purchase shares at, say, a price equal to the market value at the date of the grant of the option, if the value of the shares increased between the dates of the grant and the exercise of the option, the benefit accruing by the purchase at an undervalue was due to an increase in the employee's investment and so it was not a taxable emolument.

At first, this arrangement received something of a set-back in the courts. In the case of Forbes' Executors v IRC[116], Forbes was granted the right to acquire shares in two companies at par. He exercised that option in 1946 and he was assessed to income tax for the year 1946/47 on the difference between the par value of the shares and the price at which they could have been sold at the date of allotment. The Special Commissioners dismissed the appeal of Forbes' executors. When they appealed to the Court of Session, the executors only raised the question of when the taxable benefit arose, claiming that it should have been in 1944, when the option was granted; they did not dispute the size of the taxable benefit. The Court of Session held that the Commissioners' decision was correct.

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115. (1935) 19 TC 174
116. (1958) 38 TC 12

However, only two years later in Abbott v Philbin[117], the House of Lords came to a different conclusion, namely, that the profit obtained on the exercise of the option was obtained by virtue of the holding of the option and not by virtue of the employment.

As a result of this case was, not surprisingly share options grew in popularity and, again, not surprisingly, legislation was introduced to withdraw the tax advantages of such arrangements. Accordingly, the Abbott v Philbin decision was reversed by section 25 and Schedule 4 FA 1966.[118] This section stated that, where a person realises a gain by the exercise, assignment or release of a right to acquire shares obtained by him as a director or employee,[119] he is chargeable to tax under Schedule E on the difference between the market value of the shares at the date of acquisition and the price paid on the grant and the exercise of the option.

With this avenue closed, it did not take employers long to think up different ways of benefiting employees through the provision of shares. Two schemes were devised which, again, brought legislative counteraction, this time in 1972.

The first of these schemes had a similar effect to the option scheme but was not caught by the 1966 legislation. The employer allowed the employee to subscribe for shares on a partly paid basis on the understanding the company would not make any call for a period (approximating to the option period under the original scheme). During this period the employee would normally have had restricted dividend rights, but he would have obtained the benefit of any growth in the value of the shares.

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117. (1960) 39 TC 115
118. Now section 135 ICTA 1988
119. This refers to any employee, not just a higher paid employee.

The other main type of scheme that became common was for an employee to subscribe for fully paid shares, but their value would be depressed by the shares being subject to restrictions, such as limited dividend or voting rights, so that, although the employee paid the full price for the shares, their value at that time was less than if the restrictions had not applied. After a while, the restrictions would be lifted and the employee would obtain the benefit of the consequent increase in the value of the shares. Often, the purchase price for the restricted shares, or the partly paid shares in the first scheme, was provided by loans from the employer.

These schemes were attacked in 1972, the beginning of a period of great activity as regards employee shareholdings. In 1972, these schemes were stopped but, at the same time, largely for political rather than fiscal reasons, certain types of approved schemes were allowed to escape the charges. In the following year, the rules concerning unapproved schemes were tightened up and, in 1974, again due to a shift in politic thinking, the approved scheme rules were to reappear a few years later when the politicians once again changed their minds.

Section 79 FA 1972[120] contained the provisions attacking the above schemes. These provisions were, to say the least, far from being the model anti-avoidance legislation. The drafting was complicated and at times obscure, there were traps for the innocent taxpayer, and there were opportunities for the well-advised avoider to side-step the charges imposed by this legislation.

These provisions attempted to counter the schemes mentioned above by imposing an income tax charge on the

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120 Later to become sections 138-9 ICTA 1988, and now repealed by section 88 FA 1988 and replaced by the provisions of sections 77-89 ibid.

increase in the value of shares acquired by a person in pursuance of a right conferred on him or opportunity offered to him as a director or employee of that or any other company. The amount charged to income tax was the increase in the value of the shares in the period beginning with the date of acquisition by the employee and ending at the earliest of three alternative dates:

(i) the date of disposal by the employee;

(ii) the date when any restriction were lifted; or

(iii) seven years from the date of acquisition by the employee.

These provisions could work very unfairly. They caught, for example an employee who purchased shares at their proper open market value, and who then saw his shares increase in value because the genuine commercial factors rather than through the operation of any avoidance arrangements.

On the other hand, it did not take those who did want to avoid the charges long to think up effective way of doing so. For example, schemes were devised to trigger the section 79 charge by imposing minor artificial restrictions which were then lofted, thus attracting a small section 79 charge. Once the machinery had operated, it was effectively spent and could not catch the more substantial manipulation that occurred later. Another scheme involved an employee purchasing some unrestricted shares at their proper open market value and then have a bonus issue to give him more shares. The bonus shares were not acquired in pursuance of a right conferred on him as an employee but in pursuance of his status as a shareholder.

The effect of section 79 and also of the share option legislation which, as mentioned above, was introduced in 1966, was for a time mitigated by Schedule 12 FA 1972 which contained rules for approved schemes, giving exemption from both capital gains tax on increased in the value of employee shares acquired within the terms set down for approval. It was not necessary to consider these approved schemes because they were very soon abolished: in 1974 these rules for approved schemes were repealed, leaving the full force of section 79, as tightened up by Schedule 8, FA 1973[121] to operate. Similarly, the share option scheme rules, first introduced in 1966 and, at the time, contained in section 186 ICTA 1970, came back into prominence.

To ease the rigours of section 79, there were certain exemptions. The two main ones were as follows:

1. The majority of the shares not held by an associated company were acquired otherwise then as director or employees and any restrictions applied to all shares of the same class.[122] Such shares were less likely to have been issued for tax avoidance reasons and the opportunities for manipulation were restricted.

2. The majority of the shares of the same class which were not held by an associated company were acquired by directors or employees who controlled the company, and any restrictions applied to all shares of the same class. This exemption was introduced in 1973 to cater for employee-controlled companies.[123]

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121. Which brought within section 79 restrictions imposed by a collateral agreement.
122. Section 79(2)(c)(i) FA 1972
123. Section 79(2)(c)(ii) ibid; section 19 and Sch 8 para 4, FA 1973.

Despite these exemptions, section 79 remained a problem for many people, usually those who were unaware of its effects, unless they took advantage of one of the three "approved" schemes introduced in 1978, 1980 and 1984.[124]

Those taxpayers who were fully conversant with the workings of the section usually avoid being caught by it, either by engineering a situation in which one the exemptions applied or by using an arrangement that was not caught by the section such as the two mentioned above, which were not, infact, stopped until 1986.[125]

These provisions, which, on the 1988 consolidation, became sections 138-9 ICTA 1988, were finally repealed and replaced in 1988. Chapter II, Part III, FA 1988 applies to shares acquired on or after 26 October 1987. These provisions are much fairer because they restrict the income tax charge specifically to increases in the value of shares attributable to "chargeable events" such as the manipulation of rights or restrictions attaching to shares.[126] Accordingly, innocent taxpayers are largely protected because they are much less likely to trigger a chargeable event in their normal commercial activities than before; and also because increases in the value of shares nor attributable to manipulations of shares are not caught.

The 1988 provisions contain a separate charge for shares in "dependent subsidiaries". A subsidiary is a dependent subsidiary for a period of account unless, throughout that period, the whole or substantially the whole of the company's business is carried on with persons who are not fellow group companies. Furthermore, during that period

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124. Infra
125. Section 26 FA 1986
126. See section 78(2)(4)(5) FA 1988

there must be no increase in the value of the company as a result of intra-group transactions or that any increase does not exceed 5%.[127] A charge arises on any increase in the value of the shares in a dependent subsidiary that are acquired by a person as a director or employee.[128] As the value of a dependent subsidiary's shares can be manipulated by controlling the flow of business through it, the reason for this charge can be seen.

The new provisions are much fairer and less liable to lead to unjust results than the thoroughly unsatisfactory section 79 FA 1972.

In any case, a number of factors have made the employee share legislation much less important than it used to be. The approved share option schemes introduced in 1984[129] and, to a lesser extent the approved profit sharing schemes dating from 1978[130] and the savings-related share option scheme introduced in 1980[131] mean that, often companies can achieve their objectives within one of the Inland Revenue approved schemes to which the various anti-avoidance provision do not apply. Furthermore, with the income tax rates being brought into line with capital gains tax rates, the disadvantages of having an income tax liability imposed is not so great as they once were. There is a timing difference which can be substantial and, with a capital gains tax liability, there may be exemptions and indexation relief to reduce the ultimate tax liability, yet the parity of rates has meant that unapproved share schemes are growing substantially in number.

Two other anti-avoidance provisions should be mentioned here. A liability to Schedule E might arise on the grant

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127. Section 86 ibid
128. Section 79 ibid
129. Section 38 and Sch 10 FA 1984
130. Sections 53-61 and Sch 9 FA 1978
131. Section 47 and Sch 10 FA 1980

of an option if it is capable of being exercised more than seven years after it has been obtained. The charge arises to the extent that the value of the option being not less than the excess of the market value of the shares at the date of grant, over the price of those shares under the option. If a liability to income tax arises on the exercise of the option, credit is given for the tax paid on the grant.[132] These provisions do not often apply in practice and the value of an option when it is granted is usually very low in any case. Unlike section 79 FA 1972, these rules have not been a significant factor in shaping employers' policy over employee shareholdings over the past two decades.

The final anti-avoidance provision to consider in relation to employee shareholdings is part of the directors and higher paid employee legislation. This provision was originally section 67 FA 1976 and is not section 162 ICTA 1988. It is aimed at two situations; partly paid shares, and certain "stop loss" and other arrangements for the disposal of the shares.

The first situation in which the section applies is where a director or higher paid employee or someone about to the employed in such a capacity, acquires shares at an undervalue.[133] Shares are acquired at an undervalue if the amount paid up shares of the same class.[134] As shares issued at an undervalue are caught under the normal Schedule E rules,[135] section 162 applies only to the unpaid amount on the shares and that unpaid amount is treated as a national loan under the beneficial loan provisions of section 160.[136]

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132. Section 77 FA 1972, now section 135(2)(5) ICTA 1988
133. Section 162(1) ICTA 1988
134. Section 162(2)(b) ibid
135. Weight v Salmon supra
136. Supra

The second situation in which the section applies is where a director or higher paid employee acquires shares in that capacity and later disposes of them for a consideration exceeding their market value. The excess consideration is treated as an additional emolument. This charge arises whether or not the shares are originally acquired at an undervalue. Thus, a "stop-loss" arrangement, whereby the employee receives a stated consideration even if the value of the shares has fallen below that figure, is caught under section 162.

With employee shareholdings being such an emotive topic on which the two main political parties tend to have widely different views, it would probably be naive to think that the present fairly benign attitude to share schemes will continue indefinitely. If, in the next few years, a government of a different political complexion, for example, increases income tax rates as compared to capital gains tax rates, and withdraws or restricts the approved schemes, particularly the 1984 approved share option scheme, taxpayers might once again have to face up to complex and obscure legislation if they are to provide benefits through employee shareholdings.

CHAPTER 8

THE AVOIDANCE OF CAPITAL GAINS TAX

INTRODUCTION

Since its introduction in 1965, capital gains tax has generated a great deal of activity in the tax avoidance field and the Legislature and the courts have had a busy time trying to cope with the ingenuity of taxpayers and their advisers. Many of the most artificial and provocative tax avoidance schemes have been those attempting to avoid a capital gain or, more often, to generate a capital loss to set against a separate gain. The "new approach" of the courts to tax avoidance[1] was initially built around CGT cases.

It is not just in the area of complicated and artificial schemes involving large amounts of money that taxpayers have sought to exploit the CGT rules to avoid tax; there have been many areas where avoidance has been attempted on a much more modest scale. These arrangements too have generated couteracting legislation.

The trouble appears to have been that CGT was introduced as a completely new code in 1965; it was not built on the foundations of any previous legislation[2] or case law. The structure of the tax is itself very artificial and there is a very large number of deeming provisions and notional disposals. Because of the artificial nature of the tax avoidance devices often have themselves to be artificial to achieve their intended results. Some of the cases dealt with below involve schemes of great complexity, as artifice was built on artifice in a bewildering way.

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1. See Chapter 11
2. Although there had, of course, been provisions relating to short-term gains in the FA 1962

In W.T. Ramsay Ltd v IRC[3], Lord Wilberforce said:

> "The capital gains tax was created to operate in the real world, not that of make-belief ... It is a tax on gains ... it is not a tax on arithmetical differences"[4]

It is barely credible that a judge of Lord Wilberforce's experience and knowledge of taxation can have said this about a tax built around notional disposals, deeming provisions and artificial calculations; the CGT code contains some of the most unreal provisions in the whole of UK taxation.

In this Chapter the various ways taxpayers have used to exploit the CGT code, and the measures taken to stop them, are examined. It will be seen that sometimes arrangements have been implemented to avoid or reduce the CGT on a disposal, and other arrangements have attempted to produce an allowable loss that can then be set-off against a separate gain.

In this Chapter, corporation tax on capital gains made by companies will be incorrectly, but for ease of reference called as "CGT".

No reference will be made in this Chapter to the tax on short-term capital gains which was introduced by the FA 1962 and which operated from 1962/63 onwards until abolished for 1971/72 and subsequent years.[5] Such gains were assessable to income tax under Schedule D, Case VII. The legislation obviously did contain anti-avoidance provisions[6] some of which have parallels in the CGT

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3. (1981) 54 TC 101
4. p187
5. Section 56 FA 1971
6. See, for example, section 14 FA 1962 relating to gains on disposals of shares in land-owning companies

legislation[7], but the charge was not in operation for long enough for any significant body of case law to be built up, or for the provisions to have a major impact on the tax avoidance field.

In this Chapter the avoidance of CGT is dealt with in two Parts. In Part 1 certain general rules are considered and, in Part 2, the specific rules relating to companies and shares are examined.[8]

The CGT provisions with an overseas element, concerning such matters as non-resident trusts and companies are dealt with in Chapter 9.

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7. See, for example, section 12(3) FA 1962 (bargains not at arm's length); para 17 Sch 9, ibid (associated transactions treated as a single bargain), para 6, Sch 9 ibid (disposals to a controlled company); and section 18 FA 1965 (disposals of sets of articles)
8. The "Ramsay" principle, as in applies to CGT, is dealt within Chapter 11.

PART 1

GENERAL RULES

Transactions Not at Arms Length

It was provided in section 22(4) FA 1965 that:

> "... a person's acquisition of an asset and the disposal of it to him shall for the purposes of ... the Act be deemed to be for a consideration equal to the market value of the asset -
>
> (a) where he acquires the asset otherwise by way of a bargain made at arm's length and in particular where he acquires it by way of gift ..."

This section became, on consolidation, section 19(3) CGTA 1979. It should be noted that section 22(4) referred to both an acquisition and disposal. This aspect of the section was considered in Harris on v Nairn Williams Limited[9]. Although the decision in both the Chancery Division and the Court of Appeal went in the Revenue's favour, it was subsequently turned against the Revenue by taxpayers in one of the pre-packaged and widely marketed schemes available prior to the adoption of the " new approach" to tax avoidance by the courts.[10] This scheme[11] was known, not surprisingly, as the "Reverse Nairn Williamson" scheme. This scheme lead directly to the repeal of section 19(3) CGTA 1979 and the substitution of section 29A ibid.[12]

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9. (1977) 51 TC 135
10. See Chapter 11
11. In fact, there were two basic schemes using the same principle, infra
12. Section 90(1)(3)(4) FA 1981

The facts of the case were that the taxpayer company was, at the time of the relevant transactions, called Nairn & Williamson (Holdings) Limited. It was the parent company of a group which included a wholly-owned trading subsidiary then called "Nairn-Williamson Ltd." ("Nairn"). In 1964, Nairn bought all the ordinary shares of another trading company, Tercol Ltd, for £13,176 on terms which included making Tercol a loan of £94,640 to enable it to repay a loan from the vendor. Over the next three years, Tercol borrowed from Nairn another £114,360, making a total of £210,000. Losses were created in the hands of the taxpayer company as a result of the following transactions:

(i) the creation by Tercol of £250,000 5% unsecured loan stock;

(ii) the sale by Nairn to the taxpayer company of its ordinary shares in Tercol at cost, namely, £13,176; and

(iii) the issue by Tercol to the taxpayer company of £210,000 loan stock for cash which Tercol immediately applied in repaying the loan from Nairn.

Although the taxpayer company ostensibly spent £223,176 to acquire the shares and stock of Tercol, it was agreed that the market value of the shares and stock at that time was only £72,500. Four months later, Tercol reorganised its capital structure so as to convert the loan stock into preferred shares. The taxpayer company then sold the resulting reconstituted assets to the third part, at arm's length, for £40,000, of which £39,900 was in respect of the preferred shares.

The taxpayer company claimed on allowable loss on the disposal of the preferred shares of the difference between £210,000 and £39,900. This claim was rejected by the Revenue. The taxpayer company appealed to the Special Commissioners contending:

(i) that it had acquired the stock of £210,000;

(ii) that neither 22(4)[13], nor paragraph 17 of Schedule 7, FA 1964[14], applied because there was no disposal of the stock by Tercol corresponding to the acquisition by the taxpayer company.

The Crown agreed that paragraph 17 of Schedule 7, FA 1965 did not apply but contended:

(i) that the taxpayer company's acquisition of Tercol's shares and stock by three connected transactions with the object of creating allowable losses for the taxpayer company was a single exercise not made at arm's length;

(ii) that section 22(4) applied to the taxpayer company's acquisition of the shares and stock which was deemed to have been "for a consideration equal to the market value", namely £72,500 either

(a) because the subsection applied equally to the case where an acquisition by an acquirer was not matched by a corresponding disposal as to the case where an acquirer's acquisition of an asset coincided with a disposal by the disposer, or, alternatively,

(b) because the word "disposal" in the subsection was a simple counterpart to "acquisition".

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13. Later section 19(3) CGTA 1979, now repealed
14. Now section 62 CGTA 1979, infra

The Special Commissioners rejected the Crown's arguments and allowed the taxpayer company's appeals.

Goulding J, in the High Court, reversed the decision of the Special Commissioners on the ground that the Crown's contention set out at (ii)(a) above was correct, namely, that section 2(4) applied to any acquisition, whether or not matched by a corresponding disposal.

This decision was affirmed by the Court of Appeal which held that:

(a) the provisions of paragraph 17 of Schedule 7 were of no help in construing section 22(4); and

(b) the Crown's construction of section 22(4) was to be preferred to that of the taxpayer company.

Of section 22(4), Goff LJ said:

> "The section deals with two matters, acquisition and disposal. If there be no disposal, it simply does not bite on the second limb ... The words clearly and categorically provide for the case of an acquisition which is not at arm's length, and, it would be very odd indeed if it were held to apply only provided there be also a disposition. Issue of assets, not involving a disposition by the company issuing them, at an inflated price is the most obvious way of tax evasion[15], and I accept [Counsel for the Crown's] argument that the scheme of the Act should lead one to construe section 22(4) as covering such a case if the language permits, as I think it does, of such a construction."[16]

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15. The judge must have meant "avoidance" rather than "evasion" here.
16. p149. See also Buckley LJ at p147

This decision, which was clearly correct on the wording of section 22(4), was turned against the Revenue by taxpayers who seized upon the principle that, where there is a bargain otherwise than at arm's length, the actual consideration was to be ignored in favour of market value. Whereas in the Nairn Williamson case the higher actual consideration was ignored in favour of the lower market value, the "Reverse Nairn Williamson" schemes operated on the principle that a lower actual consideration would have to be ignored in favour of a higher market value.

Based on this rule, two types of "Reverse Nairn Williamson" scheme were widely marketed prior to 1981, when they were stopped by a combination of a change in the legislation and, in connection with arrangements already implemented but in relation to which the tax liabilities had not been agreed with the Revenue, by the decision of the House of Lords in the Ramsay case.[17]

The first type of scheme was straightforward and was used, for example, where shareholders held shares in a company standing at a substantial gain, which they wanted to sell. They would be issued with new shares at par. When they subsequently sold their complete holdings, comprising both the original and the new shares, the acquisition cost for CGT purposes included the market value of the new shares; not just their par value.[18]

The second type of arrangement was more artificial and its object was to create a capital loss that could then be set against a separate capital gain. This version of

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17. <u>W.T. Ramsay Ltd v IRC</u> (1981) 54 TC 101; see Chapter 11.
18. In practice, the new shares were not issued to the shareholders in the same proportions as the old shares, to ensure that the "reorganisation" provisions in sections 77-81 CGTA 1979 did not apply so as to substitute par for market value: Section 79(1) ibid.

the scheme was widely marketed in a pre-packaged format with documentation already drafted, off-the-shelf companies ready, and the temporary finance available if the taxpayer did not have sufficient resources to put the various steps into operation.

A simplified example will show the basics of the scheme. A taxpayer had already made a capital gain of £10,000 on which he would, in due course, have to pay CGT. He therefore wanted to generate a "loss" of the same amount in the same tax year to eliminate his liability. He therefore incorporated or bought a new company with a share capital of 2,011 £1 ordinary shares. He subscribed for 11 £1 shares at a premium of £999 each. He was then allotted 1,000 more shares at par. If the company was then liquidated, the company would be worth only £11,000 + £1,000 = £12,000. The base cost of the new shares would be their market value, namely:

$$\pounds 12{,}000 \times \frac{1{,}000}{1{,}011} = \pounds 11{,}870$$

If this was added to the cost of the original shares (£11,000), the taxpayer would have made a capital loss of £10,870; more than enough to eliminate his capital gain. Usually, of course, the sums involved were much larger than in this example and there was a danger that the Exchequer would lose a great deal of tax. Accordingly, the legislation was amended with effect from 10th March 1981. Section 90 FA 1981 repealed section 19(3) CGTA 1979[19] and replaced it by section 29A ibid.

Section 29A starts by saying that market value is to be used instead of actual consideration where there is a disposal otherwise than by way of a bargain at arm's length[20], but then says that this rule will not apply to

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19. Previously section 22(4) FA 1965
20. Section 29A(1)(a) CGTA 1979

the acquisition of an asset if there is no corresponding disposal of it, and there is no consideration or the consideration is lower than the market value of the asset.[21] This meant that, in a "Reverse Nairn Williamson" scheme, the acquisition of the new shares would be deemed to have been for the consideration actually paid. It should be noted, however, that the decision in the Nairn Williamson case itself is still good law because, there, the consideration given exceeded the market value.

These changes killed the "Reverse Nairn Williamson" schemes immediately, and no such manipulation has been possible since 10th March 1981. In any case, by coincidence, two days after the provisions of section 29A came into operation, the House of Lords handed down their judgement in the Ramsay case.[22] As will be seen from the analysis of this case and the principle it created in Chapter 11, the more artificial, second type of "Reverse Nairn Williamson" scheme described above would undoubtedly have failed in the courts, being a pre-ordained series of transactions including steps inserted solely for tax avoidance purposes.

On the other hand, the more straightforward first type of scheme would still have succeeded as long as the shareholders had not reached a stage where there was no practical likelihood that a deal with a specific purchaser would not go through. Merely setting up the desired share structure with the intention of finding a purchaser would not have fallen foul of the "new approach" as subsequently clarified by the House of Lords.[23] Such considerations were, however, rendered academic by the replacement of section 19(3) by section 29A.

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21. Section 29A(2) ibid
22. W.T. Ramsay Ltd v IRC (1981) 54 TC 101
23. This is analysed in depth in Chapter 11

That part of section 29A aimed at the "Reverse Nairn Williamson" type of case was, then, wholly successful in its objective of preventing a blatant and widely used avoidance device. By contrast, the section also originally contained an ill-thought out and badly drafted provision which applied to an acquisition, either for no consideration or for a consideration lower than market value, from an "excluded person". The term "excluded person" encompassed persons outside the charge to CGT, such as persons neither resident nor ordinarily resident in the UK, and charities.[24]

In the case of an acquisition from an "excluded person", the market value rule in section 29A(1) was excluded and the actual consideration, if any, was taken as the acquisition cost.[25] The obvious intention of this provision was to prevent a person obtaining a base cost above the amount of consideration paid through an acquisition from someone outside ambit of CGT.

The "excluded person" provisions were unpopular and unnecessary and they were repealed with effect from 5th April 1983[26] so that the market value rule applies to acquisitions from an excluded person, unless there is no corresponding disposal. It is not intended to analyse these short-lived and unimportant provisions relating to acquisitions from "excluded persons" further here.

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24. Section 29A(5) CGTA 1979
25. Section 29A(2)(a), ibid, as originally enacted. There was an exception for certain tangible movable property and currency: section 29A(4) as originally enacted.
26. Section 66 FA 1984

Transactions Between Connected Persons

When the original CGT legislation was being enacted it was appreciated by Parliament that there was a great deal of scope for manipulation in disposals between members of a family and between other persons between whom there is a close connection. The provisions relating to bargains not at arm's length covered some of the anticipated abuses but even tighter provisions were introduced relating to transactions between "connected persons".[27]

Where there is a transaction between persons within this wide category of persons, it is enacted that:

> "Without prejudice to the generality of section 29A above the person acquiring the asset and the person making the disposal shall be treated as parties to a transaction otherwise than by way of a bargain made at arm's length."[28]

Accordingly, the actual consideration passing is not taken into account for CGT purposes, but the market value is used instead. It should be noted that the wording of the subsection requires there to be a person acquiring the asset "and" an person making the disposal: if there is an acquisition but not a disposal, such as on a subscription for shares in a company, section 62(2) cannot apply. Section 29A, however, could well apply in such circumstances.[29]

Goff LJ in the Nairn Williamson case[30] compared the predecessor of section 62[31] with the predecessor of

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27. As defined in para 21 Sch 7 FA 1965; now section 63 CGTA 1979.
28. Section 62(2) CGTA 1979
29. Supra
30. Harrison v Nairn Williamson Ltd (1977) 51 TC 135; supra
31. Para 17, Sch 7 FA 1965

section 19(3)[32] which, as mentioned above, was replaced by section 29A. He said:

> "The point on paragraph 17 is that that paragraph is, as indeed it is, limited to cases where there is both an acquirer and a disposer, and paragraph 17 (2)[33] provides that without prejudice to the generality of section 22(4) of the Act, the person acquiring the asset and the person making the disposal should be treated as parties to a transaction otherwise than by way of a bargain made at arm's length.
>
> In my view, however, paragraph 17(2) was inserted, not to save the operation of section 22(4) as being wider in the sense of not requiring that there should be any disposition, but as being wider in that it covers cases where the lack of bargaining at arm's length is proved as a fact, whereas under paragraph 17, it is presumed.
>
> Paragraph 17 is dealing with a limited class of cases in which the lack of bargaining at arm's length is presumed, and irrebuttably presumed. That class of cases necessarily involves having both an acquisition and a disposal, because it is dealing with cases where a person acquires an asset and is connected with the person from whom he acquired it."[34]

Section 62(3) contains a further anti-avoidance provision relating to transactions between connected persons. That subsection states that a loss made on a disposal to a connected person is not deductible except from a chargeable gain accruing to the transferor on some other

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32. Section 22(4) ibid
33. Now Section 62(2) CGTA 1979
34. p150

disposal to the same connection person.[35] It is easy to see why this provision was needed. If it had not been enacted, a person could generate capital losses to set against other gains by disposing of any assets standing at a loss to, say, a close relative. However, this rule often catches taxpayers who have no thought of avoiding tax.

Originally there was an exception for gifts to charities[36] but this became otiose when it was enacted in 1972 that gifts for charitable purposes are to be made on a "no gain, no loss" basis[37] because, obviously, the transferor cannot make a loss to which the section 62(3) restriction can operate.

The next restriction in section 62, in subsection (4), concerns options. Where a person acquires an option from a connected person, a loss on a later disposal of that option is not an allowable loss unless it accrues on a disposal of that option on a disposal at arm's length to a person who is not connected with him. Again, it is clear to see the sense in this provision. A disposal of an option to a connection person could easily be exploited to produce an artificial loss.

Section 62 also has special rules relating to restrictions. These can be found in subsection (5). The reason for this provision is that a restriction can be placed on as asset which would greatly reduce the value of that asset even though the restriction itself would have a limited value, or at least a value of significantly less than the drop in the value of the asset by reason of the imposition of the restriction.

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35. Subject to an exception in respect of gifts in settlement for educational, cultural or recreational purposes: proviso to section 62(3) CGTA 1979
36. Para 12, Sch 19 FA 1969
37. Section 119(2)(a) FA 1972; now section 146(2)(a) CGTA 1979.

Therefore, a person with a valuable asset standing at a substantial gain could arrange for a connected person to impose a restriction which would reduce the value of the asset, which restriction would later be lifted.

Accordingly, it is provided by subsection (5) that, where a person acquires an asset from a connected person and the asset is subject to any right or restriction enforceable by the person making the disposal, or by a person connected with him, then, where the amount of the consideration is deemed to be equal to the market value by virtue of subsection (2), that market value is taken to be:

(a) what its market value would be if not subject to the right or restriction, minus

(b) the market value of the right or restriction or the amount by which its extinction would enhance the value of the asset to its owner, whichever is the less.

The subsection further states that, if the right or restriction is of such a nature that its enforcement might effectively destroy or substantially impair the value of the asset, without bringing any countervailing advantage, either to the person making the disposal, or a person connected with him, or is an option or other right to acquire the asset or, in the case of incorporeal property, is a right to extinguish the asset in the hands of the person giving the consideration, that market value is determined as if the right or restriction did not exist. Although the wording of this part of the subsection is rather complicated, the reason for it is clear if it is considered that an unconnected third party would not dream of acquiring an asset subject to the kind of restrictions referred to unless he was sure that the restriction would not be enforced or that it would be removed. Consequently, it is only right that no account should be taken of the restriction in determining the market value of the asset.

The operation of the two parts of section 62(5) can best be seen by considering two examples. Whiteman and Wheatcroft on Capital Gains Tax[38] gives a couple of particularly clear examples,[39] which are set out below.

The following is an example of the first part of the subsection:

> A owns two adjoining plots of land, Blackacre and Whiteacre, each of which, although undeveloped, has the benefit of planning permission for the erection of eight dwelling-houses. A decides to keep Blackacre and to give Whiteacre to his son B. However, before giving Whiteacre to B, A imposes a restrictive covenant on Whiteacre in favour of the owner of Blackacre, whereby no houses or any other buildings may be erected on Whiteacre. B accepts the gift on that basis. Whiteacre with the benefit of planning permission is valued at £150,000, but subject to the restrictive covenant at only £20,000. The market value of the restrictive covenant is £40,000. On the gift of Whiteacre to B, A is deemed to dispose of the land for £150,000 less the lower of £40,000 (the market value of the restriction) or £130,000 (the amount by which the extinction of the restrictive covenant would enhance the value of the land). The market value would therefore be £110,000 (£150,000 less £40,000).

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38. Third edition (1980)
39. pp 168-9

The second part of the subsection can be demonstrated by the following example:

> In 1970 A acquired 1,000 ordinary shares in X Ltd, constituting the entire issued share capital of the company. In 1975 the value of X Ltd was estimated to be £100,000 (£100 per share). In that year, A granted his son, B, an option to acquire all the shares in the company at £110 per share, the option to be exercisable at any time during the following seven years. In 1981, when the shares were valued at £150 each, B exercises his option in respect of each share. For CGT purposes, A is deemed to disposal of, and B to acquire each share for £150.

The final point to note in connection with subsection (5) is that it does not apply to a right of forfeiture or other right exercisable on breach of a covenant contained in a lease, or to any right or restriction under a mortgage or other charge.[40] It would clearly be inappropriate to ignore such commercial restrictions.

Section 62 is throughout a provision in which the intended targets are clear but it does catch transactions between connected persons even if they are not implemented for tax avoidance reasons. On the whole, however, the need for such provisions is clear, to prevent some obvious avoidance devices.

As well as the specific rules in section 62, there are certain other provisions relating to transactions between connected persons which will be dealt with below: such as section 71 FA 1985 (assets disposed of in a series of transactions), section 75 CGTA 1979 (shares in a close company transferring assets at an undervalue) and section 346 ICTA 1988 (capital distributions of chargeable gains).

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40. Section 62(6) CGTA 1979

Assets Disposed of in a Series of Transactions

The CGT legislation has always contained provisions which take into account the fact that often a number of articles valued together are worth more than the sum of their individual values. A "set" is perhaps the most obvious manifestation of this. For example, a complete stamp collection, or set of silver cutlery or of antique chairs will almost invariable be worth more than the total values of the items in the set valued independently.

The principle, however, has a wider relevance than being merely concerned with sets. For instance, a leasehold interest in land and the freehold reversion, valued separately will, in total, be worth less than the unencumbered freehold of the land.

The FA 1965 therefore took into account the fact that a person might seek to reduce the taxable value of an asset by fragmenting the disposal and having a series of disposals of the individual constituent parts.

The main provision to deal with this was originally paragraph 16, Schedule 7 FA 1965, later consolidated as section 151 CGTA 1979. Unfortunately, this provision was badly drafted and sufficient thought was not given to the various methods taxpayers could use to exploit the fragmentation principle.

The original legislation said simply this:

> "If a person is given, or acquires from one or more persons with whom he is connected, by way of two or more gifts or other transactions, assets of which the aggregate market value, when considered separately in relation to the separate gifts or other transactions, is less than their aggregate market value when considered together, then for the

purposes of this Act their market value, where relevant, shall be taken to be the larger market value, to be apportioned rateable to the respective disposal."[41]

It can be seen that this provisions concentrated on the donee: it had to be the same donee for the section to operate.[42] A person could easily avoid the section, for example, by giving one item to a husband and the other to his wife. The section also gave no guidance on what was to happen in a number of important situations, such as when a donee receives the separate items at different times and the values of the assets have altered in the meantime.

The Inland Revenue issued a Press Release on 27th December 1984 in which they said that only transactions within two years prior to the latest one would be linked in a series. Prior to this Press Release, the Revenue did not consider that there was any time limit, as indeed there was not, and they even took the view that transactions occurring before CGT came into effect on 6th April 1965 could form part of the series.

This unsatisfactory section was replaced, in respect of transactions made after 19th March 1985, by section 71 and Schedule 21 FA 1985. These provisions, which are altogether more detailed, switched the emphasis to the transferor. The transferor has to be the same person but the donees can be different, as long as the donor is connected with each of them.

The transactions in the series must also be within a certain time period if they are to be aggregated. Basically, a series includes the last of the linked transactions made within the series in the previous six

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41. Section 151 CGTA 1979
42. Although there could be different donors as long as the donee was connected with each of them.

years,[43] although a particular transaction can be part of more than one series, with the beginning of one and the ending of the other being more than six years apart.

Having established the transactions in the series, it is then stated that where the "original market value" of the assets disposed of by any of the transactions in the series is less than the "appropriate portion" of the "aggregate market value" of the assets disposed of by all the transactions in the series, the disposal effected by any linked transaction in the series is deemed to be for a consideration equal to the "appropriate portion"[44]

The "original market value" is determined as follows:

(1) In the case of the last transaction in a series, it is the market value which, apart from the operation of section 71, would be deemed to be the consideration for that transaction for CGT purposes.

(2) In the case of the other transactions in the series, it is the value which, prior to the most recent transaction in the series, would have been deemed for CGT purposes to be the consideration for the transaction concerned (either under the general CGT rules or under section 71).[45]

The "aggregate market value" is defined as a reference to what would have been the market value of all the assets disposed of in the series for CGT purposes if, considering all the assets together, they had been disposed of by one disposal occurring at the time of the

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43. Section 71(3) FA 1985
44. Section 71(1)(b) ibid. This section does not affect the amount of consideration deemed to be given in a disposal between husband and wife: section 72(2) ibid
45. Para 2, Sch. 21 ibid

transaction concerned.[46] It is further stated that any reference to the "appropriate portion" of the "aggregate market value" of the assets disposed of in the series is a reference to that portion of the aggregate market value which it is reasonable to apportion to those of the assets which were actually disposed of by the transaction concerned.[47] This last provision is curiously imprecise when compared with the amount of detail in the rest of section 71 and Schedule 21.

There are special rules for groups of companies. Inter-group transfers[48] are not treated as part of a linked series of transactions. Where an asset is transferred through a number of group companies before being transferred outside the group, that transfer is treated as having been made by the first group company and linked with any other transactions made by that first company within the relevant time period.[49] Without this particular anti-avoidance provision, a company could prevent separate disposals being linked by channelling each through a different group company.

Section 71 and Schedule 21 FA 1985 form a much more satisfactory code than section 151 CGTA 1979 which was brief, vague and far too easy to avoid. The present provisions, being restricted to fragmented transactions between connected persons tend not to interfere with genuine commercial transactions between parties at arm's length; while at the same time, they make it very difficult for connected persons to avoid CGT by fragmenting disposals.

Another provision relating to sets of articles was section 30(4) FA 1965, now Section 128(4) CGTA 1979 which concerns the chattel exemption. This subsection seeks to

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46. Para 3(1)(a) ibid
47. Para 3(1)(b) ibid
48. Within section 273 ICTA 1970: section 71(6) FA 1985
49. Section 71(7) ibid

prevent a person taking advantage of the chattel exemption, which currently stands at £3,000, where he has a set worth more than that, by fragmenting their disposal. Accordingly, section 128(4) states:

> "If two or more assets which have formed part of a set of articles of any description all owned at one time by one person are disposed of by that person, and -
>
> (a) to the same person, or
>
> (b) to persons who are acting in concert or who are connected persons,
>
> whether on the same or different occasions, the two or more transactions shall be treated as a single transaction disposing of a single asset".

It can be seen that, unlike section 71 FA 1985, this provision actually refers to a "set of articles", although it makes no attempt to explain what this means, presumably on the basis that, like the elephant, it is easy to recognise, but not easy to describe. In practice, this does not lead to many problems: it is normally obvious whether a collection of articles forms a "set" or not.

Hold-Over Relief Restrictions

When the general hold-over relief for gifts was introduced in 1980[50] and extended in later years, it was only available where the donee was either resident or ordinarily resident in the UK.[51] The reason for this was clear: if hold-over relief was available on a disposal to a donee who was neither resident nor ordinarily resident in the UK, the donee could then have made a further disposal eliminating the gain completely for CGT purposes because he would not be within the charge to CGT.[52]

Given that this sensible restriction was placed on the original hold-over legislation, it is surprising that those preparing the hold-over legislation failed to make provision for the simple expedient of the donee emigrating after he had received the asset which had been transferred to him under a hold-over claim. The danger of this being exploited would have been much greater after 5th April 1981 when hold-over relief was extended to cover gifts to trustees [53], due to the ease with which trusts can be exported.[54]

Section 79 FA 1981, however, dealt with this obvious gap in the legislation. This section provides that, if the donee has not disposed of the asset by the time he emigrates, a chargeable gain shall be deemed to have accrued to the donee immediately before his emigration, equal to the held-over gain[55]. There is a six year time limit in the case of individuals, so that there is no clawback of relief if the emigration occurs more than six

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50. Section 79 FA 1980
51. Section 79(1) ibid. The same was true of the relief for gifts of business assets: section 126(1) CGTA 1979
52. Section 2(1) CGTA 1979
53. Section 78(1) FA 1981
54. See Chapter 9
55. Section 79(1) FA 1981

years after the end of the year of assessment in which the donee acquired the asset under the hold-over relief.[56] There is no limit where the donees are trustees.

The chargeable gain is deemed, by subsection (1), to accrue to the transferee, but it was foreseen that there could be real problems in actually collecting the tax from a person who is neither resident nor ordinarily resident in the UK. Accordingly, it is provided that where the tax is not paid within twelve months of it becoming payable, the transferor may be assessed and charged to all or any part of the tax,[57] although no assessment can be made more than six years after the end of the year of assessment in which the relevant disposal was made.[58]

To cover temporary periods of non residence and non-ordinary residence caused by reason of the donee's employment, there is an exception to the clawback charge if the donee becomes neither resident nor ordinary resident in the UK because the duties of his employment or office are performed abroad and he returns, not having disposed of the asset in the meantime, within three years.[59]

Another anti-avoidance provision had to be introduced in 1986 to prevent another, more specific abuse. It is explained in Chapter 9 that it is possible for a trust to be resident both in the UK and in another country at the same time. For example, at least half of the trustees might be resident in the UK: this is enough to render the trustees as a whole resident in the UK.[60] If the general

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56. Section 79(4) ibid
57. Section 79(7) ibid. The transferor has a right to recovering the tax from the transferee (section 79(9) ibid) but he might run into practical difficulties in enforcing his right.
58. Section 79(8) ibid
59. Section 79(5) ibid
60. Section 52(1) CGTA 1979

administration of the trust is carried on, not in the UK, but in another country, that might, depending on the location, render the trust also resident in that other country. Where this dual residence occurs recourse has to be made to the double tax agreement between the two countries, if there is one, to resolve the conflict. Some agreements deem the trust to be resident only in the other country,[61] with the result that capital gains made by the trustees are not taxable in the UK.

Accordingly, an asset could be transferred to such a trust with the benefit of a hold-over claim and the asset could then be sold by the trustees, thus taking the whole of the held-over gain outside the UK CGT net.

Section 58 FA 1986 was enacted to deal with this scheme which was beginning to be used with increasing frequency. This section provides that, for disposals made after 17th March 1986, no hold-over claim can be made in respect of a transfer to a dual resident trust where the terms of the relevant double tax agreement are such that exemption from UK tax is given as described above.[62]

The section also covers situations where a trust acquires dual-residence status after it acquires an asset on which the gain has been held over. In these circumstances, the held-over gain becomes chargeable immediately before the dual-residence status is acquired unless this occurs before 18th March 1986.[63]

Hold-over relief could also be exploited so as to eliminate chargeable gains rather than merely defer them by holding-over gains on a gift into a settlement, with the gain subsequently become exempt on the death of the life tenant, giving rise to a deemed disposal under sections 54(1) and 55(1)(a) CGTA 1979. Accordingly,

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61. See the UK/Eire double tax agreement
62. Section 58(3) FA 1986
63. Section 58(5) ibid

section 84(3) FA 1982 inserted section 56A CGTA 1979 which states that the exemption does not apply to the held-over gain, although the trustees can claim a further hold-over in respect of the gain that would otherwise arise.

When hold-over relief was restricted in the FA 1989, the above anti-avoidance provisions were retained for the restricted situations in which hold-over relief is still available on or after 14th March 1989.

In relation to gifts on which inheritance tax is chargeable and hold-over relief is granted under section 147A CGTA 1979, the relief does not extend to gifts to persons who are neither resident nor ordinarily resident in the UK.[64] The restrictions described above relating to the emigration of the donee, gifts into dual resident trusts, and the death of a life tenant are all applied to the section 147A relief.[65]

Similarly, these restrictions were made applicable to the expanded section 126 CGTA 1979 relief. Gifts to non residents are covered by the new section 126A[66]. The restrictions relating to the emigration of the transferee, gifts into dual resident trusts and the death of a life tenant were also applied to this relief.[65]

However, because section 126 relief also applies to gifts to companies, further safeguards against exploitation have had to be enacted.

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63. Section 58(5) ibid
64. Section 147B CGTA 1979, inserted by para 4, Sch 14, FA 1989
65. Para 6(1)(3)(5), Sch 14 FA 1989
66. Inserted by para 2, Sch 14 ibid

Accordingly, the new section 126A denies relief not only where the transferee is neither resident nor ordinarily resident in the UK; but also where the transferee is an individual or a company resident or ordinarily resident in the UK and also in another country, and exempt from UK CGT under a double tax agreement.[67] In other words, relief is disallowed in the case of dual resident individuals and companies as well as in the case of dual resident trusts. It is interesting that it was felt necessary to bring dual resident individuals within this provision: avoidance of CGT through manipulating an individual's residence to make him dual resident must have been very rare, but, having said that, it is sensible to bring dual resident individuals into this provision for the sake of completeness.

Provision also had to be made to counter a scheme which had been popular even before section 126 was expanded by the FA 1989. Under this scheme, for example, a UK individual who owned an asset qualifying for relief under section 126 and who wanted to sell that asset without crystallising a substantial gain, could cause to be set up a UK resident company owned by a non-resident trust in which he had an interest in possession. He would then transfer his asset to the UK company, and the shares in that company would then be sold by the non-resident trustees.

A new section was introduced to counter this scheme: section 126B CGTA 1979[68]. This section states that relief under section 126 is not available if the transferee is a company controlled by non-residents connected with the donor. This includes persons regarded as non-residents not subject to CGT under a double tax agreement.

67. Section 126A(2) CGTA 1979
68. Inserted by para 2, Sch 14 FA 1989

Another way the section 126 relief might have been exploited would have been to transfer the relevant asset to a UK company controlled by UK trustees, who subsequently emigrate. This is covered by section 126C CGTA 1979[68]. This section imposes a charge on the held-over gain immediately before the emigration of the trustees. If the trustees do not pay the tax thus assessed within twelve months, it can be assessed on the transferor within six years after the end of the year of assessment in which the relevant disposal was made.

When section 126 was first introduced in 1979[69] and the general hold-over relief was enacted in 1989[70], there was an almost naive lack of awareness of the possibilities for exploitation by enterprising taxpayers. However, during the 1980's there has been the gradual tightening-up of the rules, as described above, until the position has been reached where the remaining hold-over reliefs are protected by detailed anti-avoidance rules, making it very difficult for taxpayers to use the reliefs to eliminate rather than defer CGT as intended by the legislation.

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68. Inserted by para 2, Sch 14 FA 1989
69. Section 46 FA 1978
70. Section 79 FA 1980

Value Shifting

The CGT legislation is, of course, built round the concept of the disposal.[71] The original CGT legislation also acknowledged that a person could move value from his hands into those of another person without the need for a disposal of an asset. Such arrangements were dealt with by paragraph 15, Schedule 7, FA 1965. This paragraph, with the addition of another subsection in 1975, is now contained in section 25 CGTA 1979.

Three separate forms of value shifting are countered by section 25. Each measure is subject to the provisions of section 25(1) which states that any transaction which is treated as a disposal by section 2 shall be so treated (with a corresponding acquisition) notwithstanding that there is no consideration, so far as, if the parties had been at arm's length, there would have been consideration or additional consideration. The transaction shall be treated as not being at arm's length and the actual consideration plus the consideration or the additional consideration which could have been obtained, shall be treated as the market value of what is acquired.

The first of the situations covered by the value shifting provisions is dealt with in section 25(2) which states:

> "If a person having control of a company exercises his control so that value passes out of shares in the company owned by him or a person with whom he is connected, or out of rights over the company exercisable by him or by a person with whom he is connected, and passes into other shares in or rights over the company, that shall be a disposal of the shares or rights out of which the value passes by the person by whom they were owned or exercisable."

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71. Section 1(1) CGTA 1979

A straightforward example of a situation envisaged by this provision is where a controlling shareholder exercises his control to vary the rights attaching to the shares in the company so that his shares become less value valuable and those held by others become more valuable.

Section 25(2) came up for consideration in the case of Floor v Davis[72], a case concerning what was at one time a very common CGT scheme; a scheme that has been the subject of a number of leading cases.[73]

The facts were that the taxpayer, Major Floor, and his two sons-in-law held the majority of the shares in IDM Electronics Ltd ("IDM"). In February 1969 they agreed, subject to contract, to sell all their shares in IDM to an American company, KDI. A direct sale to KDI would have entailed a substantial CGT liability arising in the hands of each of the vendors. Accordingly, the vendors entered into the following scheme, on 24th February 1969, a new company FNW Electronic Holdings Ltd ("FNW") was incorporated with an authorised share capital divided into preferred and ordinary shares of one shilling each. Under FNW's articles of association, the ordinary shares were to carry rights to one-seventh of total declared dividends and six-sevenths of surplus assets on a winding-up, while the preferred shares would carry the rights to six-sevenths of all declared dividends and one-seventh of all surplus assets on a winding-up. All the issued shares were to have equal voting rights. On 27th February, the vendors entered into an agreement with FNW for the transfer of their shares in IDM to FNW in consideration for the issue by FNW of 100,000 preferred shares. The taxpayer acquired 43,954 preferred shares in FNW for the transfer of 38,075 ordinary and 38,075 "A" ordinary shares in IDM. On 28th February, FNW agreed to

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72. (1979) 52 TC 609
73. See Furniss v Dawson (1984) 55 TC 324; Craven v White and Baylis v Gregory (1988 STC 476, infra and Chapter 11

sell its IDM shares to KDI for a cash consideration of £560,889. On 27th March, Donmarco, a company registered in the Cayman Islands, applied to FNW for 100 preferred shares, offering £5 per share and enclosing a cheque for £500. That application was accepted on the same day. Also on that date, letters were sent to each of the vendors and to Donmarco offering a rights issue of one ordinary share at par for two issued preferred shares. By the time given for the acceptance of this offer had elapsed, only Donmarco had accepted, and it was accordingly allotted 50 ordinary shares. On 5th April, FNW was voluntarily wound up by a resolution passed at a meeting attending by one of the taxpayer's sons-in-law, with the result that six-sevenths of its surplus assets passed to Donmarco, as the only ordinary shareholder, and one-seventh was divided between the vendors and Donmarco, as preferred shareholders.

The Revenue assessed the taxpayer on the basis inter alia, that what was then paragraph 15(2), Schedule 7, FA 1965 applied because the word "person" in that paragraph had also to be read in the plural by virtue of the operation of section 1 of the Interpretation Act 1889, so that several persons could together exercise control and that the vendors had controlled FNW in this case.

Not only did this depend on "person" being read in the plural; it also depended on the omission by the vendors to exercise their rights being taken to constitute the exercise of control.

In the High Court, Goulding J held in favour of the taxpayer, deciding that:

(i) the taxpayer did not by himself have control of FNW within paragraph 15(2), because he could only control the company in conjunction with his son-in-law;

(ii) paragraph 15(2) did not apply to a case where two or more persons together had control and that, a "contrary intention" appearing, section 1 of the Interpretation Act 1889 did not apply so to make the singular include the plural; and

(iii) in order to satisfy the words "exercise .. control" in paragraph 15(2), some positive act capable of specific identification as an exercise of control was required.

These findings were rejected by the Court of Appeal, where it was held that paragraph 15(2) did extend to control by two or more persons acting together.

Sir John Pennycuick pointed out that by virtue of the extended definition of "control" in section 45(1) and paragraph 3(1) Schedule 18, FA 1965[74], unless the context otherwise requires, where two or more persons possess the greater part of the share capital or voting power in a company, they are taken to have control of the company. The judge said:

> "The context of paragraph 15(2) of Schedule 7 emphatically does not otherwise require. There is nothing in the context which renders the provision of that sub-paragraph inappropriate to operations carried out in concert by two or more persons."[75]

Accordingly, he said,[76] what is now section 25(2) CGTA 1979 should, where two or more persons have control, be read as follows:

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74. See section 155(1) CGTA 1979 and section 416 ICTA 1988
75. p.630
76. Ibid

> "If persons having control of a company exercise their control so that value passes out of shares in the company owned by them respectively or persons with whom they are respectively connected ... that shall be a disposal of the shares ... out of which the value passes by the persons by whom they were respectively owned ..."

It is submitted that this is a most inappropriate extension of the wording of the statute and that it gives rise to some real problems. In the circumstances, it is surprising that this construction was upheld by the majority of the House of Lords, and their reasons for doing so are unconvincing.

Of the majority in the House of Lords, only Viscount Dilhorne gave a reasoned judgement; Lords Diplock and Edmund-Davies merely expressing their agreement with him.

Viscount Dilhorne said that applying the Interpretation Act 1889 and paragraph 3 of Schedule 18 FA 1965 did not, in his view, make paragraph 15(2) unworkable, nor did they expand that paragraph in a way that Parliament cannot have intended. He said:

> "I can see no reason for not treating the passing of value out of shares owned by two or more persons as the result of the exercise by them of control and out of shares owned by persons connected with them in precisely the same way. I can see no indication that Parliament intended to secure that what would be a disposal if effected by the exercise of control by one person would not be a disposal if the control was exercised by two or more and in the absence of any clear indication of such an intention, paragraph 15(2) must in my opinion be construed in the light of the Interpretation Act 1889 and paragraph 3 of Schedule 18 ...

This construction of paragraph 15(2) does not in my opinion, involve any extension of it but gives effect to the language used and to the intention of Parliament. It is said that a minority shareholder owning say 10% of the shares will be liable to be taxed if one or more others have shares which with his add up to a controlling situation.

I do not agree that this is so, such a minority shareholder will only have the value passing out of his shares treated as a disposal if he has joined with other shareholders in the exercise of control to bring that about or if he is a person connected with those whose exercise of control has brought it about."[77]

Unfortunately, Viscount Dilhorne gave no guidance on what circumstances would in his view justify one shareholder being held to have joined with other shareholders in the exercise of control. This is precisely the problem inherent in Viscount Dilhorne's construction. Presumably, the judge had in mind some notion of common purpose but this important, and indeed, fundamental point was not analysed.

Lord Wilberforce approached the problem in a rather more analytical and thorough manner.

Dealing with the application of the Interpretation Act 1889 and whether it justified reading "person" as "persons", Lord Wilberforce convincingly stated:

"In deciding which sense is required one should have regard to the fact that the word 'person' in a taxing Act usually denotes 'an entity of assessment' ..... Persons are taxed, normally, one by one, not

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77. p640

> collectively with others and paragraph 15(2) seems to be drafted on this normal basis. The person having control is the same as the person later referred to as the person by whom [the shares] were owned", and that person is made liable to tax. I take this as an indication that a singular taxable person is meant in both places. This is certainly the case in the next following paragraph, paragraph 16[78], where the (taxable) single person is contrasted with one or more connected persons. I do not think that the Interpretation Act 1889 should be used so as to impose tax on several persons at the same time. If that had been intended, the draftsman would surely have said so."[79]

This, it is submitted, is a correct and sensible interpretation of the legislation. Lord Wilberforce then underlined the logic of his construction by applying two tests, the first of which was picked up and commented on, wholly unconvincingly, by Viscount Dilhorne, in the passage from his judgement set out above.

Lord Wilberforce said that to impose tax on a controlling shareholder is one thing; he is in quite a different situation from a shareholder who does not control a company. A controlling shareholder may fiscally be regarded as the owner of the company. However, where control is split, that is a totally different situation. Using the interpretation favoured by the majority, the shareholder would be taxed on a minority shareholding because other shareholders together with him may have control. This introduces a new basis of taxation resting, not on control by the shareholder, but on control in association with others.[80]

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78. Later section 151 CGTA 1979 (now repealed), supra
79. pp637-8. See also Lord Keith at pp 646-7
80. p638

The second test, he said, was to consider what happens if "person" is replaced by "persons". How is the phase "if persons having control" to be interpreted? Does it mean either or both of "persons jointly having control" or "persons taken together having control"? In normal companies control rests with the shareholders; is the phrase to mean all of them, or a majority of them? It may be easy to say in the present case that control is possessed by three people who or any two of whom were able to exercise it together, but paragraph 15(2) applies to all companies, not only family companies; if there is to be pluralisation, he said, it must be total. He then commented:

> "There are many combinations possible by which control may be arrived at, if more than one person is to be considered, and if the company is a public company many more. What is the position of the taxpayer has 5% and votes together with a shareholder who has 51%? If 'person' includes 'persons', those two have control, and the taxpayer is liable to tax on his 5%, if value passes."[81]

Regarding the rewording of the paragraph by Sir John Pennycuick which is set out above, and which found favour with Viscount Dilhorne, Lord Wilberforce's view was clear:

> "This may or may not be a 'sensible provision' but, it amounts, I respectfully think, to a rewriting of the paragraph. But nothing is clearer than that rewriting, or the introduction of words, into a taxing provision is inadmissible."[82]

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81. p639
82. Ibid. See also Lord Keith at p647

This must be correct; provisions of what is now section 25(2) constitute an important taxing measure and it should not have been subjected by the majority to an uncertain and imprecise rewriting without very clear analysis of both the reasons for, and consequences of, doing so. Neither Sir John Pennycuick nor Viscount Dilhorne provided such an analysis.

Lord Wilberforce, concluded his judgement by noting that it had been argued that his construction "would invite tax avoidance and expose a loophole in the Act". But, he said, in order to close this loophole, the House of Lords was invited to accept a construction which would involve "an uncertain and indefinite extension" of the legislation. He noted that it was said that the Revenue would not seek to apply the extended provision to cases of public companies. Lord Wilberforce rejected this argument by warning that:

> "the consequences of the suggested pluralisation cannot be brushed away in this manner. The correct course, I venture to think, is to construe the paragraph so as not to produce these indefinite and uncertain results. Apart from the merits of the present case I regard it as a dangerous and unsound principle to introduce an extensive and uncertain basis of taxation into a carefully drafted fiscal provision by the use of the Interpretation Act."[83]

Unfortunately, the majority of the House of Lords ignored this warning without explaining clearly their basis for doing so, leaving the application of what is now section 25(2) to minority shareholders in an unnecessarily vague and uncertain state. As mentioned above, Viscount Dilhorne's construction must be based on some principle of common purpose; in that the shareholders in question

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83. pp639-40

have, presumably, some shared objective. It is not clear to what extent this must include value passing out of the shares of some of all of them or whether, or to what extent, any tax avoidance motive must be present. In so far as any sensible or local guidance can be gleaned from Viscount Dilhorne's judgement, it appears that there need not be any tax avoidance motive in whatever common objective the relevant shareholders may have.

There is clearly a lot of scope for disputes here between taxpayers and the Revenue. It may be that this problem was somewhat overshadowed by the rather more momentous events surrounding tax avoidance, and such schemes as the one in this case, arising out of the "new approach" in the Ramsay case.[84] Now that some semblance of order has returned to the question of tax avoidance following the cases of Craven v White et al[85], more detailed questions such as those arising out of Floor v Davis might again come to the fore.

The other important point on paragraph 15(2) decided in Floor v Davis was whether an "exercise" of control required a positive act. It has been noted above that Goulding J thought it did. This decision was overruled by the Court of Appeal and by the majority in the House of Lords.[86]

In relation to this point, it should be noted that, at the EGM of FNW called to consider the resolution to wind the company up, only one of the vendors (one of Major Floor's sons-in-law) attended. The meeting was also attended by a Proxy for Donmarco. Votes were not cast for either Major Floor or the son-in-law who did not attend the meeting.

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84. W.T. Ramsay Ltd v IRC (1981) 54 TC 101; see Chapter 11
85. [1988] STC 476
86. Lord Wilberforce and Keith did not deal with this point

On this point Sir John Pennycuick stated:

> "I do not doubt that in the ordinary case of control by the holding of a majority of shares the expression 'exercise control' indicates the casting of the votes attached to those shares upon the relevant resolutions and that a shareholder could not be treated as exercising control when he is absent or inactive when the resolution is proposed. But the expression 'exercise control' is not a term of art denoting by its own force the casting of votes and nothing else and there may be circumstances, in the case of control by more than one person, where those persons should indeed be treated as collectively exercising control without all of them actually casting their votes. It seems to me that the circumstances here are of that character. Major Floor and the sons-in-law acquired voting control of FNW as the first step in a series of operations designed to eventuate in the proceeds of their shares in IDM passing to a foreign company. This series of operations represented a scheme planned in advance by the three individuals acting in concert. The passing of the winding up resolution by FNW was an integral and essential operation in this scheme and was indisputably carried out in furtherance of a common and continuing intention on the part of the three individuals. Upon these facts it seems to me that the resolution should be regarded as an exercise by all three individuals of their collective control. It is, I think, immaterial that two of the individuals did not actually case their votes in favour of the resolution."[87]

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87. p632

Viscount Dilhorne expressed himself to be "in complete agreement" with these observations.[88]

This view is not objectionable in itself, in fact, in a case like Floor v Davis where there was a "common and continuing intention" on the part of the vendors, it is sensible. But it is entirely unclear how far it goes, particularly when linked with the first point regarding minority shareholders. It is apparent that, in some cases, a minority shareholder can do nothing but still be "exercising ... control". In a case like Floor v Davis this causes little problem because the facts were extreme. May be this lead Viscount Dilhorne into delivering such an unhelpful judgement. But it is dangerous to lay down general rules by reference to extreme facts without explaining fully how those general rules are to apply to less extreme, or "ordinary", cases. To take the view that such matters will be sorted out in later cases is in direct disregard of the principle that a taxpayer is entitled to know the law. That Lords Wilberforce and Keith were alive to this is apparent from their judgements.

Returning to section 25, the operation of subsection (2) can give rise to a loss as well as to a gain. Section 60 F(No 2)A 1975[89] enacted that a loss on the disposal of an asset shall not be an allowable loss to the extent to which it is attributable to value having passed out of other assets, being shares or rights treated as disposed of under section 25(2) CGTA 1979. In other words, where there is a value shifting transaction giving rise to a loss on another asset, that loss is disallowed to the extent to which it is attributable to the value shifting.

Section 25(4) deals with the second type of transaction covered by the value shifting rules. It relates to leases and provides that:

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88. p644
89. Now section 25(3) CGTA 1979

> "If, after a transaction which results in the owner of land or of any other description of property becoming the lessee of the property there is any adjustment to the rights and liabilities under the lease, whether or not involving the grant of a new lease, which is as a whole favourable to the lessor, that shall be a disposal by the lessee of an interest in the property."

This, then, covers sale and leaseback transactions. The type of arrangement at which this subsection is aimed is where the owner of a freehold retains a lease and disposes of the freehold reversion on such terms that the value of the lease is not significantly less than the value of the original freehold (because, for example, it is for a long fixed term at a low rent). This first transaction would be a part disposal of the underlying land giving rise to a small gain. The second stage would be for the terms of the lease to be altered so that the rent would be increased to a full market rent. This would have the effect of transferring value from the lease to the freehold reversion.

Section 25(4) effectively prevents this form of value shifting by charging the lessee to tax on the value flowing from him to the lessor.

The third situation covered by section 25 is dealt with in subsection (5), which states:

> "If an asset is subject to any description of right or restriction the extinction or abrogation, in whole or in part, of the right or restriction by the person entitle to enforce it shall be a disposal by him of the right or restriction."

This provision prevents a person who has an asset which he wishes to give away, depressing the value of the asset by imposing on it a restriction which he would release having given it away. An option to purchase the asset back for a nominal sum would be an example of such a restriction.

Now that CGT hold-over relief for gifts has been restricted[90] this provision, for a long time of little practical relevant, might become more important as taxpayers seek ways of transferring assets not qualifying for hold-over relief, in a way which does not give rise to a large liability to CGT.

A final point to consider in connection with section 25 is the extent to which section 25(2) is overruled by the reorganisation provisions in Chapter II, Part IV CGTA 1979.[91] Logically, the specific relieving provisions in Chapter II should override the general charging provisions of section 25(2). This is not to say that section 25(2) is robbed of any real importance because in the normal case of, say, a bonus issue covered by section 77, section 25(2) is clearly inappropriate because section 25(1) envisages parties (i.e. more than one), one of whom, if they had been at arm's length, would have given consideration or additional consideration. Section 25(2) is therefore inappropriate in a straightforward section 77 situation.

However, in circumstances in which there are two parties, such as where sections 85 and 86 apply, section 25(2) could well be relevant. It seems that there is no conflict because sections 85 and 85 are subject to section 87 which states that sections 85 and 86 shall not apply "unless the exchange, reconstruction or amalgamation in question is effected for bona fide commercial reasons".

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90. Section 124 and Sch 14, FA 1989
91. See Part 2

This view was confirmed by Nicholls J in Young v Phillips[92]. In this case the taxpayers were resident but not domiciled in the UK. They held all the shares in three English companies which had become very valuable. They wanted to take advantage of the provisions in what is now section 14(1) CGTA 1979, which exempts from CGT gains made by foreign domiciled persons on the disposal of non-UK situs assets, unless the proceeds are remitted to the UK.

The problem for the taxpayers was, of course, that they undeniably held UK situs assets: shares in UK companies. They therefore entered into a series of transactions designed to transfer the value of their interests in the UK companies to two newly formed Jersey companies.

The scheme involved the following transactions. The Jersey companies were incorporated, each having a share capital of £5,000 in £1 shares. The taxpayers were neither directors of, nor subscribers to, those companies. The share capital of the three English companies was increased by the creation of preferred ordinary shares of £1 each, ranking pari passu with the ordinary shares save for priority in repayment of capital on a winding up. It was resolved that sums standing to the English companies' profit and loss accounts be capitalised and be appropriated to the taxpayers and applied in paying up in full the new preferred ordinary shares to be allotted to the taxpayers. The preferred ordinary shares were then allotted to the taxpayers and renounceable letters of allotment were issued to them. The taxpayers were appointed directors of the Jersey companies and it was resolved that half of the outstanding 4,990 shares in the two companies be issued to the taxpayers. It was further resolved by the Jersey companies that all their shares be issued at a specified

92. [1984] STC 520

premium. The consideration received by the Jersey companies from the taxpayers for the issue of the shares was £1,364,216. The taxpayers went to Sark, taking with them the letters of allotment, and disposed of their rights under them to the Jersey companies by completing the form of renunciation in each of the letters. The Jersey companies paid the taxpayers £1,364,216 and thereafter they became registered shareholders of the preferred ordinary shares in the three English companies.

The taxpayers, in fact failed because Nicholls J held that the rights comprised in the renounceable letters of allotment were not situated outside the UK so that their disposal was not covered by section 14(1).[93] However, the judge then went on to say that, even if the rights in the letters of allotment had been situated outside the UK, the "Ramsay" principle[94] would have applied. Accordingly, although the taxpayers could prima facie have relied on the relieving provisions of what is now section 85, the restrictions now contained in section 87[95] had the effect of curtailing the application of those provisions because one of the main purposes of the issuing of the shares in the English companies was tax avoidance. Therefore, the effect of the scheme was to cause value to pass out of the taxpayers' original shares to the English companies and into the new preferred ordinary shares within section 25(2).[96]

What Nicholls J was saying is that there would have been a disposal under section 25(2) by the taxpayers to themselves as the first holders of the renounceable letters of allotment. It is submitted that this analysis would have been unsound had it stood on its own, but that application of the "Ramsay" principle means that the value in fact passed from the taxpayers' original shares into the preferred ordinary shares acquired by the Jersey

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93. See p535
94. See Chapter 11
95. See Part 2
96. pp 538-9

companies.[97] As far as the interaction of section 25(2) and Chapter II, Part IV is concerned, the judgement of Nicholls J seems to confirm that section 85 would take precedence over section 25(2), but that section 87 can exclude section 85 in cases of tax avoidance, leaving section 25(2) to take effect. It is submitted that this is a correct and sensible view which resolves what might otherwise be certain areas of conflict between the two sets of provisions.

A further value shifting provision was introduced by section 43 FA 1977 which is now section 26 CGTA 1979. This is a provision of extreme width and some complexity. In fact, section 26 is one of the widest, if not the widest, anti-avoidance provision in the CGT legislation. The reason for the width of the section can probably be attributed to the time which spawned it. In the mid-1970's many millions of pounds were potentially being sheltered by highly artificial and very complicated capital loss schemes. Although these schemes varied widely their aim was normally the same. The taxpayer would have made a substantial gain on the disposal of an asset, on which he would have to pay a large amount of CGT. He would therefore enter into one of these capital loss schemes to produce a capital loss that he could use to reduce or eliminate his capital gain. The trick was, of course, to produce a capital loss without suffering a "real" loss.

One such scheme has already been considered: the "Reserve Nairn Williamson" scheme.[98] For two others, one need look no further than the cases that formed the basis of the "new approach": W.T. Ramsay Ltd i IRC and Eilbeck v Rawling.[99] It is not necessary to set out either scheme

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97. How this case fits into the development of the "new approach" as whole is considered in Chapter 11. This case is also dealt with further in Chapter 9.
98. Supra. Although this scheme would have technically been outside section 26
99. (1981) 54 TC 101

in detail, but a summary of their basic steps will show the type of arrangements at which section 43 was aimed.[100]

Ramsay, in fact, was really concerned with the meaning of "debt on a security". This is important because what is now section 134(1) CGTA 1979 says that no chargeable gain (or allowable loss) accrues on the disposal of a debt by the original creditor unless it is a "debt on a security".

The facts of the Ramsay case were that the taxpayer company carried on the business of farming. It sold the freehold of the farm and made a chargeable gain of £187,977. It therefore needed to generate a loss, if it was to avoid a substantial capital gain. To this end, it entered into pre-arranged tax avoidance scheme marketed by a company specialising in such schemes. The taxpayer company acquired the whole of the share capital of a newly formed investment company, Caithmead Ltd. It then offered to make two loans to Caithmead "L1" and "L2". Each loan was of £218,750 and the rate of interest was 11% per annum. The taxpayer company had the right to increase the rate of interest on one loan and decrease it on the other. The taxpayer company later exercised these rights, decreasing the rate of interest on L1 to nil, and increasing the rate on L2 to 22%. The taxpayer sold L2 to a third party for its market value (£393,750). This gain was, according to the taxpayer company, not subject to CGT because the debt was not a "debt on a security". Caithmead was then liquidated and, after repaying L1 to the taxpayer company at par (£218,750), there was, it was hoped, the required capital loss on the Caithmead shares.

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100. Although it should be noted that each scheme failed, not only by virtue of the "new approach" but also for other technical reasons arising out of the mechanics of the schemes.

In fact, the House of Lords held, for reasons not relevant here, that L2 was a debt on a security so the gain made on it was a chargeable gain which eliminated the loss on L1.

Although the scheme was held to be technically flawed, as well as being susceptible to the application of the "new approach"[101], it does demonstrate a common factor seen in many of these schemes; namely, two assets are produced, with the intention of one being disposed of to give rise to a non-chargeable gain; the other generating an allowable loss.

The Eilbeck v Rawling scheme was completely different from the Ramsay one but it was based upon this same common factor. Here, the taxpayer had made a chargeable gain of £355,094 on the sale of certain shares and needed an allowable loss to set against it. He, like the taxpayer company in the Ramsay case, purchased an off-the-shelf tax scheme which he hoped would achieve this. Under this scheme, he created a Jersey settlement in which he had a reversionery interest. There had previously been set up by the purveyors of the scheme a Gibraltar settlement with a trust fund of £600,000. The taxpayer purchased a reversionary interest in this settlement for £543,600. The trustees of the Gibraltar settlement advanced to the trustees of the Jersey settlement £315,000. As a result, the taxpayer's reversionary interest in the Gibraltar settlement dropped in value. The taxpayer then sold his reversionary interest in the Gibraltar settlement for £231,130. The taxpayer claimed that this produced a loss of £312,470 because the exemption from CGT for disposals of interests in settlements does not apply where the interest had been acquired for a consideration in money or money's worth.[102]

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101. See Chapter 11
102. See now section 58(1) CGTA 1979

The taxpayer then sold his interest in the Jersey trust for £213,100. The interest was worth this much because of the advance from the Gibraltar trust. The taxpayer claimed that this sale was free of CGT because this reversionary interest had not been acquired for money or money's worth.

Like the Ramsay scheme, this one failed both under the "new approach" and for technical reasons[103] but it can be seen that the object of the scheme was to shift value from one asset into another to produce a tax advantage.

Although these three leading cases all failed for various reasons, such arrangements were so prevalent that there was the prospect that many would succeed, giving rise to an enormous loss of revenue. At the time Parliament took action by passing section 43 FA 1977, the House of Lords had not adopted their "new approach".[104]

Faced with a barrage of highly sophisticated tax avoidance schemes being aggressively marketed, it is hardly surprising that Parliament decided to combat them with a wide and sweeping section.

Section 43 FA 1977, now section 26 CGTA 1979, applies to a disposal of an asset if a scheme has been effected or arrangements have been made (whether before or after the disposal) whereby:

(a) the value of the asset has been materially reduced; and

(b) a tax-free benefit has been or will be conferred:

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103. The technical aspects of this case are considered in Chapter 9
104. See Chapter 11

(i) on the person making the disposal or a person with whom he is connected, or

(ii) on any other person.[105]

The section does not apply where the tax-free benefit is conferred on someone other than the person making the disposal or a person connected with him if it is shown that avoidance of tax was not the main purpose or one of the main purposes of the scheme or arrangements in question.[106]

It can be seen that, unlike section 25, section 26 applies to an actual disposal, and before or after that disposal, a scheme or arrangement has been entered into "materially" reducing its value.

Regarding the benefit conferred under (b) above, a benefit is treated as being conferred on a person if he becomes entitled to any money or money's worth, or the value of any asset in which he has an interest is increased, or he is wholly or partly relieved from any liability to which he is subject. Furthermore, it is stated that a benefit is tax-free unless it is required, on the occasion on which it is conferred, to be brought into account in computing the income, profits or gains, of the person in question for the purposes of income tax, CGT or corporation tax.[107] Notice that a benefit is tax-free unless it is taken into account on the occasion on which it is conferred. Therefore, if it is brought into account later, that would not prevent the section from applying.

It is apparent that the section is drafted in very wide terms indeed. In that respect it should be noted that, unlike section 703 ICTA 1977[108], a section with a number

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105. Section 26(1) CGTA 1979
106. Section 26(3) ibid
107. Section 26(2) ibid
108. See Chapter 1

of points similarity with section 26, there is no procedure available for seeking clearance in advance. Another difference from section 703 is that section 26 only permits a defence that tax avoidance was not a main purpose for certain transactions; namely, those in which the tax-free benefit is conferred on someone other than the person making the disposal or a person with whom he is connected. Even where the defence is available, it is clear that the onus is on the taxpayer to prove that none of the "main" purposes was tax avoidance. This is a particularly tough test to satisfy.

Another difficulty about the section arises out of the requirement that the value of the asset being disposed of must have been "materially" reduced. No guidance is given as to what this means. Normally, of course, there will be no problem in practice: any "scheme" or "arrangement" worthy of the name will considerably reduce the value of the asset; that would be its whole point. On the other hand, very few Inspectors would be alert to the application of this section where only minor reductions in value are involved. Nevertheless, there is potential for protracted arguments. At the end of the day, the fact that in thirteen years not a single dispute on this has reached the courts is testimony to the fact that this danger is more apparent than real.

The procedure for counteracting the tax avoidance is also less than precise. Where the section applies, any allowable loss or chargeable gain accruing on the disposal is calculated as if the consideration for the disposal were increased by such amount "as appears to the Inspector ... to be just and reasonable having regard to the scheme or arrangements and the tax-free benefit in question." There is an appeal against the Inspector's decision to the Commissioners.[109] It is further provided

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109. Section 26(4) CGTA 1979

that where the consideration for the disposal of the asset is increased by the operation of the Inspector's power, and the tax-free benefit was an increase in the value of another asset, the Inspector can, when that other asset is disposed of, treat the consideration on that disposal as being reduced by such amount as appears to him to be just and reasonable having regard to the scheme or arrangements and the notional increase in the consideration on the disposal of the first asset. Again, there is a right of appeal to the Commissioners.[110]

The Inspector is therefore given wide discretionary powers to adjust the gain or loss, not only on the disposal in question, but on other disposals as well.

There are certain exemptions from the operation of section 26. It does not apply to:

(a) disposals between spouses within section 44 CGTA 1979;

(b) disposals by personal representatives to legatees under section 49 ibid, or

(c) inter-group disposals within section 273 ICTA 1979.[111]

It is not surprising that section 26 does not apply to these disposals because they are all "no gain no loss" disposals anyway.

There was originally a second exemption relating to the disposal by one company of shares in another company, whereby the section did not apply to the extent that the reduction in the value of the shares disposed of was attributable to a dividend when both companies were

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110. Section 26(5) ibid
111. Section 26(6) ibid

members of the same group, or to the disposal by the second company of an asset to another company within the same group.[112] This exemption was being exploited and, as will be explained in Part 2, changes were made in 1989.

The last provision to consider extends the ambit of the section in one specific instance. Where the disposal of an asset preceeds its acquisition, the main provision relating to a reduction in its value is read as including a reference to an increase.[113] In other words, a "bear" sale can be caught by section 26.

Section 26, with its wide scope, lack of clearance procedure, and discretionary power given to the Inspector to make the necessary counteracting adjustments, has proved to be an effective deterrent to implementing the artificial capital loss and similar schemes at which it was aimed. Shortly after its enactment, of course, the House of Lords announced their "new approach"[114] which tended to overshadow section 26, because most schemes that could have been attacked under the section were abandoned by the taxpayer or never even implemented in the first place because of the potential application of the "Ramsay" principle. Now that the principle has been confined within relatively narrow and well defined boundaries[115], section 26 might be used more by the Revenue. It sometimes seems as though the Revenue, particularly local Inspectors, do not fully appreciate the power of this weapon to counter tax avoidance.

The FA 1989 introduced new rules relating to value shifting and groups of companies. These changes are examined in Part 2.

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112. Section 26(7) ibid, as originally drafted
113. Section 26(8) ibid
114. See Chapter 11
115. See Craven v White et al [1988] STC 476, discussed in Chapter 11

Settlements in which the Settlor Retains an Interest

The FA 1988 brought the CGT rates for individuals into line with the income tax rates.[116] This meant that individuals were subject to either 25% or 40%, with settlements being subject to the 25%, unless they were accumulation or discretionary settlements which also had to pay a sum equal to the additional rate,[117] giving a total rate of 35%. There would therefore have been an incentive for higher rate taxpayers to channel disposals through settlements. This was anticipated and appropriate counteracting measures were contained in section 109 and Schedule 10 FA 1988.

To prevent the obvious avoidance opportunities it is provided that if, in any year of assessment, the settlor has an interest in a settlement, chargeable gains accruing to the trustees from the disposal of any or all of the settled property are not chargeable on the trustees, but are treated as accruing to the settlor. The gain thus treated as accruing to the settlor will be reduced by the trust's losses but not the annual exemption.[118]

A settlor has an interest in the settlement if capital or income can become payable to or applicable for the benefit of the settlor or his spouse, or if the settlor of his spouse enjoys a benefit deriving directly on indirectly from the property comprised in the settlement or any income arising under the settlement.[119]

However, it is provided that a settlor does not have an interest in a settlement if none of the capital and income of the settlement can become applicable for his benefit except in the event of:

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116. Section 98 FA 1988
117. Section 100 ibid
118. Para 1, Sch 10, FA 1988
119. Para 2(1) ibid

(a) the bankruptcy of a beneficiary;

(b) any assignment of or charge on the property or income;

(c) the failure of a marriage settlement;

(d) the death of a beneficiary before reaching 25.[120]

There are certain limitations placed on the application of the charges: namely, the fact that it cannot arise in the year of assessment in which the settlor dies or, if his spouse has the interest, in the year in which the spouse dies or ceases to be married to him.[121] Furthermore, the charge on the settlor does not arise unless the settlor and the trustees are either resident or ordinarily resident in the UK in the year in question.[122] Because of this last restriction, non-resident trusts remain valuable tax planning instruments.[123]

These provisions are thorough and wide ranging as regards UK trusts and are valuable in preventing taxpayers reducing their CGT rate from 40% to 25% (or 35% in the case of accumulation or discretionary trusts).

There is, however, a glaring loophole which is bound to be closed by amending legislation. In fact, it surprised most people who were aware of it that it was not stopped in the FA 1989. The loophole arises out of the interaction of these provisions with those providing for a clawback of hold-over relief on the emigration of a trust.[124] Section 79 FA 1981 clawsback the hold-over

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120. Para 2(2)(3) ibid
121. Para 3 ibid
122. Para 4 ibid
123. See Chapter 9
124. Supra

relief on the emigration of a trust by deeming there to be a chargeable gain[125], but is does not deem there to have been a disposal. As the settlor is only treated as having made the trustees' gains if there is a disposal[126], the clawback charge cannot arise in the hands of the settlor.

The way this can be exploited is obvious. An individual has an asset standing at a large gain. He wishes to sell it[127] but does not want to suffer CGT at 40%. He settles the asset on UK trustees and elects to hold-over the gain (assuming that it is an asset in respect of which hold-over is still available, of course). He retains an interest in possession so that there is no chargeable transfer for inheritance tax purposes.[128] The trust is then exported by the UK trustees retiring in favour of non-resident trustees and the administration of the trust being move overseas.[129] This will crystallise the held-over gain, but it cannot be attributed to the settlor, so the trustees pay CGT on the held-over gain at only 25%. The trustees can then sell the asset on to the ultimate purchaser, probably making no further gain, and, even if there is a small gain arising, no UK CGT would be payable on it until a capital payment is received in the UK.[130]

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125. Section 79(1) FA 1981
126. Para 1(1)(a), Sch 10, FA 1988
127. Although negotiations cannot be finalised otherwise the scheme would be vulnerable under the "new approach": see Chapter 11
128. Section 49(1) IHTA 1984
129. See Chapter 9
130. Ibid.

PART 2

COMPANIES AND SHARES

Introduction

There has always been a great deal of tax avoidance activity relating to companies and their shares. Shares, by their very nature, are susceptible to manipulation and the general value shifting provisions in section 25(2) CGTA 1979, which are examined in Part 1, were aimed at certain types of avoidance, and there have been many more specific areas of exploitation. Two aspects, in particular, have been of particular interest to tax avoiders:

(1) reorganisations, reconstructions and amalgamations;

(2) groups.

Reorganisations of share capital and reconstructions and amalgamations of companies are common commercial transactions and the CGT code contains reliefs to facilitate them. However, it is almost inevitable that, when Parliament provides reliefs for bona fide commercial transactions, those taxpayers who are not intended to be the beneficiaries of the reliefs will seek to use them in a way not originally envisaged. The reorganisation and reconstruction provisions are prime examples of this.

More anti-avoidance legislation has had to be aimed at the activities of groups of companies than at anything else in the CGT code. These provisions can be categorised in several different ways but, in this Part, they are dealt with as follows:-

1. Companies joining and leaving groups.

2. Inter-group transactions.

3. Depreciatory and value shifting transactions.

Finally, in this Part, consideration is given to a handful of miscellaneous anti-avoidance provisions relating to companies and shares.

Reorganisations, Reconstructions and Amalgamations

The CGT code contains various provisions aimed at facilitating the reorganisation of share capital and the reconstruction and amalgamation of companies. These provisions have had to be bolstered by anti-avoidance legislation to prevent them being used in ways not intended by the legislature.

Three cases in which taxpayers sought to exploit these provisions have been discussed in Part 1: Harrison v Nairn Williams, Floor v Davis and Young v Phillips[1]; others are dealt with in this part.

Floor v Davis concerned an embellishment on one of the most popular CGT avoidance schemes in the early and mid 1970's. Three other important cases involved the same basic scheme: Furniss v Dawson,[2] Craven v White and Baylis v Gregory.[3] In fact, in its basic form, as in Furniss v Dawson, it was not an avoidance scheme at all; it merely provided a deferment of liability.

Such schemes caused Parliament to enact <u>section 40 FA 1977</u> which is now <u>section 87 CGTA 1979</u>. This section provides that the reconstruction and amalgamation provisions of section 85 and 86 CGTA 1979 do not apply in certain circumstances. It is not necessary to examine the provisions of sections 85 and 86 in detail, except to note that each section involves the issue of shares or debentures of a new company to shareholders of an existing company. Section 85 basically caters for paper-for-paper takeovers; whereas section 86 gives relief in the case of schemes of reconstruction or amalgamation involving the retention or cancellation of the original shares.

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1. Supra
2. [1984] 55 TC 324
3. Both [1988] STC 476

The scheme used in Floor v Davis, Furniss v Dawson, Craven v White and Baylis v Gregory[4] was typical of the abuses of sections 85 and 86 which eventually forced Parliament to act with the introduction of anti-avoidance legislation in 1977. The scheme, like all the best avoidance arrangements, was essentially very simple and can be demonstrated by a short example.

Messrs. A and B own a company X Ltd. They have built the company up from nothing and they stand to suffer a substantial CGT liability when they sell their shares. They are approached by Y Ltd, which wishes to purchase X Ltd. To avoid, or in the first instance, merely defer their liability to CGT, Messrs. A and B swap their shares in X Ltd for shares in a new company Z Ltd. Z Ltd then sells X Ltd to Y Ltd for an open market consideration.

The reason why this does not give rise to any CGT in the hands of Messrs. A and B or Z Ltd is that, on the share swap at the first stage, as far as Messrs. A and B are concerned, the exchange is merely treated as a reorganisation with X Ltd and Z Ltd being treated as the same company.[5] In effect, therefore, their gain on the X Ltd shares is rolled-over into their Z Ltd shares. Z Ltd, for its part, acquires the X Ltd shares at market value under normal principles so that, when it sells X Ltd, it makes no gain. Messrs. A and B, therefore, defer their CGT liability until they dispose of their Z Ltd shares. The additional steps in Floor v Davis, Craven v White and Baylis v Gregory were added in an attempt to extract the proceeds of sale from the intermediate company without triggering the deferred CGT.

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4. The details of the Floor v Davis scheme are set out in Part 1; the precise facts of the other three cases are set out in Chapter 11.
5. Section 85(3) CGTA 1979

It was to prevent avoidance of this nature that section 40 FA 1977 was enacted. In fact, it was the case of Floor v Davis itself that finally prompted the Revenue to seek a change in the law. The case was heard at first instance in 1976 and, as is explained above, was decided in the taxpayer's favour at that stage. This section provided that, with effect from 19 April 1977, the exemptions in what are now sections 85 and 86 shall not apply unless the exchange, reconstruction or amalgamation in question is effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to capital gains tax or corporation tax.[6] There is a de minimis exemption from this requirement for persons who hold (together with connected persons) 5% or less of, or of any class of, the shares of the original company.[7]

Section 40 FA 1977 also provided a clearance procedure whereby an application can be made to the Revenue in advance of the transactions in question for the Revenue's confirmation that section 87 will not be applied to the transactions. An appeal may be made against the Revenue's decision to the Special Commissioners.[8]

It should be noted that, as the abuses aimed at were concerned with the avoidance of CGT or corporation tax, it is only transactions with the object of avoiding these taxes that are caught by section 87.

The ambit of the reliefs in sections 85 and 86 are such that transactions that fall within their scope are numerous and very few reconstructions or amalgamations involving share exchanges can safely proceed without a

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6. See now section 87(1) ibid, When the provision was introduced into Parliament in the Finance Bill 1977, it also referred to a purpose of avoiding income tax, but this was dropped in Committee.
7. Section 87(2)(3) ibid
8. See now section 88 ibid

section 88 clearance being obtained. In practice, although clearance is readily available for most genuine commercial arrangements, there are occasions when the peculiar situation arises that clearance can be obtained under section 707 ICTA 1988[9] but not under section 88. Admittedly, the wording of section 703 ICTA 1988 and section 87 are not identical, but situations have arisen in practice where the Revenue department dealing with section 703 ICTA 1988 has agreed that a transaction would be carried out for bona fide commercial reasons, whereas the deparment dealing with section 87 has contradicted this.

For example, one situation in which this situation almost invariably arises is where there are two companies, X Ltd d and Y Ltd, each of which is jointly owned by the same two individuals, A and B. It may be that A and B want to go their separate ways. Perhaps they are husband and wife whose marriage has broken down. They agree that each of them will take one of the companies, and so they wish to exchange their shares. They do not want to extract any cash from the companies, they simply want to end up with shares. There are various ways the exchange can be effected within section 85 and 86, For instance, a new intermediate company, Z Ltd, could be formed, and A and B could exchange their shares in X Ltd and Y Ltd for shares in Z Ltd, X Ltd and Y Ltd becoming subsidiaries of Z Ltd. Z Ltd could then be liquidated under section 110 of the Insolvency Act 1986, the shares in X Ltd being transferred to a new company (Newco A), in exchange for the issue of Newco A shares to A; the shares in Y Ltd being transferred to another new company (Newco B), in exchange for the issue of Newco B shares to B.

It is relatively easy to obtain clearance under section 707 ICTA 1988 for this in appropriate circumstance; but, in no circumstances will clearance under section 88 be forthcoming, the relevant Revenue department taking the

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9. See Chapter 1

view that A and B could achieve the same object by straight transfers between them, giving rise to CGT, so by implementing such an arrangement as described above, they would be avoiding CGT.

However, apart from the reservation that, on a few occasion, the Revenue have been a little too narrow in their application of the clearance procedure,[10] sections 87 and 88 have worked very well indeed at cutting out the abuses, while allowing most commercial transactions to proceed unimpeded. When clearance procedures are operated (on the whole) sensibly and commercially by the Revenue, as section 88 mostly tends to be,[11] it ensures that widely drafted anti-avoidance procedures work effectively and not oppressively. Compare, for example, the almost completely useless clearance procedure in section 776 ICTA 1988,[12] which makes that section a much more awkward one to deal with.

Another provision granting relief on company reconstructions and amalgamations was paragraph 7(2), Schedule 7 FA 1965 and which is now contained in section 267 ICTA 1970. The effect of this provision is that, where a scheme of reconstruction or amalgamation involves the transfer of one company's business to another, the two companies are treated as if any assets included in the transfer are transferred on a no-gain no-loss basis. This is obviously a valuable relief applicable to many genuine commercial transactions. However, like sections 85 and 86 CGTA 1979, this relief was used in way not intended by the Legislature and when, in 1977, action was taken, in the wake of schemes such as that in Floor v Davis,[13] to restrict reconstruction etc reliefs to bona fide commercial transactions, new subsections (3A) - (3C)

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10. See ICAEW Memorandum TR 657 comprising a text of a letter sent to the Inland Revenue in November 1986 and the Revenue's reply in February 1987.
11. The same comment applies to section 707 ICTA 1988
12. See Chapter 5
13. Supra

were introduced into section 267 with effect from 19 April 1977.[14]

Subsection (3A) states that section 267 does not apply unless the reconstruction or amalgamation is effected for bona fide commercial reasons and does not form part of scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to corporation tax, capital gains tax or income tax. The section 88 CGTA 1979 clearance procedure applies to this subsection as it does to section 87.

Like section 87, section 267(3A), when taken with the clearance procedure in section 88, has proved to be, on the whole, an effective and fair anti-avoidance provision. The Revenue have even extended the scope of section 267 by not insisting on the identity of shareholders in the old and new companies, which is usually required in a scheme of reconstruction, on the division of a company on a share for share basis, where different shareholders (or groups of shareholders) take over different parts of the company's business.[15]

There was another, more specific, anti-avoidance provision relating to what became section 267. Section 45(8) FA 1965 applied the part of the FA 1965 relating to capital gains to any unit trust scheme as if the unit trust were a company. Therefore, by the simple process of transferring assets to a unit trust, the tax liability on gains already accrued could be greatly reduced due to special provisions relating to unit trusts in the FA 1965. Accordingly, paragraph 22, Schedule 19 FA 1969 provided that, where the transfer of a company's business took place after 19 June 1969, the reference to a company

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14. Section 41 FA 1977
15. Inland Revenue Statement of Practice SP5/85

in paragraph 7(2), Schedule 7 FA 1965 was restricted to a company proper. It further provided that paragraph 7(2) did not apply on a transfer after 29 April 1969 of a company's business to a unit trust scheme exempt or partially exempt from CGT under the FA 1965.

In Part 1 of is Chapter the "Reverse Nairn Williamson" scheme is considered. There was, in fact, a second type of scheme built around the principles examined in Harrison v Nairn Williamson.[16] This was commonly called the "Rights Issue" scheme and the most celebrated example of this scheme in action is IRC v Burmah Oil Co Ltd,[17] in which it was held that the scheme worked, based on a technical analysis of the CGT legislation as it then stood. However, as is explained in Chapter 11, the House of Lords held that it failed under the "new approach" of the courts to tax avoidance schemes.

The essence of the scheme was that a rights issue constitutes a "re-organisation"[18] and so does not involve any disposal or acquisition.[19] Accordingly, regardless of the provisions of section 19(3) CGTA 1979,[20] the consideration for the new shares, in relation to any disposal of the new holding, is treated as having been given for the original shares.[21]

The way this situation could, it was thought, be used to a taxpayer's advantage can be seen in the Burmah Oil case. As is explained in more detail in Chapter 11, Burmah Oil lost over £159 million on a loan to a subsidiary but found itself unable to obtain any tax relief whatsoever for this loss because it was not a debt on a security within section 134 CGTA 1979. The rights issue scheme was implemented by Burmah Oil in an attempt

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16. Supra
17. (1982) 54 TC 200
18. Section 77(2)(a) CGTA 1979
19. Section 78 ibid
20. Now repealed, see Part 1

to turn a non-allowable loss into an allowable one.[21]

The scheme, reduced to its bare bones, involved Burmah Oil and three wholly-owned subsidiaries, OMDR Holdings Ltd ("Holdings"), the company that owed Burmah Oil the £159 million; Manchester Oil Refinery Holdings Ltd ("Manchester"); and Burmah Oil Trading Ltd ("Trading").

The steps in the scheme were as follows:

1. Burmah Oil lent Manchester a sum equal to the debt owned by Holdings, which was, in fact, £159,299,999. Manchester lent an equivalent sum to Holdings. Holdings then repaid the debt to Burmah Oil.

2. A few days leter, Holdings made a rights issue of 700,001 £1 shares at £228 per share. These were allotted to Burmah Oil which paid £159,500,000. Trading, as nominee, was allotted one share at £228. Holdings then repaid Manchester the £159,299,999, and Manchester repaid that sum to Burmah Oil.

3. The following day, Holdings went into liquidation and Burmah Oil claimed £159,600,228 as allowable expenditure.

The Revenue argued that the rights issue was an acquisition of the new shares of Holdings and was a transactions otherwise than at arm's length and so should be deemed to be for a consideration equal to its market value under section 19(3) CGTA 1979. The Court of Session and the House of Lords rejected this, holding, on a strict literal interpretation of the CGT legislation,

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21. Section 79(1) ibid

that the arrangement constituted a "reorganisation" under section 77(2) CGTA 1979, and so no new acquisition took place by virtue of section 78 ibid. As there was no disposal or acquisition, section 19(3) ibid did not apply to substitute market value for the actual consideration. However, as is explained in Chapter 11, the House of Lords ignored the technical analysis of the scheme in the light of the relevant CGT legislation and applied the "new approach", and held that Burmah Oil had not made a "real" loss, so they would not be allowed to make a "tax" loss. As will be seen in Chapter 11, the reasoning of the House of Lords, such as it was, was rather weak. Burmah Oil might have expected more incisive reasoning considering the Law Lords were denying the taxpayer company a tax loss which the legislation undoubtedly gave them.

By the time the House of Lords heard the Burmah Oil case, the law had been changed. Section 91(1) FA 1981 added a second proviso to section 79(1) CGTA 1979, which states that any consideration given for the new holding in a reorganisation otherwise than by way of a bargain made at arm's length is disregarded to the extent that it exceeds "the relevant increase in value", which is defined as the amount by which the market value of the new holding immediately after the reorganisation exceeds the market value of the original shares immediately before the reorganisation. This is a round about way of saying that market value is substituted for actual consideration.

The amended section 79(1) applies only as regards reorganisations taking place on or after 10 March 1981. In other words, the Legislature allowed the old rules to apply until the change was announced. The Law Lords in Burmah Oil brushed aside the fact that the scheme was perfectly legal and effective in 1972 when it was implemented.

It will be seen in Chapter 11, that a second case involving the rights issue scheme, implemented before the change in 1981, has succeeded in the Court of Appeal on both the technical merits and under the "new approach". As far as the "new approach" is concerned, this case, Dunstan v Young Austen & Young,[22] differed from Burmah Oil in that the Special Commissioners found that the rights issue arrangements were implemented for commercial reasons.

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22. [1989] STC 69

Companies Joining and Leaving Groups

Companies have constantly tried to use the CGT rules relating to groups in ways not intended by the Legislature. The main provision that has been open to exploitation has been the one allowing capital assets to be transferred between companies in a group[23] on a no-gain no-loss basis.[24] This rule recognises the fact that, although companies within such a group are legally separate entities, they usually form an economic unit with common, or at least complementary, policies and objectives. This rule also compensates for the fact that, unlike trading losses, capital losses cannot be surrendered to other companies in the same group.

Group companies have traditionally got around this problem by one company, which owns an asset standing at a gain, transferring that asset to a group company with capital losses. That company then transfers the asset outside the group, thus crystallising the gain against which it can set its losses.

Often, of course, groups will not already contain a company with capital losses through which disposals can be channelled in this way. But, some such groups have sought to solve this problem by purchasing a company with accumulated losses at a price which ultimately would give both the vendor and the group a profit. The one loser was the Exchequer, which would be deprived of the CGT otherwise payable by the group companies with assets, the gains on which were eliminated by the newly acquired company's losses.

For a long time, the Revenue could do nothing about this, but, with the advent of the "new approach" of the courts

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23. As defined in section 272 ICTA 1970
24. Section 273 ibid

to tax avoidance,[25] they saw this as a weapon for attacking the growing market in tax loss companies. Their general attitude was that they considered the practice of passing assets around a group, so that the disposal outside the group could be made by a tax-loss company, unobjectionable if those losses had accumulated while that company had been a member of the group; but they found the market in tax-loss companies distasteful and would often seek to apply the "Ramsay" principle to such arrangements.[26]

The Revenue's view on the purchase of tax-loss companies was challenged in Shepherd v Lyntress Ltd.[27] The facts were that Grendon Trust plc owned a company called Monotype Corporation Ltd which had, by 1978, suffered heavy losses. Grendon acquired a number of shell companies (including Lyntress Ltd) and transferred its Monotype shares to them. Those shares were exchanged for shares in Monotype Holdings Ltd, which was not a 75% subsidiary of Grendon. In 1979, Grendon decided to utilise part of the accumulated losses by selling Lyntree to a company with chargeable gains which could be set-off against Lyntress's losses on the Monotype Holdings shares.

News International plc owned shares in Broken Hill Proprietary Co. Ltd, London Weekend Television (Holdings) Ltd and News Corporation Ltd which it wanted to sell, but in respect of which it would make large capital gains. News International became interested in acquiring Lyntress, having already acquired another tax-loss company, Salcombe Securities Ltd, the previous month. The purchase of Lyntress by News International was made in two stages. First News International acquired 35% and, two days later, the remaining 65%.

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25. See Chapter 11
26. See for example ICAEW Memorandum TR 588 setting out the text of a letter written by the ICAEW on 10 June 1985 and the Revenue's response date 20 September 1985
27. [1989] STC 617

Between the two purchases of its shares by News International, Lyntress sold its Monotype Holdings shares to Manilsa Ltd, a subsidiary of Grendon, for their market value, namely, £668.

In 1980 and 1981 News International sold Broken Hill, News Corporation and LWT shares at below market value to Lyntress and Salcombe and, within a few days, Lyntress and Salcombe sold those shares in the market at a profit.

When News International acquired the first 35% of Lyntress, the latter company ceased to be a member of Grendon's group, that caused a loss to arise in the hands of Lyntress[28] on the difference between the adjusted base cost of the Monotype shares inherited from Grendon[29] and their market value when Lyntress acquired them. This loss exceeded £4 million, and it was this loss that News International sought to use.

The Revenue sought to prevent News International's gains being set against the losses of Lyntress and Salcombe by applying the "Ramsay" principle. The Revenue assessed both News International and Lyntress. News International was assessed on the gains made on the Broken Hill, News Corporation and LWT shares as if the transfers to Lyntress and Salcombe could be ignored. Lyntress and Salcombe were assessed on the capital gains they made while in the News International group without any relief for the losses they had made before joining the group.

As will be seen when this case is examined in Chapter 11 in relation to the "new approach", Vinelott J held that:

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28. Under section 278 ICTA 1970
29. Under section 273 ibid

> "it is impossible to conclude that the transfer of the shares of LWT, News Corporation and Broken Hill to Lyntress and Salcombe..... and the subsequent sales of these shares were in each case part of a single composite transactions within the Ramsay principle. It is simply not enough to say that the shares were transferred to Lyntress and Salcombe with the intention that they should be sold so that the gain could be offset against losses in those companies."[30]

The judge had said that the LWT and News Corporation shares were transferred to Lyntress and Salcombe after a decision had been made by the group to sell them through the Stock Exchange, but there was no finding by the Special Commissioners that any arrangement had been made to sell the shares at the time when the shares were sold to Lyntree and Salcombe.[31]

Vinelott J was therefore saying in effect that, whether or not the losses are bought in, there is no room for the application of the "Ramsay" principle if arrangements have not been made for the onward sale of the assets in question before they are transferred to the tax-loss company. As discussed in Chapter 11, Vinelott J was here taking a very narrow view of a "pre-ordained series of transactions" and, if his judgment is not overturned on appeal, the acquisition of tax loss companies will, in nearly every case, be possible, as long as the acquiring group is careful enough not the make firm arrangements for the onward sale before the assets in question are transferred to the loss company.

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30. p659
31. p658

Vinelott J also made some more general comments about the application of the "Ramsay" principle to inter-group transfers in the light of observations of Lord Templeman in Reed v Nova Securities.[32] Vinelott J said:

> "It is a necessary but not a sufficient condition for the application of the [Ramsay] principle that there should be a finding that the intermediate step which it is sought to disregard as having no fiscal consequence was inserted for no purpose except that of saving tax. The intermediate step is disregarded because if a composite transaction is treated as a single transactions it is evident that it falls outside the purpose of the exemption or the relief or allowance which the taxpayer seeks to avail himself of..... [T] he provisions in sections 272 to 279 [ICTA 1970] permit assets to be shuffled round within a group and the transfer of an asset which has an unrealised gain to a company which has a loss which cannot be surrendered within the group but which can be set off against gains on assets transferred to it within the group cannot be said to conflict with the inferred statutory purpose even though the asset with an unrealised gain was transferred to the company with a realised loss as a step in the realisation of the gain. There is not in any relevant sense a step inserted for the purpose of tax avoidance."[33]

It only remains to be noted at this stage that, as the sale to News International of 35% of Lyntress could not be ignored under the "Ramsay" principle, the loss that step generated was allowable after News International acquired all the shares in Lyntress and so the assessments on Lyntress itself could not stand.

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32. [1985] STC 124, infra
33. pp662-3 This is considered in the context of the "new approach" as a whole in Chapter 11.

Although the acquisition of tax loss companies is not covered by legislation, there are a number of provisions specifically aimed at arrangements to avoid tax by companies joining and leaving groups.

Paragraphs 18 and 19 of Schedule 12, FA 1968 were enacted to counteract schemes whereby CGT could be avoided by the transfer of an asset to a subsidiary followed by the sale of the shares in the subsidiary,[34] or by a member of a group in the course of amalgamation or reconstruction of the group disposing of shares in another member of the group which thereby ceased to be a group member.

Paragraph 18 is now section 278 ICTA 1970. This section applies when a company leaves a group. If that company then owns any assets (otherwise than as trading stock) acquired from another member of that group in the previous six years, they are deemed to have been disposed of and immediately reacquired when they were first acquired by the departing company, at their then market value.[35]

The charging provisions also apply to any asset into which a gain on an asset acquired from another group company within the previous six years had been rolled over under sections 115 to 121 CGTA 1979.[36]

Because the deemed disposal takes place when the departing company acquired the asset, rather than when it leaves the group, it is only the gain that was held-over on the transfer to the departing company that is taxed at that stage.

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34. This is the so-called "envelope trick"
35. Section 278(1)(3) ICTA 1970
36. Section 278(4)(b) ibid

There is an exception from the charge where two or more associated companies cease to be members of a group at the same time and the asset in question has been acquired by one of them from the other.[37] However, if the asset was originally acquired from a group company which is not leaving at the same time, within the the six years prior to the associate companies' departure, the exception will not apply.

This exception is fair enough as far as it does, but it is rather narrow in that two companies are only associated for this purpose if they would form a group by themselves.[38] Therefore if two companies, X and Y are both wholly-owned subsidiaries of another company, Z, and X and Y leave the group together, the associated companies exception will not apply.

It is provided that a company does not cease to be member of a group for the purposes of a charge under the section by being wound up or dissolved or in consequence of another member of the group being wound up or dissolved.[39] This is a reasonable rule which prevents the charge from arising in many commercial arrangements. It has, however, been used to avoid a section 278 charge as part of an avoidance scheme. This can be seen in the case of Burman v Hedges & Butler Ltd,[40] the facts of which were that the taxpayer company, a member of a group, agreed to sell the share capital in Old Bushmills Distillery Co Ltd ("Bushmills") to Joseph E Seagram & Sons Inc. ("Seagram") for £4 million. In order of avoid the CGT which would have accrued on a straight sale to Seagram, the following scheme was implemented:

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37. Section 278(2) ibid
38. Section 278(4)(a) ibid
39. Proviso to section 278(1) ibid
40. (1978) 52 TC 501

1. Vostoka was incorporated and its 100 £1 shares were divided into (a) 76 participating preference shares, which were allotted to the taxpayer company, with no voting rights and entitlement to only £76 on a liquidation; (a) 24 ordinary shares, allotted to Seagram, carrying all the voting rights and all the equity on a liquidation. Vostoka was thus a member of the same group as the taxpayer company because the participating preference shares qualified as "ordinary share capital" as defined in section 526(5) ICTA 1970.[41]

2. Zagal was incorporated and its 100 £1 ordinary shares were issued to Vostoka.

3. Seagram lent £4 million to Zagal to put it in funds to purchase the Bushmills shares from the taxpayer company.

4. Zagal duly purchased the Bushmills shares.

5. Vostoka was immediately wound up, the liquidator distributing £76 to the taxpayer company and the shares in Zagal (which of course, owned the Bushmills shares) to Seagram.

This scheme was attacked by the Crown on the basis that the disposal by the taxpayer company was to Zagal, not as principle, but as nominee for Seagram. Walton J rejected this, holding that the only reasonable conclusion from the documents was that Zagal acquired Bushmill as a principal, with money lent to it by Seagram.[42]

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41. Now section 832(1) ICTA 1988
42. This decision is considered further in Chapter 12

The Revenue did not try to apply section 278 to this scheme, presumably because they accepted that Zagal left the company's group in consequence of another member of the group, Vostoka, being wound-up. Not long after the Hedges & Butler case, of course, the House of Lords adopted their "new approach" to tax avoidance[42A] and that severely restricted the use other taxpayers could make of the Hedges & Butler decision. Furthermore, the Revenue have tended to take a rather narrow view of the proviso and apply section 278 to bona fide commercial reorganisations under section 110 of the Insolvency Act 1986 where one company is put into liquidation and the liquidator transfers its assets (e.g, shares in subsidiaries) to one or more other companies, in return for the issue of shares by the other company or companies to the shareholders of the liquidated company. Here the Revenue take the view that the subsidiaries cease to be members of the liquidated company's group, not as a result of the liquidation, but as a result of the liquidator's decision to transfer the subsidiaries to the new companies.

There is an important exception to the section 278 charge in section 278A ICTA 1970[43] in respect of certain mergers,[44] and another in paragraph 10, Schedule 18 FA 1980 in the case of "demergers".

Paragraph 19 of Schedule 12 FA 1968 became <u>section 279 ICTA 1970</u>. The need for this provision can best be seen from an example:

> X Ltd has a subsidiary Y Ltd which it wants to sell to Z Ltd. However, X Ltd would suffer a large CGT liability on a straight sale. X Ltd therefore forms

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42A. See Chapter 11
43. Inserted by section 27 FA 1970
44. The term "merger" is narrowly defined for this purpose; section 278A(2) ICTA 1970

a new company ("Newco") and transfers its Y Ltd shares to Newco in exchange for Newco shares. Newco then sells the Y shares to Z Ltd.

It can be seen that this is a company version of the Furniss v Dawson[45] scheme.

With effect from 10 April 1968, the provisions of what is now section 279 would operate to treat X Ltd as disposing of the Y Ltd shares immediately before their transfer to Newco, and as immediately reacquiring them at their then market value.

When the provision that are now contained in section 87 CGTA were introduced[46] in 1977 they effectively superseded those of section 279 and, accordingly, section 40(10) FA 1977 provided that section 279 does not apply unless the disposal of the subsidiary took place before 20 April 1977.[47]

1989 Parliament eventually took steps to stop the use of "bridge" companies as demonstrated in the case of Burman v Hedges & Butler Ltd.[48] It is possible that the Revenue were for several years after 1981 confident that the "Ramsay" principle would contain the problem, but with the courts' continued resistance to the Revenue's attempts to expand the principle beyond strictly controlled limits,[49] it appears that the Revenue felt that it needed action on the statutory front.

The "bridge" company schemes were, of course, based on the wide definition of "ordinary share capital" in what is now section 832(1) ICTA 1988. It has been noted in Chapter 4 that this definition was also used to exploit the loss relief rules for group relief purposes. When

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45. (1984) 55 TC 324, see Part 1
46. As section 40 FA 1977; see Part 1
47. See now section 279(1)(a) ICTA 1970
48. (1978) 52 TC 501
59. See Chapter 11

action was taken to stop such schemes in 1973, it was not done by making any amendment to the definition of "ordinary share capital" but by specifically attacking arrangements for exploiting group relief.[50] No similar action was taken at that time to stop the use of "bridge" companies.

Action was eventually taken in section 138 FA 1989, which amended the definition of groups of companies in section 272 ICTA 1970.

The main definition of a group as a principal company and its 75% subsidiaries remains[51] but it is now provided that no company can be included in the group unless it is also an effective 51% subsidiary of the principal company.[52]

To be an effective 51% subsidiary, the principal company must be beneficially entitled to more than 50% both of any profits available for distribution to equity holders in the subsidiaries and of any assets available to equity holders in a winding up.[53]

The structure of the new rules, particularly the rule that the effective subsidiary test can be satisfied by entitlement through intermediate subsidiaries,[54] means that a company could belong to two groups. Where this happens, there are provisions to determine which of the two groups the company belongs to. These tie-breaker rules prevent the use of "bridge" companies within the new provisions. There are four tests set out to determine to which of the two group the subsidiary belongs.[55]

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50. Section 28 and Sch 12 FA 1973, see Chapter 4
51. Section 272(1A)(a) ICTA 1970
52. Section 272 (1A)(b) ibid
53. Section 272(1E) ibid
54. Section 272(1F) ibid, para 6, Sch 18 ICTA 1988
55. See section 272(1D) ICTA 1970

There is a transitional provision to prevent a section 278 charge arising by reason only of a company losing its group status by virtue of these new restrictions when they came into effect on 14 March 1989.[56]

Another transitional relief applies where a scheme or arrangement under section 425 of the Companies Act 1985 was agreed before 14 March 1989 and sanctioned by the court and, under that agreement, one company acquires shares in another. If the two companies would have been in the same group under the old rules, but not under the new ones, the old group definition will continue to apply for six months following the date of the agreement.[57]

Overall, the new rules appear to have successfully tackled the problem of "bridge" companies. However, these new provisions are rather complicated and, although they are unlikely to effect most group structures in any way, only time will tell whether any genuine commercial arrangements will be disadvantaged by the introduction of the new regime. By the very nature of the abuse, and the structure of the counteracting measures, the new rules should not cause many problems to bona fide group arrangements in the future.

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56. Section 138(8) FA 1989
57. Section 138(10) ibid

Inter Group Transactions

Two cases considered by the House of Lords in recent years have highlighted an arrangement for exploiting the rules relating to appropriations to and from trading stock by groups of companies. Both cases concerned the same scheme. It was designed to convert a capital loss into a trading loss which could then be surrendered by way of group relief to shelter trading profits around the group.

This scheme exploited the provisions of section 274 ICTA 1970 and section 122 CGTA 1979. Where a member of a group acquires an asset as trading stock from another member of the group, and the asset was not trading stock in the hands of the transferor company, section 274(1) states that the transferee company is treated, for the purposes of section 122 as having acquired the asset otherwise than as trading stock and as having immediately appropriated it to trading stock. The effect of section 122(1) is that, where an asset is appropriated to trading stock in this way, the owner is treated as having sold the asset for market value. The transferee company will have acquired the asset at the transferor company's base cost[58] and it can elect to bring the asset into its trading accounts at that inherited base cost, rather than market value.[59]

These rules were exploited by groups in the following way. A non-trading member of the group would have a capital asset standing at a loss. That company would transfer that asset to a trading member of the group which would elect to bring the high base cost of the transferer company into its trading accounts, rather than the low market value. When the transferee company sold

58. Section 273(1) ICTA 1970
59. Section 122(3) CGTA 1979

the asset on, or when it prepared its accounts for that year, the loss would then crystallise as a trading loss.

This scheme can be seen in action in the two cases referred to above, It is interesting to compare them because, in the House of Lords, one application of the scheme failed; but, in the other case, even Lord Templeman had to admit, albeit grudgingly, that the scheme partially succeeded.[60]

The first of these cases was Coates v Arndale Properties Ltd[61]. The facts were that the taxpayer company was a property dealing company and was a member of the same group of companies as Sovereign Property Investments (Newport) Ltd ("SPI"), a development company, and Arndale Property Trust Ltd ("APT"), an investment company.

On 30 March 1973, the taxpayer company acquired a leasehold property for £3,090,000 from SPI and, on the same day, assigned it to APT for its then market value of £3,100,000. By that date, SPI's expenditure in connection with the property was £5,313,822. The taxpayer company had previously acted as a property dealer within the group. The taxpayer company claimed that it had acquired the property as trading stock for the purposes of section 274(1) ICTA 1970, and it made an election to have the property brought into its trading account at £5,313,822 under the predecessor to section 122 CGTA 1979.[62] It was not disputed that the motive of the group companies for implementing this scheme was the expectation of favourable tax consequences.

The Crown attacked the scheme by arguing that the taxpayer company had not acquired the property from SPI as trading stock and therefore that section 274(1) did not apply.

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60. Lord Templeman's attitude towards tax avoidance is examined in Chapter 11.
61. [1984] STC 637
62. Para 1 Sch 7 FA 1965

The General Commissioners allowed the taxpayer company's appeal, holding that the transaction was a proper transaction in the course of its trade, and that the property was acquired by the taxpayer company as trading stock.[63] This was overruled by both the Court of Appeal[64] and the House of Lords[65] on the basis that the taxpayer company clearly was not trading. Lord Templeman, with whom the other Law Lord's agreed, stated:

> "Arndale did not trade and never had any intention of trading with the lease. In order to give the whole transaction a faint air of commercial verisimilitude, the trading company Arndale was awarded the modest sum of £10,000 for entering into two assignments of property worth over £3 million. The award of £10,000 was ostensible made at the expense of APT which paid Arndale for the lease £10,000 more than the price paid by Arndale to SPI. In reality the award of £10,000 was made at the expense of SPI which sold for £10,000 less than the market value assessed by the group. The profit of £10,000 did not represent the difference between the price at which Arndale negotiated the purchase and the price at which Arndale negotiated the sale. The profit of £10,000 did not represent the difference between the value of the lease to SPI and the value of the lease to APT. The profit of £10,000 was a timid veil designed to conceal the fact that the lease was not being traded."[66]

This view is not surprising in the light of the fact that the taxpayer company's counsel had admitted that the sole purpose of the transaction was to obtain a tax advantage.

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63. See [1982] STC 573 at p577
64. [1984] STC 124
65. Ibid at p637
66. p641

Lord Templeman said that he did not have to rely on the "new approach"[67], but he clearly had it in mind and it appears to have influenced his attitude towards the facts of this case.[68] For example, he commented that the taxpayer company, SPI and APT were "wholly-owned subsidiaries of the same parent" and "the £10,000 was a book entry which had no material effect on the overall financial position of the group."[69]

Lord Templeman concluded with a general comment on the use of tax reliefs such as that now contained in section 122(3) CGTA 1979. He said:

> "In the present case the legislature has expressly provided a method of tax mitigation designed no doubt to ensure that a group of companies is in no worse position than an individual whose activities embrace all the activities of a group of companies. The tax statutes allow a potential capital loss to be converted into a trading loss in respect of an asset which becomes part of the stock-in-trade of the trading activities of the group. The lease never became part of the trading assets of any company in the group."[70]

The situation was different in the second case inwhich this scheme was used: Reed v Nova Securities Ltd.[71] Here, the taxpayer company had traded in shares and securities since 1955. In March 1973 it was acquired by The Littlewoods Organisation Ltd. In August that year Littlewoods disposed of certain shares and debts to the

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67. p642. This case is considered in the context of the "new approach" in Chapter 11.
68. This is not surprising as Lord Templeman was the first judge to speak out consistently against artificial tax avoidance; see Chapter 11
69. p641
70. p642, see also Lord Templeman's judgment in Reed v Nova Securities Limited, infra, [1985] STC 124 at p131
71. (1985) STC 124

taxpayer company for £30,000, which was their market value. The shares alone were valued at only £10. The shares and debts did not form part of the trading stock of Littlewoods and had been acquired by Littlewoods for £3,936,765.

The taxpayer company claimed that the shares and debts were acquired within section 274(1) ICTA 1970 as trading stock, and made an election under what was then paragraph 1(3), Schedule 7, FA 1965, that in computing the profits or losses of the taxpayer company's trade for the purposes of corporation tax, the market value of the shares and debts should be treated as increased by £3,906,765.

Unfortunately for the Revenue, they mishandled their case before the General Commissioners to such an extent that the Law Lords took the unusual step of criticising their conduct of the appeal. It is probably true to say that they let the taxpayer company off the hook.

Before the Commissioners, the Revenue agreed that the issue be determined, not by oral evidence, but on the basis of an agreed statement of facts which did not deal with the intentions of either the taxpayer company or Littlewoods of trading at any time with the shares and debts. The Commissioners proceeded to find as a fact that the taxpayer company acquired all the assets in the course of its trade and that the assets were acquired as trading stock.

At first instance,[72] Walton J had no doubts that the Commissioners' decision was correct. He said:

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72. [1982] STC 724

"I have no doubt at all that, being properly advised, the group considered carefully what the consequences of the sale to the taxpayer company would be, and calculated that they would be of benefit to the group as a whole. But that does not make the exercise in any way a tax avoidance scheme, any more than (for example) a covenant by a high taxpayer in favour of charity becomes a tax avoidance scheme merely because the taxpayer reckons correctly that it will bring him certain tax allowances. Indeed, this is all so obvious that I cannot help thinking that if it were not for the quite startling figures here involved - very nearly £4 million - nothing would ever have been heard of this case."[73]

The Court of Appeal[74] agreed (Lawton LJ dissenting). The House of Lords[75] agreed as regards the debts. Again, Lord Templeman gave the main judgment. He agreed with the majority in the Court of Appeal that it could not be concluded that no reasonable tribunal, properly instructed, could have decided, on the evidence, that the debts were acquired by the taxpayer company as trading stock. The taxpayer company was a trading company and it bought property of a kind in which it was authorised to deal. Before deciding the buy the debts, the board of the taxpayer company considered what, in ordinary commercial terms, was the profit which the company was likely to make on the transaction.[76]

However, different considerations applied to the shares. They were worthless and these was no commercial justification for their acquisition by the taxpayer

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73. p730
74. [1984] STC 124
75. [1985] STC 124
76. p132

company. No reasonable tribunal could have concluded that the shares were acquired by the taxpayer company as trading stock.[77]

Both Lord Templeman and Lord Bridge criticised the conduct of the Revenue's case before the Commissioners. They were both emphatically of the view that it was wrong that counsel was not instructed to present the Crown's case before the Commissioners. Lord Bridge said that:

> "this was a case where the Inland Revenue owed it to the general body of taxpayers to ensure that their case was competently conducted before the General Commissioners. A claim to tax relief of nearly £4 million turned on the result. The facts were, to say the least, unusual and a difficult issue of fact arose for decision. In these circumstances any competent advocate experienced in tax matters would have realised that, if the Revenue were to succeed on the grounds unsuccessfully argued before Walton J and the Court of Appeal, it was essential to leave the taxpayer to prove their case before the commissioners by oral evidence. The background to the transactions in question could then have been thoroughly explored in cross-examination, This might very well have elicited material to support the conclusion of fact reached in the dissenting judgment of Lawton LJ.
>
> Instead the Revenue allowed the case to proceed before the commissioners on an exiguous statement of facts. In the result, the Revenue have only themselves to blame that, so far as the debts are concerned, neither Walton J, nor the majority of the Court of Appeal, not any of your Lordships feel able to interfere with the inference which the commissioners drew from the facts so agreed."[78]

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77. Ibid
78. p126. See also Lord Templeman at p130

So, although the taxpayer company won part of its case, it was really by default. The message was clear for other taxpayers; the House of Lords did not like finding for the taxpayers in Nova Securities, and the Revenue could not be expected to make the same mistake again. Furthermore, the possible application of the "new approach" had not been fully explored.[79] Accordingly, the use of section 274(1) ICTA 1970 and section 122(3) CGTA 1979, in the absence of a genuine trade in the assets being acquired, ceased after the Arndale and Nova cases.

Turning to other devices to exploit inter-group transfers, the FA 1988 contained two provision aimed at specific arrangements. The first was <u>section 114 and Schedule 11 FA 1988</u>. These provisions were aimed at schemes implemented by groups of companies to exploit the indexation provisions so as to make large capital losses. An Inland Revenue Press Release of 15 March 1988 explained what the Revenue were concerned about. Although transactions between members of the same group of companies do not normally attract a tax liability,[80] a debt on a security is a chargeable asset even if the loan is between group companies.[81] Although the lending company might receive repayment to such as debt in full, it was still entitled to an indexation allowance which created a capital loss.

These rules were being exploited in two ways.

1. The group would interpose one or more companies between the member with the money and the member that wanted to borrow it, Each intermediate company received and made a loan of the same amount and each was able to get indexation relief. This meant that more than

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79. On this aspect of these case, see Chapter 11
80. Section 273 ICTA 1970
81. Section 134 CGTA 1979

one amount of relief was given on what was in substance the same asset. If the end borrower bought an asset with the money, then the asset would also qualify for indexation relief on disposal.

2. Funds were passed round in a circle back to the lender. In substance, there was no asset, but, again, more than one amount of indexation relief arose.

Similar effects could be obtained by using redeemable preference shares or ordinary shares whose acquisition was financed by an inter-group loan.

Section 114 and Schedule 11 FA 1988 countered these devices with effect from 15 March 1988.[82] The indexation allowance is removed on disposals of linked debts on a security.[83] A debt on a security is a linked debt if it is owned by a company and that company and the debtor company were linked when the lending company acquired the debt.[84] Two companies are linked if they are in the same group or associated with each other.[85] A group is a parent and its 51% subsidiaries, and companies are associated if one controls the other or both are under common control.

If the companies only become linked after the acquisition, the indexation allowance is removed from the date they become linked and, if the lending company acquired the debt on a reorganisation, the indexation is reduced by such amount as appears to the inspector, or on appeal, the Commissioners, to be just and reasonable.[86]

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82. Para 7, Sch 11, FA 1988
83. Para 1, ibid
84. Para 1(4) ibid
85. Para 4 ibid
86. Para 1(3) ibid

The provisions also cover arrangements for routing the debts through non-linked companies.[87] The similar schemes using shares are dealt with by paragraph 3.

There was no scope for these highly artificial schemes following these provisions.

The other counteracting measure was enacted to nullify the decision in the case of <u>Westcott v Woolcombers Ltd</u>,[88] which had the effect that share exchanges by companies in the same group could give rise to gains or losses which were charged or allowed twice. There was therefore, scope for manipulating group companies to double up losses.

The actual facts of the Woolcombers case need not be set out except that it should be noted that the parent company transferred the shares of three subsidiaries to a fourth subsidiary, in return for shares in the fourth subsidiary. The problem the Court of Appeal had to decide concerned the interaction of the rules governing transfers of assets between members of the same group[89] and the reorganisation provisions.[90]

The general rule relating to transfers between members of the same group is, of course, that assets are transferred on a no-gain-no-loss basis with any gain or loss only crystallising when the asset leaves the group. However, if the asset is a holding of shares, and the holding is acquired by another group company in exchange for the issue of its own shares, the accrued gain or loss on the transferred shares is rolled over into the newly issued consideration shares, so that the gain or loss only crystallises when the consideration shares leave the group. The

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87. Para 2 ibid
88. [1987] STC 600
89. Section 273 ICTA 1970
90. Now section 85 CGTA 1979

reorganisation rules were intended to take precedence over the general rule on inter-group transfers.

However, it was decided in the Woolcombers case that both rules apply to the transferred shares, with the result that the accrued gain or loss is rolled-over into the transferred shares, which are disposed of on a no-gain no-loss basis, and to the newly issued consideration shares. Consequently, the gain or loss would eventually be charged or allowed twice.

Before this decision it was widely thought that groups could achieve a tax-free step-up in base costs by engineering a share-for-share exchange within a group, because the deemed acquisition cost to the acquiring group company would be the market value at the time of the share exchange. The Woolcombers decision showed that this ploy did not work. It was reported that one company, Exco, had to pay an extra £73 million tax as a result of the decision. However, while the decision closed one door, it opened another by holding out the possibility for double loss relief.

Clearly, the inintended effect of the interaction of the two provisions was capable of producing great injustices: sometimes for the taxpayer, and sometimes for the Revenue.

Section 115 FA 1988 cured the defect in the law by inserting a new subsection (2A) in section 273 ICTA 1970 which says that the no-gain no-loss rule in section 273 does not apply to shares exchanges within section 85 CGTA 1979. This change has effect from 15 March 1988.

Depreciatory and Value Shifting Transactions

Paragraph 20 of Schedule 12 to the FA 1968 was introduced to prevent the creation of allowable losses on the disposal of shares in a subsidiary by the transfer of assets at other than market value between members of the same group. Paragraph 20 was consolidated in 1970 as section 280 ICTA 1970. This section applies in relation to a disposal of shares in, or securities of, a company (an "ultimate disposal") if the value of those shares or securities has been materially reduced by a depreciatory transaction effected after 5 April 1965.[91]

As well as covering transfers of assets at other than market value, a "depreciatory transaction" is defined as also meaning any other transaction where the company whose shares or securities are disposed of in the ultimate disposal (or any of its subsidiaries) was a party to the transaction, and the parties to the transaction were, or included, two or more companies which at the time of the transactions, were members of the same group.[92]

A transaction is not treated as a depreciatory transaction to the extent that it consists of a payment which is required to be or has been brought into account in computing a chargeable gain or allowable loss accruing to the person making the ultimate disposal.[93]

The effect of being caught by the section is that, if the person making the ultimate disposal is, or has at any time been, a member of the group of companies referred to above, an allowable loss accruing from the disposal is reduced to such extent as appears to the inspector, or on appeal, the Commissioners, to be just and reasonable

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91. Section 280(1) ICTA 1970
92. Section 280(1)(a)(2) ibid
93. Proviso to section 280(1) ibid

having regard to the depreciatory transaction. However, if the person making the ultimate disposal is not a member of the group when the relevant disposal is made, no reduction of the loss is made by reference to a depreciatory transacions which took place when that person was not a member of the group.[94]

In restricting the allowable loss, the inspector (or the Commissioners) must make the adjustment on the footing that the allowable loss ought not reflect any diminution in the value of the company's assets which was attributable to a depreciatory transaction, but allowance can be made for any other transaction after 5 April 1965 which has enhanced the value of the company's assets and depreciated the value of the assets of any other member of the group.[95]

As originally drafted, in making the decision referred to above, the inspector (or Commissioners) had to make the decision on the footing that the allowable loss ought not reflect any diminution in the value of the company's assets attributable to a depreciatory transaction "if and so far as the effect of the transaction was to increase the value of the assets of any other member of the group." Taxpayers could therefore resist a restriction under the section by establishing that the depreciatory transaction did not give rise to an increase in the value of the assets of another group company. This avenue of frustrating the effect of the section was removed in relation to ultimate disposals recurring after 26 March 1974 by section 29 FA 1974 which removed the words in inverted commas set out above.

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94. Section 280(4) ibid
95. Section 280(5) ibid

The operation of section 280 is restricted to the reduction or elimination of an allowable loss; it cannot create a chargeable gain. Furthermore, it only applies if the depreciatory transaction has reduced the value of the shares of the subsidiary "materially". The section does not define what is meant by "materially", but in most cases, it is fairly clear whether the Revenue would seek to apply the section.

If an allowable loss is reduced under the section, any chargeable gain accruing on the disposal of shares or securities in another company which was a party to the depreciatory transaction is reduced to such extent as appears to the inspector, or on appeal to the Commissioners, to be just and reasonable having regard to the effect of the depreciatory transaction. The reduction in the chargeable gain must not exceed the earlier reduction in the allowable loss. For there to be a reduction in the chargeable gain in this way, it must arise from a disposal occurring not later than six years after the depreciatory transaction.[96]

Soon after the original depreciatory transaction provisions were enacted in 1968 it became clear that further abuses had to be tackled. Accordingly, in the following year, paragraph 21, Schedule 19 FA 1969 was passed to cover situations in which capital losses are created by the payment of dividends from a subsidiary to a parent.[97] These provisions are now contained in section 281 ICTA 1970.

These provisions apply where one company owns at least 10% of the shares of the same class in another company and the first company is not a dealing company in relation to that holding. There must be a distribution to the first

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96. Section 280(6) ibid
97. The subject of dividend stripping is examined in detail in Chapter 1.

company in respect of the holding, made after 29 April 1969, which has the effect of materially reducing the value of the holding.[98]

Where these condition apply, the distribution is treated as a depreciatory transaction within section 280 by the first company or by any other member of the same group to which the holding is transferred. A distribution is not treated as a depreciatory transaction to the extent that it is brought into account in calculating a chargeable gain or allowable loss accruing to the person making the ultimate disposal.[99] It is not clear how a distribution can possibly be brought into account in computing a chargeable gain or allowable loss of the top company because the distribution will always be regarded as income.[100]

In determining whether the 10% holding test is satisfied, shares held by person connected with the top company can be taken into account.[101] It is therefore not possible to avoid the operation of the section by fragmenting a holding between connected person so that each owns less than 10%.

Sections 280 and 281 ICTA 1970, together with the value shifting provisions of section 26 CGTA 1979,[102] cover a very wide range of schemes designed to exploit companies and groups; but taxpayers were still able to find gaps, particularly in relation to the sale of subsidiaries. This form of avoidance was countered by well-targeted but rather complicated provisions in the FA 1989.

The schemes at which this legislation was aimed involved selling a subsidiary after reducing its value in a way

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98. Section 281(1) ICTA 1970
99. Section 281(2) ibid
100. Section 20 ICTA 1988
101. Section 281(6)(b) ibid
102. See Part 1

not caught by the existing legislation. The basic intention of the various schemes was to convert unrealised capital gains into tax-free distributions, This object was achieved by a subsidiary paying a dividend to its parent, or transferring an asset at an undervalue to another group company prior to the sale of the subsidiary by the parent. The value of the subsidiary would, of course, have been reduced by the dividend or transfer at an undervalue. The actual dividend or transfer would normally have been tax-free.[103] The existing value shifting provisions in section 26 CGTA 1979 did not apply because subsection (7) stated that references to the material reduction in the value of an asset did not include a reference to any reduction attributable to:

(a) the payment of a dividend between two members of the same group within the meaning of section 272 ICTA 1970; or

(b) the disposal of an asset within section 273 ibid.

<u>Section 135 FA 1989</u> replaced section 26(7) CGTA 1979 so that section 26 can apply to sale of subsidiaries where there has been a dividend or transfer of assets at an undervalue within situations covered by new section 26A and 26B inserted by section 136 FA 1989.[104]

Section 135 FA 1989 also added a new subsection to section 26. The Revenue were concerned at schemes where a subsidiary pays a dividend or transfers an asset at an undervalue, and that subsidiary is transferred to another member of the same group, and it is that transferee group

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103. Section 247 ICTA 1988 and section 273 CGTA 1979
104. Infra

member that is sold. The value of that group member is obviously less than if the depreciatory transaction had not taken place.[105]

This type of scheme is countered by the introduction of section 26(1A) CGTA 1979.[106] The new provision applies when a subsidiary is sold, and allows section 26 to apply in relation to the reduction of an asset other than the subsidiary's shares if all three of the following apply:

(1) the asset is still owned by a company in the group at the date of the sale of the subsidiary;

(2) the asset had not been treated as having been disposed of by a company leaving the group within section 278 ICTA 1970;

(3) if the asset had not been reduced in value, the value of the shares in the subsidiary would have been materially greater.

The provisions of section 135 apply where the disposal of the shares in the subsidiary occurs on or after 14 March 1989.[107]

The next provision to consider is <u>section 136 FA 1989</u>. This section adds three new section to the CGTA 1979; sections 26A, 26B and 26C.

<u>Section 26A CGTA 1979</u> sets out certain circumstances in which section 26 can apply to the disposal of a subsidiary following a value shifting transaction. A dividend will activate section 26 if it is paid out of

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105. See Inland Revenue Press Release 14 March 1989; "Capital Gains: Sale of Subsidiaries"
106. Section 115(1) FA 1989
107. Section 135(4) FA 1989

chargeable profits[108] which are profits arising from a transaction which is:

(1) an inter-group transfer within section 273 ICTA 1970;

(ii) a reorganisation within section 85 CGTA 1979; or

(iii) a revaluation of an asset in the accounting records of the subsidiary.[109]

As pointed out in the Inland Revenue Press Release of 14 March 1989, a revaluation as mentioned in (iii) would not normally increase distributable profits under UK law, but it might do in the case of companies incorporated outside the UK.

Any of the three circumstances mentioned above will give rise to an "asset with enhanced value". In situation (i) it is the asset acquired by the transferee group company; in (ii) it is the shares received by the subsidiary; and in (iii) it is the revalued asset.

It is further provided that section 26 will only come into operation if, during the period beginning with the transaction and ending with the sale of the subsidiary, the asset remains in the group;[110] and, immediately after the subsidiary is sold, the asset with enhanced value is owned by a person other than the company making the disposal or a company associated with it.[111] For section 26 to apply, the asset with enhanced value must not be one the disposal of which gives rise to neither a chargeable gain or allowance loss.[112]

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108. Section 26A(1) CGTA 1979
109. Section 26A(6) ibid
110. Section 26A(7) ibid
111. Section 26A(8) ibid
112. Section 26A(9) ibid. Gilts and qualifying corporate bond would be with this last category.

Section 263 CGTA 1979 also defined certain circumstances in which section 26 can apply. This section applies where an asset has been transferred by the subsidiary to another group company within section 273 ICTA 1970, and the subsidiary is then sold.[113]

Section 26 is stated to apply if the consideration for the disposal of the underlying asset is less than its market value and less than its cost, unless the disposal is effected for bona fide commercial reasons and does not form part of scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to corporation tax.[114]

If a subsidiary is dissolved or wound up, a distribution to the parent is not caught.[115]

There are certain provisions supplementary to those in section 26A and 26B in section 26C CGTA 1979, dealing with such matters as part disposals and cases where assets have been merged.

The new provisions of sections 26A and 26B apply if the disposal of the subsidiary and the payment of the dividend of transfer of the asset occurs on or after 14 March 1989.[116]

A further new section, section 26D CGTA 1979, was introduced by section 137 FA 1989. This new section deals with value shifting transactions which are followed by a reorganisation, reconstruction or amalgamation. This new section states that a chargeable gain or allowable loss will arise to the extent of the value shifting, with the normal reorganisation provisions of section 85 or 86 applying to the remainder of the transaction.

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113. Section 26B(1) ibid
114. Section 26B(2) ibid
115. Section 26B(5) ibid
116. Section 26(C)(14) ibid

This section applies where the reduction in value for section 26 purposes, takes place on or after 14 March 1989.

The new value shifting provisions introduced by the FA 1989 are very complicated in their structure and drafting but, nevertheless, they appear to have been well targeted. There were specific schemes at which the provisions were aimed and all indications at this stage are that these schemes will have been effectively stopped without unduly interfering with normal commercial transactions.

Miscellaneous Provisions Relating to Companies and Shares

On the subject of companies and shares, it only remains to deal with a handful of miscellaneous anti-avoidance provisions. The first is section 75 CGTA 1979. This section applies where a close company transfers an asset to any person otherwise than by way of a bargain made at arm's length and for a consideration of less than the market value. In such circumstances, the amount of the undervalue is apportioned among the issued share capital.[117] A gain accruing on the disposal of any of those shares by the person owning them on the date of the transfer is adjusted by excluding the amount so apportioned from the allowable expenditure under section 32(1)(a) CGTA 1979.[118]

If an amount is apportioned to another close company, a further apportionment is made to the shareholders of that company.[119]

The object of this legislation is clear; if a close company makes a transfer at an undervalue, the value of its shares will be reduced accordingly. It was therefore thought appropriate that the shareholders should have the amount of undervalue shared between them. This has been done in a rather ineffective way, namely by reducing allowable expenditure. A great many close companies start life as off-the-shelf £100 companies. Unless they were incorporated prior to 31 march 1982 and they have benefited substantially from rebasing, a reduction in allowable expenditure would be virtually meaningless. An increase in the proceeds from the disposal, in those cases, would have been much more effective.

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117. Section 75(1) CGTA 1979
118. Section 75(2) ibid
119. Section 75(3) ibid

Another provision by virtue of which an action by a company can affect the tax position of the share holders is section 346 ICTA 1988. Unlike section 75 CGTA 1975, this section is not restricted to close companies. It applies where a person who is connected with a company resident in the UK receives a capital distribution from the company, in respect of shares in the company, other than a capital distribution representing a reduction of capital, and

(a) the capital so distributed derives from a disposal of assets in respect of which a chargeable gain accrued to the company; or

(b) the distribution constitutes such a disposal of assets.[120]

In such cases, if corporation tax assessed on the company for the accounting period in which the chargeable gain accrues includes any amount in respect of chargeable gains, and any of the tax is not paid within six months from the date when it becomes payable by the company, the recipient may be charged (in the name of the company) to an amount of that corporation tax not exceeding;

(i) the amount or value of the capital distribution received; and

(ii) a proportion equal to the recipient's share of the capital distribution made by the company of corporation tax on the amount of that gain at the rate in force when the gain accrued.[121]

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120. Section 346(1) ICTA 1988
121. Section 346(2) ibid

Accordingly, it is not possible for shareholders to extract assets standing at a substantial gain from a company and leave the company without the funds to pay the tax. However, virtually all capital distributions are treated as income in the hands of the recipient,[122] so this section does not often apply.

The final provision to be considered here is section 58 F(No2)A 1975. This concerned "bed and breakfast" deals by companies. Companies, as well as individuals and trustees, could sell and immediately reacquire shares, either to crystallise losses to be used against other gains, or to crystallise gains if there were losses available in that year or, in the case of individuals and trustees, there were annual exemptions available.

Although such transactions can still be implemented by individuals and trustees, restrictions were placed on the ability of companies to enter into such deals by section 58. With effect from 14 April 1975, where shares are sold and reacquired, or acquired and sold, within one month, in the case of a stock exchange transactions, or six months, for other disposals, the transaction is ineffective for CGT purposes if, at any time during the one/six month period, the company held 2% or more of the issued share capital of the type in question.

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122. Section 209 ibid

CHAPTER 9

THE UNITED KINGDOM PERSPECTIVE ON INTERNATION TAX AVOIDANCE

INTRODUCTION

This Chapter is devoted to an examination of tax avoidance with an international element. This wide subject has increased greatly with the expansion of international trade, communications and investment overseas. The many aspects of international tax avoidance, seen from a UK viewpoint, are examined in this Chapter.

Part 1 contains a general survey which considers a number of fundamental points such as the exploitation of tax havens, "treaty shopping", the types of anti-avoidance provisions, and international co-operation.

The attempts of UK individuals to transfer their assets abroad and out of the reach of the Inland Revenue, and the steps taken to stop them doing so, are the subject of Part 2.

In Part 3, the subject of transfer pricing is considered. This is a major consideration for all countries whose residents are involved in a significant amount of international trade, and most such countries have anti-avoidance legislation to prevent the loss of revenue due to artificial pricing arrangements.

Part 4 is concerned with a specific area of avoidance arising out of the UK remittance basis of taxation. Under this basis, certain categories of income and gains are not taxable unless payments are made to the UK. Taxpayers subject to this basis of taxation have attempted to enjoy in this country the fruits of their overseas income and gains, without having to bring taxable sums to the UK.

The structure of companies makes them an ideal tool for tax avoidance, in that they are separate legal entities capable of being set-up in a particular country where particular benefits can be obtained, and their residence can often be manipulated so that tax advantages arise that would not otherwise be available for the type of business concerned. This exploitation of companies is considered in Part 5.

One major way of combating tax haven activities of domestic companies and groups is by attributing profits of a tax haven subsidiary to the domestic parent. An increasing number of companies are turning to this type of anti-avoidance legislation, and Part 6 examines the measures taken by the UK and other countries in this area.

Parts 7 and 8 are concerned with the exploitation of the residence of individuals and trustees respectively and, finally, in Part 9, a number of miscellaneous international tax issues, such as captive insurance companies and artificial transaction in land are examined.

PART 1

GENERAL SURVEY

Introduction

Many taxpayers over the years have sought to exploit the different tax systems of various countries and their interaction, having realised the enormous scope such differences provide.

The importance of this area of the law has increased greatly with the expansion of international trade and private investment overseas.

A potential tax avoider who contemplates exploiting international factors has had to examine two basic areas:

1. The domestic tax laws of the countries involved.
2. The interaction of the laws of the various countries.

It is not only tax laws themselves that have affected the types of avoidance that have been implemented. A list of the more important non-tax factors would include:

1. Exchange controls.
2. Investment incentives.
3. Currency and exchange rates.
4. Communications.
5. Financial framework (banking, accountancy and professional expertise etc.).
6. Political stability.
7. Types of legal entities and ease of setting up and running them.

A government of a country which is the victim of international tax avoidance would be concerned not only because it is unfair to the general body of its own taxpayers and is a drain on the country's resources, but also because the flow of capital from country to country is distorted and the country's strength as regards international competition is weakened.

Part 1 of this Chapter examines a number of fundamental points relevant to international tax avoidance and the measures taken by governments to combat it.

This examination begins by isolating what it is that enables a country to raise taxes in the first place. This is referred to below as the "nexus". Then the main opportunities for tax avoidance are examined. Firstly there are tax incentives offered by many countries and then, more fundamentally, there are "tax havens". The use of tax havens will be considered in some detail. There is also the problem of "treaty shopping" whereby the benefits of double tax treaties are exploited by those who would not normally be entitled to use the treaties.

Faced with tax avoidance through the use, for example, of tax havens, consideration will then be given to how such tax avoidance is combatted.

The "Nexus" Concept

Starting with perhaps the most fundamental point, potential avoiders have sought to exploit the fact that tax liability in any country depends on a nexus between that country and either the actor or the action. In other words, liability may attach to a taxpayer or to a taxable operation, or both. If this nexus is broken, liability ceases.

Dealing with the nexus between the country and the taxpayer first, the precise nature of the nexus varies from country to country and from entity to entity.

In the case of a company, for instance, a country may attach tax liabilities depending on such things as central management and control, place of incorporation, ownership of shares, presence of a permanent establishment etc. With individuals, it might be residence and/or ordinary residence, domicile, nationality or centre of economic interests, or a combination of these factors. The relevant nexus in the case of trusts might be, say, place of administration, residence etc. of the settlor, trustees or beneficiaries, place of creation or the applicable law expressed in the trust deed.

Avoiding or breaking the appropriate nexus has been the object or an integral part of many tax avoidance schemes.

The other relevant nexus is between the country and the activity, by which is meant the existence of a taxable source in the country. Again, the exact nature of this nexus varies from country to country and from operation to operation. Liability in the case of trading might depend on the place where contracts are finalised, where the main activities are carried on, where the capital is employed etc. Liability arising out of more passive activities is more often than not determined by the situs of the asset giving rise to the income or gain. Once again the avoidance or severance of such a nexus has been the object of many schemes.

Many countries have combatted attempts to avoid or sever the appropriate nexus by anti-avoidance legislation. The UK has a wide range of such provisions from narrowly targeted and specific sections to sweeping and widely drafted rules. However, unlike many other countries, there is no general anti-avoidance provision.

Double taxation agreements, too, normally contain articles aimed at preventing abuse, as will be seen below.

Anti-avoidance rules in this area often operate by preventing or prohibiting the severance of the nexus or creating or deeming a nexus that would not otherwise exist.

Another factor in international tax planning, although it can often be just as important in domestic tax planning, is the type of entity through which operations are carried out. Different entities may, and normally do, suffer different tax rates or be entitled to different tax incentives or reliefs or be subject to a different nexus. Consequently, manipulation in this area has been widespread.

Similarly, in many countries, different sources of income and gains are taxed according to different rules or are subject to different taxes. The UK scheduler system is a good example of this. Manipulating the source has been another fruitful area for the tax avoider. An interesting illustration of this for UK based entities has been their attempt over the years to bring profits within the remittance basis rules.[1]

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1. See Part 4

An allied factor is the nature of the transaction. As far as the UK is concerned, the main example of this has been the traditional distinction between income and capital (the latter not being taxed at all until 1965).

Tax Incentives

In an international tax context, perhaps the most important factor exploited by avoiders are tax incentives offered by many countries. Included in this are nil and low tax regimes.

The existence of low taxes or generous reliefs is normally to attract investment into the country or to a particular region, either investment in general or of a particular type. The scope for abuse, however, is often great. Some countries, particularly traditional tax havens, do not mind the abuse of their system and some can even directly or indirectly encourage it to bring in further investment. An example of this is the use of a Netherlands royalty company, where the Dutch tax authorities allow foreigners to exploit the Dutch network or double tax agreements with nil or low withholding tax rates on royalties and thus to channel royalties through the Netherlands, with the Dutch authorities taking their "cut" in the form of corporation tax at normal rates but only on a small percentage of the royalties passing through (usually on a maximum of 7% of the royalties).

Most countries, from tax havens to high tax jurisdictions, offer certain incentives to promote a particular area or areas of their economy. Taxpayers often seek to exploit the incentives offered by other countries to produce tax savings not available in their own countries. The extent of this can be seen from the fact that 68 of the 100 leading foreign trade nations offer incentives of one sort or another for foreigners to invest in their country.

The incentives offered vary widely. The main ones are:

1. Complete exemption from tax.
2. Reduction of tax.
3. Deferment of tax.
4. Reduction of taxable base in the form of, say, capital allowances.[2]

It is in the interests of the tax avoider to take advantage of the incentives offered in other countries if and to the extent that he is allowed to do so.

This is not a static subject; the extent to which a particular country offers tax or other incentives can vary dramatically over a short period of time. Twenty years ago countries like Cuba, Morocco and Venzuela were nil or low tax countries but now generally exact high taxes and, only a few years ago, the UK was considered by many to be a corporation tax haven due to the existence of stock relief and 100% first year capital allowances on, for example, plant and machinery. Uruguay was originally a tax haven, then it had a spell as a high tax country and has now drastically cut its taxes in order to come back within the category of tax haven.

Often in choosing a tax haven, non-tax factors can be just as important as low or nil taxes. These may include investment incentives, political stability, lack of government control, communications and availability of labour.

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2. Good examples of the exploitation of this type of incentive are the capital allowance based leasing arrangements exmined in Chapter 6.

Tax Havens - Introduction

The use, or, depending on how one looks at it, abuse of tax havens has been a subject of major concern of high tax countries for many years. In fact, they began to be used to a significant extent after the first world war. The use of tax havens has been increasing rapidly as have the efforts of other countries to prevent loss of revenue through their use.

The flow of funds into tax havens is normally very much at odds with normal commercial considerations and this leads to great distortions in the proper flow of capital around the globe and in normal financial decisions.

What is a tax haven? The name is not a term of art and a country may be considered a tax haven by one person but not another. As noted above, the UK, for example, in the days of stock relief and extensive capital allowances, was looked on by many to be a corporate tax haven.

But, on the whole, tax havens normally fall into one of the following categories.

1. Countries with nil or very low taxes in the areas of operation in which the particular taxpayer is involved.
2. Countries which have substantial taxes but only in relation to operations taking place inside their borders, with nil or low tax rates on overseas sources.
3. Countries which give tax priveleges in particular fields of operations.

The tax advantages are often bolstered by strict secrecy and confidentiality rules and the lack of liaison and cooperation with other countries. Secrecy in the field of banking is often specifically safeguarded. Banking and allied financial operations often produce a great deal of revenue for tax havens.

Another common feature is the lack of exchange controls and currency restrictions, at least for non-residents dealing in foreign currency whose investment the haven is keen to encourage; and other government controls are often absent or reduced to a minimum.

Following a number of unfortunate incidents in recent years, one of the major factors taken into account by taxpayers in their choice of a tax haven is not a fiscal one; it is the extent to which assets placed in a particular haven are safe from nationalisation or seizure by the government. Linked to this is political stability - another important factor. For example, when Castro took over Cuba (then a tax haven), nationalised property belonging to United States investors alone totalled $7 billion. Taxpayers' concerns about this are recognised in some tax havens and the Netherlands Antilles and the Cayman Islands, for example, have enacted guarantees and protection against expropriation by their governments. Other countries are willing to give written guarantees on a case by case basis.

Some tax havens will even give guarantees concerning future taxes Bermuda, for example, in appropriate cases will give a guarantee to exempted companies against future taxes until the year 2006.[3] The Cayman Islands will give guarantees to both exempted companies[4] and exempted trusts.[5]

The nature of the guarantee given will vary from country to country and, even within a particular country, various types of guarantee might be given to an exempted company that it would not be subject to any future law levying tax on profits, income or gains. Some guarantees might

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3. Exempted Undertakings Tax Protection Act 1986, as amended.
4. Tax Concessions Law (Nos 20 and 21 of 1962), as amended.
5. Trusts Law (No 6 of 1967), as amended.

even cover such things as future death duties on the exempted company's shares. In the Cayman Islands, guarantees to exempted companies are normally given for fifteen or twenty years, whereas, in the case of trusts they can last for up to 50 years.

As well as tax factors, the economic background of a country is also important and here major considerations will include such things as interest rates and inflation. Communications and transport facilities will also be extremely important in the modern international business climate.

The Exploitation of Tax Havens and Treaty Shopping

A tax haven can be used by a taxpayer in a high tax country in numerous ways. A number of the most common are mentioned below. It should be kept in mind that, in particular circumstances, a high tax country can effectively be a tax haven due to certain reliefs or incentives that might be exploited by foreign entities.

A. "Base" Companies

These are companies established in a tax haven to shelter income from the high tax country by receiving the income that would otherwise be received in that high tax country. The fundamental principle that protects the taxpayer in the high tax country from tax in respect of the base company's profits is the fact that the base company is a separate legal entity. The corporate veil of the base company might, however, be pierced by specific legislation such as the Controlled Foreign Companies legislation in the UK or the Subpart F Legislation in the U.S.A.[6]

Such a company can serve many functions depending on the tax planning structure of which it is part. For example:

(1) A holding company. Not all tax havens are suitable locations for holding companies because very few have tax treaties with high tax countries and so dividends to the tax haven holding company normally suffer high withholding taxes. Furthermore, capital gains on the sale of subsidiary company shares or on the liquidation of the subsidiaries may also suffer high withholding taxes. However,

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6. See Part 6

jurisdictions with particularly beneficial rules which encourage the establishment of holding companies, in particular, Luxembourg, the Netherlands and the Netherlands Antilles, are popular locations for holding companies.

A tax haven company can also be used as an investment holding company with the object of ensuring that income and gains on the sales of shares are accumulated tax-free. As well as nil and low tax countries, Switzerland is a favourite location for such companies because, as well as its network of double tax agreements which reduce withholding taxes on dividends, Swiss domestic tax is low and a Swiss investment holding company might expect to pay only 9%, with a total or partial refund of the foreign withholding tax.

(2) Trading Companies. Tax haven companies can be set up either to trade within the tax haven or abroad. Onshore trading companies are less numerous because only a few countries give tax benefits to local companies carrying on business within their borders. There are, of course, tax havens which levy no taxes at all and these are suitable for such companies but also a few other companies such as the Netherlands Antilles and the Republic of Ireland provide concessions for such companies.

Much more usual is the company established in a tax haven which carries on all of its business activities outside the jurisdiction. In fact, some countries prohibit offshore trading companies from doing business within their borders (for example Switzerland).

(3) A Finance Company. Such a company is set up in a tax haven to accumulate funds earned by other group companies tax-free and, for example, to lend accumulated funds back to group companies to finance further operations. Furthermore, an intermediate finance subsidiary may be established in a country such as the Netherlands or Switzerland so that funds can be channelled through that company to a second finance subsidiary established in a "pure" tax haven to take advantage of the reduced withholding taxes under the double tax agreements of the intermediate country.

(4) Licensing and Leasing Companies. Tax haven companies are often used to own intellectual property rights such as patents which are licensed to group companies in other countries, often via a sub-licensing conduit company.[7] Royalties can be paid from some countries such as the Netherlands, Switzerland and Sweden without withholding tax and these royalties can be paid directly to a tax haven licensing company. Most other countries, however, levy withholding tax unless eliminated by an appropriate double taxation agreement. In these cases, it is common to channel the royalties through a conduit company situated in, say, the Netherlands to reduce or eliminate withholding taxes.

(5) A Manufacturing Company. Many countries try to encourage manufacturing companies to set up within their borders and, to this end, give concessions which often include tax benefits in

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7. Infra

the form of, for example, reduced rates or a tax holiday. Notably, investment grants or generous capital allowances may be given. However, more than with most other types of company, non-tax factors are likely to be more important than tax considerations in deciding where to set up a manufacturing company. There are relatively few manufacturing companies set up in "pure" tax havens.

(6) A Real Estate Company. Tax haven companies are often used to hold real estate situated in high tax countries.

The above list is by no means exhaustive but gives an indication of the range of uses to which tax haven base companies can be put.

Once the income has been received in the tax haven, the problem for the taxpayer is how to get the benefit from it. Payment out to him in the high tax country in the form of, say, dividends obviously would not serve his purpose. The operations effected to solve this problem are often described by the phrase "secondary sheltering".

This too can take many forms but normally they are characterised by the fact that the nature of the income is changed so that it can be enjoyed by the taxpayer in the high tax country without the tax liability that would have attached to a direct receipt from the original source. The taxpayer might, for example, take a loan from the base company or perhaps sell the base company's shares or liquidate it to realise a capital gain, which has traditionally been taxed at a lower rate than income (although this is no longer so in the UK, of course).

Alternatively, the taxpayer might take the money out in a form which is exempt under a double tax agreement or under national law such as in the form of salary. On the other hand, the tax haven company might accumulate the income and reinvest it outside the high tax country.

Of particular interest in choosing a location for a base company are those countries with direct, but normally indirect, access to a network of double taxation agreements. A prime example of this is the Netherlands Antilles which, by its treaty with the Netherlands, can "plug into" the latter's extensive network of treaties.[8] Added to this is the Dutch authority's willingness to allow their country to be used as a conduit, in return for a relatively small tax contribution. As a result, royalties, for example, can be channelled from a high tax country to the Netherlands, suffering a nil or low withholding tax rate in the high tax country under its treaty with the Netherlands and, in the Netherlands itself the royalties suffer tax at a concessionary rate, and the royalties can then be paid out to the Netherlands Antilles at a nil withholding tax cost. In the Netherlands Antilles, the domestic tax rate is very low on such income.

Switzerland, which in many respects can be a tax haven, has an extensive network of treaties. Belgium, which also has negotiated many treaties, can also be a tax haven in certain circumstances. The UK has one of the most extensive treaty networks of all and also has a number of traditional tax havens (such as Jersey and Guernsey) within its treaty network.

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8. However, an increasing number of countries are taking action against perceived abuses of tax treaties. For a detailed survey of the steps taken throughout the world to combat "treaty shopping", reference should be made to "Treaty Shopping - An emerging Tax Issue and its Present Status in Various Countries" by Deloitte Haskins & Sells International (Kluwer, 1988).

B. Conduit Companies

Tax haven companies themselves can be used as channelling vehicles, again mainly in a haven with access to one or more double tax treaties.

Treaty shopping through conduit companies consists basically of setting up an entity (usually but not always, a company) in a country in order to enjoy the benefits of the tax treaties of that country.[9]

Conduit companies fall into two basic categories: "direct" conduits and "stepping-stone" conduits. These terms were succinctly defined in the OECD Report published in 1987, "Double Taxation Conventions and the Use of Conduit Companies". These definitions are as follows:

1. Direct Conduits

   "A company resident in State A receives dividends, interest or royalties from State B. Under the tax treaty between States A and B, the company claims that it is fully or partially exempt from the whithholding taxes of State B. The company is wholly owned by a resident of a third State not entitled to the benefit of the treaty between States A and B. It has been created with a view to taking advantage of this treaty's benefits and for this purpose the assets and rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax exempt in State A, eg. in the case of dividends by virtue of a parent-subsidiary regime provided for under the domestic laws of State A, or in the convention between States A and B."

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9. This is considered further, infra

(2) Stepping-stone Conduits

"The situation is the same as in example 1. However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related conduit company set up in State D. These payments are deductible in State A and tax exempt in State D where the company enjoys a special tax regime."[10]

The 1987 OECD Report examined possible solutions to the conduit company problem.

1. The "Look-through" Approach

This is in effect, piercing the corporate veil and it amounts to allowing treaty benefits to a company only if the company is owned by residents of the country in which the company is resident.

Although this is a direct and simple way of approaching the problem, the Report did acknowledge that there were certain disadvantages such as:

(1) It would be incompatible with the principle that corporate bodies are treated as separate legal entities as recognised by all OECD members. This is correct and it would be a major departure from this principle to adopt the "look-through" approach. Furthermore, a point the Report did not consider is that the courts of some countries (for example, the UK) would be likely to treat such a provision with suspicion and give it a very restricted interpretation.

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10. Paragraph 4

(2) The relevant provisions would require extensive bona fide exclusions. As the Report comments, the resulting rules would be complicated and burdensome to administer. The Report could also have added that such provisions would undoubtedly be a fruitful generator of complicated, expensive and time consuming litigation.

(3) Such provisions would not prevent "stepping-stone" strategies.

(4) Machinery would be necessary to apply the provisions in a simple way, and this might require the shifting of the burden of proofs. Another criticism along these lines that could have been made is that the provisions would be very difficult to draft if they are to work in an effective but equitable way.

(5) The provisions would be very difficult to implement in countries where the capital of the company could include bearer shares. Indeed, it is probably true that the Report did not go far enough: the provisions would be virtually impossible to apply effectively in such circumstances.

The Report thought that this approach would be adequate "for treaties with countries which have no or very low taxation and where little substantive business activities would normally be carried on".[11] There are, in fact, very few such treaties and, in addition, as the Report states, even in the few cases where such a treaty does exist, it would be necessary to safeguard bona fide business

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11. Paragraph 25

activities. On the whole, it appears that such an approach would be difficult to draft and implement if it is to be applied effectively but equitably.

2. The Exclusion Approach

Under this approach conduit companies would be denied the tax treaty benefits which they are seeking to exploit. The OECD Report sites two examples. Article 1 of the Germany/Luxembourg agreement reads:

> "1. The Agreement shall not apply to holding companies within the meaning of the special Luxembourg laws (currently the Act of 31st July 1929 and 27th December 1937). Neither shall it apply to income derived from such holding companies by a person domiciled in the Federal Republic of Germany or to shares in such companies belonging to such person."

Article 29 of the Germany/Canada agreement states:

> "1. With respect of income taxable in a Contracting State, the provisions of the Agreement shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded:
>
> (a) by the laws of a Contracting State in the determination of the tax imposed by that State, or;
>
> (b) by any other agreement entered into by a Contracting State.

2. It is understood that nothing in the Agreement shall be construed as preventing:

   (a) Canada from imposing its tax on amounts included in the income of a resident of Canada according to Section 91 of the Canadian Income Tax Act;

   (b) the Federal Republic of Germany from imposing its taxes on amounts included in the income of a resident of the Federal Republic of Germany according to Part 4 of the German Aussensteuergesetz.

   Where such imposition of tax gives rise to a double taxation, the competent authorities shall consult for the elimination of such double taxation according to paragraph 3 of Article 25.

3. Articles 6 to 23 of this Agreement shall not apply to non-resident-owned investment corporations as defined under Section 133 of the Canadian income tax act, or under any similar provision enacted by Canada after the signature of this Agreement, or to any income derived from such companies by any shareholders thereof."

As the Report acknowledged, this approach is of very limited scope and is not suitable to deal with more sophisticated treaty shopping arrangements. Nevertheless, within its limitations, it is useful in preventing special treaty privileges being used in an improper way. So, although it is not a complete answer by any means, it is a useful limited addition to the anti-avoidance armoury.

3. The "Subject-To-Tax" Approach

The concept here is relatively simple in that treaty benefits are only granted by the state in which the source arises if the income is subject to tax in the state in which the recipient is resident. An example is Article 23 of the Germany/Switzerland Treaty, the relevant parts of which read as follows:

"2. Even though a company meets the conditions provided in paragraph 1, a company resident in Switzerland in which persons who are not residents of Switzerland have, directly or indirectly, a substantial interest in the form of a participation, may only claim the benefit of the reduction of taxes imposed by the Federal Republic of Germany on German source interest, royalties, and on capital gains, if these interests, royalties or capital gains are subject, in the canton in which this company has its seat, to the cantonal tax on income under the same or similar provisions as are envisaged in regarding the federal defence tax.

"3 A family foundation resident in Switzerland may not claim the benefit of the reductions of tax imposed by the Federal Republic of Germany on German source dividends, interest, and royalties, and capital gains, if the founder, or the majority of the beneficiaries are non-residents of Switzerland and more than one-third of the relevant income is not, or will not benefit persons which are residents of Switzerland.

4. If the competent authority of the Contracting State, from which the items of income originate, has reasonable grounds to cast doubt on the declarations made by the recipient of the items of income in his effort to obtain a tax reduction, which are confirmed by the competent authorities of the other State, then the competent authority of the first mentioned State shall communicate these grounds to the competent authority of the other State; this authority shall then undertake a new investigation and inform the competent authority of the first mentioned State of the conclusions reached. In case of disagreement between the competent authorities of the two states, Article 25 shall apply."

Although this is wider than the exclusion approach, it again would be insufficient to stop the more involved treaty shopping techniques. In particular, the "stepping-stone" arrangements would not be caught. Furthermore, the Report acknowledges that the approach would exclude from treaty protection some bona fide privileges. For example, tax privileges of charities and pension funds would be excluded as would "tax holidays" (namely privileges granted with the object of fostering economic development). It would be difficult to cover such situations by specific exclusions without leaving loopholes that could be exploited by other taxpayers.

4. The "Channel" Approach

This approach is specifically directed towards conduit arrangements, particularly "stepping-stone" transactions. An example cited in the Report is again Article 23 of the Germany/Switzerland Double Tax Agreement which reads in paragraph 1:

> "A company which is a resident of a Contracating State, and in which persons who are not residents of that State have, directly or indirectly, a substantial interest in the form of a participation, or otherwise, may only claim the tax reductions provided for in Articles 10 through 12 with respect to dividends, interest, and royalties, derived from sources in the other State, as provided for in Articles 10 through 12, where:
>
> (a) the interest bearing debts to persons who are not resident of the first mentioned State are not higher than six times its equity capital and reserves; this restriction does not apply to banks and similar institutions;
>
> (b) the interest paid on loans agreed upon with non-resident lenders is not paid at a higher rate than the normal interest rate; the normal interest rate means:
>
> (i) with respect to the Federal Republic of Germany: the rate of the current yield of interest bearing securities from inland issuers plus 2 percentage points;
>
> (ii) with respect to Switzerland: the average interest rate on debt obligations issued by the Swiss Confederation plus 2 percentage points;
>
> (c) not more than 50% of the relevant income derived from source in the other Contracting State is used to satisfy claims (interest, royalties, development, advertising, initial and travelling expenses, depreciation on any kind of business asset including on immaterial

goods, processes, etc.) by non-residents of the first mentioned State;

(d) expenses connected with the relevant income derived from sources in the other Contracting State are met exclusively from that income;

(e) the Corporation distributes at least 25% of the relevant income derived from sources in the other Contracting State.

Additional measures already taken, or to be taken by one of the Contracting States, against abuse of the use of tax relief relating to withholding tax levied at source in the other Contracting State, are not prejudiced hereby."

Such Articles, however, almost invariably cover a wide range of normal busines activities and so it is necessary to build into such provisions a wide range of exclusions for bona fide business arrangements.

No one solution provides a complete answer to the problem of conduit companies and it is difficult to draft a provision which, at the same time, is sufficiently wide to catch the abuses at which it is aimed but which does not unduly inhibit normal business activities. Probably the most effective is the "channel" approach as long as the bona fide exclusions are drafted with sufficient care.

The OECD Report identified three characteristics which enabled the "stepping-stone" arrangements to work.[12] The Report noted that such arrangements make use of the fact that two high tax countries:

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12. Paragraph 45

(1) have differing tax laws (for example, as regards withholding tax);
(2) respect the taxation rights of the tax haven country.
(3) regard anti-abuse clauses in their treaties as unnecessary.

As the Report says, changing one of these characteristics to catch stepping-stone devices would also catch many bona fide activities. As a result, bona fide exemptions would have to be inserted into the counteracting provisions. The Report notes that this would be highly burdensome to tax administrations but, what the Report did not acknowledge was that, most tax administrations are becoming increasingly sophisticated and much less arbitrary in the application of bona fide exclusions, although some are tending to become rather more aggressive in their approach. Also, there is a general reluctance on the part of many people to see more fiscal power put into the hands of the Executive, particularly in a country, such as the UK, with a tradition of separation of powers.

The OECD preferred recourse to the principle of "substance over form". But this could lead to its own problems given the different ways that that principle is used in various countries and the general uncertainty regarding the extent to which it can be used. Accordingly, in the circumstances, it seems that bona fide exemptions would be preferable despite the fact that more power would be given to the Executive.

Some countries have taken unlateral action against certain abuses of their tax treaties by appropriate provisions in their domestic laws. Perhaps the best-known example of this is the Federal Decree of 14 December 1962 issued by the Swiss government which provides the reduction of withholding tax granted by another counteracting state under a treaty concluded by Switzerland may not benefit persons claiming through an individual, company, partnership or other legal entity in Switzerland if, by such a claim, a substantial part of the tax relief would benefit, directly or indirectly, persons not entitled to the benefits of a Swiss tax treaty.

C. Captive Insurance Companies

Certain tax havens are particularly popular as bases for captive insurance companies. The main ones are Bermuda, the Cayman Islands, Luxembourg and Vanwatu. Others include Guernsey, the Netherlands Antilles, the Bahamas and, within the U.S.A., the states of Colorado and Tennessee which are two states that have laws attractive to insurance companies.

There are a number of advantages in setting up captive insurance companies in such locations as compared with, say, the UK. Most of them are, in fact, non-tax factors. The main considerations are:

(1) Wider coverage.

A captive insurance company can cover risks not covered except at prohibitive cost by independent insurance companies in the taxpayer's home country. For example, a major security firm in the UK found that, because of increased attacks on their vehicles, reasonably priced insurance was becoming much more difficult to find in the UK. As a result, a captive insurance company was set up in a tax haven to enable the group to cover its risks at reasonable cost.

(2) Tailor made policies.

A captive can write a policy which is

tailor-made to the taxpayer's own circumstances.

(3) Fewer restrictions.
Tax havens normally have fewer statutory restrictions on the writing of insurance policies. This freedom from regulations is an important and often underestimated factor.

(4) Lower costs.
The absence of sales commissions and marketing costs can be an important incentive for the creation of a captive insurance company.

(5) Better liquidity.
Premiums can be invested "in house" rather than paid away to an independent insurance company.

(6) Lower taxes.
Despite the importance of the non-tax factors, the advantage of lower taxes should not, of course, be ignored. Premiums paid by the companies in the high tax country would normally be deductible (in the same way as premiums to an independent insurance company would be) and they would be taxed in the hands of the captive insurance company at a low or nil rate. Some countries, however, have sought to treat payments to captive insurance companies as capital.[13]

Captive insurance companies, as well as handling "in house" business, also take business from outsiders on a fee basis. In fact, over one-third of captive insurance companies' premiums come from outsiders.

The extent of captive insurance company operations can be seen from the fact that premiums written by such companies exceed £6 billion a year, a large proportion of this (about £4 billion) being written in Bermuda.

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13. See the US. IRS Ruling 77-316

The role of captive insurance companies will be considered in greater detail in Part 9.

D. Service Companies

Income can be moved from a high tax country to a tax haven by means of a payment for a "service" provided by the tax haven company such as administrative, management or coordinating functions. Normally, of course, a tax haven would rarely be used for the location of a service company in the absence of tax factors.

E. Emigration

Taxpayers in high tax countries sometimes change their residence to a tax haven for the purpose of avoiding tax. An example would be a UK resident moving to the Channel Islands. This is not too widespread given that many tax havens are rather out-of-the-way places.

On a rather more sophisticated level, taxpayers can leave their home country for just long enough to obtain the required tax advantage. An extreme example of this concerns the 1960's pop star, Dave Clark, who left the UK for one year and went to live in the U.S.A. The timing of his move was so precise that he escaped tax in both the UK and the U.S.A.[14]

F. Shipping

The phrase "flag of convenience" is a well known one. The countries which allow foreigners to register ships in their territories even though the business is run elsewhere often give both tax and other incentives.

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14. See Part 7

The tax incentives are usually in the form of nil or low income tax on the shipping business profits, and the non-tax factors would often include low registration fees, slacker technical and safety standards, and less interference from government bodies.

Traditionally, the favourite jurisdiction for such companies has been Liberia but other countries with favourable laws are Panama, Cyprus and the Netherlands Antilles.

G. Trusts

It will be seen that trusts can be a very useful tool in international tax avoidance.[15] A number of tax havens recognise trusts such as the Bahamas, the Cayman Islands, the Channel Islands, Hong Kong and Lichtenstein.

As might be expected, anti-avoidance legislation against the use of trusts in tax avoidance is extensive although, in countries which do not themselves recognise the concept of trusts, such legislation is less specific.

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15. See Part 8

The Size of the Problem

A Report issued by the OECD, "International Tax Avoidance and Evasion",[16] published in 1987, contains some interesting data about the size of the problem caused by the exploitation of tax havens.

The Report quoted[17] an earlier study, "Tax Havens and Their Uses by United States Taxpayers - An Overview" by Richard Gordon of the U.S. Department of the Treasury (1981). The Gordon Report examined the nine year period up to 1979 and came to the following conclusions:

1. The use of tax havens by American taxpayers was large and apparently growing.
2. Direct investment in tax havens was growing much faster than that in non-havens.
3. The increase in investment was more pronounced in some of the better known havens, for example, a five fold increase in the Bahamas and a 37 fold increase in Bermuda.
4. The level of increase in assets of American controlled corporations in tax havens outstripped that of those in non-havens by a ratio of 5 to 3.
5. Activities conducted by American controlled corporations in the jurisdictions examined were predominantly those expected to be encountered with haven usage; generally being financial, insurance, real estate, wholesale, construction, services and transportation (essentially shipping).
6. Banking deposits in tax havens had escalated rapidly (from $11 billion in 1968 to $385 billion in 1978).

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16. This publication was a collection of four Reports of which "Double Taxation Conventions and the Use of Conduit Companies", op cit, was one.
17. Para 41 of the first study; "Tax Havens: Measures to prevent Abuse by Taxpayers".

7. Gross dividends, interest and other income payments to tax haven residents from sources in the United States constituted, for 1978, 42% of all such payments to non-resident recipients.

The OECD Report then cited[18] a second study which updated the material in the Gordon Report. The second study was "Tax Havens in the Caribbean Basin" by the U.S. Department of the Treasury (1984). This study's conclusions were:

1. The level of foreign financial activity represented by foreign assets in banks in Bermuda, the Cayman Islands and Panama far exceeded their needs for foreign trade by some $300 billion.
2. The level of offshore banking activities in those countries rose sharply during the period 1978 to 1982.
3. U.S. direct investment in Caribbean countries other than the Netherlands Antilles increased by over 43% in the same period.
4. Financial activities through the Netherlands Antilles increased during that period with net United States borrowings from affiliates in that country increasing from $1 billion to $16 billion and reported income paid to Antillean residents increasing from $191 million to $1,400 million.
5. Reported currency transactions with the Caribbean havens revealed a considerable imbalance in respect of net flows to and from certain havens. Such imbalances possibly indicating a high level of illegal activities such as "laundering"

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18. Op cit para 42

of criminally obtained funds, deposit of funds from drug related and other criminal dealings.

It can be seen that the use of tax havens is escalating despite the evermore sophisticated anti-avoidance provisions being introduced in most high tax countries and moves in those countries against "treaty shopping".

The conclusions of the two above mentioned Reports were confirmed by the work of the OECD itself, the results of which were also sited in the Report on "International Tax Avoidance and Evasion".

The Development Assistance Committee of the OECD produced some figures showing that the stock and flow of private direct investment to some of the most popular tax havens from the 17 member countries of the DAC, was far out of proportion to the real size of their economies.[19]

Their investigations showed that five of the most popular tax havens (the Bahamas, Bermuda, Liberia, the Netherlands Antilles and Panama) had 14.3% of the investment stock flowing from DAC member countries to all developing countries at the end of 1981, even thought their economies counted for less than 0.3% of the total GNP of all developing countries. A similar inequality existed in private sector net investment flows.[20]

Tax havens do, however, have their defenders, and not just from the havens themselves and the tax avoiders who use them. The Business and Industry Advisory Committee to the OECD is responsbile for representing the views of the private sector. The BIAC gave its opinions to the

19. Op cit para 43
20. Ibid

OECD and these were reproduced in the OECD Report.[21] The BIAC gave examples where the use of tax havens might be justified on economic grounds and where industry would regard the use of havens as legitimate. Their points are of varying degrees of relevance. The following examples of the non-tax uses of tax havens were given:

1. To raise funds competitively on international markets and to reduce financing costs (including taxes). To this it may be commented that, although no doubt tax haven companies are very useful for fund raising, it is surely inaccurate to describe this as raising funds "competitively" because the use of tax havens tends to distort competition by giving the taxpayers who use such havens an unjust advantage.

2. To receive income from dispersed overseas operations in the form of dividends. This is a good point, as can be seen from the rather inequitable position suffered by UK holding companies where excess withholding tax from one overseas subsidiary cannot be set-off against a withholding tax shortfall on dividends from another overseas subsidiary with the result that the UK company would often have a sub-holding company set up in a suitable overseas jurisdication to receive the various dividends and to pay to the UK a single dividend thus ensuring, in effect, the averaging out of withholding taxes.

3. In the case of licensing and patent holding companies, to overcome the imposition of high

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21. Op cit paras 73-77

withholding taxes in cases where, in the absence of a treaty, a country will not allow a credit. This is a good point in that the tax haven would be used to avoid double taxation.

4. As regards service, wholesaling and construction companies, to coordinate dispersed commercial and industrial operations from a central or convenient operating base. This is a rather weak point in that tax havens are rarely either central or convenient.

5. In the case of international pension funds, to provide flexibility for members working internationally. This is a fair point.

6. In the case of group insurance companies, to reduce costs by providing risk coverage within a group. This is a good point and, in fact, the non-tax factors are rather greater than the one identified by the BIAC as will be seen below.[22]

7. As regards shipping companies, tax havens can overcome the difficulties of applying domestic labour laws to internationally employed staff. This is a good point but, again, it does not, in fact, go far enough because there are certain other non-tax factors in setting up a shipping company in an appropriate tax haven.[23]

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22. See Part 9

23. Supra

The BIAC also commented on counteracting measures that are taken against the use of tax havens. They commented "that faced with restrictive legislation, companies will either discontinue existing operations or more likely, change the method of conducting the operations so as to minimise the effect of legislation, the latter course often involving higher (non-tax) costs. Since not all competitors will be equally affected by the legislation, it may have unfortunate competitive effects". However, the BIAC appeared to have overlooked a more fundamental point in that the use of tax havens in the first place has a greater distorting effect on competition than the measures taken to counteract their use.

The BIAC noted three other "objectionable" features. These were:

1. The compliance burden on taxpayers as well as the enforcement burden on tax authorities is very costly. This can be so but it is really the decision to avoid tax in the first place that gives rise to the extra cost, except where anti-avoidance provisions are drafted so widely as to catch innocent taxpayers.

2. Profits from affected operations are subject to tax but losses are normally ignored. This is so but a properly structured tax haven operation should not give rise to losses so this point rarely arises in practice.

3. Such legislation often involves an element of "over-kill". This is a good point which is dealt with in more detail below.

The BIAC considered that "the correct way of tackling this problem is by singling out specific abuses and then devising legislation carefully aimed at the abuses in question". In other words, they were advocating the "sniper" approach. The problem with this is that such specific legislation can be easy to circumvent.[24]

As a general point, the BIAC also submitted that "much of the use of tax havens is not motivated by a desire to pay no, or little tax so much as an economic necessity to reduce costs, including taxes, to a bearable level in circumstances where the laws of countries are uncoordinated and even the laws of individual countries are inconsistent, insofar as they relate to the treatment of international business". This is a defence often put forward for tax avoidance in general and, in one sense, it can be seen as a bona fide commercial objective to reduce costs (including taxes). However, this has never been accepted as a legitimate reason to condone tax avoidance in general and, in the same way, it cannot be seen as a justification for tax haven activities.

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24. Infra

Counteracting Measures

The "abuse" of tax havens is a matter of concern to all high tax countries. Each country has taken some steps to prevent the loss of revenue through the use of tax havens. The measures that have been taken vary from country to country but certain categories of anti-tax haven provisions can be identitified.

The main categories of measures which are either specifically aimed at tax havens or particularly useful in combatting tax haven "abuses" are:

1. Controlled Foreign Companies Legislation

   Under this heading comes the legislation similar to the controlled foreign companies provisions in the UK and the Subpart F Legislation in the U.S.A. under which the profits of a subsidiary company set up in a low tax country can be taxed directly in the hands of the parent in the high tax country, normally unless the existence of a tax haven company can be justified on commercial grounds.[25]

2. Transfers of Assets Abroad

   Under this heading come provisions akin to Section 739 ICTA 1988 in the UK whereby income from assets alienated by a resident in the high tax country can still be taxed in his hands. Although these provisions are not specifically aimed at transfers of assets to tax havens, they often involve such transfers to a suitable low tax area.[26]

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25. See Part 6
26. See Part 2

3. Anti-Emigration Rules

Many countires have provisions attaching special rules or conditions to individuals and/or companies wishing to emigrate for tax reasons, very often to a tax haven.

4. Exchange Control

This is a powerful non-tax weapon commonly used to prevent the outflow of funds to tax havens.

5. Evidential Obligations

Some countries have enacted that certain transactions, often involving tax havens, will only give rise to favourable tax treatment if the taxpayer can show that the transaction is being carried out for commercial, rather than tax reasons.

6. Offshore Funds

Some countries, including the UK, have rules aimed at the setting up of unit trusts and similar funds in low-tax areas.

The extent to which measures such as these have been used by the major high-tax countries can be seen in Chapter 10.

In addition to the above specific provisions, several more general rules or concepts have a significant part to play in the prevention of the abuse of tax havens. The main types of provision in point here are:

1. General Anti-Avoidance Rules

It is appropriate to start with the most general and widespread provisions of all: The across the board general anti-avoidance rules employed by some countries, such as Australia and New Zealand. Of the avoidance devices at which they can be used, are the exploitation of tax havens, although countries with such general provisions rarely rely solely on them to counter tax haven abuses; they are normally bolstered by more specific provisions. It will be seen that general anti-avoidance provisions are rarely effective enough on their own to combat the use of tax havens.[27]

2. Abuse of Law/The Substance Doctrine

Many civil law jurisdictions employ the concept of "abuse of law" or "abuse of right" just as many other jurisdictions espouse the "substance" doctrine to a greater or lesser extent.

These doctrines can be used against tax haven devices as long as it is possible to determine what the economic or financial substance is; a lack of information may be a problem here although the growth of exchanges of information, particularly under double tax agreements, is helpful in this respect.

The substance doctine can be used in a number of ways to combat tax haven activities. For example, if it can be found that the tax haven company is, in substance, either controlled or managed in the high

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27. See Chapter 10

tax country, it may be deemed either to be resident in the high tax country or to have a permanent establishment. Both of these situations envisage the separate legal existence of the tax haven company being respected but, in some circumstances, the substance doctrine can be used to ignore the separate legal existence of the tax haven company altogether. A third use of the substance doctrine in this respect is to acknowledge that the tax haven company has a separate identity and that it is managed and controlled in the tax haven but that the activities it purports to carry on are, in reality, carried on by the company in the high tax country.

3. Transfer Pricing

Again, transfer pricing provisions are not specifically aimed at tax haven operations but they are particularly useful in preventing the siphoning of profits to companies established in tax havens. Transfer pricing rules are of only limited use against certain other types of tax haven activity such as the transfer of income producing assets to a tax haven. Furthermore, it may not always be apparent that a link exists between the company in the high tax country and the tax haven company.

For the transfer pricing rules to be used effectively it is necessary to be able to identify the functions and activities of the tax haven company accurately. Just because a company is set up in a tax haven does not mean that transactions between it and the company in the high tax country will be at an artificial price.[28]

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28. See Part 3

4. Withholding Taxes

These are sometimes overlooked as anti-avoidance tools. Withholding tax rates of 30% are common on such things as dividends, royalties, interest, technical service fees, and so on, paid from a high tax country. In double tax agreements between high tax countries these rates are normally reduced or eliminated. Very few double tax agreements have been agreed with tax havens and, where double tax agreements have been negotiated with a tax haven, the withholding tax reduction may not be applicable in many circumstances.

General Review of Anti-Avoidance Provisions

There are many different types of anti-avoidance provisions employed by the various countries around the world. Some of these provisions are very specific in nature, whereas others are wide ranging and general. These provisions have been found to be of varying effectiveness, as will be seen below.

The best classification of anti-avoidance provisions has been made by the Carter Commission[29] which grouped them under the following four heads:[30]

1. Specific provisions dealing with specific transactions and couched in detailed language prescribing precisely the tax consequences of such transactions. Most early UK anti-avoidance legislation falls into this category. The Carter Commission referred to this as the "sniper" approach.

2. General provisions imposing tax on transactions which are defined in a general way. Increasingly, provisions falling within this category are being introduced in the UK.[31] These provisions are not meant to be confined within precise or certain limits. This was labelled the "shot-gun" approach.

3. Provisions attacking non-arm's length transactions. The transfer pricing rules of section 770 ICTA 1988 fall within this category.[32]

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29. The Report of the Royal Commission on Taxation (Canada, 1966)
30. Volume 3, Appendix A at p552
31. For example sections 703, 739 and 776 ICTA 1988
32. See Part 3

4. The final category is the "administrative control" approach whereby wide powers are given to an official or administrative tribunal to counteract tax avoidance. There are no current provisions in UK law falling within this category although Section 35, Finance Act 1941 was such as provision. It related to Excess Profits Tax and did not really work too satisfactorily as is explained in Chapter 1.

Before the Carter classification is examined in more detail, it should be noted that the choice between narrow, specifically targeted provisions and a wide general provision was considered by the Royal Commission on the Taxation of Profits and Income in 1955. In their Final Report[33] they said:

> "The choice seems to lie between the enactment of some general provision which nullifies or controls the effect of transactions that violate the suggested principal, and the enactment of specific provisions which identify with precision the kind of transaction that is to be struck at and prescribe with corresponding precision the consequences that are to follow for the purposes of tax assessment."[34]

The Carter Commission categories are now examined in more detail.

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33. Cmd 9474
34. Para 1020

1. <u>The "Sniper Approach"</u>

The Carter Commission considered that there were certain desirable and undesirable features of the "sniper" approach. These were described as follows.

(A) Desirable Features

(1) The Commission said that "it can be argued that a person's liability to pay taxes should be imposed in explicit terms and with the authority of parliament; and that this precept is not observed where control of tax avoidance is maintained through the use of some general declaration of principle governing tax avoidance and particularly where the application of the principle and the consequential tax adjustment is left to the discretion of the Department or some other body. If general or discretionary provisions are enacted, Parliament does not know when they will be applied or how far they may be extended."[35] This is the traditional view accepted in the UK from the earliest days of anti-avoidance legislation.

(2) Specific provisions "are relatively clear and certain in their application and they tend to produce certainty in the law."[36] If the provisions prove inadequate they can be amended. Again, this is very much the view traditionally taken in the UK.

(B) Undesirable Features

(1) It is impossible to foresee every tax avoidance technique. The Commission identified certain areas of Canadian legislation that had been "far from

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35. pp553-4
36. p554

totally effective" in stopping tax avoidance, such as "dividend stripping", which was carried on openly until Parliament resorted to ministerial discretion in 1963. Similarly, the "associated corporation" provisions were repeatedly amended but satisfactory control was not established "until the remedial legislation of 1963, invoking ministerial discretion". Finally, the Commission cited several "income splitting" arrangements. The fact that it is not possible to foresee every avoidance technique has been a problem with the UK "sniper" legislation especially when it has been coupled with the literal interpretation at one time given to tax legislation by the Courts.

(2) Specific anti-avoidance legislation often opened new loopholes. The phrase used by the Commission was "particularisation breeds avoidance".[37] The Commission quoted a passage from "The Problem of Personal Income Tax Avoidance" by H.J. Rudick,[38] which referred to the US experience. It ran as follows:

> "As the years rolled on and the Treasury and Congress awakened to the realisation that avoidance was rife, the process of statutory amendment was adopted as a means of checking it; and there were enacted particular provisions to prevent specific types of avoidance. But... particularisation in a statute leaves less room for the play of judicial interpretation and hence, while a particular device is eliminated, avoidance in general is not decreased. In other words,

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37. p554
38. (1940) 7 Law and Contemporary Problems 243 at pp246-7

particularisation reaches its immediate objective but gets no closer to the ultimate goal. It wins the battles but loses the wars, so while the legislators pass amendments right and left, they discovered that when they closed the dyke in one place, they often used an implement which opened up a hole right next to it. Congress was fighting a losing battle until the Supreme Court came to its aid in the Gregory case.[39] Taxpayers were becoming bolder and bolder, and, relying, with a confidence built up by earlier cases, on the doctrine that the law meant what it said, were pursuing every scheme that complied with the law as it read. Generally speaking, the Lower Courts justified this confidence, but with the Gregory decision the avoidance balloon was considerably deflated. Taxpayers discovered that no longer did safety lie in the literal meaning of the Statute."

This process in the USA is described in detail in Chapter 10. The UK, of course, went along a similar road some four decades after the Gregory case in the USA but the result of this process in this country was rather different from that reached in the USA.[40]

(3) The "sniper" approach may result in inequity where "the draughtsman, eager to catch all avoiders casts the net very wide" thereby including situations never intended to be included. "Yet the language of the Statue is so specific that it is impossible for the Court to afford relief through interpretation, for as the articulation of the Statute increases, the room for interpretation must contract."[41]

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39. <u>Gregory Helvering</u> (1935) 293 US 465, see Chapter 10
40. <u>See Chapter 11.</u>
41. p555

This too has happened in the UK as, for example, with Section 703, ICTA 1988.

(4) Highly particularised language aimed at specific avoidance devices assists a tax avoider because, in the words of the UK Royal Commission, "it defines for him the obstacle that he must be ingenious to get round". The Carter Commission said: "The [Royal] Commission was critical of the tendency of draughtsman, in order to meet this problem, to cast statutory provisions in language that is more and more vague and imprecise in the hope of covering some unforseen situation".[43]

(5) Anti-avoidance legislation is responsible for much of the obscurity of the Income Tax Act, couched "in tortuous and obscure language of unrivalled complexity and difficulty"[44] It was noted that the UK Royal Commission recommended modification of the legislation "that will make it shorter, briefer and more precise". The Carter Commission considered that: "It would be easy to make the legislation shorter and briefer but it may be difficult to make it at the same time more precise."

2. <u>The "Shotgun" Approach</u>

The Carter Commission considered this under four heads:

(1) The Use of General Provisions.
(2) The "Reasonableness" Test.
(3) The "Undue and Artificial Reduction of Income".
(4) The Benefit Approach to Income.

The second, third and fourth heads being different classes of general anti-avoidance provision.

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43. p556
44. Ibid

(1) The Use of General Provisions

These are anti-avoidance provisions in general language which are not directed at any specific device or technique. These provisions seek to avoid the position where, when the legislature stops one loophole by specific legislation, the taxpayer finds another loophole.[45]

(2) The "Reasonableness" Test

A number of sections of the Income Tax Act, as with some sections of the UK legislation, sanctioned the recognition of transactions for tax purposes to the extent that they are reasonable. The use of the word "reasonable" leaves scope for the exercise of judicial discretion, thus bringing the provisions within the "shotgun" rather than the "sniper" category.

(3) The Undue and Artificial Reduction of Income

Section 245 (1) of the Canadian Income Tax Act comes within this head. This section, which is analysed in Chapter 10, originally read as follows:

> "In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce income."

This section left the question of undue or artificial reduction of income to be determined by the Courts, without providing criteria by which to determine it.

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45. Examples are considered in Chapter 10

The UK Royal Commission criticised[46] a UK tax avoidance provision that struck at "artificial" transactions and "artificial" operations. This was section 44(3) F(No2)A 1915 an Excess Profits Duty provision which stated:

> "A person shall not, for the purpose of avoiding payment of excess profit duty, enter into any fictitious or artificial transaction or carry out any fictitious or artificial operation."

They said that " a transaction is not well described as "artificial" if it has valid legal consequences, unless some standard can be set up to establish what is "natural" for the same purpose. Such standards are not readily discernible." The Royal Commission also said that, if a transaction is fictitious, it ought to be ignored. This must be correct, taking "fictitious" as meaning the same as a "sham".

In drafting subsequent anti-avoidance provisions, the UK legislature has steered clear of the description "artificial". Section 488 ICTA 1970 was headed "Artificial Transactions in Land" but it was clear from the case of Yuill v Wilson[47], that the section could apply to bona fide commercial transactions if the required avoidance of tax could be shown. On the 1988 consolidation, the description "artificial", which was plainly inaccurate, was dropped from the heading of the consolidated section.[48]

The Carter Commission said that, in view of the difficulty in determining what is artificial, it seems probable that Section 137 (1) (the predecessor to Section 245 (1)) would be held to be applicable only in rare and extreme cases. They did, however, consider that it would

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46. Para 1024
47. (1980) 52 TC 674, see Chapter 3
48. Section 776 ICTA 1988

be useful as a deterrent and that it should be retained.[49] Cases in which the Section has been applied are considered in Chapter 10.

(4) The Benefit Approach to Income

By this category, the Commission was referring to those sections requiring a taxpayer to include in his income certain "benefits" or "advantages".

A good example of this is section 245 (2) of the Canadian Income Tax Act which originally read:

> "Where the result of one or more sales, exchanges, declarations of trust or other transactions of any kind whatsoever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the legal transactions or that one or more other persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending on the circumstances, be
>
> (a) included in computing the taxpayer's income...
>
> (b) deemed to be a payment to a non-resident person...,
>
> or
>
> (c) deemed to be a disposition by way of gift...."[50]

The Carter Commission said of this Section:

> "The language of this provision is far from clear. It is so broad and general that it would probably be

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49. p559
50. See Chapter 10

held applicable only in extreme cases, and even then it would be difficult to determine what type of tax should be imposed. Its precise meaning must await interpretation by the Courts which so far have had virtually no occasion to consider it. The section does not appear to have been significant in thwarting tax avoidance, although its deterrent effect is difficult to estimate."[51]

The subsequent history of this subsection is described in Chapter 10.

The UK Royal Commission compared these first two approaches described by the Carter Commission (they did not extend their classification to further categories).

It appears that they did not analyse tax systems of other countries in any great detail but they came to the conclusion that the usual approach to the problem of tax avoidance in other countries was to set out "some general declaration of principle governing tax avoidance... and to leave the application of the principle and the consequential tax adjustments to the decision of a special tribunal, subject in most cases to some appeal to a court of law."[52] They further noted that this course had been taken because of the impossibility of foreseeing all possible methods of tax avoidance and it had been felt that the only way to deal with this was to hand over the tax assessment procedure to the discretion of the tribunal. They compared this to the UK approach of specific enactment.[53]

They acknowledged that the UK system was based on the principal that a person's liability to pay tax should be

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51. p560
52. Op cit para 1025
53. Ibid

imposed in explicit terms and with the authority of Parliament. It was also noted that this procedure allowed for informed discussion of specific proposals before they became law. The Royal Commission considered that these were "advantages of great importance". They noted that the disadvantage was that additions to the tax legislation "are certainly prolix and sometimes obscure".[54] It should be noted, in addition, that the tax legislation in 1955 when the Final Report of the Royal Commission was published, was considerably simpler than the mass of detailed legislation we have on the Statute books now.

They also made an interesting observation by saying that they might have thought it necessary to suggest a different approach along the lines adopted in other countries, if the UK system failed in "any considerable measure" to control tax avoidance. The view of the Royal Commission was, however, that there had not been any such failure. Since 1955, of course, the level of tax avoidance has grown rapidly, particularly in the 1970's and 1980's and the volume of complicated tax legislation drafted to combat this avoidance has greatly increased. It could well be that the Royal Commission would come to a different conclusion now. The Commission noted that the Board of Inland Revenue were "not dissatisfied" with the position. The Board's conclusion was that "future devices are more likely to be related to new taxes or new relieving provisions or to be capable of use only in narrow and specialised fields". Accordingly, the Board did not think that the introduction of a general anti-avoidance provision was desirable or necessary. The Board, like the Commission, could not foresee the enormous increase in tax avoidance in the decades that followed.

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54. Para 1026

Based on these views, the Commission recommended that there should not be a change from the UK approach considering that "it would only cause harmful confusion if our present system were to be abandoned in favour of the other".[55]

They were, however, disturbed by the wide and obscure wording of a lot of the anti-avoidance provisions. They recommended that there should be a review of tax legislation by a body made up of people such as Parliamentary draughtsman, representatives of the Inland Revenue, lawyers and accountants with a view to making the legislation "shorter, briefer, and more precise".[56] No such review, of course, ever took place and the legislation, since 1955, has become longer, more wordy and less precise.

3. <u>The "Transaction Not at Arm's Length" Approach</u>

The Carter Commission commented:

> "Generally speaking, an object of the legislation should be to prevent avoidance of a tax liability by carrying out non-arm's length transactions on terms different than those which would have prevailed between independent persons dealing at arm's length."[57]

The Commission divided up the provisions dealing with non-arm's length transactions into four categories:

(1) Those which provide for the adjustment of the terms of transactions for tax purposes.

(2) Those provisions which do not adjust the terms of a transaction but charge with taxation the benefits that flow from it.

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55. Para 1029(1)
56. Para 1029(5)
57. p561

(3) Provisions which for tax purposes ignore or look through a transaction so as to prevent or offset the artificial tax effect which would otherwise result from it.

(4) Those provisions which affect the tax consequences of a situation by treating all person's not dealing at arm's length as if they were one person. The purpose of provisions in this category is basically to prevent or offset the tax effects of an artificial division of interests between closely related person's or among a number of companies which they control.

4 <u>The "Administrative Control Approach"</u>

Several sections of the Canadian Income Tax Act gave the Minister of National Revenue a discretionary power such as is contained in what is now section 247 (1).[58] This section (previously section 138A) "was enacted as a temporary measure to halt tax avoidance practices which had become widespread and blatant. This was necessary since legislative amendments had proved inadequate".[59] This section was originally aimed at dividend stripping and associated corporations. It is set out and discussed Chapter 10.

The opinion of the Carter Commission was that ministerial discretionary powers are undesirable except in extreme circumstances. They said:

> "Where such powers exist, taxpayers cannot be assured that they will be judged by the same standard as other taxpayers. If an unfavourable decision is reached by the Minister, the taxpayer's rights of appeal are narrowly limited. Such a decision may have been reached privately and on the basis of evidence not communicated to the taxpayer.

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58. See Chapter 10
59. Carter Commission Report Vol 3 App A

To the extent that discretionary powers were granted, there is a departure from the rule of law."[60]

The UK Inland Revenue's claim to have a discretion in connection with what was then section 478 ICTA 1970 was, of course, severely rejected by Walton J and the House of Lords in the Vestey case.[61] Such discretions have not found a place in UK tax law although section 32, Finance Act 1951, a profits tax provision, did have such a discretion.[62]

The widest power was given to the Canadian Treasury Board in section 246 (previously Section 138). This stated:

> "Where the Treasury Board has decided that one of the main purposes for a transaction or transactions... was improper avoidance or reduction of taxes that might otherwise have become payable under this Act... the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction".[63]

The section was aimed at challenging tax avoidance by administrative action by the Treasury Board, subject to supervision by the Courts.

Where the section applies, tax is assessed according to the directions of the Treasury Board, notwithstanding any other provision of the Income Tax Act or, indeed, any other Act.

This sweeping provision was justified by the Minister of Finance, Mr. Ilsley, when an earlier version of the provision was before the Canadian Parliament. It is worth setting out his justification in some detail. He said:

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60. pp567-8
61. Vestey v IRC (1980) 54 TC 503, see Part 2
62. See Chapter 1
63. See Chapter 10

"For years the Commissioner of Income Tax has advised that it is impossible to foresee or envisage the methods that will be adopted, and that the only possible way of dealing with the matter is to express general principles and leave it to some tribunal to decide.... Somebody has to be entrusted with the duty of watching these transactions, determining how much tax is avoided and whether the main purpose was to avoid taxation. If the main purpose was not to avoid taxation; if it was a legitimate business purpose, then the transaction should not be impuned.... Whatever jealousy Parliament may have of the rights of the individual, Parliament has to make sure that this economic system functions clearly and justly and fairly, to the extent of its ability. I have perhaps given an impression that the practices I mentioned... are widespread. I do not think they are, but a few instances, known by a few individuals and passed from mouth to mouth of skillful and wealthy individuals who legally are able to escape the clear spirit and intent of taxation legislation, will do more to discredit the system we live under and more to discredit the Parliament that did not have the foresight to prevent these things, than almost anything you can think of; and I have come to the conclusion that we ought to strain a point here. We are at war.[64] It may be that this would not be as necessary in time of peace.... In the Victorian period the avoidance of taxation was a polite, gentlemanly game. Taxation was low, and if a taxpayer could find a hole in the law and crawl through it, everyone laughed about it and tried to block up the hole. But it did not make very much difference. If the Crown could prevent his finding a hole, they would not get away with it. There was no moral interest involved. But when taxation

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64. This was in 1943

becomes as heavy as it is today, when to a very great extent the people of this country are working for the state - and properly working for the state - then it is not an amusing matter, and is beyond the realm of a game. It becomes something - well, perhaps not exactly treason, but something considered most unpatriotic and unsocial.... As I have said, if we make it as definite as we ought to make it for the guidance of a Court we will be definite that other ways will be found to get around it. Therefore it must be pretty wide, and there must be some discretionary powers in the tribunal making the decision."[65]

These strong words might be seen as a justification for such stringent legislation in a time of national emergency, but not for the retention of those provisions in time of peace.

The Carter Commission[66], highlighted what it saw as criticisms of section 138. It noted that the section had not been interpreted by the Courts, so that its meaning was uncertain.

The section empowers the Board to designate a legal transaction as improper, but contains no tests by which impropriety may be determined. It empowers the Board to give such directions as it thinks appropriate to counteract avoidance, but what form the directions might take and the persons against whom they may be made is not clear. Furthermore, the section provides for judicial review, but little guidance is given as to the grounds for such review.

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65. House of Commons debates, April 15 and 16 1943, Vol 3, pp2232, 2254-5, quoted in the Carter Commission Report, Vol 3, App A at pp 568-9
66. pp569-70

The Commission also wondered how the Board is to determine whether one of the main purposes of the transaction was the improper avoidance or reduction of taxes. "An investigation into the subjective purposes lying behind a business transaction or series of transactions is at least a highly speculative undertaking".[67]

The Carter Commission commented that section 138 "may be open to the criticism that it violates the most fundamental common law concept regarding taxation - that taxing legislation must impose a tax in clear and unambiguous language and the taxpayer is free from taxation unless he comes within the letter of the law. It also offends the principle that the rules on which tax is imposed should not be changed retroactively."[68] It also produces uncertainty in genuine business transactions.

It was noted that, 1948, the Minister of Finance, Mr. Abbott, gave assurances that the power had only been used four times in the five years since its inception in 1943 and he emphasised the large sums of money and the barefaced type of avoidance involved in those cases.

But, as the Commission noted, "if it is beyond the ability of the draftsman to fashion effective, specific anti-avoidance provisions which will pass the judicial test of strict, literal construction, as not infrequently seems to happen, it is not surprising, for reasons advanced by Mr. Ilsley, that the Government occasionally resorts to administrative discretion. However, experience with section 138 has shown that where the discretion is given to a body such as the Treasury Board it is hardly ever used."[69]

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67. p569
68. p570
69. Ibid. This section is examined in Chapter 10

The Commission considered a UK provision falling within this category, Section 32 Finance Act 1951.[70] This was a profits tax provision which provided that where the Commissioners of Inland Revenue were of the opinion that, the main purpose or one of the main purposes of a transaction was avoidance of liability to profits tax, they could direct adjustments of liability to profits tax to counter the avoidance. If it appeared in certain specified types of transaction that the main benefit which might have been expected to accrue within the subsequent three years was the avoidance of liability to profits tax, the avoidance of liability was deemed to have been the main purpose or one of the main purposes of the transaction. The test applied was an objective test. Clearance in advance was obtainable.

The UK Royal Commission approved this provision on the basis that the form of profits tax was such that it would be too easy for a corporation to arrange its affairs to reduce its profits tax liability without any alteration in the substance of its position. They said:

> "We do not think that there is any serious criticism to be made of the form of the section. Sub-section (3) deals with the difficult question of motive or purpose and it imputes the purpose of avoidance summarily where certain specified conditions are found to exist. But the imputation arises from the objective test of discovering what was the main benefit that might have been expected to accrue from a given transaction. That does not seem to us materially different from saying that a man's motives are to be inferred from the probably consequence of his actions. There are circumstances in which that principle is a better test of motive than can be afforded by his own answers some time after the event."[71]

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70. Considered in Chapter 1
71. Op cit para 1034. This test is examined in Chapter 1

The Carter Commission also considered briefly section 260 of the Income Tax Assessment Act 1936,[72] the general anti-avoidance provision enacted in Australia. They noted that, in the Newton case,[73] the Privy Council had held the section to be applicable to a complicated dividend stripping operation. Lord Denning said that the Court must see whether the arrangement itself discloses the purpose or effect of avoiding tax irrespective of the motives of the persons behind the plan; i.e., the Court must be able to predicate - by looking at the overt acts by which the arrangement is implemented - that it was implemented in that particular way to avoid tax. If the Court cannot so predicate, but has to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, they are not within the section.

It was also noted that the section does not allow the Commissioner to reconstruct transactions: Clarke v Federal Commissioner of Taxation.[74]

Section 260 is examined in detail in Chapter 10.

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72. Now repealed and replaced with another general anit-avoidance provision.
73. Newton Federal Commissioner of Taxation [1958] AC 450
74. (1932) 48 CLR 56 at p77

Common Law and Civil Law Jurisdictions

A characteristic of civil law jurisdictions is the abuse of rights doctrine. In some countries it is written into the civil code (as in Germany, Japan and Switzerland); whereas in others, it has been developed by judicial decision (as in France, Belgium and Netherlands).

In common law jurisdictions such as England and other Commonwealth countries, the development of the law has been completely different. Whereas in continental civil law countries, legal rights were defined in absolute terms and the Courts placed limitations upon the exercise of those rights; in common law jurisdictions, legal rights were not defined in absolute terms by the Courts but were developed case by case and normally without regard for any purpose of the person whose acts were being challenged. In each case, a person's rights were defined in relation to a particular thing. This case by case approach can be seen in the development of the "Ramsay" doctrine.[75]

Among common law countries, the United States differs from the rest in that it does limit the rights of individuals in various areas of the law. This process is achieved by the application of concepts such as "judicial legislation" (which has a wider application than the abuse of rights principle), "social engineering" and "creative judicial interpretation".[76]

On an examination of the position in various countries throughout the world, although it is generally accepted that:

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75. See Chapter 11
76. The position in the USA is examined in detail in Chapter 10

> "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores".[77]

The tax laws of almost every country now enable the tax authorities to examine the actual transactions carried out by the taxpayer with a view to deciding whether the legal form adopted was not the normal and appropriate form, justifying the application of the abuse of law principle, or to examine whether the "substance" principle justifies imposing on the transaction a different form from that actually adopted.

The traditional approach, which was dominant until the end of the last century, was based on following the letter of the law and the legal forms used by the taxpayer. In other words, a transaction was considered for the effects which it produced in private law, and the fact that such forms were utilised to achieve an economic result different from that intended by the legislation, was immaterial. In the UK this was manifested in the adherence to form which is examined in Chapter 11. This approach is beneficial to the taxpayer because he can arrange his affairs with a fair degree of certainty.

On the other hand, the economic approach was developed by many countries with a view to equity, on the basis that a taxpayer should not be allowed to exploit the form doctrine and the loopholes contained in the wording of the legislation if that achieves an economic result equivalent to that which the legislature intended to tax.

The traditional approach is strongest in those countries whose legal systems are distinguished by a clear legal classification of transactions and whose constitution established the supremacy of the the legislature.

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77. Ayreshire Pullman Motor Services and Ritchie v IRC (1929) 14 TC 754 at p763 per Lord Clyde

Although most countries recognise as a general principle the private law right enjoyed by an individual which bestows freedom of action on the holder and the immunity from challenge by third parties, it became clear at the end of the last century that the individual should not be allowed to abuse this right.

The countries with a civil law jurisdiction developed the doctrine of "abuse of law" under which no one can exercise his rights in conflict with the function to which the right was attached. Most continental countries incorporate this doctrine into their legal systems.[78]

The abuse of rights doctrine in most countries came to be recognised in tax law so that, although most countries recognised the right of a taxpayer to arrange his affairs so that he pays the least amount of tax, and therefore to choose the legal forms which are in his view the most suitable, if the sole or main motive for a certain transaction is the avoidance of tax, the form of the transaction may be ignored on the grounds that the taxpayer has abused his right to use such a form.

In France and Germany the motive to avoid tax must be accompanied by the artificiality of the legal form which is chosen to achieve a given economic result. On the other hand, in the Netherlands, the concept of "Fraus Legis" is used by the Courts to replace a non-taxable transaction with a taxable one when the exclusive purpose of avoiding tax is combined with a factual situation economically equivalent to the one which the legislation intended to give rise to a tax liability.

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78. See Chapter 10

In some countries legislation has been used to introduce a principle of equivalent economic result based on a rationale similar to that of the abuse of law.

A transaction is disregarded for tax purposes if the sole motive was tax avoidance in, for example, Australia, Israel, the Netherlands, New Zealand and Sweden.

The Courts of these countries have found it difficult to apply such legislation and, therefore, the provisions have made little contribution to the fight against tax avoidance.[79]

As can be seen from the discussion of the substance doctrine in Chapter 11, most tax provisions consist only of a description of the circumstances giving rise to a tax liability. If the Courts restrict themselves to a literal interpretation of these provisions the way is open for a taxpayer to exploit any loopholes those provisions contain. It is not surprising, therefore, that many countries have developed the principle of substance over form.

In some countries, this approach is embodied in statute (for example, Austria, Germany and Luxembourg), whereas in other countries it is a general principle of interpretation (such as in the Netherlands and Norway).

The introduction of a substance over form principle has been hindered in some countries by the prohibition of analogy (such as Belgium, Greece and Italy).

It is difficult to differentiate clearly between the abuse of law principle, the general anti-avoidance provisions and the substance over form doctrine.

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79. See Chapter 10, when the Australian position in particular is analysed.

The purpose of them all is to look to the economic substance of the transaction. But whatever form the principle takes, it is increasingly being used to levy tax on the basis that the avoidance scheme had not been implemented, that is, on the economic reality of the case.

Some countries, such as the USA and Canada, give importance to the motive of a transacation, whereby a transaction must have a business purpose before a certain tax treatment is given to it. The role of motive in anti-avoidance legislation in these countries is examined in detail in chapter 10.

Another doctrine found in many jurisdictions is that of the "sham". A transaction is a sham where two parties say they have effected a transaction when they have no intention of giving effect to it and they have not in fact done so. Care must, however, be exercised here because, as with other terms in this area (such as "avoidance" and "evasion"), "sham" can mean different things in different countries. Compare, for example, the way the term is used in the USA and the UK.[80]

The countries of continental Europe have more general tax laws containing wider anti-avoidance provisions. This is in contrast to the detailed tax law of the UK with its specific anti-avoidance legislation. This difference could be kept in mind when comparisons are attempted between the UK and European anti-avoidance provisions.

A number of trends are discernible when looking at the tax laws of European countries. For example, many countries supplement their tax legislation and tax cases by regulations and guidelines from the tax authorities.

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80. See Chapter 10

This seems to produce a fair measure of consistency in the application of the law.

Another trend is that many of the European countries have specialist tax Courts, often with judges with a tax background, dealing exclusively with tax cases. This is in stark contrast to the UK. Here, of course, judges of the Chancery Division will normally have dealt with tax to some extent when at the Bar, although relatively few will have come from the specialist tax Bar. However, in the Court of Appeal and, even more so in the House of Lords, the judges may well have never been involved in a single tax case in their careers.

The application of the abuse of rights doctrine and widely drafted anti-avoidance provisions often operates in terrorem, even in those countries where they are not often actually applied in practice, due to the uncertainty which their potential application creates.

The Renton Committee[81] considered the approach of European countries to anti-avoidance legislation. It said:

> " European law is basically very different from English law, founded as it is on another legal tradition deriving largely from Roman law, later develped to suit modern needs by, for example, the Code Napolean. The style of the code is illustrated by many of the codifications of the 19th century. The deliberate aim in these codes was to confine the statement of terms to principles of wide application, and to practice a deliberate restraint in the proliferation of detailed rules."[82]

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81. "The Preparation of Legislation" (Cmnd 6053).
82. para 9.1.

Later, the Committee commented:

> "It has been put to us by Sir Charles Davis[83] that it is still true to say that whilst in English statute law more emphasis is placed on certainty, in the legislation of continental countries and of the European communities the emphasis is on clarity in the expression of broad intention and principles."[84]

What Sir Charles Davis had said to the Committee was:

> "English law, being for historical reasons so firmly based on the doctrine of stare decisis has an inherant tendency, in my view, towards achieving certainty - sometimes indeed at the expense of logic - and this is reflected not only in our common law but also in our legislation, both original and delegated. This is customarily drafted with almost mathematical precision, the object (not always attained) being in effect to provide a complete answer to virtually every question that can arise. Community law on the other hand, being based on the legal systems of the original six member states, and being thus derived from the Code Napolean and indirectly from Roman law, adopts an entirely different approach. With the Community law certainty - in other words the ability to answer almost every question that can arise by textual analysis - is much less important, and the main desideratum appears to be the logical formulation of an idea so that the general objective of the legislation is never lost sight of.... Essentially, the dilemma seems to be to be a choice between two eminently desirable but mutually exclusive objectives namely clarity and certainty".

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83. Legal adviser to the House of Commons Select Committee on European Secondary Legislation.
84. Para 9.5.

Although it has proved difficult to reconcile clarity and certainty, they are not necessarily inconsistent with each other and should not be incompatible in practice. But, it is easy for intolerable uncertainty to be generated if the Legislature and the Courts go about it in a haphazard way, such as with the "Ramsey" principle in the UK, before the House of Lords decision in Craven v White[85] brought some certainty back into the approach. Although, even here, Lord Templeman made it clear that he did not consider himself to be bound by the decision and that he would reverse it if he were to get the chance. He appeared to have the backing of Lord Goff in this.[86]

Looking at the various approaches adopted in different jurisdictions, it is clear that a balance must be found between effective anti-avoidance rules and sufficient certainty for a taxpayer to be able to plan his business affairs properly.

Some countries have tried to apply broad anti-avoidance provisions giving a lot of scope for interpretation by the Courts (such as, for example, Australia and New Zealand). These provisions have not been conducive of certainty and the Courts have not generally been enthusiastic about applying them.[87]

The resolution of the problem must be of a legislative character rather than judicial process: it must respect the supremacy of the Legislature. The problem generated by the "Ramsey" line of cases in the UK should be a salutary lesson in the dangers of leaving such widespread reforms to the judges in common law jurisdictions where the system is not designed to make such judicial law making appropriate.

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85. [1988] STC 476
86. See Chapter 11
87. See Chapter 10

Judicial interference can manifest itself in different ways. For example, in looking to the economic reality of a transaction or series of transactions, some countries (for example the USA, Japan and Canada) have elaborated these so called "step transaction doctrine" under which a transaction involving various connected acts must be viewed in its entirety, and accordingly taxed in relation to its ultimate result.[87]

In the UK, where traditionally there has been a tendency to interpret tax law literally, a similar but not identical result to the foregoing was achieved by the Courts in the "Ramsey" line of cases and, before that, the development of the substance doctrine in general as charted in Chapter 11.

A detailed analysis of the judges' role in the UK and other common law jurisdictions in the light of the tradition of the separation of powers, is given in Chapter 13.

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87. See Chapter 10

Tax Avoidance, Tax Evasion and Tax Planning

A brief introductory word should be said here about terminology and the definitions given to the above terms.

Most countries have found that tax evasion and tax avoidance are a real and growing problem. The laws on this subject do, of course, vary from country to country but, on the whole, there are generally, three recognised categories: tax saving, tax evasion and tax avoidance.

Tax saving is usually defined as occurring when a taxpayer can bypass a tax liability in his normal business dealings. Reduced to its simplest form, an example of this would be a person who refrains from buying a particular product thus avoiding the payment of purchase tax.

Tax saving is, without exception, accepted and regarded as legitimate. In cases of tax saving a taxpayer is involved in an area which the legislature did not wish to regulate. In fact, the intention of the legislature is the real distinction between tax saving and tax avoidance because transactions falling within the heading of tax avoidance are those in an area where the legislator intended to control but where he failed.

Tax evasion is normally treated as a situation which arises when a taxpayer escapes the payment of tax which is due under the law. This is not, however, a universally accepted concept. All countries do agree, however, that evasion involves the avoidance of payment without avoidance of the tax liability.

In countries such as Austria, Denmark, France, Greece, Israel, Italy, Luxembourg, Norway and Switzerland an intention to evade by the taxpayer is not normally required to give rise to tax evasion. As a general rule, such an intention is necessary if it is intended to establish that a criminal offence has been committed.

In those countries where an intention is required, it is relevant in different ways. For example, in France motive is inferred where there has been "concealment" or "disguise". In other countries, evasion is judged according to normal criminal law standards (for example West Germany and Israel).

Tax avoidance is not always distinguished from tax saving although, as mentioned above, legislative intent is normally the decisive factor. Similarly, the distinction between avoidance and evasion is not always clearly drawn (although it is widely accepted throughout the world). Those countries that do not give a separate meaning to avoidance, normally do so on one of two grounds:

1. If only direct violation of the tax law is punishable, indirect violations are fully legitimate.

2. In those jurisdications where indirect violations can be penalised, all violations of the tax code are termed "evasion".

The OECD's Committee on fiscal affairs has stated that the tax administrations of member countries appreciate that there is no clear demarcation line between "legitimate minimisation of tax" (i.e. tax saving in the sense used above) and "those activities which aim to frustrate the intentions of the law"(i.e. tax avoidance as that term is used above).[88]

It is correct to say that no clear demarcation line can be drawn although, in most cases, it is possible to distinguish between the two. As mentioned above, the criterion for differentiating the two is the intention of

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88. Colloquy on International Tax Avoidance and Evasion (Strasbourg 1980)

Parliament or, more particularly, the Legislature. In other words, tax avoidance is 'an attempt to reduce tax liability to a level below that which the Legislature intended should apply to that particular income in those particular circumstances'. Three typical characteristics of tax avoidance were suggested:

1. Artificiality. That is, in the absence of tax factors, the transactions would have taken a different form.

2. The use of loopholes or the application of legal provisions for purposes for which they were not intended.

3. Secrecy. In other words, the desire to keep the details quiet for as long as possible.

No recognised distinction ever existed in English law between tax mitigation and tax avoidance until Lord Templeman invented one (or purported to spot one that was there all along) in dealing with a New Zealance anti-avoidance provision in Commissioner Inland Revenue v Challenge Corporation Limited[89] [1986] STC 548.

Lord Templeman appears to have based his distinction, not directly on the intention of Parliament, but on whether the taxpayer has reduced his income or incurred expenditure or suffered a real loss (i.e. whether his financial position has changed). This is a spurious distinction not supported by authority, except indirectly by the "Ramsey" line of cases. The examples he gives of "tax mitigation"[90] would have been supported by reference to the intention of Parliament had Lord Templeman chosen

89. [1986] STC 548, see Chapter 11
90. pp554-5

to do so, and here he would have been on stronger ground. Leaving the distinction to rest on whether there is a "real" loss or not, leaves a lot of scope for disputes and uncertainty.

So here we have a difference of approach between the OECD, which bases its distinction on the intention of Parliament, and Lord Templeman, and those Lords who agreed with him in the Privy Council, who relied on whether there was a "real" loss. It may be that Lord Templeman, if he thought of it at all, was wary of espousing any doctine which relied on the intention of Parliament because, under English Law, if one asks what the intention of Parliament is, the answer comes back: "look at the words of the Act".

The Challenge case is examined in detail in Chapter 11.

International Cooperation and Exchanges of Information

Introduction

As the pace of international tax avoidance increases with the development of international trade and the greater sophistication of taxpayers and their advisers, the need for governments to take steps to counter this trend also increases. Changes in domestic law can go some of the way but it cannot possibly provide a complete solution. International tax avoidance must be tackled by ensuring that domestic laws are supplemented by cooperation between governments. It has been seen that taxpayers find that the differences between the tax systems in different countries is an area ripe for exploitation.

The efforts governments have together made to combat international tax avoidance are here examined. It will be seen that no single comprehensive system has yet been set up, but moves are being made in the right direction. We are still, however, a long way from finding a single workable and acceptable solution.

International cooperation can take a number of forms:

1. Bilateral treaties.
   There is an extensive network of such treaties; most recently negotiated ones being based on the 1977 OECD Model Treaty which contains, in Article 26, provision for exchanges of information in respect of particular cases.

2. Tax administrations are regularly exchanging information on ways of detecting and defeating tax avoidance. Attempts are being made to standardise the form of these exchanges to make it easier for such exchanges to take place.

Within the OECD, in particular, this process is being intensified. In 1976 a programme began of tax inspectors from member countries having regular meetings to exchange information about detecting and combatting tax avoidance and tax evasion. A working party has been set up to act as a forum and it has established links with other bodies. For example, a representative of the EEC attends regularly.

3. Multilateral treaties.

These are few in number but there are some in existence, for example between the Benelux countries and also between the Nordic countries. There are pressures for more multilateral treaties to be negotiated. A major recent move has been the publication of a draft multilateral convention under the aegis of the Council of Europe and the OECD.[91]

A lot of work on combatting international tax avoidance has been carried out by the OECD. Its influence can be seen, for example, in its Model Double Tax Agreement which has been used as the basis for nearly all modern treaties, and also in its work on transfer pricing. The criteria and recommendations in its 1979 Report on transfer pricing have been accepted and followed by many countries, some of whom have based their published regulations or guidelines on the report's recommendations, for example, the USA, Canada and West Germany.[92]

The OECD is particularly interested in combatting tax avoidance and has been keen to foster international cooperation to this end.

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91. Infra
92. See Part 3

The OECD, which has been working on international cooperation in tax matters since 1956, is an inter-governmental organisation. Representatives of the tax administrations of member countries make up its Committee on Fiscal Affairs.

Bilateral Treaties

The first cooperation agreements were agreed as long ago as the 19th century (for example Belgium/France and Belgium/Netherlands) but the first agreements in the modern sense relating to direct taxes were negotiated between the two world wars. This was piece-meal until the 1960's and the massive increase in tax avoidance activity at that time. The large-scale administrative cooperation since then has been mostly based on Article 26 of the OECD Model Treaty, first published in 1963.

The OECD Model Treaty was not the first attempt at drafting a standard treaty. In 1928, the General Meeting of Government Experts on Double Taxation and Tax Evasion drafted four model treaties under the auspices of the League of Nations.

The League of Nations, in the form of its fiscal committee, prepared a new model at its meetings in 1943 and 1946. This model was not, however, extensively used.

By contrast, the 1963 OECD model was widely accepted and used and, in time, it and its predecessor have become the blue print of nearly all bilateral treaties, even when contracting parties are not OECD members.

A working paper by J.W.B. Westerburgen, Chairman of Working Party 8[93] of the Fiscal Affairs Committee of the OECD, presented to the Colloquy on International Tax

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93. On Tax Avoidance and Evasion

Avoidance and Evasion[94], noted that around 400 treaties were concluded between 1963 and 1st January 1979, based on the two OECD Models; 180 between OECD member states, 200 between OECD members and developing nations and about 25 between OECD members and eastern bloc countries. It is not known how many conventions have been concluded between non-OECD members based on the OECD models.

The 1963 model was improved and redrafted in the years between 1971 and 1977 when the second model treaty was published.

In 1968, the United Nations Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries began working on guidelines for the negotiation of treaties between developed and developing countries. As a result, in 1979, there was published a "Manual for the Negotiation of Tax Treaties Between Developed and Developing Countries". This is, in effect, a model double tax agreement together with a commentary. Guideline 26 is similar to Article 26 of the OECD 1977 Model Treaty.

Article 26

Article 26 of the OECD Model Treaty forms the basis for most exchange of information articles in bilateral treaties. It is therefore important to consider its terms. Its wording is as follows:

> "1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the convention insofar as the taxation

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94. Strasbourg 1980

thereunder is not contrary to the convention. The exchange of information is not restricted by Article 1. Any information received by a contracting state shall be treated as secret in the same manner as information obtained under the domestic laws of that state and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracating State;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public)."

This Article is of wide application. It is expressly stated, for example, that the exchange of information "is not restricted to Article 1". In other words, it is not restricted to information about residents of the contracting states. This is important; such a provision would be a severe limitation on the application of the article. This provision dates from the 1974 Revised Text.

It is noticeable that the exchange of information is mandatory as long as the relevant conditions are fulfilled: the wording of the Article is "the competent authorities of the contracting states shall exchange such information..."

The breadth of the obligations is demonstrated by examples given in the Commentary to the Article. The Article does not just supplement the implementation of the provisions of the treaty, but also covers the implementation of domestic laws of the contracting states concerning the taxes covered by the treaty even if a particular article of the treaty need not be applied. However, information should only be given insofar as the domestic taxation laws are not contrary to the convention. The words "not contrary to" were inserted in 1974 in place of "in accordance with" which was the wording of the 1963 draft. The 1974 wording is considerably wider because, as already noted, the information is to be supplied even if a particular article need not be applied. The examples in the commentary referred to above show how widely the article extends. They are contained in paragraphs 7 and 8 and are as follows:

"7 Application of the Convention

(a) When applying Article 12,[95] State A where the beneficiary is resident asks State B where the payer is resident, for information concerning the amount of royalty transmitted.

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95. This article deals with royalties.

(b) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last mentioned state and the beneficial owner of the royalties.

(c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different states or the adjustment of the profits shown in the accounts of a permanent establishment in one state and in the accounts of the head office in the other state (Articles 9, 7, 23A and 23B).

8 Implementation of the Domestic Laws

(a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods with a view to a correct application of the provisions of its domestic laws.

(b) A company in State A sells goods through a company in State C (possibly a low tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between A and B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods.

(c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position). It should be borne in mind that the exchange of information in this case might be a difficult and delicate matter owing in particular to the provisions of sub-paragraph (c) of paragraph 2 relating to business and other secrets."

As to the way information is to be exchanged, the rules allow for three different methods:

1. On request, with a particular case in mind.
2. Automatically, for example when information about a source of income in one contracting state is transmitted systematically to the contracting state where the income is received.
3. Spontaneously, for example where a state has acquired, through certain investigations, information which it thinks may be of interest to the other state.

It can be seen that "fishing expenditions" are not allowed. Methods 2 and 3 were not included in the commentary to the 1963 draft. This is another example of how much wider the revised draft is.

A useful analysis of exchange of information articles in UK tax treaties is contained in a draft report prepared for the British Branch of the International Fiscal Association by Jill Pagan called "International Mutual Assistance and Exchange of Information."

This report disclosed[96] that, as of September 1989, the Uk is a party to 78 income tax treaties, which were negotiated between 1947 and 1988, and all of them contained an exchange of information article. These, 50 contain an article similar to Article 28 of the UK/Austria treaty which reads:

> "The Competent Authorities of the Counteracting States shall exchange such information (being information which is at their disposal under their respective taxation laws in the normal course of administration) as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or the administration of provisions against legal avoidance in relaton to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret but may be disclosed to persons including a court or administrative body) concerned with assessment and collection of taxes which are the subject of this Convention. No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process, or the disclosure of which would be contrary to public policy."

It was noted that this article is similar in approach to that in the 1963 OCED Model except that the UK article specifically states that information may be exchanged "for the prevention of fraud or legal avoidance."

The Report notes[97] that originally the main purpose of exchange of information articles in treaties negotiated by the UK was to facilitate the application of the treaty. That is why the older Uk treaties have the

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96. p4
97. pp7-8

wording "shall exchange such information ..... as is necessary for carrying out the provisions of the Convention", and why this wording is also found in the 1963 OCED Model. However, the Report questions whether the addition of the words "for the prevention of fraud or the administration of provisions against legal avoidance" actually adds anything.

The Report comments:

> "The act of incorporating words such as 'legal avoidance' means that those words have to be defined and there is no statutory definition of those words in the UK legislation. Even allowing for what are known as the 'loose construction cases' (IRC v Exxon Corporation[98] and Union Texas Petroleum v Critchley[99]) whereby words in tax treaties when before the United Kingdom Courts on matters of interpretation may be given an interpretation in the context of what the treaty was seeking to achieve and the meaning intended by the parties to the treaty, it is possible that the words 'legal avoidance' would be interpreted quite narrowly. For example would 'legal avoidance' be restricted to those instances expressly defined in United Kingdom statutory provisions and exchange of information not be permitted in cases where there was an alleged scheme to avoid a charging provision by a route not specifically targetted by an anti-avoidance provision. If this is so, then it would follow that the extent of the United Kingdom treaties is actually narrower than either the 1963 or 1977 OECD wording which permit exchange of information necessary for carrying out the provisions of the domestic laws of the Contracting States."

98. [1982] STC 356
99. [1988] STC 691

As well as the 50 treaties that have an article similar to Article 28 of the UK/Austria treaty, a further 13 contain a clause closer to the 1963 OECD Model, although four of them have the "fraud or legal avoidance" wording. Of the remaining 15 treaties, nine follow the 1977 OECD Model closely, of which six omit the statement that the exchange of information is not restricted by Article 1. The remaining six treaties have hybrid wording.[100]

The Report also points out[101] that almost 40 of the treaties negotiated by the UK, like the 1977 OECD Model, do not contain a restriction to residents or nationals of either contracting state.

There was an interesting development regarding exchange of information powers in UK treaties in 1986.Although the Inland Revenue has very wide powers to obtain information, this can only be used for the purposes of determining liability to UK tax[101A] and it is an offence for an officer of the Inland Revenue to make an unauthorised disclosure of information.[102] The UK authorities had, for the best part of half a century, been negotiating treaties providing for exchanges of information. However, the Select Committee on Statutory Instruments in 1986, told the Government that the legislation relating to the agreement of treaties in seciton 497 ICTA 1988 might not actually give sufficient authority for an exchange of information, and they advised that the power to enter into exchange of information agreements be made explicit in UK legislation. Accordingly, section 70 Finance Act 1987

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100. See for example the UK/USSR and UK/Yogoslavia treaties.
101. p8
101A. See section 6 and Sch 1 TMA 1970
102. See now section 182 FA 1989

introduced new sub-sections into both section 497 ICTA 1970 and section 158 IHTA 1984.

The form of wording was taken from the OECD Model Treaty. The new sub-section inserted into section 497 ICTA 1970[103] reads as follows:

"(1A) Without prejudice to the generality of subsection (1) above, if it appears to Her Majesty to be appropriate, the arrangements specified in an Order in Council under this Section may include provisions with respect to the exchange of information necessary for carrying out the domestic laws of the United Kingdom and the laws of the territory to which the arrangements relate concerning taxes covered by the arrangements including, in particular, provisions about the prevention of fiscal evasion with respect to those taxes; and where arrangements do include any such provisions, the declaration in the order in Council shall state that fact."

Formal double tax treaties are not the only ways two countries can agree to exchange information. For example, in a News Release in June 1977 it was announced that the Canadian and US tax authorities had agreed on simultaneous joint audits of selected taxpayers. During each stage of the audit, information is exchanged between the two countries in accordance with the treaty.

In the following year, on 2nd March 1978, the UK Inland Revenue issued a Press Release regarding a "working arrangement" with the Internal Revenue Service in the USA for the simultaneous examination of the affairs of related taxpayers with substantial operations in both

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103. Now section 778 ICTA 1988

countries. The working arrangement was made under the terms of the double tax agreement. Under it, the two tax authorities coordinate their examination of important cases. The objectives of the working agreement are expressed to be to:

"1. Determine taxpayers correct tax liabilities particularly where costs are shared, or charged, and profits are allocated between taxpayers resident or operating in different taxing jurisdictions.

2. Improve the procedures for exchanging information which can be used by each country in accordance with the treaty in its examinations of inter-alia, multinational enterprises having intra-group transactions which may include arrangements involving tax haven countries.

3. Exchange of information on new or apparent patterns or techniques of tax avoidance that significantly affect the tax administration of each country.

4. Study transfer pricing practices."

The procedure to be followed to achieve these objectives is, in the following sequence:

"1. Appropriate taxpayers will be independently identified for simultaneous examination by tax administration officials of each country.

2. Each country will inform the other of its choice of potential cases using the selection criteria described below.

3. Each country will determine whether it wishes to participate in a particular simultaneous examination. Neither country, however, is obliged to cooperate in all examinations undertaken by the other country.

4. In those cases where there is agreement to conduct a simultaneous examination, the competent authority of each country will

formally request of the other competent authority exchange of specific information pursuant to the tax treaty.

5. Representatives of the competent authorities will designate areas and periods to be examined in the particular cases selected, the timetable for the examinations and approaches to be taken. They will initiate exchange of specific information in accordance with formal written requests.
6. The information which may be requested under this arrangement must:
   (a) be obtainable under the respective taxation laws of the two countries;
   (b) be related to an income tax, corporation tax or capital gains tax matter.

7. Whenever possible, the Internal Revenue Service representative in London will be used to channel the information between the United Kingdom and the Unted States".

The criteria for selecting cases for examination are that the examination will involve related taxpayers with substantial operations in both countries and the factors to be used to determine whether such a case is selected "will mainly be, but will not be limited to":

(1) the scale of its worldwide operation;
(2) the extent of intra-group transactions;
(3) compatible tax years.

Jill Pagan[104] notes that nine such simultaneous examinations took place in the years 1977-1986, but there were none in the next three years.

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104. Op cit p12

In addition, a House of Commons Written Answer[105] disclosed that regular meetings take place between senior officials of the tax authorities of the UK, USA, France and Germany (which countries have been called "the Group of Four") to improve their exchange of information under their respective treaties in practical ways. The Answer states that:

> "These include the study of more effective methods of avoiding double taxation, the simplification of arrangements for the assistance of taxpayers by way of mutual consultation between tax authorities and also the exchange, under the authority of tax treaties, of information needed for ascertaining the liability of taxpayers with interests and activities in the respective countries. Under these arrangements each tax authority separately examines the accounts and returns of the taxpayer within its own jurisdiction but they may meet to coordinate the exchanges of information made under the provisions of the relevant tax treaties."

A similar grouping is the "Pacific Association of Tax Administrations" "PATA", namely the USA, Canada, Japan and Australia.

As a result of meetings of the Group of Four and PATA, tax avoiders have been identified for in-depth investigations on a bilateral basis under the relevant treaties.

As to the collection of information, the country which is asked to give information must go about the process of collecting the requested information as if its own tax were involved (unless any of the three situations set out in the second paragraph of Article 26[106] exist).

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105. 16 November 1977, Hansard Vol 939, cols 269-70
106. Supra

The information given can only be used by the requesting country for the purposes mentioned in the Article; it cannot he used for, say, a prosecution of a non-tax crime. The requesting state would have to apply separately through the appropriate channels (if any) relating to the particular use in question.

Some countries have set up internal systems to coordinate information. Germany and the USA are prime examples. The USA one concentrates on identifying taxpayers who use foreign entities and bank accounts protected by strict secrecy laws for tax avoidance purposes.

An example of a spontaneous exchange of information is given by a German case heard by the Lower Tax Court of Dusseldorf on 20th April 1982.[107]

The taxpayer was a German steel sales company. It paid commissions of DM 350,000 to its Belgian agent in bearer cheques in 1976-8. The German tax authorities agreed that the commissions were deductible business expenses but told the taxpayer that they would provide details of the payments to the Belgian tax authorities. The taxpayer claimed that this spontaneous exchange of information was precluded by both German domestic law and the Germany/Belgium Double Tax Agreement and also that it would infringe the secrecy provisions of both domestic law and the treaty.

The relevant provisions of German domestic law were contained in Article 30 of the German Fiscal Code, which states that government officials must observe secrecy in fiscal matters, Article 30 (4) (2) of the Code, which allows information to be disclosed if expressly permitted by law, and Article 117 (2) of the Code, which permits the tax authorities to render assistance if so provided by a tax treaty.

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107. Entscheidungen der Finanzgerichte (1982) No12 p604

The treaty provision in question was Article 26 of the Germany/Belgium Treaty which was comparable to Article 26 of the OECD Model Treaty.

The Court held that Article 26 of the Treaty was broad enough to cover spontaneous exchanges as in point here and therefore it was allowed by Article 117 (2) of the Code.

The taxpayer's secrecy argument was also rejected. The domestic and treaty secrecy provisions could only be applied if the disclosure would seriously damage the German economy.

Multinational Agreements

On a multinational level, Denmark, Finland, Iceland, Norway and Sweden concluded the Nordic Convention in 1972. This convention is the most advanced so far agreed. It covers assistance with the assessment and recovery of tax and the service of documents. It covers direct and indirect taxes, estate duties and gift taxes and social security contributions. Furthermore, as well as the three forms of cooperation specified in the commentary to Article 26 of the OECD Model Treaty, the convention also provides for the participation of officials in investigations in another state.[108] Such officials cannot exercise any form of decisive powers and they cannot determine what procedures are to be used, but they can ask that the investigations are carried out in such a way that their interests will be adequately covered. Normally, such requests are granted in practice if there is no legal or administrative reason for not doing so. Furthermore, certain information is exchanged automatically every year including dividends, interest, royalties, salaries etc. received by residents of one Nordic country from sources in another Nordic country.

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108. This is not possible under, for example, Article 28 or under the "Working Agreement" between the UK and USA.

The Nordic Convention has been a great success and even the business community appear to accept that it has been a major contribution to a fairer system of taxation within the countries involved.

In 1977 the EEC agreed a Directive on administrative assistance which is similar in approach to Article 26 of the OECD Model.[109] This is the EEC Directive on "Mutual Assistance by the Competent Authorities of Member States in the Field of Direct Taxation" (although it was extended in 1979 to cover VAT by means of a supplementary Directive). Under this Directive, Member States had to bring their domestic legislation into line by 1st January 1979 so that bilateral exchanges of information between Member States would be possible. Most Member States were doing this anyway under their double tax agreements but at least the exchange of information requirement was put on an up to date footing and the Directive also covered the situation where there was no double tax agreement between Member States (such as Luxembourg/Denmark and Luxembourg/Italy) and where there was a double tax agreement but it did not contain an exchange of information Article (Italy/ Netherlands). The Directive also covered automatic and spontaneous exchanges in certain circumstances which had, by then, been included in the commentary to the OECD Model but had not yet found its way into many double tax agreements negotiated by EEC Member States. As with the Nordic Convention, it provided for the possibility of an agent of one Member State carrying out an investigation in another. On the whole, however, the powers in the Directive are little used because of the bilateral treaties between most EEC countries. What is more, some

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109. EC Council Directive No 77/779 of 19 December 1977

countries were slow in enacting laws to give effect to the Directive. For example, West Germany did not enact the Directive until 1985 and, in the Netherlands, it was 1986.[110]

The Directive is also wider than Article 26 of the Model Treaty in a very important respect: information can be used for purposes other than tax in the requesting state if certain conditions are fulfilled. This is strictly forbidden under Article 26.

Negotiations were held between 1964 and 1968 between EFTA countries on a multinational convention. The negotiations were never completed and were eventually abandoned but the negotiations did get far enough for a draft convention to be prepared. In the end, because of one or two difficult problems, the Member States agreed to rely on existing bilateral treaties instead.

Futhermore, the Benelux countries have been working closely together since the 1950's in the field of mutual cooperation. The convention between the three countries was concluded in 1953.

The latest move to agree a multilateral treaty has been by the Council of Europe and the OECD.[111]

In January 1977 the Fiscal Affairs Committee of the OECD came to the conclusion that a concerted approach to tax avoidance and evasion was needed and set up a special Working Party on Tax Avoidance and Evasion.[112]

On 21st September 1977 the OECD Council made a recommendation on tax avoidance and evasion. The recommendation was for governments of member countries:

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110. The UK enabling legislation was section 77 FA 1978
111. Infra
112. Working Party 8

"(a) to strengthen, where necessary, their legal regulatory or administrative provisions and their powers of investigation for the detection and prevention of tax avoidance and evasion, with regard to both their domestic and international aspects, and to exchange experiences with respect to such action;

(b) to facilitate, improve and extend exchanges of information between their national tax administrations, with a view to combatting tax avoidance and evasion, notably by making more intensive use of international conventions or instruments in force and by seeking new arrangements of a bilateral or multilateral character, with due regard to the provision of adequate safeguards for taxpayers;

(c) to exchange experiences on a continuing basis on tax avoidance and evasion practices, on techniques for detecting and preventing them and on ways and means of improving tax compliance in general."

Another positive development from about the same time was Recommendation 833 of the Parliamentary Assembly of the Council of Europe.[113]

The Recommendation noted with approval the steps that had already been taken, such as the 1972 Nordic convention, the 1977 EEC Directive and the 1977 OECD Recommendation, but regretted that these measures were not inter-related.

The Recommendation "invites" Member States of the Council of Europe to conclude a multinational agreement on cooperation between tax administrations to stop international tax avoidance and evasion covering exchange of information, assistance in the recovery of tax etc. in

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113. "Recommendation on Cooperation Between Council of Europe Member States Against International Tax Avoidance and Evasion" (1978)

the field of direct and indirect taxes and social security contributions.

Among the specific recommendations were:

1. To urge governments of Member States of the Council of Europe to abolish unduly strict bank secrecy rules while paying due regard to the protection of individual privacy.
2. To urge Member States to refrain from passing special laws which give undue tax advantages to certain categories of company in respect of foreign earned income.
3. To take action to make it more difficult for international firms to use tax havens for tax avoidance purposes.
4. To promote an effective system for taxing multinational companies, particularly with regard to transfer pricing.

The Recommendation, therefore, covered a wide area and, although no such multinational convention was immediately implemented, the Recommendation did show that the problem had been recognised and that the Member countries were actively considering ways to improve the situation. The long process towards the drafting and agreeing of such a multilaternal treaty did, however, begin with the Recommendation and the subsequen history of this process is charted below.

However, so far it has only been possible to go beyond bilateral treaties in the field of tax avoidance where the countries involved have close links, either of a political, social or economic kind, such as the signatories to the Nordic Convention, the EEC Directive or the UK/USA Working Agreement.

There are inherent difficulties in agreeing a wider multilateral agreement. The needs and aspirations of different countries vary as does the extent of cooperation they are willing or able to give to a multilateral agreement. Some countries do not have the resources to devote to far reaching liaison with other countries. It is all they can do to deal with their own tax problems. Some countries have more efficient tax administrations than others, some have tighter legal constraints on collecting information than others (for example, in the area of bank secrecy).

Therefore, unless there were many reservations to such an agreement, it would have to take a form acceptable to the least enthusiastic countries. Either way, it is not likely to add very much to the present situation. Accordingly, such a multilateral treaty is probably inappropriate for the time being except within groupings of similar countries as noted above.

Nevertheless, despite the absence of such an overall multilateral treaty, it can be seen that moves are being made towards greater cooperation on the exchange of information.

What is more, there is still plenty of scope for greater use of existing facilities. For example, the working paper by the Chairman of Working Party 8 of the OECD Committee for Fiscal Affairs to the Colloquy on International Tax Avoidance and Evasion[114] recorded the fact that the head of the US tax administration had, in 1978, stated that, under the 25 treaties the US had with other countries which provided for exchanges of information, the USA had received 125 requests and had made 106. This is a very small number, particularly in connection with an aggressive tax administration such as that in the USA. The UK experience is similar. In the year to 31st march 1986, 453 pieces of information were sent to 32 countries, of which 317 were sent

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114. Strasbourg 1980

spontaneously. During the same period, the UK received 309 pieces of information from 33 countries of which 127 were spontaneous. This is still a relatively modest number, particularly as a lot of the above exchanges would have been under the UK/USA Double Tax Agreement. Nevertheless, such exchanges are increasing in number, slowly but surely.

It can be seen that there is a great deal that can still be done within the framework of existing bilateral treaties.

There is also an important factor that should not be overlooked. The general public of a country which enters into an exchange of information agreement usually views the move with suspicion; some governments are more likely to be influenced by such criticism than others. In fact, in the UK a taxpayer has very little real power to prevent information about his tax affairs being disclosed to another tax authority. In theory, he can apply for judicial review, but, in practice, he will not normally find out about the disclosure until it is too late.

However, given the problems of achieving one structure acceptable to all or most countries, there is nothing inherently wrong in having several different agreements of varying depth and detail from which a country can choose. This is not as ideal as having one all embracing and comprehensive agreement but it is certainly better than nothing.

The existing network of bilateral treaties goes a long way in providing for exchanges of information but the coverage of countries is not complete and there are sometimes problems when taxpayers conduct business through a third country or where a multinational group's activities take in a number of countries simultaneously.

The Nordic Convention has been very successful and ought to encourage other groups of countries to seek to do the same. The application of the rules has been much more uniform than if the signatories to the Nordic Convention had relied on bilateral treaties.

Whatever happens, it is absolutely essential that the safeguards of secrecy and confidentiality, such as in Article 26 of the OECD Model Treaty, be retained and respected so that the necessary increased international cooperation does not begin to infringe the rights of the ordinary taxpayer. It is important here that taxpayers' rights are fully respected. The commentary to Article 26 states that secrets "should not be taken in too wide a sense". This is not very clear and it must not be taken as a licence unduly to ignore legitimate commercial confidentiality.

Article 26 itself perhaps provides the basis on which countries can build. Most countries find it acceptable (but not all do) and they can build on it with other bilateral and multilateral agreements of greater detail.

However, the fact is that not even Article 26 is unconditionally acceptable to all countries and this shows how widely attitudes differ. Japan, for example, has pointed out that, in view of its strict domestic laws on making information public, it would be difficult to provide information under an exchange of information article unless the requesting country had comparable domestic laws.

Furthermore, Switzerland has entered a reservation on the Article because it believes it unnecessary since such a clause could not provide for more than for an exchange of information necessary for the correct application and prevention of an abuse of the convention.[115]

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115. See para 23 of the Commentary to the Article

One particular area of future development would be in more assistance in recovery of taxes, although common law countries will have to reconcile this with their traditional view that one country will not enforce the tax laws of another country.

At the moment, only a few bilateral treaties cover mutual assistance for the recovery of taxes. Jill Pagan notes[116] that only two UK treaties, those with the United States[117] and Canada[118] contain such a provision but, in each case it is restricted to ensuring that relief granted under the treaty does not extend to persons not entitled to it; for example, when there has been an over-deduction of withholding tax on dividends under the treaty and the UK is in a position to deduct an addtional percentage corresponding to the amount wrongly deducted on a flow-through to a non-UK beneficial owner. It is also noted that there are Dividend Regulations in force with Sweden and the Netherlands which contain provisions to correct an over-deduction of withholding tax under the relevant treaty provisions.

Given the problems inherent in drafting and agreeing a wide ranging multilateral agreement on administrative assistance, it is not surprising that the latest attempt to do so has taken the best part of ten years to get off the ground and still has some way to go.

Following Recommendation 833, the European Parliament, in 1979, agreed to the preparation of a multilateral convention. But it was, in fact, the Committee on Fiscal Affairs of the OECD which drafted the convention, a draft of which was presented to the Council of Europe in 1982 and which was put before the Committee of Ministers of the Council of Europe in 1986.[119] By the beginning of

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116. Op cit p6
117. Article 26(2)
118. Article 27.5
119. Council of Europe/OECD Draft Convention for Mutual Adminstrative Assistance in Tax Matters.

1988 the draft convention had been agreed by the Committee of Ministers and the OECD Council, who recommended that it should be opened for signature by Member States.

On 3rd March 1988 the Financial Secretary gave a Written Answer to the effect that, before reaching a decision on whether the UK should sign the convention, and, if so, with what reservations, it was intended to get the views of interested parties. The Inland Revenue had therefore been asked to seek the views of those interested parties.

The draft is a wide ranging one, covering direct taxes, VAT, estate duty, taxes on net wealth, local taxes, social security contributions and motor vehicle taxes. As well as dealing with exchanges of information, it also provides for participation in foreign tax examinations, the service of documents and assistance in the recovery of taxes.

The convention refers to exchanges between "two or more" parties, so it appears that combined operations involving a number of countries will be possible.

Article 9 of the draft convention is interesting in that it provides that a State may request that its representatives are allowed to be present at a tax examination in another State. However, there is no provision for the taxpayer in question to be informed of the request or for him to have the chance to make representations before the joint examination is opened. Even if such notice might be given in practice, it would have been much better for such safeguards to have been written into the convention.

There is provision in Article 24 for a coordinating body made up of representatives of the competent authorities to monitor the implementation of the convention. This is a useful step in that there would be a forum for the exchange of ideas on how to increase international cooperation. However, as it is drafted, there are shortcomings in that, although the body would operate under the auspices of the OECD, there is no clear system of accountablility and also no obligation or machinery for consultation with taxpayers.

When the Inland Revenue sought the views of the representative bodies of the professions, they found a lot of opposition, particularly about the wide-ranging nature of the provisions. It was felt that there was inadequate protection for taxpayers. There was also concern that the tax authorities of other countries might not observe the same level of secrecy as the UK Inland Revenue.

In view of the opposition to the convention the Government decided not to sign it. On 20 December 1988, the Financial Secretary to the Treasury, Norman Lamont announced this decisions in a Written Answer. He drew attention to the UK's extensive network of double taxation agreements and this country's European obligations and he said that, in view of these, it was felt that the UK need not become a party to the convention.

The European obligations to which he referred were those under the EEC Directive of 1977 which was extended in 1979 to VAT.[120]

An Inland Revenue Press Release issued on the same day as the Written Answer pointed out:

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120. Supra

> "A number of the provisions of the Convention (for example, in relation to the recovery of another country's taxes) would - if the Governement did not invoke the relevant reservation - require specific legislation before the Convention could be ratified by this country. In other areas the obligations to exchange information do not go beyond those which the United Kingdom has already undertaken in many of its double treaties".

At the moment, it is too early to say which other countries will decide to sign the Convention and, if so, with what reservations. Potentially, it could have been an important instrument to promote international tax compliance but the width of the wording does not ensure that the rights of the taxpayer would, in every case, be fully respected.

Conclusions

Given that there is a need for greater cooperation in the exchange of information, the way forward should encompass the following considerations:

1. Greater use should be made of existing bilateral treaties and the exchange of information provisions.
2. Countries should seek greater uniformity in the contents, functioning and application of bilateral treaties. For instance, some countries, notably Switzerland, are less committed to exchange of information provisions than others. Also, some treaties only extend Article 26 of the Model Treaty to the correct application of the convention and not to the application of domestic tax laws.
3. Moves should be encouraged towards more multilateral treaties along the lines of the Nordic Convention, particularly within bodies

which already have common economic and other interests (such as the EEC). The OECD/Council of Europe Draft Convention on Mutual Administrative Assistance is, however, rather too widely drawn adequately to protect the rights of the taxpayers.

4. Treaty obligations should be expanded to include, for instance, assistance in recovery of tax and allowing tax officials of one country to take part in tax investigations in another.

5. Multinational bodies should be encouraged to continue and expand their work on tax avoidance and the avoidance of double taxation. Bodies such as the OECD, the Council of Europe, the United Nations and the EEC have made considerable moves in this area and these should continue. The pattern of the Group of Four and PATA should be followed by other countries.

6. Pressure should be put on some countries to lessen the opportunities for abuse in such areas as excessive bank secrecy, non-productive companies which distort the international flows of capital and finance and distort competition. In addition, even if there is a double tax agreement with a tax haven (and there are not many), the tax haven is only obliged to give such information as is obtainable under local law and this might be very restricted (for example, as regards bank information, details of owners of companies etc.). Even outside traditionally secretive tax havens, some countries take a very restricted view of exchange of information, thus cutting down the effectiveness of any bilateral or multilateral treaties to which they are signatories.

The difficulty is, of course, to persuade tax havens to enter into exchange of information agreements. They normally consider them to be against their interests, so they have to be offered some inducement or threatened with some penalty. The USA appreciated this and have used both methods. It has terminated some treaties because abuses have been too great to allow the treaties to continue (for example the Netherlands Antilles and the British Virgin Islands treaties). On the inducements side, the USA, in 1983, set up the Caribbean Basin Initiative (CBI) to revitalise and expand economic opportunities in the Caribbean Basin. Part of this programme is to make certain countries eligible for "North American Area" status so that they can be locations for business conventions in connection with which business expenses are deductible for US tax purposes - in practice, a big advantage. In return for this favour, the countries have to enter into an exchange of information agreement which would override local secrecy laws. Success in this area so far has, however, been limited (except in the case of Barbados) but at least it shows how high tax countries may be able to persuade tax havens to enter into such agreements.

7. Anybody working in this area must, at all times, keep in mind that it is essential that they do not create unduly oppressive measures; taxpayers must be free to mitigate tax in legitimate ways. As a subsidiary point, there should be moves towards standardisation of different countries concepts of "evasion", "avoidance" and "planning" insofar as this is possible given the different legal system, particularly the distinction that exists between common law and civil law jurisdictions.

PART 2

THE TRANSFER OF ASSETS ABROAD

Introduction

At the turn of the century there was no movement by UK taxpayers of their assets abroad purely to avoid UK income tax, UK income tax rates were such that there was no pressure to ensure that income arose outside the ambit of the UK tax legislation.

This situation changed dramatically in the years following the First World War. Taxpayers were faced with increasing income tax and supertax burdens. Some of those who were suffering the heaviest burdens sought to arrange for the income from some of their moveable assets to arise in such a way that it did not attract a liability to UK tax. At the same time, they wished to ensure that they could obtain the benefit of that income in due course, mainly by manoeuvring the transactions to bring the accumulated income back to the UK in a capital form.

As the tax rates rose, the incentive to transfer assets beyond the reaches of the Inland Revenue increased.

The Inland Revenue were not equipped with adequate legislation to combat this growing trend and they were not supplied with such a weapon until 1936.

However, when the appropriate anti-avoidance legislation was enacted, it proved extremely successful. It was drafted in comprehensive terms and the courts adopted a practise of construing the provisions very widely so as to catch the various schemes put before them.

The first batch of cases on the new legislation arose during the Second World War (apart from the very first which was heard in 1938). During this time, the judges were ill-disposed towards tax avoidance and tended to give judgments which lent in favour of the Revenue, in that anti-avoidance provisions were construed, as far as possible, so as to catch the tax avoider. This trend is analysed later. Tax avoidance was, at that time, considered to be not in the best interests of the nation in a time of war.

The trend having been set as regards the construction of the legislation, it tended to persist after the war, although holes began to be punched in the legislation as the years progressed until, in 1979 the largest hole of all was blown in the legislation by the litigious Vestey family. Amending legislation followed which was surprisingly equitable in its application while, at the same time, plugging the hole exposed by the Vestey case.[1]

Set out below is an analysis of the various cases in which taxpayers have attempted to transfer their assets outside of the UK tax net and how the courts and the Legislature have reacted to their efforts.

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1. Vestey v IRC (1979) 54 TC 503

Section 18 and the War

Before the 1936 legislation was introduced, the Revenue had to try to bring schemes involving the transfer of assets abroad within other anti-avoidance provisions, often with no success.[2]

Legislation specifically aimed at transfers of assets abroad was introduced in 1936 and was immediately successful.

The Legislature, in introducing these provisions, would have had in mind the fact that non-residents were not subject to UK tax on interest and dividends payable in the UK on securities of a foreign state, or on other foreign dividends, or on income taxable under Sch D Cases IV and V from foreign securities and possessions, which income was only taxable if remitted to the UK.[3]

To take advantage of these rules, an ordinary resident in the UK would transfer such assets to a non-UK resident (or, in the case of foreign securities and possessions to a person neither resident nor domiciled in the UK). The UK resident would therefore avoid UK tax even though he could enjoy the income from the transferred assets.

The main avoidance schemes were based on the above rules, particularly through the use of overseas settlements; but the 1936 legislation was drafted in wider terms to catch a wider range of transactions. This can be seen from the preamble to the legislation, section 18, Finance Act 1936, which set out the object of the section:

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2. See for example, Marchioness of Ormande v Brown (1932) 17 TC 333 and Perry v Astor (1935) 19 TC 254, which are considered in Chapter 2.
3. See Part 4

"For the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets, by virtue or in consequence whereof, either alone or in conjunction with associated operations, income becomes payable to person resident or domiciled out of the United Kingdom."

The operative parts of the section were widely drafted. They were also very widely construed by the Judiciary. The first batch of cases came before the courts in the years 1938-1943. The Crown won each of them. The courts, in this time of national danger, were in no mood to countenance "unpatriotic" tax avoidance if they could help it. They therefore sought to interpret the words of section 18, as they did with other anti-avoidance sections, widely so as to cover the schemes before them. This can be seen from an examination of the cases on section 18 decided at this time.

The first was Cottingham's Executors v IRC.[4] The facts were that, for some years prior to his death in January 1936. Cottingham had resided in the UK. In October 1934, with a view to avoiding UK tax, he sold shares in an English company to a Canadian company, in return for shares and debentures in the Canadian company, which shares and debentures he had previously covenanted to transfer, when received, to two separate bodies of trustees upon discretionary trusts, for the sole purpose of being unable to deal with his assets himself: he was drinking heavily and wanted to protect the assets from himself. In other words, the setting up of the trusts did not have a tax avoidance purpose, but the actual transfer of the shares abroad did.

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4. (1938) 22 TC 344

The trustees of the debenture settlement paid to the joint account of Cottingham and his wife the whole amount received by them during the year ending 31 March 1936 in respect of the redemption of the debentures of the Canadian company.

Sur-tax assessments were raised on Cottingham's executors which included an amount which had been deemed, by virtue of section 18, to be the income of Cottingham up to the date of his death.

The executors argued that they were taken out of the charge to tax to the proviso to subsection (1) which, in an expanded form, is now section 741 ICTA 1988. The question for decision was set out by Lawrence J thus:

> "......whether, under that proviso, it is necessary for the individual referred to to show that the transfer and any associated operations, regarded together as one transaction, were effected mainly for some purpose other than the purpose of avoiding liability to taxation, or whether it is necessary for the individual to show that the transfer was effected mainly for some purpose other than the purpose of avoiding taxation, and that any associated operations were effected for some such purpose."[5]

The Crown argued that the taxpayer had to show that both the transfer of assets and the associated operations were carried out for purposes other than tax avoidance. The executors, of course, argued against this construction in view of the fact that, although Cottingham's transfer of assets had been for the purposes of tax avoidance, the associated operation (the creation of the settlements)

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5. p350

had not. They therefore claimed that one had to look at the main purpose of the transfer of assets and associated operations together. The main purpose of the whole arrangement was, in fact, to save Cottingham's assets from himself.

Lawrence J preferred the Crown's interpretation, so the fact that the associated operations were not concerned with tax avoidance did not take the executors outside the provisions of section 18.[6]

The decision of Lawrence J was upheld by the Court of Appeal.

The case was followed in MacDonald v IRC,[7] and the House of lords in Vestey v IRC[8] said that the case was clearly correctly decided.[9]

From the start, then, the taxpayer was faced with a stringent "mental element" test. This point will be developed further below.

A not dissimilar scheme and point of contention arose in the next case, MacDonald v IRC.[10]

The taxpayer was both resident and ordinarily resident in the UK. She transferred American shares to an American corporation in return for the issue to her of all its share capital. It was admitted that the object of this transfer was to avoid UK income tax and sur-tax. Three years later she transferred the consideration shares to a US trust company, upon trust to pay the income to her for life. The purpose of this transfer was to avoid UK death

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6. See p351
7. Infra
8. (1949) 31 TC 1, infra
9. See pp87 and 115
10. (1940) 23 TC 449

duties. The US corporation paid a dividend representing accumulated profits to date. The trust company, at the taxpayer's direction, made a payment in the US. The dividend was included in the taxpayer's sur-tax assessment, as was the income received by the American corporation after the payment of the dividend.

As in the Cottingham's Executors case, one of the transactions, the transfer of the American shares to the American corporation, had been to avoid UK income and sur-tax; the other one not being for that purpose. Here the later one, the transfer to the trust company, was to avoid UK death duties.

The judge, Macnaughten J, held that the later transaction, not being to avoid income tax or sur-tax, was outside the ambit of section 18. On this point, he was overruled by a later case, Sassoon v IRC.[11] In any case, that part of Macnaughton J's decision did not assist the taxpayer because, following Cottingham's Executors, he held that both the transaction in question and the associated operations had to be effected for purposes other than tax avoidance.

This decision underlined the interpretation given to the proviso to subsection (1) in Cottingham's Executors.

Another aspect of section 18 which showed how wide the section was came out in the the MacDonald case. the taxpayer was not domiciled in the UK and, under the law as it then stood, if she had formed the US corporation directly, its income would only have been taxable on her if her earning from the company, representing that income, had been remitted to the UK. Nevertheless,

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11. (1943) 25 TC 154, infra

Macnaughten J held that the section overrode the normal remittance basis, it being expressly provided in the section that the company's income was to be deemed to be her income "whether it would or would not have been chargeable to income tax apart from the provisions of this section."

The harshness of this particular part of the decision was not abrogated until 1981 when section 46(8), Finance Act 1981 introduced an amendment (to section 480(2) ICTA 1970) whereby what was then section 478 ICTA 1970 does impose a charge to tax on deemed income if the taxpayer would not have suffered tax on actual income in those circumstances.[12]

So, it can be seen from just the first two cases that the taxpayer was not having anything his way (apart from the death duty point in MacDonald, which was to be overturned just three years later).

He had no better fortune in the next case, decided a few months after MacDonald: Admiral Earl Beatty's Executors v IRC.[13] This case again showed how widely the courts were construing the section.

It concerned a different point from those considered in Cottingham and MacDonald; namely, when is the taxpayer entitled to receive a benefit out of the overseas income?

The result of this case is that it matters not that the asset actually transferred gives rise to no income and, what is more, the transferor of the assets does not have to acquire power to enjoy the income of the transferee; the income of any non-resident will do. As Lawrence J said, the section "does not say the income of the person

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12. See now section 743(3) ICTA 1988
13. (1940) 23 TC 574

to whom the transfer is made; it is any income and any person."[14]

The avoidance scheme which was the subject of this case was basically that Earl Beatty transferred certain American assets to a Canadian company in consideration of the payment to him of debentures which bore no interest but which were redeemable in yearly blocks over a period of years. The debentures were transferred to a trust company upon trust to pay the redemption moneys to the Earl for life, remainder to his two sons equally.

The Earl's executors were assessed to sur-tax on the basis that the income of the company for the relevant year was to be deemed to be the income of the Earl.

The executors, however, argued that the Earl, by his transfer of assets, had acquired only the debentures and had not acquired the power to enjoy the company's income. This argument was based on the submission that the Earl would only have received a repayment of capital on redemption equal to the value of the assets transferred. As a result, it was argued, the Earl would not have received any benefit from the non-resident company's income as a result of his transfer of assets.

Lawrence J, however, said that the debentures were charged on the income of the company as well as capital. Therefore, he said, the taxpayer was entitled to benefit from the income.

This was a wide definition of the relevant provision[15] and in keeping with the trend established in the earlier cases.

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14. p590
15. In what is now section 742(2)(c) ICTA 1988

This treatment of this particular provision was confirmed in two later cases: Lord Howard de Walden v IRC[16] and Lee v IRC.[17] The Howard de Walden case was the first in which the Court of Appeal had an opportunity to consider section 18. Macnaghten J sat in the High Court in both cases.

The Lee case is important, not only for emphasising the wide construction being given to "power to enjoy" under section 18(3)(c) FA 1936[18] (thereby underlining the Earl Beatty decision), but also for showing that a person can have power to enjoy the income of company even if he is not a director with direct control over the company under section 18(3)(e) FA 1936.[19]

The scheme in Lee's case was indicative of a popular device at the time; a UK individual transferring assets to an overseas company or trust which he controlled directly or indirectly. This particular case involved a company.

The taxpayer was ordinarily resident in the UK. He transferred some shares, of which he and his wife were beneficial owners, in two UK investment companies, plus the benefit of a debt owed to him by one of those companies, to a Canadian company in return for the transfer to him of a series of promissory notes payable on demand, the issue to him and his wife of shares, and the issue of further shares, at his direction, to his sons.

Under the Canadian company's by-laws, the taxpayer had full control because, by virtue of the rights attaching to his shareholding, he could elect and remove the directors, amend the bylaws and decide the allotment and transfer of shares.

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16. (1941) 25 TC 121
17. (1941) 24 TC 207
18. Now section 742(2)(c) ICTA 1988
19. Now section 742(2)(e) ibid

The taxpayer was assessed to sur-tax on that part of the Canadian company's income which was applied in payment to him of two promissory notes and, for the following year, he was assessed on the whole of the company's income.

The amounts payable under the promissory notes did not constitute a "capital sum" because it was not payable by way of loan or repayment of a loan and was payable for full consideration and so did not attract a charge under section 18.

However, the company's income, received in consequence of the transfer, was correctly treated as the taxpayer's income under section 18(3)(c) and (e).

Under (c), he was entitled to receive a benefit out of the company's income by virtue of his right to receive a dividend through his possession of shares. He therefore had "power to enjoy" the company's income.

As regards (e), the Crown had to show that the taxpayer was able to control the application of the income. The taxpayer was not a director but he could control the composition of the board by removing directors and appointing new ones. Macnaghten J held that he was thereby able to control the application of the company's income.

This decision again, shows how widely the section was being interpreted. Macnaghten J's finding on paragraph (e), in particular, was important and had repercussions, not only as regards control over companies, but also over other entities, principally settlements. A person ordinarily resident in the UK who has power to control, directly or indirectly, the application of income of a non-resident settlement would potentially be within (e). However, there are limitations.[20]

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20. See IRC v Schroder (1983) 57 TC 94, infra

The taxpayers faired no better at the hands of the Court of Appeal when they first had to consider section 18 in the case of Lord Howard de Walden v IRC.[21] In fact, if anything, the judges in the Court of Appeal were even harsher on the tax avoider than Lawrence and Macnaghten JJ had been in the earlier cases.

This case concerned two of the paragraphs under which it is determined whether a person has "power to enjoy" the income of the non-resident and non-domiciled person: now section 742(2)(b) and (c) ICTA 1988.

It was established that, even if the "power to enjoy" extends only to a small part of the overseas person's income, the charge under the section is not limited to that small part. Lord Greene MR said that:

> "the language of the section clearly does not limit the income of the non-resident in respect of which the taxpayer is charged to the actual benefit which he draws from the income of the non-resident."[22]

The facts were that the taxpayer, who was ordinarily resident in the UK, transferred certain assets to non-resident companies. The consideration included a series of 120 promissory notes payable at intervals of three months. There were also deposits with the companies repayable to the taxpayer on demand.

Paragraph (b) applies where the receipt of the income by the non-resident, non-domiciled person operates to increase the value of assets held by the taxpayer. Here, the receipt of the income by the companies did increase the value of the promissory notes and the deposits because more money would be available to repay the debts.

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21. (1941) 25 TC 121
22. p134

The benefit the taxpayer received from this increase in value was small compared to the total income of the companies. This did not matter; all of the income of the companies was deemed to be the taxpayer's.[23]

This principle could give rise to harsh consequences. For example, a person ordinarily resident inthe UK might transfer assets to a non-resident company in consideration for a small minority of the company's shares. He would thereby be assessable on the whole of the company's income.

In the situation where, as here, the asset in question is a debt, it would be arguable that the value of the debt was not increased by the receipt of income if the company had sufficient funds already to repay it.

A further point to note here, which again demonstrates how widely the section was being interpreted, was that the Court of Appeal's decision shows that it made no difference that it was not because of the taxpayer's holding of the promissory notes that the receipt of the income by the company increased the value of the assets (ie, the notes), because that had happened by reason of other transactions.

As to paragraph (c), this applies if the taxpayer receives, or is entitled to receive, any benefit from the overseas income. This too applied here because the taxpayer did receive payment of the notes out of the income of the overseas companies.

The interpretation given to paragraphs (b) and (c) in this case, particularly as regards the quantum of the taxpayer's liability under the "power to enjoy" point, again demonstrate how widely section 18 was being construed.

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23. See Lord Greene MR at p133

Lord Greene MR, giving the judgment of the Court of Appeal, went further and expressed himself on the subject of the tax avoidance scheme before him and section 18.

He called the section "a penal one".[24] This is a questionable description if Lord Greene MR was referring to the purpose rather than the effect of the section, and it certainly was not intended by Parliament to be penal, as can be seen from the discussions on the section in its passage through the Commons.[25]

He continued:

> "For years a battle of manoeuvre has been waged between the Legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle the Legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present Appellant has not been the least successful. It would not shock us in the least to find that the Legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers."[26]

Lord Greene MR's dislike of the arrangements in question further manifested itself in his responses to two further submissions made by counsel for the taxpayer: those relating to double taxation and to the retroactive effect of the section.

On the question of double taxation, Lord Greene MR denied that, on the facts, there was any but, in any case, he said that "the argument based on hardship leaves us

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24. p134
25. Infra
26. p134

unmoved."[27]

As regards the retroactive effect of section 18 he said:

> "The fact that the section has to some extent a retroactive effect again appears to us of no importance when it is realised that the legislation is a move in a long and fiercely contested battle with individuals who well understand the rigour of the contest."[28]

Again this comment does not truly reflect the spirit in which the legislation was introduced in 1936, but rather the mood of a country at war to those who were seen as trying to avoid paying their proper contribution to the nation.

The House of Lords were given their first opportunity to consider section 18 in Latilla v IRC.[29] They continued the pattern that had already been set in earlier cases in the lower courts. In particular, they continued to construe the section very widely; in this case "associated operations" and the phrase "income becomes payable" were the subject of the wide construction by the judges. Furthermore, Viscount Simon LC, as Lord Green MR had done in the Howard de Walden case, severely criticised those who indulge in tax avoidance schemes.

Dealing with the latter point first, the Lord Chancellor began his judgment with the following well-known passage:

> "My Lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who are prepared to adopt them might enjoy the benefits

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27. Ibid
28. p135
29. (1943) 25 TC 107

of residence in this country while receiving the equivalent of such income, without sharing in the appropriate burden of British Taxation. Judicial dicta may be cited which point out that, however, elaborate and artificial such methods may be, those who adopt then are 'entitled' to do do. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."[30]

This, of course, was a different attitude to that taken by the courts in earlier years and to a certain extent, in the post-war period. This is examined further below.

The facts of the case were that the taxpayer's wife was a member of a partnership which owned a gold mine in Rhodesia. The taxpayer and his wife were ordinarily resident in the UK. After 1932, all of the partners, apart from one, were in the UK and, with a view to protecting their interest, they formed a Rhodesian company, which, in 1933, acquired from them their shares in partnership in return for 10,000 ordinary shares and £250,000 non-interest bearing debentures. The company paid no dividends, but applied all of its profits in redemption of debentures.

The taxpayer was assessed to tax on his wife's share of the company's income under section 18.

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30. p117

The taxpayer claimed that the company's income was earned in its business and than no "income" became "payable" to it in consequence of the transfer of assets (namely, the transfer to it of the partners' interests in the partnership). It was further contended that section 18 did not apply because the transfer of assets was a bona fide commercial transaction effected mainly for a purpose other than tax avoidance.

Both of these contentions failed. The first contention, if successful, would have restricted the section to investment income. Before this case, some people had thought that "income becomes payable" could only apply to receipts which were all income in the hands of the recipient. Trading profits could only be quantified, of course, after deducting allowable expenditure. This was rejected by the courts.[31]

It was also argued on behalf of the taxpayer that the profits warned by the partnership of which the company was a member could not become "payable" to the partners because it was their income already; a person cannot pay himself. This too was rejected. Lord Greene MR, in the Court of Appeal, said:

> "In the partnership accounts the company's undrawn share of profits would appear as a debt owing to the company. If the profits were under the control of the other partner, the company could, by appropriate proceedings, compel him to pay over its share. If this is not 'income' payable to the company we do not know what is."[32]

On the question of "power to enjoy", it is to be noted that the taxpayer's wife received capital payments in the

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31. See for example Lawrence J at p113
32. p115. See also Lord Porter in the House of Lords, at p120

form of the redemption of the debentures. Nevertheless, this was held to come within what is now section 742(2)(a) ICTA 1988: "the income is in fact so dealt with by any person as to be calculated, at some point of time, and whether in the form of income or not, to enure for the benefit of the individual." This particular point is straightforward and did not require a wide construction of the words of the section.

As mentioned above, however, two aspects of the section did give rise to a wide interpretation. One, the ambit of the phrase "income becomes payable", has already been dealt with. The other was "associated operations."

In this case, the activities of the partners in carrying out the partnership business were held to be operations associated with the transfer of the partnership interests to the Rhodesian company. Lord Greene MR considered the words to be "of the widest import" which "clearly cover the operation of turning the assets to account".[33] The normal mining activities of the partnership, of which the company was a member, and its workforce were therefore associated with the original transfer of assets.

The bona fide commercial transaction argument failed on the facts. This test is considered below.

During the war years there were two further cases on section 18 heard by the Court of Appeal. Each of them again demonstrated the wide interpretation being given to section 18 and each case contained other points of interest.

The first of these cases was Sassoon v IRC.[34] The facts of this case are straightforward. A taxpayer ordinarily

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33. p116
34. (1943) 25 TC 154

resident in the UK created a Swiss company, to which he transferred certain investments. It was admitted that he had power to enjoy the income of the Swiss company within section 18 but he argued that his sole purpose in making the transfer of assets was to avoid UK death duties, which were not included in the term "taxation" in the proviso to section 18(1).

It will be recalled that, in MacDonald's case,[35] Macnaghten J had held that the transfer must be to avoid tax or sur-tax before section 18 can apply. Macnaghten J was also the judge at first instance in this case so the Crown conceded, in the the high Court, that the MacDonald decision applied. They did not even offer any arguments.

The position was completely the opposite in the Court of Appeal; the decision going in the Crown's favour without the court even hearing argument from the Solicitor-General.

Scott LJ was of the opinion that the use of the word "taxation" "calls for a liberal interpretation in favour of the Crown".[36] In view of the history of the section before the courts up to this time, any other view would have been surprising. The judge considered that the draftsman of the section deliberately chose to use such a wide word as "taxation", "in order to make sure that their concession of transfers for other purposes should not be used to deprive the Revenue of other taxes than Income Tax or Sur-tax."[37]

However, reference to the Parliamentary debates shows that, at all times, the ambit of the proposed section was assumed to be restricted to the avoidance of income tax and sur-tax.[38] It would have been interesting had the

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35. Supra
36. p158
37. Ibid
38. See for example, Hansard Vol 313 cols 675-6 and 724

Attorney-General (Somervell)[39] appeared for the Crown, rather than the Solicitor-General, to see what his arguments would have been on this point.

The second of the two Court of Appeal cases mentioned above was Corbett's Executrices v IRC.[40] Here, property was transferred by Corbett and others to a company resident in the UK. Two years later, the main assets of the UK company were transferred to a Canadian company in consideration of shares and non-interest bearing debentures of the Canadian company.

It was argued that the lapse of two years prevented the transfer of assets from the UK company to the Canadian company being "associated" with the transfer of assets to the UK company. This submission was, according to Scott LJ, "wholly unacceptable".[41] He noted that the Court of Appeal in Latilla and Howard de Walden had rejected any narrow or technical construction. His judgment, and that of the other judges in this case, continued that trend.

This case also emphasised the point that it is not up to the Revenue to establish that the taxpayer intended to avoid tax; the onus was on the taxpayer to prove that his main purpose was something other than tax avoidance.[42]

The only other case in the war years was another decision of Macnaghten J in favour of the Crown: Ackroyd v IRC.[43] This was a straightforward case, the facts of which have already been given.[44] It is not considered further here.

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39. Who had made certain assurances to the House of Common, infra
40. (1943) 25 TC 305
41. p314
42. See Macnaghten J at pp311-2 and Scott LJ at p314
43. (1942) 24 TC 515
44. See Chapter 1

The Post War Years

It has been seen that in the years before and during the Second World War, nine cases on section 18 came before the courts. The Crown won them all, the courts consistently adopting a wide construction.

The first case following the war continued this trend but, after that, the Crown began to find that they were not having it their own way.

The first post-war case is very important for a number of reasons. It established that a person may be assessed under section 18 even though he personally had not made the transfer of assets or carried out any associated operation (on this point, the House of Lords changed their minds in the 1979 Vestey case[45]). It further established that a charge may arise even though the transfer of assets was to a person who was, at the time, resident in the UK. On both these points, the finding of the House of Lords conflicted with what the House of Commons had been told when clause 16 of the Finance Bill 1936 (which was to become section 18) was being debated.

This case, therefore, strongly emphasised two matters which could already be gleaned from earlier cases: (a) the section would be given a wide construction; and (b) the findings of the courts (and the arguments of the Crown), in some respects conflicted with the assurances given to the Commons when the legislation was passing through Parliament.

The case in question was Congreve v IRC.[46] The transactions in this case were very complicated but they may be summarised as follows:

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45. Vestey v IRC (1979) 54 TC 503, infra
46. (1948) 30 TC 163

The taxpayer's father was an American citizen who had built up a substantial business in the UK which was carried on by a UK company, in which he held most of the shares. The taxpayer, his daughter, was also an American citizen and she was married to a person domiciled in Eire. She and her husband, were, however, ordinarily resident in the UK.

The father transferred a large block of his shares in the UK company to an American corporation, the taxpayer being given the whole of the share capital of the American corporation. The UK company's shares were then transferred by the American corporation to a Canadian investment company in exchange for the issue by the Canadian company to the taxpayer of redeemable debentures.

A number of other similar transactions involving Canadian and UK investment companies took place but the precise arrangements do not need to be set out here.

Assessments were made under section 18 on the basis that all of the transactions constituted transfers of assets or associated operations within the meaning of the section, and that the taxpayer had power to enjoy the whole income of the foreign companies.

In the High Court, Wrottesley J, who had not presided over a section 18 case before, gave the section a narrower construction than the Court of Appeal and the House of Lords.

He noted that the Crown had argued that it was sufficient, to raise a section 18 assessment, to find a person ordinarily resident in the UK who has power to enjoy income of a person outside the UK, which power was obtained by a transfer.[47]

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47. p186

To this he said:

> "The answer to this argument is that the section might well have been drawn in this way and so as to effect this. If so it would have been simpler and more effective, both. But in that event the introductory words would have been unnecessary; and the courts do not yet make the efforts of the Legislature to circumvent tax evasion [sic] more efficient than is provided by the language, particularly when that involves disregarding the ordinary plain language of the preamble, and the fact that that preamble is deliberately drawn into the fabric of the operative sections. Here the Legislature has been careful to hedge about the operative section with words which indicate that that target is an individual who is trying to avoid tax by means of a particular course of conduct. It is not for the courts to widen that target so as to include persons who have not evaded liability, at any rate by the means referred to."[48]

A number of interesting points arise from the views of Wrottesley J. He is taking a different, more traditional, view of tax avoidance from that which was current during the war years and which was evinced by the judges of the Court of Appeal and the House of Lords in this case. His was also a more traditional line to statutory interpretation than the one which was beginning to gain ground, particularly in connection with wide anti-avoidance provisions such as section 18. The judge's approach to section 18 was more in line with the assurances given to the Commons during the passage of this provision through Parliament. Finally he adopted a different approach to the preamble than the higher courts. These points are all considered further below.

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48. Ibid

On the question of quantum - a point on which the House of Lords were to change their minds some thirty years later - the judge was again at variance with the higher courts. He found the key in subsection (4), a subsection not resorted to by the higher courts.

The equivalent provisions are now to be found in section 742(3) ICTA 1988. The subsection directs the court to look at "the substantial result and the effect of the transfer and any associated operations" and all benefits which may at any time accrue to the individual as a result of the transfer and associated operations are to be taken into account.

The judge asked whether the subsection was to be used only to make more tax become payable - which is its more natural effect - or can it also be used, as the judge put it, "so as the confine the section to the mischief aimed at in the preamble, namely, the prevention of the avoidance of tax by means of transfers?"[49]

The judge thought that the language of subsection (4) clearly suggested that it was "an overriding subsection" which could "prevent the extravagant results which would flow from a literal reading of subsection (3) and its introduction into subsection (2)".[50]

The judge saw subsection (4) as limiting the subsection to catching the perceived mischief of the section - avoiding tax by means of transfers abroad - but also providing "that an individual who, after making a transfer, employs colourable transactions to evade the operation of the section, would nevertheless be caught."

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49. p180
50. Ibid

The higher courts, taking a wider view of the section, did not give such a limiting function to subsection (4) and considered the preamble to have a different purpose and effect. This point is dealt with further below.

The actual decision of the House of Lords was that, contrary to the finding of Wrottesley J, section 18 did apply in the present case.

It was held that section 18 applies:

(a) where there has been a transfer such as is described in the introductory words, and the individual in question has, by means of such a transfer, acquired rights by virtue of which he has power to enjoy income of a person resident or domiciled abroad, irrespective of whether the transfer was made by the individual who acquired those rights; and

(b) where a transfer of assets was made to a person who, at the time of the transfer, was resident in the UK but who, when the income arose, was resident outside the UK.

In the House of Lords, the main judgment was given by Lord Simonds, with whom the other Lords agreed.

His Lordship noted that it was a fact found by the Special Commissioners and no longer disputed by the taxpayer that the transactions were one inter-connected series and that the avoidance of tax was the purpose or one of the purposes of the transactions.[51]

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51. p202

Contrary to the analysis of Wrottesley J, Lord Simonds found no assistance in the preamble. He rejected the argument that the preamble assisted the contention that the individual must actually transfer the assets.

He relied, instead, on the operative words of the section (ie, excluding the preamble) which he considered to be "in the widest possible terms" and as not imposing the limitation that the transfer must be effected by the individual in question.[52]

On the second question, namely, whether the transfer of assets must be to a person resident or domiciled out of the UK at the time of the transfer, Lord Simonds said:

> "The transfer of assets aimed at by the section is not expressed to be a transfer to a person resident or domiciled out of the United Kingdom. I would suppose that it is deliberately so expressed, for I cannot think that so simple an expedience as the transfer of assets to a company resident in the United Kingdom and the immediate removal of that company outside it would not occur to the draftsman."[53]

He then analysed the grammar of the section which, it has to be admitted, does support Lord Simond's view. The trouble is, Lord Simond's construction does not coincide with assurances given to the House of Commons and similarly, it is doubtful whether the section was "deliberately so expressed" as Lord Simonds thought, unless the draftsman was deliberately ignoring the assurances given to the Commons.

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52. pp204-5
53. p206

Regarding the first finding of the House of Lords, the Financial Secretary to the Treasury, W.S. Morrison, assured the House of Commons, when clause 16 (later section 18) was being debated:

> "The person who is liable under this clause is the person who makes the transfer."[54]

He further said:

> "If the hon. Member looks at the scheme of the clause he will see that it is not only necessary that there should have been a transfer but that <u>the individual who is to be charged shall have made the transfer</u> and shall have acquired rights to enjoy the income."[55]

He later added:

> "This clause is concerned with cases where an individual has by the transfer of assets abroad acquired rights which enable him to enjoy the income of a company."[56]

Furthermore, the Attorney-General, Sir Donald Somervell, confirmed this intention. He told the Commons:

> "First it has to be found that a man has made a transfer of assets <u>and then it has to be found that he is enjoying the product of those assets</u>."[57]

It therefore appears, either that the draftsman misunderstood the intention of the Legislature, or that the Crown were being deliberately dishonest and misleading. What is clear is that the House of Commons acted on these assurances about the limited scope of the section.

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54. H.C Deb, Vol 313 col 689
55. Ibid col 676
56. Ibid col 678
57. Ibid

It is also clear that Morrison's comments were not merely made in passing without much thought being given to the implications of what he was saying, because he was specifically pressed on whether anyone other than the transferer or his spouse could be caught under the section. He said that the section would not operate to catch a non-transferor. In particular, it would not catch the transferor's son even though the son would enjoy the same rights[58]. Compare this assurance with the judgment of Lord Denning in Phillips v IRC.[59]

On the second finding of the House of Lords, Sir Donald Somervell had told the Commons that clause 16 covered "transfers of assets into foreign countries."[60]

The role played by Sir Donald Somervell in the early development of section 18 is worthy of comment. He was a party to the assurances given to the House of Commons as to the narrow scope of the section, and yet he appeared as counsel for the Crown in Cottingham's Executors, Lee, Latilla and Corbett's Executrices cases in which he persuaded the courts to adopt a very wide interpretation. Furthermore, he was one of the Court of Appeal judges in Vestey in 1949[61] where he himself took a wide line in the construction of the section, only to be overruled by the House of Lords in the first case on section 18 which the taxpayer won.

One gets the impression that the House of Commons were tricked into accepting this section, not appreciated how widely its scope would be.

On the question of quantum of charge, the House of Lords left it open for further consideration[62] but, in the Court of Appeal, Cohen LJ held that the charge was not

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58. Ibid cols 688-9
59. (1971) 47 TC infra
60. On this point see also <u>Herdman v IRC</u> (1969) 45 TC 394, infra
61. <u>Vestey v IRC</u> (1949) 31 TC 1, infra
62. p207

restricted to the income attributable to the assets transferred.[63] This construction does not appear to be supported by the words of the section. The words "that income" which is deemed to be the UK individual's income, can only refer to "any income which .....has become the income of a person resident or domiciled out of the United Kingdom" "by virtue or in consequence" of the transfer.[64]

It will be recalled that, in the Howard de Walden case,[65] Lord Greene MR had held that the charge was not limited to the amount the resident had power to enjoy. Again, this does not appear to be justified by the construction of the section. Going back to section 739(1) ICTA 1988 "that income" cannot refer to anything other than that which the individual has "power to enjoy".

The findings of Lord Greene MR and Cohen LJ together formed a harsh rule on the quantum of charge under the section.

Another aspect of the decision in Congreve related to associated operations. Lord Simonds held that a transfer to a person who at the time was resident and domiciled in the UK would be caught. However, he indicated that, in any case, he would have been prepared to hold that the removal of residence and domicile out of the UK would have been an "associated operation".[66]

The Congreve case capped ten years of uninterrupted success for the Crown in section 18 cases; a decade in which the boundaries of the section had been pushed even wider, almost with each case.

The Crown suffered its first defeat on the section in 1949. This was at the hands of the Vestey family, who

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63. p199
64. See section 739(1) ICTA 1988
65. (1941) 25 TC 121 supra
66. p206

were to score an even more famous victory thirty years later, a victory which caused the House of Lords to overrule Congreve and expose a loophole in the section, albeit one which the Legislature apparently intended to be there, which caused further anti-avoidance provisions to be introduced. The 1979 Vestey case is examined below:

The first Vestey case on section 18 was Lord Vestey's Executors and Vestey v IRC.[67]

This case was concerned with two major anti-avoidance provisions, section 18, which is considered here, and section 38, Finance Act 1938, an anti-avoidance section concerning settlements, examined in Chapter 2. Important points of interpretation arose on both sections.

The arrangements in question were implemented by the Vestey brothers, namely, Lord Vestey and Sir Edmund Vestey.

By a lease dated 29 December 1921, the brothers demised to a company they had created assets situated in various parts of the world. The term of the lease was 21 years from 10 April 1921, determinable by either party on six month's notice. The rent was £960,000 per annum payable to trustees resident in Paris. The brothers were authorised to withdraw properties from the lease, in which event the rent was to be proportionately reduced.

By a trust deed made on 30 December 1921, the brothers declared the trusts on which the Paris trustees were to hold the rent and trust income. The brothers reserved no beneficial interest to themselves but they did have special powers of appointment in favour of issue and of

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67. (1949) 31 TC 1

their widows. The trustees were required to capitalise the rent until the expiration of twenty years from the death of the last surviving grandchild then living of the settlors by investing it under wide powers of investment. Power was conferred on the brothers to direct how the money should be invested and, under this power, they could direct the trustees to invest upon personal credit or upon loan to any company or companies, wherever domiciled, and with or without security.

The residue of the income arising from the settled fund, when invested, after meeting certain costs and charges, was, until the end of the accumulation period, divided into two funds: "William's Fund" and "Edmund's Fund". At the end of the accumulation period the two funds were to be held in trust for the benefit of the children or remoter issue (and their wives and widows) of Lord Vestey (ie. "William") and Sir Edmund, as Lord Vestey and Sir Edmund might by deed or will respectively appoint. In default of and subject to any such appointment, the funds were to be divided among the issue of Lord Vestey and Sir Edmund. The trust deed further reserved a power to Lord Vestey and Sir Edmund to appoint by will any interest in the William or Edmund funds in favour of the widow of the appointor.

In November 1935, Lord Vestey irrevocably appointed by deed all funds, both capital and income, which he had power to appoint, to his issue, but he did not release his power to appoint his widow. In December 1935, Sir Edmund irrevocably appointed to his issue part of the property and, in 1937, he irrevocably appointed the remainder to his children and extinguished his power of appointment in favour of his widow.

Assessments under section 18 were raised on the executors of Lord Vestey (who died in December 1940) and on Sir Edmund, on the basis that the brothers were ordinarily resident in the UK at the relevant time and had transferred assets abroad and had power to enjoy the income of the Paris trustees.

The question for determination was therefore whether the brothers had, by means of the transfer of assets, either alone or in conjunction with associated operations, acquired any rights by virtue of which they had power to enjoy any of the income payable to the Paris trustees under the trust deed.

As an aside, the Case Stated disclosed that Lord Vestey had written to the Prime Minister (Lloyd George) in 1919 asking that the Government would grant the Vestey's some relief from taxation in respect of their business activities.[68] When this was refused, the Vesteys decided to evolve a scheme to achieve the desired result. This case determined that they succeeded in doing so.

It was argued on behalf of the taxpayers that there had been a "reservation" of rights as distinct from and "acquisition" by them, so that section 18(1) had no effect. The House of Lords rejected this, holding that any rights enjoyed by the taxpayers, whether against the trustees or the settled fund, were derived from the settlement, and their interests were acquired by virtue of those rights.

This finding was not, however, enough for the Crown to succeed. The rights which the taxpayer acquired were merely the rights or power of appointment in favour of their widows, and in favour of their children or remoter issue and their wives or widows.

The Crown argued that the brothers had acquired a power to direct investment and could direct the income to themselves. The House of Lords, however, pointed out

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68. p30

that this was a fiduciary power which had to be exercised properly and not in breach of trust, and held that it conferred no interest or "power to enjoy".[69]

Furthermore, the power of directing investments was a joint power, and the House of Lords held that the acquisition of rights which an individual enjoys, not solely, but jointly with others, was outside the ambit of section 18(1).

Lord Simonds dealt with this as follows, taking the case of Lord Vestey as governing that of Sir Edmund:

> "I recur then to that right upon which alone (apart from the special power of appointment in favour of a widow) the Solicitor-General [Counsel for the Crown] appeared to rely, namely the right to direct investment. At once, as it appear to me, the difficulty arises that Lord Vestey as an individual acquired no individual right. I agree .... that here the Interpretation Act cannot be invoked to convert singular into plural. The context does not admit of it. Just as it is the income of an individual that is being assessed so it is the right of that individual that must be regarded. Whatever view, then, is taken of the right to direct investment, that was not a right of Lord Vestey alone and it cannot be said that by virtue of that right he is bought within the Section."[70]

See also Lord Morton of Henryton[71] who also made the point that the failure of the section to cover such a joint power " opens the door to easy evasion [sic] of the provisions of Section 18." He continued: "If so, it is

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69. See for example Lord Normand at p90
70. p85
71. At p110

for the Legislature to fill the gap and not for your Lordships to put a strained construction on the words, 'Where such an individual has acquired any rights'".

This is the first time that anything other than a very wide construction had been put on section 18.

A further question arose regarding the rights the brothers had acquired by virtue of the transfer of assets (ie the powers of appointment): had either of them "power to enjoy" the income of the Paris trustees?

The House of Lords considered all five headings in section 18(3)[72] and held that the brothers did not have power to enjoy under any of them. Sub-paragraph 18(3)(a) did not apply because there were no findings of fact by the Special Commissioners to support an assessment under this heading. The words "dealt with" showed that there had to be a positive act by some person. This required relevant findings by the Commissioners.[73]

As regards (b), it is necessary to show that the receipt or accrual of the income operates to increase the value to the individual of any assets held by him or for his benefit; an individual being deemed to include his wife.[74] However, even if the power of appointment in favour of the widow was an "asset", it was held that "wife" did not include "widow" so (b) did not apply. As far as the power to appoint in favour of issue was concerned, even if it was an "asset", it was not held by the transferer or for his benefit.

There was also the power to direct investments but, as has already been mentioned, this was a fiduciary power, conferring neither rights nor any interest, and it could not be regarded as an "asset" within the meaning of (b).

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72. Now section 742(2) ICTA 1988
73. See Lord Simonds at p85
74. Section 18(5)(a) FA 1936; now section 742(9) ICTA 1988

For the purposes of (c), neither the transferors nor their wives received or was entitled to receive any income by virtue of the power of appointment. For reliance to be placed on (c), as with (a), there must be clear findings of fact by the Commissioners. These were absent here.[75]

Similarly, under (d), neither the transferors nor their wives could obtain the beneficial enjoyment of the income if the powers of appointment were exercised. The "widow" might but, as has already been mentioned, benefits to a "widow" were outside the ambit of section 18.

Finally, there was sub-paragraph (e). Here the Crown had to show that the brothers were able in any manner whatsoever, and whether directly or indirectly, to control the application of the income for the particular year or years of assessment for which it was sought to tax them under the section.

The House of Lords held that the brothers were not able to control the application of the income in that they could not divert it for the benefit of themselves or their wives. The power to appoint in favour of a widow or issue was not sufficient.[76]

It will be recalled that there was a fiduciary power for the brothers to direct money to be loaned (even though they could direct loans to themselves), provided the loans were on commercial terms. This was not enough to bring (e) into operation.[77] The position with regard to a non-fiduciary power was left open. Had loans actually been made to the brothers, a charge under section 18(2)[78] would have arisen, however.

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75. See Lord Simonds at p86
76. See Lord Simonds at p86 and Lord Morton at p113
77. See Lord Norman at p90
78. Now section 739(2) ICTA 1988

In any case, the irrevocable execution of the power to appoint in favour of issue by Lord Vestey on 26 November 1935, had put the matter beyond doubt, as far as he was concerned.

An additional question arose regarding Sir Edmund. In the period before he executed the second power of appointment in respect of the remainder of the property in favour of issue, could he be regarded as having control within (e)? The House of Lords thought not because, if such a limited power of appointment were intended to be caught by subsection (3), it would, in the opinion of the House of Lords, have been included in (d), which dealt expressly with powers of appointment.[79]

What is more, the power to direct investments, being merely a fiduciary power, could not be said to be control of the application of the income, as mentioned above.

Generally, then, it can be seen that the section was closely and carefully analysed by the House of Lords and the interpretation was not excessively wide, as some of the previous decisions on section 18 might be considered to have been.

Indicative of this was Lord Normand's comment on the instruction in the section to regard "the substantial result and effect of the transfer and any associated operations."[80] His views on this are dealt with in Chapter 11. The 1979 Vestey decision[81] supported this construction of the subsection.

In the same vein, Lord Simonds noted that the section was "framed in language of the widest and most general scope"

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79. See Lord Morton at p113
80. See now section 742(3) ICTA 1988
81. (1979) 54 TC 503, infra

and the operative subsections were "reinforced by a provision which appears to exhort the assessing authority, and presumably the Court, to let the balance, wherever possible, be weighted against the taxpayer." However, he then added:

> "But, this notwithstanding, I think that it remains the taxpayer's privilege to claim exemption from tax unless his case is fairly brought within the words of the taxing section."[82]

It will be seen below that, in 1969, the word "rights" was deleted from the section by section 33 FA 1969. Given that this case turned on the fact that the court was only entitled to consider the "rights" enjoyed by the individual and that, where two individuals jointly have power to enjoy the income, neither alone has "power to enjoy" within section 739, it is not entirely clear now how far this decision is still valid on that point.

Any taxpayers who were encouraged by the Vestey decision to think that the courts would substantially adopt generally a narrow interpretation would have been wrong to do so, as the next two decisions, each won by the Crown, demonstrated.

The next case after Vestey on section 18 again showed how widely the section extended, particularly in this instance, as regards "associated operations". The case concerned transactions undertaken by Rudyard Kipling and his wife, it was: Bambridge v IRC[83]. The taxpayer, Mrs Bambridge, was Rudyard Kipling's daughter.

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82. pp80-1 See also Lord Normand at p90
83. (1955) 36 TC 313

The facts were that, in 1933, Rudyard Kipling and his wife each sold Canadian and US investments to a company incorporated in Prince Edward Island in consideration of shares and non-interest bearing redeemable debentures in that company. In 1934, Rudyard Kipling made a settlement in Prince Edward Island of the shares and debentures he had received. The terms of the settlement were that the income should be paid to the settlor for his life, remainder to his widow for life, remainder to the taxpayer for life, with further remainders over.

Rudyard Kipling died in 1936 and his wife died in 1939, at which time the taxpayer became entitled to the settlement income.

Mrs Kipling had, in 1934, made a similar settlement for her consideration shares and debentures. She revoked this settlement in 1937 and, in 1938, she made a will leaving the income of the residue of her estate, which included the shares and debentures, to the taxpayer.

When the House of Lords decided, in 1948 in the Congreve case, that a person could become subject to a charge under section 18 although he was not the transferor, the Inland Revenue considered that that decision applied to the taxpayer's circumstances, and raised an assessment accordingly.

The Special Commissioners decided that the taxpayer was liable to tax under section 18 in respect of her interest under her father's settlement and also as the residuary legatee under her mother's will.

The House of Lords agreed. The leading judgment was delivered by Lord Cohen. He agreed with Jenkins LJ, who had given the leading judgment in the Court of Appeal, and he emphasised two points[84] made by Jenkins LJ,[85] the first of which was:

> "(1) An interest in remainder, or, for that matter, a contingent interest, given by settlement is given by means of the settlement and not by means of the happening of the event which brings the interest into possession or, as the case may be, fulfils the contingency."

The second point was:

> "(2) I fail to see how a will which disposes of property can reasonably be said not to have been made in relation to the property of which it disposes; nor can I see any justification for distinguishing between property specifically disposed of and property comprised in a residuary gift, and holding that the will relates to the former but not to the latter."

Lord Cohen then noted that the above two points would together have been sufficient to dispose of the taxpayer's arguments as regards her interest under her mother's will but for two arguments which had apparently not been made by her in the Court of Appeal.

These two arguments were:

(1) that the will was not an associated operation, because it could be revoked and, even while unrevoked had no operative effect during the lifetime of the testatrix; and

(2) that the taxpayer's power to enjoy the income of the company was derived not only from the will but also from the probate thereof.

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84. At p332
85. At pp 326-7

The House of Lords rejected both of these arguments. The first was rejected because "no further action is required to make it effective" after the death of the testatrix.[86] The second was based on the contention that probate could not be an "associated operation" because it was an operation of the High Court, not by the person who effected the transaction with which it was sought to be associated. This argument failed because it was held that "power to enjoy" depended on the will of Mrs Kipling and not on probate. As Lord Cohen pointed out, probate was merely a question of evidence; not of title.[87]

Another point arose on the meaning of "associated operation." It was held that the term did not include death. This was well put at first instance where Harman J, echoing Peter Pan, said:

> "Death, as we know, is an awfully big adventure, but even the Crown admits that it is not an associated operation."[88]

The taxpayer had argued that, as she did not acquire the right to enjoy the income until the death of the second of her parents to die and, as she acquired the right to enjoy the income by virtue of her parents' deaths, she should not be taxed because death was not an associated operation.

Even accepting the proposition that death was not an associated operation, the taxpayer's contention still failed because Rudyard Kipling's settlement and his wife's will were associated operations: their deaths merely being the events on the happening of which the taxpayer's interest fell into possession.[89]

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86. Per Lord Cohen at p332
87. p333
88. p322
89. See Jenkins LJ at pp326-7, whose analysis was approved by Lord Cohen at p332.

The decision in this case, whereby a non-transferor suffered a liability under section 18, was overruled in the 1979 Vestey case,[90] which is dealt with below.

The next case, Ramsden v IRC[91], a first instance decision of Harman J, is of interest because it highlighted yet another way in which section 18[92] operated in a wider way to that described to the House of Commons when the Bill was passing through Parliament in 1936. A couple of other points on the section also arose for consideration for the first time in this case.

The facts were extremely simple: the taxpayer, who was ordinarily resident in the UK, transferred the shares of one foreign company to another foreign company, with the purchase price being left outstanding, it being credited to him in an account which was described in the company's minutes as a loan account.

The taxpayer was assessed under what was then section 412 ITA 1952 under both subsections (1) and (2).[93] On (2) it was claimed by the Crown that the outstanding purchase price was a loan and therefore a "capital sum" and, as regards (1), it was argued that the taxpayer had "power to enjoy" the income of the foreign company.

The Crown's argument on subsection (2) was rejected. Harman J held that unpaid purchase money does not constitute a loan, even if it is referred to as such (it will be recalled that it was credited to a "loan account").

However, the taxpayer was held to be liable under subsection (1) on the basis that a dividend from the acquired company to the acquiring company produces a

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90. (1979) 54 TC 503
91. (1957) 37 TC 619
92. Then section 412 ITA 1952
93. Now section 739(2) and (3) ICTA 1988

surplus of income over expenditure which in turn increases the taxpayer's asset, namely, his right to recover his debt. He thus had "power to enjoy" under section 412(5)(b).[94]

This, once again, shows how widely the net had been thrown.

The point on which this decision may be seen as going further than the original limits of the legislation as put to the Commons concerned the Attorney-General's assurance that the section covered "transfers of assets into foreign countries".[94A] This might reasonably be taken to mean transfers from the UK into foreign countries. This case shows[95] that a transfer from one foreign country to another can be caught by the section.

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94. Now section 742(2)(b) ibid
94A. Supra
95. As did Herdman v IRC (1969) 45 TC 394 infra

The Swing of the Pendulum

The Ramsden case just considered ended a run of success for the Crown cases on these provision, cases in which the taxpayer had won only one out of the thirteen cases heard by the courts (the one win for the taxpayer being in the Vestey case).

During the twenty year period covered by these case, it has been seen that the boundaries of the section has been very widely drawn and that the courts had consistently shunned a narrow interpretation of the provisions.

Less than five months after the Ramsden case came another first instance decision, Flynn v IRC[96], which began a run of success for the taxpayer in cases on this legislation; taxpayers won five out of the next seven cases to be decided on substantive rather than procedural points, including the most famous success, the 1979 Vestey case, which overruled two of the Crown's earlier victories and caused further important anti-avoidance legislation to be enacted in 1981.[97]

Flynn was, in fact, an important case on the meaning of "associated operations". It is also notable for the fact that the taxpayer won even though his transfer of assets abroad was admitted to be for the purpose of avoiding UK tax.

The facts were that, in 1947, a company was incorporated in Eire, the shares being allotted to the taxpayer, who was a UK resident. The following year the taxpayer sold certain investments to the Irish company for £35,000, the purchase price being left outstanding. In 1949, the company allotted 25,000 shares to the taxpayer in satisfaction of the unpaid purchase price. Later in that

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96. (1957) 37 TC 629
97. Infra

year the taxpayer settled his shares in the Irish company upon irrevocable trusts in favour of his children. Also in 1949, the company borrowed funds from its bank to buy further investments in the market. In 1951 the company held securities worth £81,000. The company charged the original securities it had acquired for £35,000 with its bank and was granted an overdraft of £33,000. The limit of the overdraft which the bank was prepared to grant was £35,000. A few months later, at the beginning of 1952, the taxpayer lent the company £12,000 interest-free, unsecured and repayable on demand. The company's overdraft was reduced by the £12,000 and the extra margin that the company thus enjoyed was used by the company to buy further investments. Two years later the taxpayer released the company from its obligation to repay the £12,000 with the result that the value of the 25,000 shares allotted to the taxpayer in 1949 was increased.

The taxpayer was assessed under section 412 ITA 1952 for the years 1951-2 and 1952-3, the Inland Revenue arguing that the £12,000 loan reduced the company's overdraft which was secured on the transferred assets, and that that was a transaction connected with an associated operation, namely, the charging of the transferred investments to the company's bank; and that the £12,000 loan was an associated operation within section 412.

Upjohn J, however, held that there was no connection between the charging of the transferred investments to the bank and either the £12,000 loan or the right to receive repayment, and that the making of the loan was not a transaction associated with the charging of the securities.

The judge said that it was conceded that the charge by the company of the transferred investments to secure its overdraft was an operation associated with the transfer of assets. He said:

"I look at those facts and ask myself whether it can be said that the right to receive repayment of the sum of £12,000 is in any way connected with the original transfer or with the charging of the transferred assets by the company. It is said that it is so connected because the payment of the £12,000 reduced the overdraft secured on the transferred assets. Speaking for myself, I can only express my view in one sentence. I can see no connection whatever between the charge of the transferred assets on the one hand and either the lending of the money or the right to receive payment on the other. They do not seem to me to have any connection at all one with the other upon the facts of this case."[98]

On the question of whether the actual loan was an associated operation, Upjohn J could not see that the making of the unsecured loan could be said in any ordinary use of the language to have any relation to the previously created charge. It was an unsecured loan made, not for the purpose of reducing the overdraft because the bank was pressing for payment, nor for the purpose of freeing the assets from the charge. It was made to the company as an interest-free, unsecured loan which it could have used in any way it pleased. The judge could not see that it bore any relation to any of the transferred assets or to the charge.

A further question raised was whether the taxpayer had "power to enjoy" the company's income because of the increase in the value of the shares as a result of the taxpayer releasing the company from its obligation to repay the £12,000 advanced to it, within section 412(5)(b) ITA 1952.[99]

98. pp636-7
99. Now section 742(2)(b) ICTA 1988

Upjohn J held that the taxpayer did not have "power to enjoy" because subsection (5) was linked with subsection (1) and the extension of the meaning of "power to enjoy" by subsection (5) could not be used to extend the meaning of "associated operation" in subsection (4).[100] Subsection (5) could only operate if, on the facts, there was an "associated operation" within the meaning of subsection (4), and the judge had held that there was no "associated operation" here. As a result, there could not be any question as to whether the taxpayer had any "power to enjoy".

It seems that Upjohn J's decision, that the £12,000 was not an associated operation and could not be connected with either the transfer of investments or the charge given to the bank, was based on the fact that the loan was not made subject to any conditions, so the company could use the money in any way it thought fit. The decision may well have been different had the object of the loan been to reduce the overdraft, or to release the investments from the charge.

It should be noted that the taxpayer did become entitled to a capital sum by reason of making the loan within subsection (2) (ie he was entitled to the money advanced), but this was not enough to justify a charge to tax under section 412. The reason was that the right to the repayment was not in any way connected with the original transfer of investments to the company, or with the charge to the bank.

This case, then, showed that what was then section 412 ITA 1952 was subject to an important limitation. The taxpayer had transferred assets, as a result of which income became payable to a non-UK resident, and he had done this to avoid UK tax. In fact, the arrangement is

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100. Now section 742(1) ibid

similar, but not identical to, the type of scheme the section was originally introduced to combat. The taxpayer, however, escaped liability because in addition to the above conditions, it must also be shown that the income was payable to the non-UK person by virtue or in consequence of the transfer (plus any associated operations). This last element was absent here.

The line of construction taken in this case was much narrower than had been apparent in many of the earlier cases on the section. Upjohn J would not allow a tenuous link between the transfer and the associated operation be relied on by the Crown; it had to be a clear link or it had to be ignored.

It was a dozen years before the courts again had the opportunity on considering a substantive issue on this section. But when the case did come before the courts, it was a very important one. It was a House of Lords appeal from the Court of Appeal in Northern Ireland, a case in which the taxpayer again triumphed, it was Herdman v IRC.[101]

This case is important for three main reasons:

(1) As regards the mental element in the section, it was established that the bona fide commercial test in what is now section 741(b) ICTA 1988 only has to be satisfied in relation to the transfers of assets and associated operations which actually give the taxpayer the power to enjoy the non-resident's income.

(2) It disclosed a further respect in which the section operates contrary to the assurances given to the Commons in 1936: the section can

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101. (1969) 45 TC 394

apply even though the transfer of assets which was made by a person who, at the time, was not resident in the UK.

(3) It caused an amendment to be made to the section by the Finance Act 1969 relating to the "power to enjoy" the non-resident's income.

What happened in this case was that the taxpayer was chairman and controlling shareholder of Herdmans Ltd, a company incorporated and carrying on business in Northern Ireland. Between 1949 and October 1953 the taxpayer was resident in Eire and not resident in the UK.

With the object, inter alia, of avoiding super-tax and death duties in Eire, he formed a company resident in Eire, North West Holdings Ltd. He then transferred to North West Holdings shares in Herdmans, plus certain other assets, for a consideration of almost £87,000, of which £10,000 was satisfied by the allotment of 6,000 £1 shares in North West Holdings to the taxpayer, and a further 4,000 shares to a trust for his son. The balance was left outstanding on current account, payable on demand.

From October 1953, the taxpayer was resident and ordinarily resident in the UK as well as in Eire.

In each of the years 1953-4 to 1957-8 North West Holdings received from Herdmans a dividend of £14,300 and, during those years, it paid no dividends but it reduced the balance owing to the taxpayer by a total of over £15,000. On 31 December 1954 the taxpayer transferred 2,000 North West Holdings shares to his son's settlement. Throughout the period covered by the above transactions, the taxpayer effectively had control over the policy of North West Holdings.

The taxpayer was assessed under section 412 for the years 1953-4 to 1957-8 on the income of North West Holdings on the basis that he had acquired rights by virtue of which he had power to enjoy the company's income by means of the transfer to it of the Herdmans shares in conjunction with associated operations including the allotment to him and his son's trust of shares in the company, the reduction each year of the balance due to him, and the accumulation each year of the dividends received from Herdmans.

The taxpayer argued that the section could not operate because he was not ordinarily resident in the UK when he made the transfer of the Herdmans shares. This point was not dealt with in the House of Lords because the taxpayer succeeded on other grounds: but in the Court of Appeal in Northern Ireland it was rejected.

The Crown strongly argued against the taxpayer's contention, despite what was said to the House of Commons when the legislation was originally being considered. W.S. Morrison, Financial Secretary to the Treasury was specifically asked about the case of a person ordinarily resident overseas who transfers foreign securities to a foreign company (ie precisely the Herdman facts).

He said very clearly:

> "If the foreigner made that transfer in the past before he became ordinarily resident here the clause would not apply to him because in its opening words it refers to 'individuals ordinarily resident in the United Kingdom'".[102]

Compare this, however, with the analysis of Lord MacDermott CJ.[103] He noted that it had been argued by

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102. H.C. Deb Vol 314 col 435
103. At pp 403-5

the taxpayer that the words "such an individual" must relate to "by individuals ordinarily resident in the United Kingdom" in the preamble, and that they must mean someone who is ordinarily resident here at the time of the transfers of assets and associated operations. The Crown on the other hand, submitted that the words from the preamble quoted above refer merely to the year of charge. He then commented:

> "It is clear that the individual of section 412 need not be the maker of the transfer or an active participant in the scheme for avoidance".

He cited Congreve[104] for this, and continued:

> "The individual, accordingly, at whom section 412 is aimed is the person who seeks to avoid liability to charge, irrespective of whether he was or was not a participant in setting up the scheme for avoidance. This explains the reference to 'ordinarily resident in the United Kingdom' for that points to those who would gain by the avoidance rather than to those who may have contrived it, perhaps in some earlier year. There seems no reason why the section should make such residence necessary for those who play a part in the scheme for avoidance at the time they do so, and I do not think the language used provides such a requirement. The section is drafted in comprehensive terms and there can be no doubt it was intended to case a wide net."

The judge was undoubtedly right on the words of the section as interpreted in the cases that had gone before, such as Congreve, and, of course, he would not have been justified in referring to Hansard as an aid to construction. The attitude of the Revenue, however, is

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104. Congreve v IRC (1948) 30 TC 163, supra

rather more questionable. Presumably the legislation was originally introduced at the behest of the Revenue and the assurances given to the House of Commons emanted from the Treasury, yet Counsel for the Crown "vigorously disputed" the self same construction they had offered to the House of Commons.

The taxpayer therefore failed on this point, but he won on the point argued before the House of Lords (their Lordships directed that they did not want to hear argument on the point discussed above).

The point in dispute here concerned the interpretation of the bona fide commercial exemption, then contained in section 412(3) ITA 1952[105]. The Crown's view was that the test had to be satisfied in relation to the transfer and all associated operations, including those that conferred no power to enjoy on the taxpayer. The taxpayer, on the other hand, argued that the test need only be satisfied in relation to the transfer and associated operations which conferred the power to enjoy.

The Court of Appeal of Northern Ireland and the House of Lords preferred the taxpayer's construction. Applying that construction to the facts of the case, it was the transfer of assets alone which caused the income to be payable to North West Holdings and which conferred on the taxpayer rights which gave him the power to enjoy that income. This transfer was not implemented for the purpose of avoiding UK tax; it was to avoid super-tax and death duties in Eire.

The associated operations were carried out to avoid UK tax but they did not confer on him rights which gave him power to enjoy the company's income. The bona fide commercial test did not have to be satisfied in respect of them.[106]

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105. Now section 741 ICTA 1988
106. See Lord MacDermott CJ at pp406-7 and Lord Pearce at pp413-4

The fact that the later associated operations allowed the taxpayer to lay his hands on the funds, and that the construction adopted by the courts provided a means by which taxpayers could avoid tax, did not help the Crown, as can be seen from the following passage from the judgment of Lord MacDermott CJ:

> "No doubt..... the associated operations effected by [North West Holdings] made it possible for the [taxpayer] to obtain and actually enjoy capital payments from the company because it was in receipt of income from the transferred assets which it did not distribute by way of dividend; and no doubt all this was by way of the avoidance of tax. Yet if the view I have expressed is correct, these operations were but the means of harvesting the fruits of avoidance and were not in point for the purposes of either subsection (1) or subsection (3). The crucial time under the latter subsection is the time when the relevant transaction was effected, and where the relevant transaction is the transfer of assets alone and its purpose at that time was not tax avoidance, its use therefore for that purpose seems still to offer a way round the common burden for those who are minded to take it."[107]

It is apparent that the courts were still giving the section a wide construction in accordance with previous decisions, but they were putting limits on how far the section could be taken by the Crown. It is interesting to speculate how the courts would have reacted had the scope of the bona fide commercial test come up for decision during the war years when the Crown enjoyed total success in section 18 cases.

The taxpayer's victory in the Herdman case caused an amendment to be made to section 412.

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107. p407. Approved by Lord Pearce at p414

During his Budget Speech in 1969, the Chancellor referred to the Herdman case along with another decision, which is of no relevance here, relating to repairs to farm-houses. He said:

> "In recent weeks, two decisions of the House of Lords have overruled certain interpretations of the law which have long been followed by the Inland Revenue and accepted as reasonable and equitable."

He then mentioned the farm-house case, and continued:

> "The second dealt with the circumstances under which the Revenue may continue to assess to tax under section 412 of the Income Tax Act 1952 income arising from assets which have been transferred abroad. This legislation is an important bulwark against the ingenious efforts of some wealthy individuals to escape their share of the common burden of taxation by sending their assets abroad though all the time retaining real control of the money; here, again, I propose to restore the basis of liability which prevailed before the adverse Court decision. But I propose to go further. Certain countries, attracted by the idea of setting themselves up as 'tax havens', have had the idea of modifying their trust legislation so as to try to make impossible the application of section 412 as it was meant to be applied. I shall bring forward provisions in the Finance Bill to counter these manoeuvres."

The change aimed at tax havens is dealt with below; the amendment caused by the Herdman case was brought about by section 33(2) FA 1969 removed the reference in section 412(1)[108] to "rights". Prior to this change, a charge

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108. Now section 739(2) ICTA 1988

under section 412 only arose when an individual had acquired rights by virtue or in consequence of a transfer of assets which gave him the power to enjoy the income of the non-resident person. After section 33, the individual only had to have power to enjoy the income.

Despite the Law Lords reference to "rights" in Herdman,[109] it is not entirely clear, from examining the House of Lords judgments, that they would have decided in favour of the Crown had "rights" already been omitted from section 412(1).

The point on which the taxpayer won in Herdman (ie the application of the bona fide commercial test) was not affected by FA 1969.

The Chancellor, in 1969, did not restrict himself to altering the law in the light of Herdman. The high tax rates that had been levied for some years had persuaded an increasing number of UK individuals to seek to transfer their assets abroad and some tax havens had encouraged those individuals to transfer assets into their jurisdictions by amending their domestic laws in an effort to make section 412 inoperative. The prime example was the Cayman Islands.

The problem faced by the UK Government was in the form of the Cayman Islands Trust Law 1967, section 79 of which stated that:

> "Where any right or remedy in respect of a Caymanian exempted trust would vest in one or more of the beneficiaries under any such trust, the right or remedy in question would instead vest in and be exercisable by the Registrar of Trusts; and no beneficiary would enjoy in relation to the trust fund or its income any right or remedy at law or in equity."

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109. See for example Lord Reid at p413

Not surprisingly, exempted trusts with their divesting features immediately became very popular as tax planning tools.

Accordingly, section 412(6) ITA 1952[110] was amended by section 33(3) FA 1969 to take account of benefits accruing to an individual where he had no enforceable interest or right under any jurisdiction, but only an expectancy. This change brought into charge, for example, a UK resident who was no more than a possible object of a power exercisable under an overseas settlement.

It is interesting to note that, during the course of the Finance Bill debates in 1969, Sir John Foster sought to amend section 412 so that someone who was not a party to the transaction and who did not acquiesce in it would not be chargeable under the section. Harold Lever, for the Government refused. He said that there was no reason why someone who became entitled to the overseas income should not be taxed under the section, even though he had not been concerned with the transaction itself. This, of course, is different from the Government's stance in 1936.

Between Ramsden in 1957[111] and the Brackett case in 1986[112], the Crown scored only two successes in that period of almost 30 years on substantive issues on the section and one of these was partly overruled in the 1979 Vestey case.[113]

The first of these cases was Philippi v IRC[114]. A number of important points arise from this case. It is another instance of a case being decided in the Crown's favour contrary to assurances given to the Commons during the passage of the original Bill through Parliament.

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110. Now section 742(3) ICTA 1988
111. Supra
112. IRC v Brackett [1986] STC 521 infra
113. Vestey v IRC (1979) 54 TC 503 infra
114. (1971) 47 TC 75

Also there was discussion on the purpose test in the section, particularly the burden of proof, showing how difficult it can be for the taxpayer to satisfy the test.

The facts were that the taxpayer's father was originally both resident and domiciled in the UK but he then went to live in Eire. Four years later, after suffering a heart attack he moved to Switzerland on medical advice. Around this time he bought Nuova Ltd, a company resident in Eire. He sold to this company an estate in Eire which he had bought when he left the UK. He also, at this time, made a settlement for the benefit of the taxpayer and transferred the Nuova shares to the settlement trustees. He later put further UK securities into the settlement. In 1959 the taxpayer became absolutely entitled to the trust fund, including the Nuova shares, on reaching the age of 21. The taxpayer was at all times ordinarily resident in the UK.

The taxpayer was assessed under section 412 ITA 1952 for the years 1960-61 to 1963-64 in respect of Nuova's income. The taxpayer's father was unable through ill-health to give evidence but, despite this, the taxpayer claimed that he had established on the balance of probability that avoiding tax was not a purpose for which any of the relevant transactions was effected. The Special Commissioners rejected this claim and upheld that assessments.

In the Court of Appeal, Lord Denning MR analysed the purpose test, then to be found in section 412(3),[115] and his analysis shows how difficult it can be for the taxpayer to satisfy it. He said:

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115. Now section 741 ICTA 1988

"Mr. Raymond Phillips [leading counsel for the Crown] drew our attention to the history of this section. In section 18 of the Finance Act 1936 the taxpayer escaped if he could show that the transfer was effected <u>mainly</u> for some purpose other than the purpose of avoiding liability to taxation. But in section 28 of the Finance Act 1938 that was amended so that the taxpayer only escaped if he could show that 'the purpose of avoiding liability to taxation was not the purpose <u>or one of the purposes</u> for which the transfer of associated operations or any of them were effected'. Those words are repeated now in section 412. It is quite clear, therefore, that we do not look at the <u>main</u> purpose of the person making the transfer. We look at <u>all</u> the purposes which he may have had. The taxpayer must prove a negative. In this case the son must prove that the father did not have as <u>one</u> of his purposes in making the transfer the object of avoiding United Kingdom taxation, including therein not only income tax and surtax but also estate duty."[116]

Lord Denning then considered the facts of the present case in connection with this test. He noted that the taxpayer had argued that the reasonable inference was that his father had not had the purpose of avoiding UK tax. His father, at the time of the transfers, had been resident in Eire and the securities were not subject to UK tax. Why, therefore, should it be inferred that he had any purpose of avoiding UK tax when he was not subject to it?[117]

To this, the Crown gave two answers. First of all, if the taxpayer's father was giving up residence in Eire to live in Switzerland, he would be liable to UK tax on the English securities which could be avoided by transferring

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116. p111. Lord Denning's emphasis
117. p112

them to Irish residents.

Secondly, if the father, who was old and in ill health, died in the following two or three years, his estate would be liable for UK death duties; whereas, if the property was transferred to Eire, it would pay the lower Irish rates. Lord Denning MR continued:

> "I recognise that the main object of the father was no doubt to make provision for his son: but it is possible also that he had one or both of those two other purposes also in mind. And as they have not been displaced by the evidence, the burden on the taxpayer has not been discharged."[118]

It can be seen how harshly the test can operate; it was only a possibility that the taxpayers father had wanted to avoid UK tax and he was not well enough to give evidence on the point. The burden of proof was such, however, that it had not been discharged by the taxpayer.

This case, like Congreve,[119] shows that the taxpayer does not have to be the transferor to be caught by the section. In this respect it is interesting to compare two comments.

1. "If the son steps into the shoes of the father and becomes responsible in his fathers place merely for continuing the arrangement then I apprehend the provision [clause 16 of the Finance Bill 1936] would not apply. In this case it is not the intention of the clause to visit the sins of the fathers upon the children."[120]

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118. Ibid
119. Congreve v IRC (1948) 30 TC 163, supra
120. Financial Secretary to the Treasury (W.S. Morrison) a H.C. Deb. Vol 313 Col 688

2. "The father here played with fire and has burnt his son's fingers."[121]

This part of the decision was to be overruled in the 1979 Vestey case.[122]

The final point on this case was that, like Herdman, it showed that the section can apply even though the transfer of assets was made by a person who was not at the time ordinarily resident in the UK.

Again this can be contrasted with something W.S. Morrison said the Commons in 1936:

> "Under [clause 16] ... there have to be three conditions present. In the first place there has to be a transfer of assets abroad by an individual resident in this country."

The next case, the other one the Crown won, six years later, involved a short but important point. The case was Lord Chetwode v IRC[123]. The relevant facts can be simply stated. The taxpayer was admittedly subject to the charge under section 412. He was ordinarily resident in the UK and settled funds on a Bahamian trust in favour of himself for life. The trust acquired a Bahamian investment company. The trust fund was used partly in subscribing for the company's share capital and partly in making interest free loans to the company. The taxpayer was assessed under section 412 on the company's income.

The taxpayer did not dispute that he was liable, but he claimed that, in computing the income of the investment company on which he was liable, deductions should be allowed for expenses and charges (i.e. management expenses). The Crown, however, argued that the company

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121. Lord Denning MR in Philippi at p113
122. Vestey v IRC (1979) 54 TC 503, infra
123. (1971) 51 TC 647

did not carry on a trade and it did not therefore have a profit for tax purposes consisting of income less expenditure and that, since the statutory relief for management expenses of UK investment companies was not relevant for the purposes of section 412, the taxpayer was in the same position as regards expenses as if the company had been an individual.

The House of Lords held that the dividends received by the company were income of the recipient under section 412 and that the taxpayer had power to enjoy the whole of the dividends and not the dividends less expenses. His power to enjoy arose out of the extensive powers he had over the trust fund and indirectly over the investment company itself.

The Vestey Revolution

We now come to the most important decision on this legislation since it was introduced in 1936. This was a big victory for the taxpayers and it was won by the same family that had inflicted the first defeat on the Crown thirty years earlier. The case was Vestey v IRC.[124]

In this case, the House of Lords overruled two of the Crown's most important victories, Congreve[125] and Bambridge[126] and, in doing so, large gaps were exposed in what was then section 478 ICTA 1979, which caused the quick introduction if "anti-Vestey" legislation in the Finance Act 1981. The new provisions were, however, much fairer than section 478 as it had been interpreted by the courts before the Vestey case.

The transactions again involved Sir Edmund Vestey, who had been a party to the arrangements considered in the 1949 case. He and Lord Vestey ("Samuel") settled overseas property on overseas trustees to hold on discretionary trusts. The income from the settlement was divided into two parts, "Edmund's Fund", and "Samuel's Fund". Each fund had a manager; the taxpayer, Ronald Vestey, being the manager of Edmund's fund, and William Vestey being the manager of Samuel's fund.

The income from each fund was by the direction of its manager accumulated, added to the fund and reinvested. At the discretion and by the direction of the managers, capital sums were paid out of the funds to various of the beneficiaries in various years.

The beneficiaries who had received these capital sums were assessed under both subsections (1) and (2) of section 412 ITA 1952.[127]

124. (1979) 54 TC 503
125. Congreve v IRC (1948(30 TC 162 supra
126. Bambridge v IRC (1955) 36 TC 313 supra
127. Now sections 739(2) and (3) ICTA 1988

The Special Commissioners did not make any finding on subsection (1), holding that subsection (2) applied so as to justify assessments which attributed the income of the trustees, and of three overseas companies which had been acquired by the settlement, to the beneficiaries in each year in which they were resident in the UK, and in the proportion which each individual beneficiary's capital receipts bore to the aggregate receipts of them all.

The appeal on subsection (2), "Vestey (No.1)", came before Walton J, who was very unhappy about the Crown's contentions. He was obliged to follow Congreve and Bambridge and hold that the section was not confined to the persons who made the transfers of assets or to those who were actually trying to avoid tax. However, he allowed the appeals on the basis that Parliament must have intended subsection (2) to operate so as to attribute the income of the trustees to a beneficiary only in the year in which he actually received a capital sum and only to the extent that what he received comprised income of the trustees. He was of the view that subsection (2) could be amended by the court, by the insertion of words, to give effect to this intention.

The case was therefore remitted to the Special Commissioners for them to consider subsection (1).

During the course of his judgement, Walton J was highly critical of the operation of the section, a theme to which he would return in Vestey (No. 2)[128]. He said:

> "I conceive it to be in the national interest, in the interest not only of all individual taxpayers - which includes most of the nation - but also in the interests of the Revenue authorities themselves,

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128. Infra

that the tax system should be fair. Absolute equity is, of course, impossible to achieve, and nobody would cry for the moon. But rank, blatant injustice, of the kind and on the scale exemplified in ... section.412(1), in some circumstances, and section.412(2) on the Crown's construction of it, is another matter. Like Lord Upjohn in Commissioners of Inland Revenue v Bates 44 TC 225, at page 268, I am quite unable to understand upon what principle of the law the Crown, as he said, 'realising the monstrous result of giving effect to the true construction', or what it assumes to be the true construction,of these sections, feels itself entitled to mitigate their monstrosity by such concessions as it chooses to make. One should be taxed by law, and not untaxed by concession. This has now proceeded for such a long time without the Revenue authorities taking one of the numerous opportunities which they have - at least once a year - to put the matter right that I am afraid they must have failed to realise the deep, brooding resentment felt by every taxpayer who is not charged simply upon his own income (including, of course, what he himself could have had by way of his own income had he so chosen). A tax system which enshrines obvious injustices is brought into disrepute with all taxpayers accordingly, whereas one in which injustices, when discovered, are put right (and with retrospective effect when necessary) will command respect and support."[129]

The House of Lords also had some strong things to say on these matters.[130]

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129. pp 544-5
130. Infra

When the case went back to the Special Commissioners, they held that each beneficiary had rights by virtue of which he or she had power to enjoy the income of the trustees and the companies under section 412(5)(d)[131] and so the assessments were again upheld, this time under subsection (1).

The appeals again went before Walton J ("Vestey (NO. 2)") and he again allowed them in full. The judge held:

(i) prior to the actual payment to him or her no beneficiary had any "right" to any money so as to bring subsection (1) into operation;

(ii) in subsection (5) "income" did not include accumulations of income which had become capitalised, so that even when section 33, Finance Act 1969 removed "rights" from subsection (1)[132], that subsection was not brought into operation by a beneficiary receiving a capital sum;[133]

(iii) in any case, the beneficiaries did not have "power to enjoy" the income of the underlying companies, as distinct from the dividends received by the trustees from them;

(iv) if an individual receives any of the income of trustees from assets transferred abroad and within subsection (1), the whole of so much of the trustees' income as has arisen as a result of the transfer and associated operations is deemed to be his.[134]; and

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131. Now section 742(2)(d) ICTA 1988
132. Supra.
133. On this point, Viscount Dilhorne in the House of Lords disagreed, infra.
134. Following Lord Howard de Walden v IRC (1941) 25 TC 121, supra

(v) the Revenue had no power either to select which of a number of beneficiaries technically within subsection (1) to assess, or to apportion the trustees' income between those selected.

The Revenue had argued that each beneficiary had rights by virtue of which each had power to enjoy the income of the trustees. Accordingly, it was submitted, the income must separately be deemed to be the income of each of the beneficiaries. The Crown therefore claimed the right to recover multiple tax, irrespective of whether the beneficiaries received anything out of the settlement.

Walton J considered that the Crown's construction would "produce a monstrous injustice: an injustice so monstrous that the Crown itself in the present case has resiled from its logical consequence and, while claiming a wider right, has sought to attribute to each of the [beneficiaries] only a fraction of the income of the trustees equivalent to the fraction of the total disbursements made to them collectively which each individual has himself received."[135]

Walton J then went on to discuss what counsel for the taxpayer had called a serious constitutional question: namely, what rights, if any, the Revenue authorities have to exercise discretion over whom to tax and to what extent. The judge held that the Revenue has no such power, as he had done in Vestey No. 1.

He gave some examples of the ridiculous results that could technically flow from the Revenue's construction. The Revenue had said that the taxpayer was chargeable in respect of the whole of the income of the non-resident (i.e., the trustees), and, furthermore, not just the income arising from the transfer of assets; but the whole income.

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135. p550

Walton J considered the implications of this:

> "Thus, to take a simple example, if the settlors in the present case had been unwise enough to select as their foreign resident trustees, say, a New York bank which was trustee of many other settlements as well, the whole of the income of that New York bank, not only that derived from the actual settlement of which they were trustees but the income of all other settlements of which they were trustees, and the whole of the bank's ordinary trading income (not alone profits), was income upon which the beneficiary who fell within the scope of subsection (1) could be assessed. Nay, further: if the foreign trustees were unwise enough to invest part of the trust assets in the shares of a foreign company, then, because there is no correlation between the amounts of income actually enjoyed and the amount of the income of the foreign residents, the whole of that income also falls within the scope of the assessment. Thus, if the trustees invest in one share of, say, Standard Oil, the whole of the income (again, not even profits) of that company falls to be taken into consideration when assessing the taxpayer, as Standard Oil would then become a foreign resident part of whose income the taxpayer had power to enjoy."[136]

The judge then went further in analysing the Crown's case or, as he put it: "But the cream of the jest is still to come."[137]

Under clause 14 of the settlement it was, argued the Crown, technically possible for anyone in the UK, with the sole exceptions of the settlors, their wives and widows, to become a beneficiary under the settlement.

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136. p560
137. Ibid

The judge was not certain that he agreed with this interpretation and he made no ruling on the point, but, accepting the Crown's interpretation for the sake of argument, the Solicitor-General, for the Crown, had submitted that anybody in the UK could be assessed for the entire income of the trustees (as enlarged in accordance with the judge's analysis in the above extract from his judgement), in every year that the settlement continued and the funds were undistributed.

The Crown, however, submitted that they had a discretion to select who was and who was not to be assessed, and for what amount. The judge commented:

> "However, to this submission in total Mr. Potter [leading counsel for the taxpayer] made the acid but fully justified comment, that, their powers clearly being fiduciary, to whomsoever else the Commissioners of Inland Revenue were entitled to show discretionary mercy, they were certainly not so entitled to show it to themselves. Nor do I think that they would be entitled to show it to Her Majesty's Ministers of State, who, by their inactivity in this regard, clearly show that they approve of the legislation as it stands. We are therefore doubtless in for an interesting crop if bankruptcies."[138]

How different is this attitude to that of the judges who first considered this legislation during World War Two! Those judges, as has been seen, construed the provisions widely; Walton J, considering the section to be a penal one,[139] construed it "extremely strictly"[140]. Taking this narrow line, his comment on the Crown's submission set out above was straightforward:

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138. p561
139. See, for example, p550. Walton J must have been referring to the effect of the section; its original purpose was not penal, supra
140. Ibid

"The whole submission, however, is so far removed from reality, from even the most rudimentary notions of justice and fair play, that one has no more than to state it for it to be abundantly obvious that it cannot be maintained."[141]

The judge considered himself bound by the Court of Appeal decision in Howard de Walden[142] (a decision which the judged considered to be "monstrous") to uphold the Crown's main proposition that if a taxpayer receives any income of the settlement he is taxable on the whole income of the trustees. He did not like so holding but, as he said: "I do not see how I can escape the straightjacket."[142]

The judge did, however, refuse to uphold the Crown's submissions as regards income which had not arisen as a result of the transfer and associated operations. He said:

"I just refuse to believe that Parliament can ever have intended that other income to be brought into charge to tax, the results being so utterly unpredictable and unjust ... It is quite ridiculous to think that the prevention of tax avoidance requires any operation of any description upon any other income than that which has, in effect, been transferred abroad."[144]

He also refused to allow the Crown to extend the section to the income of any body in which the trustees have invested any of the trust money. The submission that the section stretched this far was described by the judge as a "fantastic suggestion" and as "utterly fantastic".[145]

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141. p561
142. Lord Howard de Walden v IRC (1941) 25 TC 121, supra
143. p562
144. Ibid
145. Ibid

The judge considered the answer to be a "very simple one"; namely, that the income of the underlying company and the income derived from the company by the shareholders were two quite different things. This point was not directly considered in the House of Lords.

The judge concluded by saying that, accepting the Howard de Walden case as correct, "my own fundamental conception of the rule of law is deeply offended" but that, being bound by that case, he was "unhappily, in no position to right a clearly perceived wrong". He considered it fortunate that the present taxpayers "whether by accident or design" escaped the subsection (1) charge as they fell to be taxed under subsection (2), to the extent determined in Vestey (No. 1), namely, the sums actually appointed to them.[146]

Thus Walton J had gone as far as he was allowed - in fact, according to the House of Lords, too far - in restricting the section and preventing the worst excesses of the Crown's construction of it. The fundamental question at this stage was what the House of Lords would make of it all. They were not, of course, bound by any of the earlier decisions (even those of the House of Lords) but the question was whether they take the constitutionally important but fiscally necessary step of overruling earlier decisions and restrict the wide interpretations given by judges to the section in times of national emergency when tax avoidance was considered to be unpatriotic.

Neither side in this case, nor the general body of taxpayers, were to have the benefit of what often are technically incisive analyses by the Court of Appeal judges, the appeals by the Crown and cross-appeals by the taxpayers being "leap-frog" appeals directly from the Chancery Division to the House of Lords.

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146. p563

It is true that Walton J, an expert in Revenue matters, had spoken strongly against the Revenue's wide construction of the legislation, but Chancery judges on other occasions have striven to restrict the Revenue's more aggressive claims, the House of Lords, often much less proficient in tax matters, taking a more general line. A prime example, perhaps the foremost example, being the "Ramsay" line of cases.[147]

As it turned out, the Law Lords, hearing the two Vestey appeals together, delivered historic judgements which were important both from a consititutional and a fiscal point of view.

The House of Lords took the major step of overruling Congreve and Bambridge, holding that the section only applied to an individual who transferred assets abroad.

However, they refused to follow Walton J in amending subsection (2) so as to attribute trustees' income to a beneficiary only in the year in which he actually received a capital sum and only to the extent that what he received comprised income of the trustees. Subsection (2) was clear in its terms and Walton J's suggested amendment could not be made.

On the other hand, they affirmed Walton J in holding that the beneficiaries, being merely members of a discretionary class, did not have any "rights by virtue of which they had power to enjoy" income of the overseas trustees or companies. Accordingly, prior to the amendment to subsection (1) by section 33, Finance Act 1969,[148], that subsection would not have applied to them.

The Crown's appeals were therefore dismissed and the taxpayers' cross appeals allowed.

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147. See Chapter 11
148. Supra

The Crown had to deal with Walton J's objection that their case depended on an apportionment and that the sum apportioned to any beneficiary might exceed the sums actually received by him. The Crown therefore argued that the need for apportionment was implicit in the section because it was clear that more than one individual could satisfy the conditions in the section in relation to the same income. It was further pointed out by the Crown that liability to tax under the section was a liability on the income of the non-resident, not the benefit received by the UK individual.[149]

The argument proceeded that where more than one individual does fall within the charge, the Revenue act on the principle that the Legislature does not impose on them a duty to recover tax on the full amount of income from each of them; the Revenue made an apportionment in "the most appropriate manner."[150]

The Crown sought to justify this practice on either of two grounds:

(i) the section does not impose multiple liability; and

(ii) the Revenue are not required by law, or as a matter of proper administration, to recover tax on the same income more than once.

On Walton J's emendation of the section, the Crown argued, firstly, that it was not justified on ordinary principles of statutory construction and, secondly, that it was contrary to the plain intention of Parliament.[151] On the first point, the Crown's argument is plainly correct, and the House of Lords so held.[152]. However, on

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149. See p564
150. p565
151. p566
152. Infra

the second point, an interesting matter arises. It is manifestly true, in the light of the "Honsard rule", that the courts can only glean the intention of Parliament from the words used. Nevertheless, reference to the House of Commons' debates[153] shows that Walton J's emandation was much more in line with the real intention of Parliament than the Crown's construction. It seems clear that Parliament used such wide words because they did not fully appreciate their width, relying, not unreasonably, on the assurances given to them by servants of the Crown as to the restricted nature of the provisions before them.

As a general principle the Crown stated that, where the great majority of subjects pay their tax in accordance with the wording of the section, it is particularly undesirable that the courts should, many years after the section first came into force, rewrite it in accordance with their own ideas of what is right.[154] It is a shame that the Crown did not show the same respect for the sanctity of the law as enacted some years later when they persuaded the House of Lords effectively to rewrite established law in their favour, in the course of the development of the "Ramsay" principle in such cases as Burmah Oil and Furniss v Dawson.[155]

Lord Wilberforce structured his judgement by first assuming that Congreve was correctly decided.

On this assumption, he then looked at subsection (2) and Walton J's suggested limitation of it. Lord Wilberforce had sympathy with Walton J's attempts to produce a result which the Law Lord considered to be "intelligible, workable, certain and, from some points of view, not unjust" under which assessments would be "clear and

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153. Supra
154. p567
155. See Chapter 11

mandatory, and lacking in any element of arbitrariness or discretion." However, Lord Wilberforce, with regret, could not accept Walton J's limitation.[156] The Law Lord correctly pointed out that the process used by Walton J was not construction, or even of "strained construction", but was a rewriting of the enactment.[157]

Accordingly, Lord Wilberforce's conclusion on section 412(2), on the assumption that Congreve was correct, was:

> "It is 'any income' of the foreign transferees which is deemed to be the income of the recipient of a capital sum, indeed of each and every recipient of any capital sum, small or large, whenever received. From these words there is no escape."[158]

Turning to subsection (1), still on the assumption that Congreve was correct, Lord Wilberforce rejected the Revenue's argument and agreed with Walton J; the taxpayers, being merely members of a discretionary class, did not have "rights by virtue of which they had power to enjoy".

The Law Lord then went further because, as he pointed out:

> "there might well be situations in which numerous persons, beneficiaries under a trust, mightly justly be considered to have 'rights, etc.' by the Act of 1969, section 33, all actual and potential beneficiaries (viz. all 29 to 32) under this settlement may have 'power to enjoy' within one or more of the definitions of that expression contained in subsection (5). More generally, and apart from

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156. p579
157. p580
158. Ibid. Viscount Dilhorne also rejected Walton J's proposed amendment as being something only Parliament could do (p590).

the provisions of this particular settlement, there may be cases in which some beneficiaries have 'power to enjoy' within one paragraph of subsection (5) and other beneficiaries have 'power to enjoy' within other paragraphs. The total of the cases may be very large. On the Revenue's contention each and every one of such beneficiaries if resident in the United Kingdom is liable to income and surtax in respect of the whole income of the trustees."[159]

Given this analysis, Lord Wilberforce wondered how the tax assessments were to be made. His Lordship completely rejected the Revenue's claims to have a discretion. He outlined some of the consequences of such a discretion which, he claimed, were "frightening enough"[160]; but there was, he said, a "more fundamental objection" which he forcefully stated to be as follows:

> "Taxes are imposed upon subjects by Parliament. A citizen cannot be taxed unless he is designated in clear terms by a taxing Act as a taxpayer and the amount of his liability is clearly defined. A proposition that whether a subject is to be taxed or not, or, if he is, the amount of his liability, is to be decided (even though within a limit) by an administrative body represents a radical departure from constitutional principle. It may be that the Revenue could persuade Parliament to enact such a proposition in such terms that the courts would have to give effect to it: but, unless it has done so, the courts, acting on constitutional principles, not only should not, but cannot, validate it."[161]

It should be noted that the power of the Revenue to decide whether or not to tax an individual in the context of section 412 has been mentioned at least once in Parliament, apparently without adverse comment.

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159. pp 580-1
160. p581
161. Ibid

During the passage of the 1969 Finance Bill through Parliament[162] there was some debate about the possibility of a double charge to tax arising under section 412 ITA 1952. In what was then section 413 ibid, a Case VI liability arose except where income had already borne tax at the standard rate.

Mr. Harold Lever, for the Government said that an individual who was worried about double taxation could go to the Inland Revenue "which with the greatest of delight and the least difficulty will accept from them normal taxation, income tax and surtax, on any income appropriately covered by the section. Nobody will be anxious to tax them on more than that or twice on the same income, either for surtax or for income tax."

But Lord Wilberforce particularly rejected, as Walton J did, the Revenue's assertion that there was no duty upon the Revenue to collect all of the tax imposed by the section from every beneficiary and that they could choose the beneficiary to tax and the amount of his liability. In the Law Lord's view, once Parliament has imposed a charge, it was the duty of the Revenue to assess it (subject to the proviso that they should not expend disproportionate amounts in collecting small sums).[163]

The result of all this was, to Lord Wilberforce, clear. Parliament has attempted to impose a tax but has not set out any basis on which the tax on discretionary

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162. The ensuing Act amended section 412 ITA 1952 following the Herdman case, supra.
163. p582. See also Viscount Dilhorne at p592

beneficiaries can be assessed or levied. His conclusion was: "In the absence of any such basis the tax must fail."[164]

Lord Wilberforce then turned to the Congreve case. He said that, if Congreve is followed then, as regards discretionary trusts, a result is produced "which is arbitrary, unjust, and in my opinion unconstitutional"[165]

Of the two possible interpretations of the section, the limited one and the extended one, he regarded the first as being the natural meaning. Under the limited interpretation, the section is "directed against persons who transfer assets abroad; who by means of such transfers avoid tax, and yet who manage when resident in the United Kingdom to obtain or to be in a position to obtain benefits from those assets."[166] This avoided the difficulties Lord Wilberforce had been cataloguing.

He noted that the extended meaning followed from Congreve. He considered that this was a possible but less natural interpretation. Viscount Dilhorne was of a similar view.[167]

The Revenue had argued in their favour that the section was a penal one. Lord Wilberforce noted that in a case such as Howard de Walden,[168] this argument had much force but, with such a "draconian" section as section 412, the argument turns the other way when tax:

> "is sought to be imposed upon persons who had no hand in the transfer, who may never benefit from it, who cannot escape from it, who remain under liability so long as they live or the settlement lasts."

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164. p583
165. Ibid
166. Ibid
167. p591
168. <u>Lord Howard de Walden v IRC</u> (1941) 25 TC 121, supra

He continued:

> "In relation to such persons equity and principle suggests that Parliament intended no such thing - or at least cannot be assumed from the veiled language used to have intended any such thing."[169]

In the Philippi case[170], Lord Denning MR had found for the Revenue where "The father ... played with fire and has burnt his son's fingers".[171] However, Lord Wilberforce took a different view:

> "To penalise is one thing, to visit the sins of the transferor on future generations is quite another."[172]

He was of the opinion that such an extension "would have been spelled out [by Parliament] and not left to be deducted from such cryptic words as have been used."[173]

Lord Wilberforce's line corresponds with the assurances given to the House of Commons in 1936 whereas, as has already been printed out, Lord Denning MR's did not.

Lord Wilberforce went on to point out that the objective of the section was tax avoidance but, here, there was no tax avoided by the persons sought to be charged. He noted that, if the settlement had been made in England with English trustees, no tax could have been levied on any of the beneficiaries at the relevant time. He therefore concluded that the mischief of the section was a more limited one than that proposed by the Crown.[174] Reference to the House of Commons debates shows this to be correct.

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169. p584
170. Philippi v IRC (1971) 47 TC 75, supra
171. p113
172. p584
173. p586
174. p584

These considerations drove Lord Wilberforce to conclude that the more limited interpretation ought to be preferred to the Congreve one, which he accepted was a tenable interpretation but one which it could be seen, as it was not when Congreve was decided, could lead to results which were "arbitrary, potentially unjust, and fundamentally unconstitutional."[175]

Viscount Dilhorne agreed, and he accepted that overruling Congreve would leave a gap in the legislation but the wider interpretation was "productive of such manifest injustices that ... Parliament cannot have intended it"[176] He urged Parliament to reconsider the section. Individuals, he said, could not complain if they were taxed on the sums the received or were entitled to receive or had power to enjoy unless, of course they had participated in the tax avoidance.[177] As will be seen, Parliament, in 1981 introduced such a code as was sought by Viscount Dilhorne. The 1981 legislation, for modern anti-avoidance provisions, was surprisingly well targeted and equitable in operation.[178]

The line taken by the House of Lords in this case, adhering to the "mischief" rule, is unusual in the interpretation of moder anti-avoidance provisions.

Viscount Dilhorne, it should be noted,[179] while overruling Congreve on what may be considered the main point, did say[1980] that the actual decision could be upheld on the alternative ground set out by Cohen LJ in the Court of Appeal in that case.[181]

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175. Ibid. See also Lord Edmund-Davies at pp 601-2
176. p591
177. pp595-6
178. Infra
179. Lord Keith concurring
180. p591
181. 30 TC 163 at p197

This particular ground of the decision was that an individual may be liable even if he is not a transferor if he procured the transfer. Cohen LJ had said:

> "But even if we were prepared to accede to the argument that the preamble connoted activity by the individual concerned, we think this condition could be fulfilled if the execution of the transfer were procured by the individual concerned, even though, it was not actually executed by him or his agent. Mr. Tucker [counsel for the taxpayer], in commenting on the judgement of the learned Judge in the Court below, said, and Mr. Jenkins [counsel for the Crown] agreed, that execution by a company could not be said to be execution by the individual, even though the individual owned all or practically all the shares in the company. We think, however, that the decision of the learned Judge can be upheld on the ground we have stated, since it is, we think, in the present case, a reasonable inference from the facts found that the execution and performance of the transfers and associated operations in question by all the companies concerned were procured by Mrs. Congreve acting through her agent Mr. Glasgow. We should have been prepared, if it had been necessary, on this alternative ground to uphold the decision of the Commissioners."

Congreve and Vestey were considered by Walton J in the next case, IRC v Pratt[182]. This was yet another victory for the taxpayer and the judge again had some strong things to say about the Crown's purported powers to apportion liability. The facts of this case have already been considered.[183]

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182. (1982) 57 TC 1
183. See Chapter 3

The scheme in this case would now be caught by section 776 ICTA 1988 but the relevant transactions were carried out in 1964 and 1965, before the section was introduced (as section 32, Finance Act 1969). Instead, the Revenue attacked the taxpayers under section 412 ITA 1952 in respect of the settlement income.

The Revenue's attack, however, failed. The two grounds for Walton J's decision were:

(i) section 412 could not apply to multiple transferors if the respective interests in the assets could not be separated; and

(ii) the taxpayers could not be said to be transferors within the remaining ratio decidendi of Congreve because they could not procure the company to do anything . The company's activities were controlled by its board of directors.

On the first point, the judge said that in some cases it may be possible to dissect the respective interests of the transferors. An example given was of A and B who own an asset jointly and who transfer it abroad. The judge left open the position in these circumstances but he was clear what the situation was where the interests could not be so separated: "section.412 does not bite at all"[184]

As Walton J pointed out, the difficulty is that the section provided no machinery for attributing anything less than the whole of the income to any transferor if no identifiable portion of the asset could be attributed to a particular transferor. The judge was of the opinion:

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184. p51

"Arbitrary, unjust and unconstitutional are some of the milder adjectives with which such a situation may be properly described."[185]

Attempts at apportioning income between all of the directors and shareholders who "concurred" in the transfer were colourfully described by the judge as "a mind-boggling exercise of the first water" which he viewed as "completely bogus" based on the authority of Lord Wilberforce in Vestey.

As far as the second point is concerned, the Special Commissioners' findings of fact effectively defeated the Crown. They found that there was no evidence that the taxpayers acted together or in concert with others to procure the company to make the relevant transfer.[186] The three taxpayers together held 12,268 out of the total of 42,400 shares and they were only three out of eight directors. A company can only act through its directors and the taxpayers did not have a majority. There was no evidence on the part played by the other directors in the transactions. On these findings, Walton J easily rejected the Crown's claims.[187]

Another defeat for the Crown followed the next year in IRC v Schroder.[188]

This was another case on what is now section 742(2)(e) ICTA 1988 whereunder an individual has "power to enjoy" if he "is able in any manner whatsoever, and whether directly or indirectly, to control the application of the income."

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185. p52
186. p44
187. p51
188. (1983) 57 TC 94

The taxpayer, who was resident in the UK, transferred shares in a UK company to discretionary settlements established under Bahamian Law. The trustees had power, with the consent of a Committee of Protectors, to appoint capital and income to any person other than certain excluded persons (the taxpayer and his wife were among those excluded).

The taxpayer had power to appoint new or additional trustees and, indeed, he appointed a newly-formed Bermuda company as an additional trustee. The trustees subsequently declared that the settlements should be governed by Bermuda law and the original, temporary, trustees resigned, leaving the Bermuda company as sole trustee. The taxpayer could also appoint new and additional members to the Committee.

The taxpayer was assessed on the settlement's income on the basis that he had power to control the application of that income. The Crown claimed that he could control the income through his power to appoint trustees and members of the Committee, it being submitted that the trustees and the Committee must be presumed to have been appointed to act as the taxpayers nominees. The Special Commissioners, in fact, concluded that "the evidence lends considerable support to that view of the matter". The various transactions all appeared to the Special Commissioners to have been pre-arranged by the taxpayer and that it was likely that the Committee and the trustees would have complied with any request from the taxpayer provided that it did not involve a breach of trust.[189]

However, they concluded:

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189. p106

"[The taxpayer] was able to appoint trustees who, with the consent of the committee so long as it existed, could be expected to deal with the trust income in accordance with his wishes: but he could not compel them to do so and there is no suggestion that any of them would have acted in breach of their fiduciary duties under the settlement. Whatever may be the scope of paragraph (e) ... we cannot construe it as applying to the powers which [the taxpayer] possessed ... We hold that [the taxpayer] had no power to enjoy the income from the [company's] shares after the assignment to the trustees."[190]

Vinelott J, too, said that it was clear that all the transactions were part of a prearranged scheme[191] but he still found for the taxpayer. It is true that he had power to appoint new members of the Committee and could appoint new trustees, but that was a fiduciary power which could not properly be used to pack the committee with persons who would follow the taxpayer's instructions. Accordingly, it couldn't be said that the settlor had put himself in a position where he could secure the appointment of trustees who would follow his wishes and not exercise their own discretion.[192]

The judge was of the opinion that:

"The fact that there was a prearranged plan does not support the inference that after [the Bermuda company] had been appointed it would act otherwise than in accordance with its fiduciary duties."[193]

The Crown also submitted that, under the constitution of the Bermuda company, the taxpayer may have been in a position to make or unmake directors and to appoint his

190. p108
191. p111
192. pp119-120
193. p120

own nominees to the board, or to control the exercise by the board of discretions confided in the company as trustee of the settlements. In the absence of evidence to the contrary, said the Crown, it should be presumed that the taxpayer was in such a position. Vinelott J rejected this: such a lack of evidence could not support the inference that the taxpayer could control the exercise by the company of its powers as trustee of the settlements.[194]

This was the case even though the taxpayer could be expected to exercise a decisive influence over the trustees. The judge said:

> "It is one thing to say that a settlor is in a position to influence or even that in the absence of any other considerations which ought properly to be taken into account by the trustees he is in a position to exercise a decisive influence on the exercise by the trustees of their fiduciary powers: it is quite another to say that he is in a position to control the exercise of those powers."[195]

It must be said that the dividing line between "decisive influence" and "control" must be a fine one. However, even if the trustees could be expected to deal with the settlement income in accordance with the taxpayers wishes, the Commissioners found that they would not have acted in breach of their fiduciary duties.

On the question of control, the Crown relied on two cases, Lee v IRC[196] and IRC v L.B. (Holdings) Ltd.[197]

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194. p121
195. Ibid
196. (1941) 24 TC 207 supra
197. (1946) 28 TC 1, see Chapter 1.

It has been seen above that MacNaughten J in Lee held that the settlor, on the facts of that case, could control the settlement income within paragraph (e). Effectively, the taxpayer was in complete control in that he could elect and remove the directors, he could decide whether further shares were to be allotted and he could prevent the transfer of any shares. He could use those powers, particularly those to control the composition of the board, to control the application of the income.[198]

Vinelott J refused to extend this to cover the present case. The taxpayer's power in Lee to appoint and remove directors was not a fiduciary power and the directors did not owe any fiduciary duty to the shareholders. The taxpayer in Lee also controlled the majority of votes in general meeting. In effect, he was the company. In the words of Vinelott J, "he could within the broad limits of what a director could honestly believe to be proper in the interests of the company ensure that ... the income of the company was used for his own ends"[199]. This was not true in the present case.

The judge then turned to the L.B. (Holdings) case, the facts of which have been given in Chapter 1. In brief, an individual's business was transferred to a company in return for shares. That company's shares were sold to the taxpayer company, the taxpayer company issuing its shares to the individual. He made a declaration of trust constituting himself sole trustee of the shares. Under the trust an annual sum was payable to the individual's wife and the balance of the income (dividends from the taxpayer company) was paid to or applied for the benefit of the individual's children.

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198. 24 TC 207 at pp 213-4
199. p123

As has been seen in Chapter 1, under the relevant apportionment provisions at that time, income of the company could be apportioned to a shareholder if he was "able to secure that income or assets, whether present or future, of the company [would] be applied either directly or indirectly for his benefit to a greater extent than is represented in the value for apportionment purposes of his relevant interests in the company".[200] It was also enacted that "a person shall be deemed to be able to secure that income or assets will be applied to his benefit if he is in fact able to so do by any means whatsoever, whether he has any rights at law or in equity in that behalf or not".[201]

The House of Lords held that, in answering the question whether a shareholder was able to secure that income was applied for his benefit, there was no requirement that he should be able to do so by means which did not involve a breach of trust.

Vinelott J did not think this finding helped the Crown in the present case. He drew the distinction by saying that

> "... the question in the instant case is not whether the settlor was likely to be able to influence or even to exercise a decisive influence over the exercise by the trustees of their fiduciary powers. The question is whether he was able to control the application of the income, and to answer that question affirmatively it must in my judgement be possible to say at least that he was in a position to ensure that the trustees would act in accordance with his wishes without themselves giving any independent consideration and accordingly to act in disregard of their fiduciary duty."[202]

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200. Section 15(2) FA 1939
201. Section 15(3) ibid
202. p125

This is a valid distinction, given the difference in the facts of the two cases and the wording of the two pieces of legislation but it seems that it is a distinction that would not have been made during or immediately after the Second World War when the law on section 18 was being formulated by the courts. It shows how far the courts had come since those days; even in the post-"Ramsay" era[203] the courts were not adopting such a broad-brush approach to these particular provisions as did the first courts to deal with them some forty years earlier.

This case should, however, be contrasted with a case decided three years later in which a wider construction was given to "power to enjoy" and in which the Crown's arguments prevailed. As will be seen, this is not an entirely satisfactory case and perhaps too much should not be read into it. It was IRC v Brackett[204] and it concerned the not uncommon arrangement of a UK resident entering into a contract of employment with an offshore company which in turn hired out his services. There were a number of additional features, as will be seen. Furthermore, the taxpayer, who appeared in person, does not appear to have put up very comprehensive arguments and the judge, not one well versed in tax matters, dismissed his arguments in a short judgment.

The taxpayer was a chartered surveyor who was resident in the UK. He made a Jersey settlement, the trustees of which formed a Jersey "corporation tax" company called Drishane Investments Ltd.

As background it should be noted that a "corporation tax" company was one registered in Jersey but managed and controlled outside the island - often in Sark or France - which, by virtue of the fact that it was not resident in

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203. See Chapter 11
204. [1986] STC 521

Jersey, did not pay Jersey income tax of 20%, but only corporation tax on its non-Jersey source income at a flat rate (£300 at that time) regardless of the level of its profits.

The taxpayer entered into a contract of employment with Drishane under which he would draw a salary until his 70th birthday, five years later. Subsequently, he was to be paid what the directors considered the company could afford, whether or not he continued to provide any services.

The company had no other employee and the taxpayer's activities were its only trade. In accordance with normal practice in similar circumstances, the taxpayer would refer potential clients to Drishane which would enter into a contract with the clients for the taxpayer's services. Following the taxpayer's 70th birthday payments of salary were indeed made to him.

The company also helped the taxpayer to realise his assets. He was having difficulty selling certain property and the company purchased it from him. The company also made payments to the trustees of an English settlement of which the taxpayer was settlor, purchased several properties for the occupation of the taxpayer's daughter, paid for repairs to the properties and made payments to the Jersey settlement for the purchase of policies on his life.

The Revenue raised assessments under section 478 ICTA 1970 on the basis that the contract of employment was a transfer of assets, that the income was payable to Drishane in consequence of the transfer, and that the taxpayer had power to enjoy that income within section 478(5).[205]

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205. Now section 742(2) ICTA 1988

The Special Commissioners allowed the taxpayer's appeal, holding that the rights confirmed on Drishane by the contract did not amount to a transfer of assets. The Revenue then raised assessments under section 79 TMA 1970 and section 487 ICTA 1970[206] which need not be considered further here. The Crown appealed to the High Court against the discharge of the section 478 assessments.

Hoffmann J allowed the appeal. He held that the rights under the contract of employment could be regarded as assets and section 478(8)(b) included within "transfer" a creation of rights. Accordingly those rights were assets transferred to Drishane.

He further held that "income becomes payable to persons resident .... out of the United Kingdom" was wide enough to include the profits of a non-resident trader. This part of his finding is fully in accordance with previous authority.

It was also held that the taxpayer had "power to enjoy" the income of Drishane within section 478(5)(c),[207] namely that he "receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income." The taxpayer had the "power to enjoy" within the above because the "substantial result and effect" of the transfer[208] was that he received, from the tax-free fund in Jersey, payments for the properties he could sell elsewhere, repairs to his properties and salary.[209]

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206. Now section 775 ICTA 1988, see Chapter 1 and Part 9 of this Chapter.
207. Now section 742(2)(c) ICTA 1988
208. See section 742(3) ibid
209. p540

It is noticeable that Hoffmann J gave a wide interpretation to both "power to enjoy" and "assets", an interpretation that sits more happily with the cases heard during and immediately after Second World War, than the more modern cases.

In this respect, it is probably significant that the only case on the section referred to by the judge was Latilla[210] in which, it will be recalled, some of the very widest interpretation was given to the section in some of the strongest language.

Furthermore, the only other two cases cited in argument were Corbett's Executrices[211] and Lord Chetwode,[212] two other noteable successes for the Crown; the former one, in particular, containing judgments demonstrating the width of construction favoured by the courts in section 18 cases during the last war.

The taxpayer appearing in person, had not brought before the court any of the more recent cases in which a much narrower view of "power to enjoy" was taken. Hoffmann J himself had no experience of section 478 either at the Bar or on the Bench. There is no way of knowing, of course, but it many well have been the case that the judge might not have given such a wide meaning to "power to enjoy" or "assets" had he been presented with competent and detailed argument by counsel on behalf of the taxpayer. Given the way the section had been dealt with in most of the more recent cases, it would have been surprising, if those cases had been properly presented to him, that the judge had construed those terms so widely.

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210. Latilla v IRC (1943) 25 TC 107, supra
211. Corbett's Executrices v IRC (1943) 25 TC 305, supra
212. Lord Chetwode v IRC (1971) 51 TC 647, supra

The Anti-Vestey Legislation

After the Vestey case in 1979, the Crown was faced with a loophole in their anti-avoidance legislation which was ripe for exploitation by wealthy individuals and their alert advisers. The Vesteys themselves are reported to have avoided millions of pounds due to the Crown's failure to beat them in the Courts.

A favourite device, for example, was for a discretionary settlement to the set up with non-resident trustees under which the trustees had power to accumulate income for period which were often much longer than the accumulating periods allowed in the UK. The trustees would accumulate foreign income free of UK income tax, and on the basis of the Vestey case, distribute the accumulated income as capital to beneficiaries resident in the UK. The beneficiaries would receive the distributions free of income tax.

Clearly remedial action was urgently required. Further, it was equally clear that the Judiciary had set its face against the sort of very wide and imprecise legislation embodied by section 478 ICTA 1970, particularly as construed by the Revenue before the House of Lords decision. It was likely that the House of Lords would construe against the Crown if at all possible when faced with such sweeping legislation in future.

The new legislation, originally contained in section 45 and 46, FA 1981[213] in fact turned out to be both effective and equitable in that it has tended to stop the devices against which it was aimed, but at the same time, has not generally acted harshly on the innocent taxpayer.

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213. Now sections 740 and 744 ICTA 1988 respectively.

It contains no provisions allowing the same income to be taxed more than once in the hands of any particular taxpayer. Furthermore, the Revenue are given no such discretion as they claimed for themselves prior to the Vestey case.

The new legislation also steered clear of the concept of "power to enjoy" which had been such a frequent source of litigation in the past. As a result, beneficiaries can no longer be taxed on the income which they do not receive.

The legislation specifically contained provisions to allocate the income of the non-resident or non-domiciled person between the various resident individuals who actually receive benefits. Accordingly, there was no need for any discretion to be given to the Revenue in the form that they thought they had prior to the Vestey decision. The Revenue have, in fact, been given a discretion to apportion the relevant income but they can only do so in such a way as appears to them to be "just and reasonable", and the exercise of their discretion is subject to review by the Special Commissioners on appeal.

The provisions of what are now sections 740 and 744 ICTA 1988 apply to the relevant income and benefits arising on or after 10 March 1981 irrespective of when the transfer of assets (or associated operations) took place.[214]

The provisions filled the gap left by the House of Lords judgments in Vestey which effectively meant that section 739 only caught the transferor and his spouse. Section 740 imposes a charge on a non-transferor. The ambit of the charge is set out in subsection (1) which states that the section has effect where:

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214. Section 740(7) ICTA 1988

"(a) by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom; and

(b) an individual ordinarily resident in the United Kingdom who is not liable to tax under section 739 by reference to the transfer receives a benefit provided out of assets which are available for the purpose by virtue or in consequence of the transfer or any associated operations."

The value of the benefit received by the person ordinarily resident in the UK is chargeable to income tax in the year it is received to the extent to which it falls within the amount of "relevant income" of years of assessment up to and including the year of assessment in which the benefit is received. The surplus is taxed in subsequent years to the extent that it falls within the "relevant income" in those years, unless it is otherwise chargeable to income tax in the hands of the recipients.[215]

The "relevant income" of a year of assessment is defined as any income which arises in that year to a person resident or domiciled outside the UK and which, by virtue or in consequence of the transfer of assets (or associated operations), can directly or indirectly be used for providing a benefit for the individual in question, or for enabling a benefit to be provided for him.[216]

Section 740 is subject to the same exemptions relating to transactions which do not have a tax avoidance purpose and to bona fide commercial transactions as section 739.[217]

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215. Section 740(2) ibid
216. Section 740(3) ibid
217. Section 741 ibid

There are two provisions designed to avoid double taxation. Where the whole or part of the benefit is subject to CGT under section 80 or section 81 FA 1981[218] the benefit, or the relevant part of it, cannot be taxed under section 740.[219] Secondly, a charge cannot arise under both sections 739 and 740 in respect of the same income. Where there is a choice as to the persons in relation to whom any amount of income can be taken into account, the Board of Inland Revenue or, on appeal, the Special Commissioners, shall make a "just and reasonable" apportionment.[220]

These provisions, introduced to fill the gap left by the Vestey decision, fortunately did not seek to give the Inland Revenue back the powers they thought they had before that decision. Instead, those responsible for preparing and drafting this legislation for once took into account the fierce criticisms of the judges[221] and provided what is, on the whole a fair and workable system for taxing income arising on assets transferred abroad. Admittedly, the Revenue have been given some discretionary powers but only in clearly defined circumstances, and subject to appeal to the Special Commissioners.

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218. See Part 8
219. Section 740(6) ICTA 1988
220. Section 744 ibid
221. Compare the inactivity on the much criticised provisions of section 677 ibid; see Chapter 2.

PART 3

TRANSFER PRICING

Introduction

The United Kingdom, like most other developed countries, has legislation to prevent profits being siphoned out of the country by means of artificial pricing arrangements between affiliated companies.

The present provisions are contained in section 770 ICTA 1988, which was introduced as section 37, FA 1951 as a package also containing section 36, which is now section 765 ICTA 1988.[1] However, unlike section 765, which has been held "in terrorem", Section 770 has been actively used. There is a special unit in the Inland Revenue to implement its provisions. This unit is manned by high-powered specialists and, even within the unit there is specialisation with, for example, a particular member handling, say, royalty questions.

There is often a close connection between the two sections in that a section 770 investigation can be sparked off by a section 765 application.

Section 37, FA 1951 replaced General Rule 7 in the ITA 1918, which had been confined to cases where UK residents were controlled by non-residents. The non-resident could be charged to tax in the name of the resident as if he were the agent of the non-resident. In fact, although section 37 was not restricted to dealings between residents and non-residents, it and its successors have not been used against transactions between parties, both of whom have been residents in the UK. Technically, it can be used, for example, for transactions between two UK

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1. See Part 5

companies, one of which is not a trading company and where the transaction takes place at a non-arm's length price. Normally other legislation is used to counter such devices, such as section 274 ICTA 1970.

Indeed, John Stevenson, then head of the special unit, confirmed at a conference organised by the London Society of Chartered Accountants in 1978, that the use of the section was in practice confined to international transactions and that section 274 ICTA 1970 and simlar legislation was more likely to be used in internal matters. He further confirmed that the section was not designed to deal with "peanuts" or fine tuning. There must be a material sum at issue to make the section worth using.

Section 770 is supplemented by provisions in most double tax agreements negotiated by the UK and, indeed, in nearly all other agreements between other countries which have been based on the OECD model. The UK has many such agreements, having begun negotiating them after the Second World War.

Section 770 is one of those anti-avoidance provisions that can only be applied if the Board of Inland Revenue so directs. The inclusion of this formality would suggest that it was intended that the section should not be over-zealously used by inspectors in borderline or small cases and, in practice, this has worked. The very fact that an inspector has to refer the matter up to the special unit and that the unit tends to be too busy on big cases to worry excessively about small ones, has, on the whole, assured that section 770 is only applied in important cases. Consequently, negotiated settlements are common at both district and at central level and a formal direction is only normally made if an impasse is reached.

There have been no cases directly on section 770 apart from IRC v Lithgows Limited[2], which was on the meaning of "control". Accordingly, no important points of interpretation have been clarified in the courts and certain parts of the section are unclear in their precise application. Indeed, John Stevenson at the conference mentioned above, said that the Revenue rarely went to the Special Commissioners because they thought that there might be problems with evidence in front of the Commissioners. This contrasts vividly with the situation in, say, the USA where there have been many cases on the corresponding provision, section 482 of the Internal Revenue Code.

It will be seen below that transfer pricing legislation was essential to prevent manipulation of prices by multi-national organisations with the resulting loss of tax revenue. However, section 770, along with the parallel provisions in other countries, has given rise to a number of problems, such as:

1. An adjustment in one country may not be reflected by a compensating adjustment in another.

2. A price agreed under the transfer pricing legislation may not be acceptable for customs and other purposes.

3. The operation of the section can often be fairly arbitrary, each case being considered on its own facts.

4. Many tax authorities thoughout the world are becoming increasingly aggressive in the operation of this and other anti-avoidance provisions.

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2. (1960) 39 TC 270 infra

Some of these problems have been considered in two reports published by the OECD on "Transfer Pricing and Multinational Enterprises"; one published in 1979 and the other in 1984. These reports are referred to, where appropriate, below as the "1979 OCED Report" and the "1984 OECD Report" respectively. Reference to paragraph numbers in the 1984 OECD Report relate to the first of three studies in that Report, entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure."

The importance of transfer pricing and the potential for exploitation can be gauged from some figures contained in the 1979 OECD Report which, quoted[3] a United Nations publication, "Transnational Corporations in World Development: A Reexamination"[4]. The UN report estimated that about 40% of imports to the U.S.A. in 1974 were "intra-firm" transactions and 50% of the U.S.A.'s exports were within "transnational corporate systems". In addition, 30% of UK exports in 1973 and 59% of Canada's in 1971 were on an "intra-firm" basis. This was in relation to the international trade in goods. Transfer pricing is also relevant in relation to, for example, intellectual property, services and loans, amongst other things.

Transfer pricing manoeuvres are not necessarily prompted by tax considerations. Prof Plasschaert in his paper to the Council of Europe Colloquy on "International Tax Avoidance and Evasion"[5] set out various non-tax inducements to transfer pricing.

Using as his hypothesis a parent company selling into a subsidiary, he gave the following examples:

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3. Para 32
4. 1978
5. 1980. Reproduced in the report by the International Bureau of Fiscal Documentation on "International Tax Avoidance and Evasion" (Amsterdam 1981) p84

Motivation	Action taken by multinational firm	Comments
Customs Duties		
- import duties	underpricing	affects revenue in only one country
- export duties	underpricing	
Exchange Risks		
- claims in weak currency	overpricing plus leading	leading or lagging allows group to avoid exchange risks and transfer pricing enhances the benefits of leading or lagging
- claim in strong currency	overpricing plus lagging	
- debt in weak currency	overpricing plus lagging	
- debt in strong currency	overpricing plus leading	
Repatriation of Profits or Capital	overpricing	
Capitalising machinery etc	overpricing	also increases the basis of depreciation allowances and of compensation in case of expropriation.
Joint Ventures	overpricing	the "gain" from transfer pricing is shared with the joint partner.
Giving Support to Claims for Price Increase, by Showing Higher Costs.	overpricing	

Avoiding Anti-Monopoly Charges	underpricing		
Avoiding Anti-Dumping Changes	overpricing		
Mollifying Claims for Wage Increases by Showing Lower Profits	overpricing		
Supporting an Infant Subsidiary	underpricing		
Enlarging Market to Detriment of Competitors ('Predatory Pricing')	underpricing	provided lower cost is shifted into lower price consumer.	Share

The Operation of the Section

For the section 770 ICTA 1988 to apply there must be:

(i) a sale or other type of transaction defined in the section;

(ii) between affiliated parties;

(iii) at a non-arm's length price;

(iv) where one of the parties is not a UK trader.[6]

There are other situations outside the scope of the section where adjustments have to be made in respect of either an expense or a receipt. For example, section 74(a) ICTA 1988, in respect of expenditure, and the principle in Sharkey v Wernher[7], may come into play.

The section 770 net is thrown over a wide area because, although the section itself refers to sales and it is drafted to cater for buyers and sellers, section 773(4) extends the operation of the section to cover a very wide range of transactions by enacting that the provision of section 770:

> "Shall, with the necessary adaptations have affect in relation to lettings and hirings of property, grants and transfers of rights, interests of licenses and the giving of business facilities of whatever kind as they have affect in relation to sales, and the references in [section 770] to sales, seller, buyers and prices shall be deemed to be extended accordingly."

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6. Section 770(1) and (2) ICTA 1988
7. (1955) 36 TC 294

The giving of "business facilities" would include such things as the lending of money, allowing the use of chattels or property and the granting of guarantees.

On the whole, section 770 is drafted in a rather tortuous way but the meaning is normally clear. Section 773(4), however is rather obscure in that the precise concept of a sale is extended in a rather clumsy and imprecise way. The sub-section does not explain exactly the scope of the extention or how relevant adjustments are to be made in the case of a non-arm's length transaction. The use of the phrase "necessary adaptations" does not lend itself to precision and certainty.

Only non-arm's length transactions between parties with a particular degree of association are caught under section 770. To be within the section, one party to the transaction must be controlled by the other party or parties or both parties must be controlled by some third party or parties.[8] The parties so controlled must be "bodies of persons" which is defined in section 832(1) ICTA 1988 as "any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate". This definition is specifically extended for the purposes of section 770 to include a partnership.[9]

Control, for the purposes of the section, is the narrower definition contained in section 840 ICTA 1988[9] rather than that set out in section 416 ibid, namely the power to secure, by means of the holding of shares or voting power or by virtue of powers contained in the Articles of Association or other document regulating the company in question or any other company, that the affairs of the company in question are conducted in accordance with the

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8. Section 770(1)(a) ICTA 1988
9. Section 773(2) ibid

wishes of the relevant person, and in the case of a partnership, the right to more than one half of the assets or income of the partnership.

This is narrower than the section 416 definition in a number of respects. For example, the right to acquire control is not included and a power exercisable by virtue of some other authority is also not within the narrower section 840 definition.

In determining whether one person has control over a body of persons, section 773(3) ICTA 1988, requires that there will be attributed to the person in question the rights and powers of:

1. his nominee, in other words, rights or powers possessed on his behalf or which the other person may be required to exercise on his direction or behalf;

2. a person connected with him or a nominee of a person so connected.

The fact that one person is one of a number of trustees of separate settlements does not permit control to be attributed to him as he can only vote in accordance with the wishes of his co-trustees. This is apparent from the case of IRC v Lithgows.[10]

In this case, the Articles of Association of a shipbuilding company and of a shipping company each contained the provision that, if two or more persons were jointly entitled to a share, and if two or more such persons were present at a meeting either personally or by proxy, then only the person whose name appeared first in the Register of Shareholders was entitled to vote in

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10. (1960) 39 TC 270

respect of the jointly owned shareholdings. The majority and controlling shareholdings in both companies were each owned by a separate trust. The same person was a trustee in both trusts and his name appeared first in the Register of Shareholders in the case of each company in respect of the holdings of the controlling trusts. The shipbuilding company sold to the shipping company two ships at prices less than they would have fetched had both companies been dealing with each other at armslength. A direction was made by the Commissioners of Inland Revenue under what was then section 469, ITA 1952 that, for the purpose of determining the liability of the shipbuilding company for profits tax and income tax, an assessment should be made on the company on the difference between the prices for which the ships were sold and the prices they would have fetched had both companies been dealing with each other at arm's length, on the ground that both companies were controlled by the trustee whose name appeared first in the Register of Shareholders of each company.

It was held that, as each company was contolled by a separate trust, and as in each trust the first named trustee could vote only in accordance with the wishes of his co-trustees, the companies were not controlled by the same person, and the commissioners were not entitled to make an assessment under Section 469.

Allied Provisions Relating to Expenditure and Receipts

In questions of transfer pricing, it is not just section 770 that requires consideration; other principles may be relevant.

As far as expenditure is concerned, if a trader (or a person carrying on a profession or vocation) pays an excessive price, then he can expect a disallowance under section 74(a) ICTA 1988 on the grounds that the expenditure was not incurred "wholly and exclusively for the purpose of the trade". Furthermore, Section 74(e) ibid disallows any loss not connected with or arising out of the trade.

Consider also the case of IRC v Europa Oil (NZ) Limited[11], which is considered in Chapter 11. It will be seen that part of the expenditure in question was disallowed on the basis that the contract under which it was incurred was closely intergrated with other contracts which enabled the taxpayer to receive income by way of dividends directly related in quantum to the expenditure in question; the arrangements had the economic effect of giving the taxpayer the benefit of a discount on the prices it paid and the expenditure was held not to have been incurred exclusively for the purchase of stock under the contracts. The opposite was held in the later case of IRC v Europa Oil (NZ) Limited (No 2)[12] (which involved slightly different contracts) where the emphasis was placed on legal entitlements accruing as a result of the expenditure in question. The dividends in that case, although related to the expenditure in a wide sense, were by no means legal entitlements.

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11. [1971] AC 76
12. [1976] STC 37, also considered in Chapter 11.

There have, of course, been many cases on section 74(a) ICTA 1988 and mostly they have been concerned with the nature of the expenditure rather than the quantum. However, there are exceptions: see for example Copeman v William J. Flood & Sons Limited.[13] But on the whole, section 770 is a much more useful weapon when the quantum rather than the nature of the expenditure is in question.

However, see Ransom v Higgs[14]. The facts of this case are set out in Chapter 11. It will be seen that this was in fact a group of cases and that, in what is referred to as the Kilmorie case, the £77,250 paid by the taxpayer was held by the House of Lords to be a price dictated by the tax avoidance scheme and not a price paid by the taxpayer company as a free agent acting from commercial motives in its own interest. Consequently, the sum was not paid wholly and exclusively for the purpose of the company's trade under section 74(a) ICTA 1988.

Lord Reid, for example, said:

> "...This sum of £77,250 was a gross over-valuation. But the scheme under which £60,000 was to reach the Downes trustees free of tax made it essential that Kilmorie should undertake to pay this large sum. The price was dictated by the scheme, and plainly had nothing to do with the market value of the rights sold. ...If it is proved that some non-commercial reason caused the trader to pay more than he otherwise would have done, then it seems to me quite clear that the payment can no longer by held to have been wholly and exclusively expended for the purposes of the trade. No authority is needed for so obvious a proposition."[15]

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13. (1941) 24 TC 53
14. (1974) 50 TC 1
15. pp 81-2

So here it can be seen that motive was being considered.

On the question of expenses, see also Fragmap Developments Limited v Cooper[16]. The taxpayer company paid two sums of £1,000 to its parent company for "administration expenses". There was no evidence that the parent had provided any relevant services to the taxpayer company. The Special Commissioners found that the taxpayer made the payments because the parent company had told it to do so and that the payments did not have the quality of management expenses. Buckley J agreed.[17]

In the same year there was the case of Stevenson v Payne, Stone, Fraser & Company.[18] The taxpayers were a firm of chartered accountants. One of the partners died so there was a deemed cessation and commencement for income tax purposes. With a view to exploiting the special Schedule D Case II rules that exist on a commencement, the partners formed a service company. The firm, for the first year after commencement, agreed to pay a service charge of £47,000, even though the services rendered in that year were known to have cost only £32,000, on the understanding that the charge for later years would be adjusted to insure that, in the long term, the company would make a nominal profit only.

The idea was, of course, to obtain as large a deduction as possible in the first year as the profits for that year would be taxed more than once under the Scedule D Case II commencement rules. The Crown objected, saying that no more than £32,000 could be deducted in computing the profits for that year. In the High Court, Pennycuick J agreed.[19]

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16. (1967) 44 TC 366
17. See p370
18. (1967) 44 TC 507
19. See p513

It has been seen in Chapter 5 that for the purposes of capital allowances, the effect of Section 78 and Schedule 7, CAA 1968 is that market value can be substituted in sales of property where there is section 840 ICTA 1988 control and the sole or main benefit that might otherwise have been expected (for one or both parties) was the obtaining of the capital allowances. It will be noted that the capital allowances legislation contains a "sole or main benefit" test; there is no similar condition in section 770.

Furthermore, it can be seen in Chapter 8 that there are provisions in the capital gains tax legislation for market value to be substituted if an acquisition of chargeable assets is on a non-arm's length basis[20] or is a transaction between connected person.[21]

Section 770 is specifically extended by section 771[22] to cover transactions by petroleum companies. If either party to a transaction is a petroleum company and the activities of either party include activities whose profits would be chargeable to overseas tax for which credit would be given under section 788 or section 790 ICTA 1988, and which are exploration activities and the transaction is connected with such activities, then the application of section 770 is not excluded by the resident buyer exclusion in section 770(2)(a) or the resident seller exclusion in section 770(2)(b). If the Board direct that section 770 shall apply to one company, they may extend such direction to the other if both are UK residents.

Another way in which section 770 is extended in the case of petroleum companies is in relation to the control requirement. The control requirement in section 770 is

20. Section 29A CGTA 1979
21. Section 62 ibid
22. Originally section 20 and Sch 9, Oil Taxation Act 1975.

unnecessary where the property is sold as part of a series of transactions and its terms are affected by those of the remainder of the transaction or transactions or where petroleum is sold and the buyer or associated companies own more than 20% of the ordinary share capital of the company with extraction rights of the petroleum sold, if in either case, either the buyer or the seller or both is or are petroleum companies.[23]

Turning to receipts, where no price is received or the transaction is otherwise not in the course of trade, market value can be substituted under the well known cases of Sharkey v Wernher,[24] and Petrotim Securities Ltd v Ayres[25]. See also Skinner v Berry Head Lands Limited.[26]

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23. Section 771(5) ICTA 1988
24. (1955) 35 TC 275
25. (1963) 41 TC 405
26. (1970) 46 TC 377

Powers to Obtain Information

Section 17, FA 1975 gave the Revenue wide powers which are now contained in section 772 ICTA 1988.

The normal provisions in section 20 and section 20 A to D, TMA 1970 apply to section 770 and under these sections an inspector may require a taxpayer or a relative to deliver documents which may contain information relevant to any tax liability. There are, of course, also wide powers of entry with a warrant to obtain documents.

However, section 17 gave additional wide powers of investigation permitting the Revenue to give 30 days written notice of particulars required where a transaction "appears" to the Board of Inland Revenue to be or be connected with a potential section 770 transaction, or to be relevant for determining whether a section 770 direction should be given, or for determining an arm's length price for section 770 purposes.[27] Notice can be served on a party to the transaction or a person associated with such a party.

Where a transaction appears to the Board to be potentially subject to section 770 and one of the parties is a non-UK company which is a 51% subsidiary of a UK parent, and the other party is either the UK parent or a UK resident 51% subsidiary of a common UK parent, then the Board can inspect the books of the parent or of any company which it controls, which books relate to that transaction or to transactions in the same or similar assets.[28] The Board can grant exemption from this requirement in relation to the books of a non-UK resident subsidiary where the parent shows adequate grounds.[29]

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27. See now section 772(1) ICTA 1988
28. Section 772(3) ibid
29. Section 772(4) ibid

The section gives the Revenue power to enter to inspect books but they cannot take them away.[30] They can enter the premises of any body of persons which may appear to the Board to be a party to a potential section 770 transaction and these powers of entry relate not merely to bodies corporate but to all bodies of persons.

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30. Section 772(6) ibid

Double Tax Agreements and Corresponding Adjustments

As the volume of international trade has increased, so has the potential for tax saving through transfer pricing manoeuvres. More and more countries have adopted measures to counter such devices and there have been cases where two countries have made adjustments in opposite directions in respect of the same transaction.

Most developed countries now have an extensive network of double tax agreements and it is mainly here that the problem of double taxation caused by the application of the anti-transfer pricing provisions has been handled by means of "corresponding adjustments". What this phrase means, basically, is that, if one country adjusts prices etc. under its transfer pricing rules, the other country in question makes a corresponding adjustment in the case of the other party to the transaction. If no corresponding adjustment is made, it is likely that economic double taxation will ensue in that the same profits would suffer tax in two countries in the hands of two associated parties.

Whether an appropriate corresponding adjustment can be made will normally depend on the two countries involved reaching agreement on the appropriate action to take in respect of the transaction in question. Often this is a relatively straightforward matter, but in other cases, problems can arise caused by, for example, differences in the domestic laws of the two countries. However, although problems do arise in practice, given the large number of transfer pricing adjustments that have been made by various countries, it is perhaps surprising that there are not many more difficulties. This is due largely to the "mutual agreement" and "corresponding adjustment" provisions in many double tax agreements. Furthermore, many countries have adopted the guidelines set out in the 1979 OECD Report.

Most modern treaties are based on the OECD Model, so the relevant provisions will be set out in detail.

The 1977 OECD Model Double Taxation Agreement states in Article 9 ("Associated Enterprises"):

"1. Where

(a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would

have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

The second paragraph was added in 1974 to permit the avoidance of double taxation where one of the countries has reallocated income or deductions pursuant to the terms of the first paragraph. The second paragraph, because it is relatively recent, has only been incorporated in a few treaties. In addition, Switzerland and Japan have expressed reservations concerning Article 9 (2) on the basis that it appears to require an automatic adjustment.

It will be seen that Article 9 (2) provides that the second country should make an appropriate adjustment to the amount of tax charged on the doubly taxed profits either by recalculating the profits using the revised price adopted in the other country or by leaving the calculation to stand and giving the taxpayer relief against his own tax for the additional tax charged by the adjusting country.

Although this sounds a simple procedure, there are significant problems which have yet to be solved. For example, paragraph 3 of the Commentary on the OECD Article 9 notes that "an adjustment is not automatically to be made". Such an adjustment is only made to reflect an arm's length transaction and if the second state is of the opinion that the adjustment made in the first state goes beyond what an arm's length transaction would be, then the relief given to the taxpayer in the second state will only be partial relief. In other words, full relief will not be given if the two countries differ on what the appropriate arm's length price for a particular transaction would be. Furthermore, the Article does not specify how the corresponding adjustment is to be made, although this would normally be agreed under the Mutual Agreement procedure within Article 25.[31]

Another problem is that the Article does not deal with "secondary adjustments". What this means is that, assume that a payment has been made to country A from country B at a price in excess of the arm's length price. If an adjustment is made in country B whereby the appropriate amount is added back to the profits of the company in that country, the tax situation would not reflect the flow of income as it in fact occurred. So, for example, country B may assume that the payment has been made and deem it to be a dividend on which withholding tax should be paid.

It is difficult to see how the problem of the absence of provision for "secondary adjustments" in Article 9 can be dealt with given the apparent differences of opinion that exist between tax authorities over how such adjustments are to be made or even, in some cases, what adjustments are permissible. The 1984 OECD Report provides no answer.[32] This is, however, clearly an important matter and it is hoped that, as transfer pricing and corresponding adjustments become more important, steps are taken in the international forum to resolve this problem.

Another problem with the Article is that it does not impose any obligation to make a corresponding adjustment within a particular period of time. Specific treaties, however, often do deal with this problem, either in the double taxation or competent authority articles.

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31. Infra
32. See para 69

Consequently, the Article as it stands, and as it has been adopted in most actual treaties, does not provide a complete and satisfactory answer to the double taxation problem.

In the 1984 OECD Report it is noted that, following the earlier report in 1979, multinational enterprises had urged a mandatory system of corresponding adjustments which would be binding on all member countries. It was felt by these companies that taxpayers could be exposed to heavy burdens of tax and be vulnerable to arbitrary and capricious pricing adjustments. It was also feared that this could also lead to double taxation in non-OECD countries which followed the principles set out in the 1979 Report.[33]

In reply, the OECD noted, that a number of countries had shown, by adopting Article 9(2) of the Model Convention, their acceptance of the obligation to make corresponding adjustments to relieve economic double taxation. However, this is not an adequate answer because it has been seen above that Article 9 (2) itself does not provide a complete answer in all cases.

Of rather more substance was the OECD comment that a taxpayer ought to look first to the domestic tax appeal system and the domestic law courts of the relevant state for protection against arbitrary or capricious transfer pricing adjustments.[34] The report continued by stating that:

> "imposing a simple mandatory requirement on tax authorities to conform automatically to a transfer pricing adjustment made by the tax authorities of

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31. See para 25 of the 1984 OECD Report
32. Ibid para 27

another country would not protect [multinational enterprises] against arbitrary or capricious adjustment although it might to some extent mitigate their total impact on an affected enterprise. But providing in this way that tax authorities must conform to the action of another tax authority over whom they have no control would leave the conforming tax authorities themselves with no protection against any arbitrary or capricious adjustments which might be made in the first place by the other tax authorities concerned, and a provision of this sort is therefore clearly unacceptable for tax authorities".[35]

This must be a valid criticism because it would be unfair to enforce an automatic corresponding adjustment on one state whether or not that state considered that the adjustment made in the other state was correct in principle and amount.

If a mandatory corresponding adjustment is therefore unacceptable, it is necessary to consider the alternatives. The OECD identitied two possible alternatives:

1. Oblige the tax authority, as Article 9 (2) does, to make a corresponding adjustment but only to the extent that it can agree that the result of the original adjustment is to substitute a proper arm's length price.
2. Compel the two tax authorities, if they cannot agree, to submit to compulsory arbitration.

As to the first alternative, presumably if a country is going to accept such an obligation, it will make the appropriate amendment to its double tax agreements to incorporate an article along the lines of Article 9 (2). The possibility of a compulsory arbitration system is considered below.

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35. Ibid

Mutual Agreement Procedure

Double Tax Agreements based on the OECD Model normally contain an article based on Article 25 of the Model under which a taxpayer who is affected by an adjustment under the transfer pricing provisions, may request its own tax authority to contact the tax administration in the other treaty country in order to arrive at a solution to the double taxation problem.

Article 25 reads as follows:

"1. Where a person considers that the actions of one or both of the Conracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracating State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When its seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States."

It is important to notice that Article 25 (2) states that the home administration is only required to contact the other administra- tion "if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution". This is dealt with further below.

Another important feature is that the Article deals with problems caused by statutes of limitations in the treaty countries by stating that:

> "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States."

This provision was introduced in 1974 and, consequently, is not yet contained in a large number of treaties.

The article clearly contemplates that the two countries should communicate with a view to avoiding economic double taxation. However, in practice, this is sometimes easier said than done and problems have arisen because tax authorities do not always use the mutual agreement procedure in a speedy and efficient manner.

What is more, as mentioned above, many treaties still do not contain an article based on Article 9 (2) of the Model and, in those cases, the mutual agreement procedure can be held to be inapplicable to cases of economic double taxation.

On the other hand, some relatively recent treaties specifically deal with the problem of economic double taxation in their mutual agreement article. For example, Article 25 (3) of the UK/USA Treaty of 31st December 1975 states:

> "The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may reach agreement on:
> (a) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
> (b) the allocation of income, deductions, credits or allowances between persons;
> (c) the nature of particular items of income;
> (d) the meaning of terms not otherwise defined in this Convention;
> (e) the place where a particular item of income has its source;
> (f) the elimination of double taxation in respect of income paid out of trusts."

It can be seen that this deals specifically with the case of economic double taxation. However, it is noticeable that the wording of the paragraph is that the two countries "may reach agreement" so that, if they fail to do so, the taxpayer can do very little about it.

One of the main problems with the mutual agreement procedure is, as mentioned above, that the two countries are not obliged to reach agreement, but merely to negotiate. Furthermore, even when the countries do negotiate, the process is usually lengthy and uncertain.

Indeed, it seems that a major factor contributing to the reluctance felt by many aggrieved taxpayers to use the mutual agreement procedure is the problem of the lengthy delay it entails. Taxpayers often prefer to agree a rather less beneficial compromise with their own tax authority than set the mutual agreement procedure in motion in the hope of gaining a better result at the end of the day

Evidence of the actual delays involved is hard to come by but an article, "The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention"[36], reproduced figures for delay in certain countries as follows:

USA -	As at the end of 1975, cases received and closed since 1973 took an average of six months.
Sweden -	Cases have taken between two to five years with an average of two-three years for the Finance Ministry and ten months for the National Tax Board.
Netherlands -	Generally "no more than two years".[37]

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36. [1979] BTR 333 and [1980] BTR 13, Avery Jones et al
37. [1980] BTR at p21

Even these scant figures display large difference from country to country.

The 1984 OECD Report acknowledged that the time factor was "an important difficulty in practice with the mutual agreement procedure."[38]

One suggested solution is that double tax agreements should prohibit the making of transfer pricing adjustments after a certain specified period. The 1984 OECD Report recognised the undoubted fact that such a time restriction would be unacceptable to a large number of countries, given the need to make sometimes lengthy investigations.[39] Where two countries are sufficiently at one on the point they can, of course, make provision for a time restriction in their treaty and perhaps more such provisions will be made in the future, but it seems that the 1984 OECD Report was right in saying that it would be inappropriate to make a general recommendation along these lines.[40] However, it did say, and multinational enterprises would support this view:

> "Nevertheless, on balance the Committee recommends that competent authorities should be prepared to enter into discussions under the mutual agreement procedure at as early a stage as is compatible with the economical use of their resources."[41]

A great deal of the uncertainty surrounding the mutual agreement procedure arises out of the very nature of negotiated settlements but, in addition, the 1984 OECD Report noted another area of uncertainty which had been identified by multinational enterprises. This was that "tax authorities tend to lump together all current

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38. Para 80
39. Para 84
40. Ibid
41. Para 89

cases and to negotiate a general settlement on a very rough and ready basis". Consequently, the outcome of one taxpayers case could jeopardise the chances of another taxpayer. Given the time consuming nature of the process, one can, perhaps, sympathise with tax authorities who wish to deal with what they consider to be similar cases at the same time, but this can obviously lead to injustices in particular taxpayers' cases. Not surprisingly, the OECD, in their 1984 Report, expressed their view that "competent authority cases should each be settled on their own individual merits and not by reference to any balance of the results in other cases".[42]

Given the delay and uncertainty inherent in the mutual agreement procedure, the OECD noted that multinational enterprises, consider that owing to the protracted nature of this procedure and the risks involved, most enterprises look at the mutual agreement procedure only as a last resort.

The Commentary on Article 25 in the OECD Model Treaty notes that:

> "The conclusion of a mutual agreement depends to a large extent on the powers of compromise which the domestic law allows the competent authorities. There may be a reluctance in many countries for the Legislature to give the tax authorities, normally part of the Executive, the power to determine the amount of tax paid by taxpayers by agreement with the authorities of another country."[43]

It has been seen, therefore that there are problems in the mutual agreement procedure but, on the whole, it does tend to work fairly well in practice and it is difficult

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42. Para 105
43. Para 42

to see how any real improvement can be made that would be acceptable to most countries. The Commentary on Article 25, for example, states that:

> "On the whole, the mutual agreement procedure has proved satisfactory. The most recent treaty practice shows that Article 25 represents the maximum that Contracting States are prepared to accept."[44]

A similar conclusion was reached in the 1984 OECD Report, where it is stated:

> "Notwithstanding the criticisms that have been made of the mutual agreement procedure, it has been widely recognised as an efficient and flexible instrument in the interpretation, application and development of double taxation agreements and a suitable means for the elimination of both juridical and economic double taxation. Certainly the experience of tax authorities within the OECD at least, is that, within its limitiations, the mutual agreement procedure can be a very useful instrument in resolving difficulties arising in transfer pricing cases and that, up to the present, acceptable compromises have in practice nearly always been found. It does not appear that the experience of taxpayers has been significantly different."[45]

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44. Ibid
45. Para 40

Binding Arbitration

One of the suggested improvements to the corresponding adjustment procedure mentioned above was the possibility of binding arbitration.

The 1984 OECD Report identified a number of possible advantages that had been suggested to the Committee.[46] These were:

1. If recourse to arbitration was required in the absence of a settlement within a specific period, this would avoid the uncertainty and delay inherent in the present system.

2. The expense associated with the present lengthy procedure would be reduced.

3. The matter would be dealt with while the relevant information was still fresh in the minds of those concerned.

4. The arbitration proceedings themselves would probably be expeditious; the absence of the need for administrative or procedural rules would probably speed the decision making process.

5. If the arbitration process allowed the taxpayer to present evidence and arguments, it would give the taxpayer the opporunity to deploy all the relevant information and to correct any misunderstandings in the information given to the tax authorities.

6. The problem could be put before impartial experts who would understand the commercial situation and would thus be particularly able from their experience to interpret the pricing information put

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46. Para 42-44

before them. There would, therefore, be less need for elaborate preparation of the case and, consequently, it would be less expensive than preparing a case for the present competent authority procedure or for litigation in the courts.

7. It is possible also that the arbitration decisions could be based less on a strict interpretation of national pricing rules than on what the arbitrator considered in the light of his experience to be a fair solution.

8. Such an arbitration system would reduce the danger that the merits of a particular taxpayer's case would be ignored by a tax authority in order to achieve more successful results on behalf of other taxpayers.

9. The idea of a binding arbitration procedure was supported in a Draft Directive of the European Communities which was favourably received by the Assembly of the Communities and by the Economic and Social Committee.

Given the undoubted advantages of a binding arbitration procedure and the backing given to it by multinational enterprises themselves and by the Draft Directive, it is interesting to consider the reasons why the OECD rejected a binding arbitration procedure.

They first considered that there would be problems in formulating the machinery to be used. Commenting on the suggestion that it would be inappropriate for the tax authorities to be part of the arbitrating body so that a taxpayer could put the problem to a completely independent tribunal, the OECD commented that:

> "This approach, however, would leave the tax authorities in an odd situation - effectively a difference of opinion between two tax authorities would be litigated before an arbitrator on the initiative of a third party - admittedly a third party interested in the outcome but still, in the context, a third party and one interested, it is possible indirectly in the outcome. The system would need to provide adequately for the interests of both taxpayers and tax authorities and it is not easy to see how that could be achieved with this kind of arrangement."[47]

It seems odd to refer to a taxpayer as a third party who might be interest only indirectly in the outcome of an arbitration. The taxpayers are the most important parties to such a procedure and they are the party normally most directly affected by the outcome. After all, the whole object of the procedure should be to produce an equitable result for the taxpayer.

Furthermore, it undoubtedly would be difficult to provide adequately for the interests of taxpayers and the tax authorities, but that is not to say that it would be impossible. It seems unsatisfactory that this point should have been dismissed by the OECD in one sentence.

Then there is the problem of how the arbitration system would inter-relate with the taxpayer's right of appeal to his own domestic courts. There are two schools of thought here. One is that a taxpayer should be obliged to exhaust or abandon his own domestic rights of appeal before being allowed to institute arbitration proceedings. Factors in favour of this option are, firstly, the straightforward question of equity and,

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47. Para 46

secondly, the taxpayer should not be able to choose whichever of two possibly conflicting decisions was more advantageous to him.

The second school of thought is that a taxpayer need not have exhausted or abandoned his domestic rights of appeal before instituting arbitration procedures. In fact, the EEC Draft Directive would allow some countries to require the taxpayer to exhaust or abandon his domestic legal rights of appeal, while allowing other countries to allow a taxpayer to seek arbitration while his domestic appeal procedures were still open to him.

The approach taken in the Draft Directive appears to be the most satisfactory solution in the circumstances given the inevitable different approaches that would be taken by different countries, some of whom may object to having one or other of the systems imposed upon them.

The objection given by the OECD to this suggestion neither adequately nor satisfactorily deals with the point raised. They say that this solution "could leave some problems of balance between the situations of different national tax administrations engaged in an arbitration procedure".[48] Perhaps this is the case, but these possible "problems of balance" are surely not incapable of solution given the sophisticated international cooperation that takes place these days between different countries on questions of international tax.

The other objections raised by the OECD to a binding arbitration procedure were not persuasively analysed in their 1984 Report.

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48. Para 47

They considered whether the arbitration should be final or whether there should be further right of appeal.[49] They raised this question without giving a firm view one or the other. However, logically the procedure must be final because one of the main objections to the present procedure is the uncertainty and delay inherent in it. To be effective, any arbitration procedure must be final and a taxpayer must be ensured that he will obtain a quick and certain decision.

Linked to this is the question of what approach the arbitrators should take. If the fundamental objects of speed and cheapness are to be obtained, it is clear that the arbitrators would have to adopt a pragmatic approach rather than a legalistic one. The questions the arbitrators would have to decide would nearly always be questions of fact rather than law and they would have to sift through a great deal of evidence. The OECD were not sure what effect this approach would have on the ability of tax authorities to concede points in order to obtain a negotiated settlement at an earlier stage. The OECD said that it would be unfortunate if tax authorities were afraid to make concessions because of a tendency on the part of the arbitrators simply to seek a middle way between the tax authorities.[50] Again, however, the OECD did not go further than this and seek to find an answer to the problem they had raised. As far as the tax authorities are concerned, if they are serious in wanting to avoid injustice to their taxpayers, they must be prepared to accept that economic double taxation is a real problem and that arbitration can ensure that justice is not only done but is seen to be done and that they ought to make real efforts to accept that a pragmatic

49. Para 48
50. Para 51

approach would ultimately be to the benefit of, not only the taxpayers, but also the tax authorities themselves, who should benefit from the lack of expense and delay as well as the taxpayers. Regarding the arbitrators, it would have to be impressed upon them that it would not be acceptable simply to seek a middle way between the conflicing positions of the tax authorities and, in any case, presumably the calibre of the arbitrators, and the depth of business knowledge they would have would ensure that the pragmatic approach did not entail woolly compromises. There is also no reason why the functioning of the arbitrators could not be kept under careful scrutiny to ensure that the procedure was working properly. It is really not good enough for matters such as this to be dismissed by the OECD without what appears to be proper consideration.

Allied to the approach of the arbitrators is the question of what their object should be. Obviously, they must seek to avoid economic double taxation, but the question then arises as to whether, in setting out a transfer pricing adjustment, the taxpayer who sought to obtain a tax advantage by artificial transfer pricing arrangements should suffer a tax penalty. It is likely that the OECD are correct in saying[51] that some tax authorities would consider that complete relief from double taxation would be over-generous and, in fact, it might well be appropriate to build in to the procedure some provision for a tax penalty, perhaps, if the arbitrators saw fit in the circumstances of the particular case.

The OECD also identified a problem of how to deal with the situation where double taxation did not arise in a particular case because, for example, one of the taxpayers concerned was making losses. However, assuming that the pragmatic approach is accepted as the correct one for the arbitrators to adopt, surely this cannot be a

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51. Para 49

problem as it would be a factor to be taken into account when the appropriate adjustment is decided upon.

The conclusion of the OECD on these "problems" is that they show that the matter of binding arbitration "is one which would require much international consideration and cooperation if a satisfactory system were to be set up in which a large number of countries could participate"[52]. This is undoubtedly true but, given the amount of international cooperation in the field of international trade that already exists, particularly within such bodies as the OECD and the EEC, such cooperation must be a real possibility and it seems difficult to accept the conclusion of the OECD that "an arbitration procedure must invevitably therefore be a matter which tax administrations would have considerable hesitations about seeking to design even if it was recognised that there was an obvious and urgent need for one". They continued that "it is not in fact clear, however, that there is an obvious and urgent need for such an arbitration process".[53] This is clearly not a view shared by multinational enterprises themselves which have considerable reservations about the present procedure and which see binding arbitration as a positive improvement.

On the other hand, there is one real problem that must be addressed. It was set out by the OECD in their 1984 Report which said "that the setting up of such a scheme [i.e. a binding arbitration procedure] would involve an unprecedented surrender of fiscal sovereignty."[54] Some Member countries have in fact made it clear already that they would find such a scheme quite unacceptable for this reason.

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52. Para 53
53. Ibid
54. Para 55

This is a very important consideration, although more countries now are accepting that their sovereignty in fiscal matters, as in other areas must be diminisehd in favour of greater international cooperation. This is particularly noticeable in, for example, the EEC where positive steps are being taken, particularly as regards VAT, to harmonise the tax systems. There is no denying that this is a long process, but at least the countries involved have been prepared to move towards such a scheme. This is a major restriction on their fiscal sovereignty and, if they are prepared to countenance it in one area, they ought to be prepared to consider it in another. Furthermore, it is relevant to keep in mind that the very process of entering into a double taxation agreement with another country entails a partial surrender of fiscal sovereignty.

In view of the above, the conclusion of the OECD that "these are conclusive arguments against recommending such a scheme [i.e. a binding arbitration procedure]"[55] is surprising. They continue that:

> "It is not in fact apparent that existing arrangements are working so unsatisfactorily that a new form of machinery is imperative. Indeed it seems at present that where there are double taxation agreements very few cases of transfer pricing adjustments lead to adjustments which give rise to unresolveable disputes between the relevant tax authorities or leave the taxpayers suffering significant inequity."

This has been true to a certain extent up to now, but many tax administrations are becoming increasingly aggressive in the operation of their transfer pricing provisions and so disputes are likely to increase. Another factor to keep in mind is that, when a dispute

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55. Para 56

does arise, it usually involves a very large amount of money which may not be significant as far as the tax administrations are concerned, but is usually very significant as far as the taxpayers are concerned.

Certainly, the question of whether a binding arbitration procedure should be introduced is still an open question and the fact that the OECD looked on the question unfavourably in their 1984 Report will probably mean that relatively little effort will be made towards introducing such a procedure in the foreseeable future. This is a shame given that it is submitted that the objections to such a procedure are not as substantial as the OECD seem to consider them to be.

The Procedure in Operation

Having examined the corresponding adjustment and mutual agreement procedures, the points made can be put into context by taking a specific treaty and seeing how the procedure works in practice.

Assume that a company resident in the UK has a subsidiary resident in the USA. The UK company sells its goods to its US subsidiary at cost plus 15%. The UK Inland Revenue taxes the full amount received by the UK company, but the IRS in the USA forms the opinion that the price paid by the US subsidiary is artificially high and that a proper arm's length figure would be cost plus 10%. It therefore disallows the extra 5%. The group therefore finds itself in the position that the additional 5% is disallowed in the USA but taxed in the UK. It is therefore faced with economic double taxation.

The first stage would be for the US subsidiary to argue its case with the IRS and seek to establish that a deduction should be allowed for the full 15%. Assuming domestic remedies fail to resolve the situation, recourse must be had to the relevant double tax agreement.

Article 9 of the Treaty is along the lines of the OECD model quoted above. The actual wording in the UK/USA Treaty is as follows:

> "(1) Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises

but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.

(2) Where any income, deductions, receipts or outgoings which have been taken into account in one Contracting State in computing the profits or losses of an enterprise are also taken into account in the other Contracting State in computing the profits or losses of a related enterprise in accordance with paragraph (1) of this Article, then the first mentioned State shall make such adjustment as may be appropriate to the amount of tax charged on those profits in that State.

(3) If one Contracting State disagrees with the amount of any income, deductions, receipts or outgoings, taken into account in computing profits or losses in the other in accordance with paragraph (1), the two Contracting States shall endeavour to reach agreement in accordance with the procedure in Article 25 (Mutual Agreement Procedure)."

In other words the IRS is entitled to apply the transfer pricing provisions in its domestic law[56] and tax the US subsidiary as if it had carried out the transaction on an arm's length basis. The adjustment to be made by the UK Inland Revenue is then provided for in Article 9 (2), although the Inland Revenue are only obliged to make an adjustment to the extent that it considers that the

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56. Section 482, Internal Revenue Code

adjustment made by the IRS is justified in principle and in amount. This is the problem that has been identitied above where two tax authorities take different views as to the proper arm's length price.

Unlike Article 9 in the OECD Model Treaty, the UK/USA Treaty specifically provides for the use of the mutual agreement procedure.[57] Article 25 of the UK/USA Treaty has been set out above.

The UK Revenue, unlike the IRS,[58] has not issued detailed guidelines on the procedure to be used. In practice, however, the situation is as follows.

Paragraph 11 of the Commentary to Article 25 in the OECD Model (on which Article 25 of the UK/USA Treaty is closely based) notes that the mutual agreement procedure can be set in motion if the taxpayer establishes that the risk of double taxation is "probable". On 26th January 1981 the UK Inland Revenue issued a Press Release giving some sketchy comments on transfer pricing under the title "The Transfer Pricing of Multinational Enterprises". All that this says on the subject is that "a taxpayer who fears that unrelievable double taxation may result in his own case from some action of the tax authorities of a treaty partner may ask the UK Inland Revenue to enter into.... consultations and it will do so whenever the need arises. All that such a taxpayer need do is to write a letter, putting his request and giving the relevant details, to the International Tax Policy Division of the Inland Revenue at Somerset House, London."[59]

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57. Para 3
58. Infra
59. Para 18

Once the taxpayer has submitted this letter to the Inland Revenue, that could be the last part the taxpayer plays in the mutual agreement procedure. Assuming that the Inland Revenue agrees that the taxpayer's claim is valid, it will take the matter up with the IRS without further reference to the taxpayer. The taxpayer might be able to arrange a meeting with the Revenue before the process gets under way but this would be on an informal basis.

Another point is that, the Revenue is only obliged to initiate the mutual agreement procedure if the objection raised by the taxpayer appears to be justified. In practice, the UK Inland Revenue tend only to be sympathetic to taxpayer's claims if there is a significant level of tax at stake. Given the relatively high level of resources required for the Revenue to operate the mutual agreement procedure, this is understandable from the Revenue's point of view although it can lead to injustice and frustration on the part of taxpayers who may have claims involving sums of money which are large to them, but small in comparison to other cases that may be awaiting the attentions of the Inland Revenue.

Regarding the time factor, again a lack of information is a problem but, in practice, when the mutual agreement procedure is used by the UK Inland Revenue, it normally takes between 18 months and two years for a solution to be reached.

Not being able to take part in the mutual agreement procedure once it has been initrated is a universal problem faced by taxpayers throughout the world who seek to invoke the mutual agreement procedure. Should taxpayers have the right to put their case to both competent authorities or even to have face to face discussions with them? Or, if this is not practical, perhaps they could be kept informed of the progress of the discussions between the relevant tax authorities.

The OECD, however, in their 1984 Report thought that:

> "Formal rights for the taxpayer to appear and be heard in the discussion between the competent authorities would.....be out of place".[60]

The reason they reached this conclusion was that, in their view, the mutual agreement procedure is not a process of litigation but is rather a discussion between the competent authorities to find a way of solving the problem that has been placed before them.

They did, however, concede that taxpayers should be given every reasonable opportunity to present the relevant facts and arguments and, further, that they should be kept informed of the progress of the discussions.[61]

It appears that, in many cases, taxpayers are not given these opportunities, or they feel that they have not been given sufficient opportunity to present their arguments to the competent authorities. On the other hand, the OECD would appear to be right in saying that it would be inappropriate to go as far as creating a quasi-judicial structure. If more countries adopt the recomendations of the OECD in giving the taxpayers sufficient opportunity to present the facts and arguments, and ensure that the tapayers are kept fully informed of the progress of the discussions, the reservations and frustrations felt by many taxpayers about the mutual agreement procedure might be reduced.

A related point is made in the 1984 OECD Report. It says:

> "It has been pointed out that in many cases [a multinational enterprise] faced by the problems created by an adjustment of its profits in one State which has an effect on the tax liability of another part of the [multinational enterprise] in another

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60. Para 98
61. Para 100

> State, has been able to resolve these problems by its own efforts. In fact, it seems likely that [a multinational enterprise], when faced with an adjustment in State A which might require a counter-adjustment in State B would thereupon examine the question of such a counter-adjustment under the laws of country B, make appropriate arrangements and seek to settle the case eventually by negotiations with the tax authorities of that State. There are obvious advantages in this procedure and Member country tax administrations would generally wish to encourage [multinational enterprises] to seek to resolve their problems in this way before pressing for a formal mutual agreement procedure."[62]

This seems a sensible suggestion and the 1984 OECD Report notes that suggestions along these lines have been incorporated in the guidelines of Germany and the United States.[63]

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62. Para 101
63. Infra

A Comparison of the Transfer Pricing Provisions in other Countries

Introduction

Most countries have now enacted provisions along the lines of section 770 ICTA 1988 to combat the transfer pricing manoeuvres of multinational companies. The wording and operation of these provisions vary widely and it is, therefore, instructive to consider some of the forms these provisions can take and compare them to the UK rules. Set out below is an analysis of the transfer pricing provisions in a number of major industrial countries.

It will be seen that some countries have issued detailed regulations and guidelines to supplement the transfer pricing legislation. The main countries to have adopted this procedure are the USA and Germany. On the other hand other countries, such as the Netherlands, have enacted very general provisions.

One relevant point to be kept in mind when examining these various provisions is that, when transfer pricing arrangements concern a company in a low tax country, the object of the exercise is normally clear, i.e., to reduce the overall tax burden of the group. However, often transactions are between companies situated in countries with comparable tax rates. It may be, of course, that there are particular tax shelter opportunities in one country or, perhaps, one company may have losses to set against profits and, here again, the object of the exercise is normally clear.

However, this may not be the case and there may be no obvious tax benefit to be obtained for either of the companies involved. In these situations, the two companies will be concerned, less with saving tax, as with avoiding double taxation. To this end, the taxpayers will be interested in precise and clear legislation and consistent and reliable procedures on behalf of the tax administrations. Unfortunately, sometimes the legislation is not sufficiently precise and the tax authorities may not be either consistent or helpful in their operation of the transfer pricing provisions.

It will be seen that the main influence in the drafting of a large number of these provisions was the 1979 OECD Report. Even in the UK, where there is a complete lack of regulations or other guidance to aid the application of the transfer pricing legislation, the Inland Revenue have said, in the Press Release of 26 January 1981 referred to above, that they will be guided, in their search for an arm's length price, by the 1979 OECD Report.[64]

The Press Release states:

> "In ascertaining an arm's length price the Revenue will often look for evidence of prices in similar transactions between parties who are in fact operating at arm's length. They may however, find it more useful in some circumstances to start with the re-sale of the goods or services etc and arrive at the relevant arm's length purchase price by deducting an appropriate mark-up. They may find it more convenient on the other hand to start with the cost of the goods or services and arrive at the arm's length price by adding an appropriate mark up. But they will in practice use any method which seems likely to produce a satisfactory result."[65]

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64. Para 16
65. Ibid

The Press Release was here referring to the four methods considered in the 1979 OECD Report for reaching an arm's length price. These methods have been widely adopted in transfer pricing legislation around the world. They are:

1. Comparable uncontrolled prices. The 1979 OECD Report points out that making a judgment whether a particular price conforms to the arm's length standard would ideally require direct reference to prices in comparable transactions between enterprises independent of each other. This method, said the Report, was in principle the most appropriate to use and in theory the easiest. However, the Report also acknowledges the undoubted fact that such evidence is often not readily available, and so other methods have to be used.[66]

2. The resale price method. This is the method mentioned in the Press Release of starting with the price at which the goods are sold to arm's length purchasers and deducting an appropriate mark up.[67]

3. The cost plus method. This is effectively the opposite, starting with the cost and adding a mark up.[67]

4. Other methods. This general description covers any other method considered to be appropriate in the circumstances. The 1979 OECD Report states:

> "The complexities of real life business situations may put many conceptual and practical difficulties in the way of the application of the methods referred to

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66. Para 11
67. Para 12

> above. A mixture of these methods, or other methods still, may sometimes therefore have to be used. Any method which is used will involve problems of judgment and the evaluation of evidence and it has to be recognised that the object of using it is to produce a figure which is acceptable for practical purposes. Experience shows that the difficulties can in general be satisfactorily dealt and acceptable prices agreed."[68]

Many countries look into the above methods in the order they are set out above, although it should be noted that the 1979 OECD Report itself did not express any preference between the resale price and the cost plus methods. In the UK there is no generally accepted order in which the various methods are used. The same is true in Japan.

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68. Para 13

United States

The relevant provision in the USA is Section 482 of the Internal Revenue Code which runs as follows:

> "In any case of two or more organisations, trades, or businesses (whether or not incorporated, whether or not organised in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organisations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organisations, trades, or businesses."

It can be seen that the section can be applied, not only where there is a transactions between a resident and a non-resident entity, but also where two resident or two non-resident entities are involved.

This provision is supplemented by detailed regulations which define the terms used in the section and also give detailed examples of specific calculations. Further guidance can be obtained from a considerable body of case law that has grown up on the operation of the Section.

Both of these factors contrast strongly with the position in the United Kingdom where there are no regulations at all to assist in the interpretation of section 770 ICTA 1988 and where there has only been one case on a relatively minor aspect of the section.

Another difference is that, in the USA, the IRS has issued guidelines on the enforcement of Section 482 cases and these have been published so that they can be consulted, not only by IRS officials but also by taxpayers and their advisers.[69]

The publication of these guidelines is helpful to taxpayers and their advisers in that it enables them to consider the sort of things likely to be scrutinised by the IRS and to conduct their affairs accordingly. Similarly, the detailed regulations give taxpayers a precise idea of the scope of Section 482 and taxpayers have a much clearer idea than their counterparts in the UK of what falls within the transfer pricing provisions.

The key to the application of section 482 is that the two entities must be "owned or controlled directly or indirectly by the same interests". This is explained in the regulations at section 1.482-1(a)(3) as follows:

> "It is the reality of the control which is decisive not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."

It can be seen that this is quite wide. Early cases suggested that control without ownership was not sufficient for the application of the section. However, recently, courts have been more prepared to apply the section where control exists but formal ownership does not. For example, in <u>Cadillac Textiles Inc</u>[70] the section was applied on the basis that the stockholders and partners were members of the same family and could collectively exercise control.

According to the Regulations section 1.482-1(b)(1):

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer."

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69. These guidelines are set out in the Internal Revenue Field Manual.
70. 1975 TCM 46

It can be seen that as in the UK, the test is whether the parties are acting on an arm's length basis; it is not necessary for there to be a tax avoidance motive. This is shown, for example, by the case of Eli Lilly & Co v US.[71] Here a parent company sold goods to its subsidiary at a price below the arm's length price but was able to show that this was not to avoid US taxes, but was merely an effort to expand and develop its foreign business. Despite this, section 482 was supplied because the below arm's length price "resulted in a failure to reflect clearly Eli Lilly's income from manufacturing and this is enough to warrant an allocation under section 482".

On the other hand, if there is a tax avoidance motive but the parties are at arm's length or if the parties are not sufficiently related, the section cannot be applied. See, for example, Davies v US.[72]

Another limitation on the application of the section has been established by the Supreme Court. This is that those who control the party in question must have complete power to shift income. This was shown by the case of CIR v First Security Bank.[73] In this case the Supreme Court refused a request by the IRS to reallocate certain insurance premium proceeds to the controlling bank because, by virtue of certain other regulations, the bank could not legally have received the premium income.

The regulations deal with the question of primary and correlative adjustments. If, for example, a primary adjustment is made so that, for example, extra income is allocated to a US taxpayer, a correlative adjustment (that is, a corresponding reduction of tax of the related party) must be made by virtue of Regulation section 1.482-1 (d) (2). This regulation states that:

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71. 372 F 2nd 990 (1967)
72. 282 F 2nd 623 (1960)
73. 405 US 394 (1972)

> "Thus if the District Director makes and allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the United States income tax liability of the other member for any pending taxable year."

This does, of course, only relate to US tax liabilities and cannot force a foreign tax administration to make an appropriate adjustment. To achieve this, the taxpayer must go through the mutual agreement procedure.

Another respect in which the US procedure is better than that in the UK is that the IRS have issued Revenue Procedure 70-18,[74] which sets out the procedures taxpayers should use to initiate the competent authority rules. These are much more helpful that then the brief notes issued by the UK Inland Revenue in 1981.[75]

Regulation section 1.482-1(d)(2) concerns a doctrine called the "creation of income" doctrine under which the Commissioner can adjust income and deductions, even if there is no gross income in practice available to allocate. This can be done insofar as a correlative adjustment is made to the other party.

The regulations set out how the relevant adjustments are to be made. For example, in the case of sales of tangible property, Regulation section 1.482-2(e)(1) states that the price to be determined between the buyer and seller is the price that an unrelated party would have paid for the property under the same circumstances.

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74. 1970-2 CB 493
75. Inland Revenue Press Release 26 January 1981

The Regulations set out three specific methods at arriving at an arm's length price and the order in which these three methods are to be applied. In addition, a fourth method is available if the conditions required for the other three methods are not satisfied. The three main methods, and the order in which they are to be used unless the taxpayer can prove otherwise are:

(1) The "comparable uncontrolled price" method;

(2) The "resale price" method;

(3) The "cost plus" method

It can be seen that the first three methods are those set out in the 1979 OECD Report although, unlike the OECD, the US Regulations express a preference between the resale price and cost plus methods.

Also in line with the OECD recommendations, Resulation section 1.482-2(e)(1)(iii) states that if, in relation to the circumstances of a particular case, none of the first three methods can reasonably be used, the taxpayer may use another method provided that it is "appropriate".

If there can be found comparable uncontrolled sales, namely, sales of the same goods under similar circumstances but to unrelated parties, that is the price that will be taken to be the arm's length price. The section 482 Regulations lay down a rigorous standard of comparability. The goods sold and the circumstances of the unrelated party sale must be identical to the related party sale or so nearly identical that any difference in price can be reflected by a "reasonable number of adjustments". In addition, the sale will only be considered to be comparable where the differences in the type of goods sold or the circumstances of sale "have a definite and reasonably ascertainable effect on price."[76]

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76. Reg 1.482-2(e)(1)(ii)

See, for example, the case of Johnson Bronze.[77] The taxpayer company here sold goods to its Western Hemisphere Trade Corporation at a price made up of the manufacturing costs, overheads plus a profit of 6%. This profit was shown to be the average profit earned by the taxpayer company on all of its sales of all of its products. However, the price thus obtained was not accepted, and the court instead took the price which the taxpayer sold the goods in question to an unrelated customer.

In Nissho Iwai American Corp v CIR[78], the court relied on comparable uncontrolled sales figures advanced by the taxpayer. However, in Paccar Inc & Subsidiaries v CIR,[79] this method was rejected because of differences in the geographic market. The resale price method was used instead.

Sometimes there may even be scope for a taxpayer to manipulate the comparable uncontrolled price method for its own benefit. See, for example, US Steel Corp v CIR.[80] In this case, an offshore transportation subsidiary of the taxpayer (a US corporation) had some contracts with outsiders but these constituted only 5% of its business. The taxpayer paid the offshore company at the same rate. Contracts with the taxpayer had created a favourable comparable price and it was attacked by the IRS. However, the comparable was accepted by the court. The IRS had attempted to use a "fourth method" (ie. not one of the three specified in the section 482 regulations), namely, an allocation of overall profit proportionate to the costs incurred by the taxpayer and the offshore subsidiary.

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77. 24 TCM (1965)
78. 50 TCM 1485)
79. 85 TC 754 (1985)
80. 617 F 2d 942 (2d Civ 1980)

If the comparable uncontrolled price method is not appropriate, the next test is the "resale price method". This method is used when a sale between related companies is followed by a sale to an unrelated third party. Regulation Section 1.482-2(e)(3)(ii) lays down the following conditions:

(1) The applicable resale price (namely, the second sale to the unconnected third party) must be available.

(2) Before the resale to the unconnected third party the buyer-reseller must not have added more than an "insubstantial amount" to the value of the property, either by physically altering the property or by employing an intangible asset.

(3) The Regulation specifies that packaging, labelling or minor assembly operations do not constitute a physical alteration of the property. An "insubstantial amount" is not defined but, from examples set out in the Regulation, it appears to be around 10%.

This method can also be used, even if the added-value requirement is not satisfied if the intermediary's functions are easier to evaluate in the transactions in question than those of the original manufacturer.

The way the arm's length price is found is to take the "applicable resale price" and subtracting an "appropriate markup percentage". The "appropriate markup percentage" is the gross profit expressed as a percentage of sales earned by the buyer-reseller or others in a similar position on a resale of similar property both bought from and sold to unrelated parties under similar circumstances. If the taxpayer has no such sales, reference may then be made to similar taxpayers or to industry-wide figures or, if foreign figures are unreliable, to US figures.

It can be seen that the Regulations go to great lengths to find a fair arm's length price. They even contain criteria for determining whether the uncontrolled sales are similar to controlled sales; and, if necessary, adjustments can be made to account for differences. No guidance is, in fact, given on how to measure such differences but such criteria would undoubtedly be very difficult to draft with precision. In determining whether sales are similar, factors to be taken into account are the type of goods involved, the functions performed by the buyer-reseller, the effect on price of intangible property, the geographic market in which the buyer-reseller performed the function, and whether there are differences in the accounting treatment of the various cost elements such as freight, packaging, returns of faulty merchandise etc.

If there are a number of differences, this method may become inappropriate and it may then be necessary to move on to the third method.

The "cost plus" method can be used not only where there are difficulties in applying the resale price method, but also if the original seller's cost factors are easier to evaluate than were the buyer-resellers. This might be the case, for example, where the original seller was merely buying and reselling the goods, but the intermediate buyer-reseller incorporates the goods into another product.

Regulation section 1.482-2(e)(4)(i) states that the arm's length selling price is the seller's cost of producing the property plus an appropriate profit. The appropriate profit, according to Regulation section 1.482-2(e)(4)(iii), is a gross profit percentage which is applied to the cost of producing or purchasing the properties. This would normally be the gross profit earned by the seller on the sale of comparable property sold under similar circumstances to an uncontrolled purchaser. However, if no similar transactions can be found, the allocation can be based on percentages of other similar taxpayers.

The rate of profit applied in sales to unconnected parties cannot be used in determining the controlled sales profit unless the uncontrolled sales are comparable or the differences involved are capable of measurement. Regulation Section 1.482-2(e)(4)(iii) sets out a list of factors which are taken into account.

The description of the operation of Section 482 set out above concentrates on the sale of goods but the Section and the Regulations also deal with transactions involving transfers of intangible property, leases, the rendering of services and loans and advances.

In fact the USA adopts a special rule for pricing intangible property. Section 482 was amended by the Tax Reform Act 1986 to state that the income from a transfer or licence of intangible property shall be commensurate with the income attributable to the intangible. This is sometimes known as the "super royalty" principle and, at the moment, only the USA operates such a system. A detailed White Paper by the US Treasury Department and the IRS has been published describing methods of valuing intangible property. It is not necessary to examine the contents of the White Paper here. It can be commented that the complicated procedures set out in the White Paper, which are likely to be made law in due course, have not yet been mirrored in the laws of other countries, and could well increase disputes between the IRS and other tax authorities and the incidence of double taxation, particularly as super royalty procedures are not really catered for in double tax agreements. The White Paper proposals will also, if enacted, greatly increase compliance costs through the need for more documentation and the need to meet greater reporting requirements.

Also the, USA demands more stringent reporting by its taxpayers in relation to section 482 as a whole than is demanded by most other countries. A US taxpayer is obliged to file form 5471 each quarter. Failure to do so can result in a fine of up to $10,000 or one year's imprisonment. On this form, the US taxpayer must disclose the relationship between it and the foreign entity and all receipts, payments etc., as well as inter-company current accounts at the beginning and the end of each quarter.

In conclusion, it can be seen that the operation of section 482 is clarified by detailed Regulations as well as published guidelines which assist both taxpayers and the IRS in applying the section to the transactions in question. This is in stark contrast to the lack of guidance on the operation of section 770 in the UK.

As regards the competent authority procedures, these are initiated in the USA in a similar way to the UK. A written request for the intitiation of the competent authority procedures should be sent to the appropriate office of the IRS, normally while the case is being audited.

As mentioned above, detailed rules for the operation of the competent authority procedure in the USA have been published, in contrast to the position in the UK.

As in the UK, the taxpayer cannot compel the IRS to implement the competent authority procedures although, if the IRS turns down the taxpayers request, the taxpayer can ask the Commissioner of Internal Revenue for a review by a panel chosen by the Commissioner. The taxpayer has a right to attend the hearing and present oral arguments.[81] However, the decision of the review panel is final.

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81. Revenue Procedure 79-31

If the competent authority of the other state refuses to enter into negotiations, the US authorities can grant unilateral relief to the US taxpayer even if this means overriding a transfer pricing allocation made by the US tax authorities. Again, however, the US authorities are not obliged to give unilateral relief and factors taken into account in deciding whether such relief is given include such things as the absence of actual or constructive notice of the proposed allocation, so that the taxpayer may not have availed itself of remedies in foreign jurisdictions, the absence of abusive tax arrangements in the transactions in question, and the absence of recurring adjustments. It is made clear that no relief will be granted where there is fraud or negligence in the relevant transactions.[82]

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82. Ibid

West Germany

The German transfer pricing provision, introduced on 1st January 1972, is the Foreign Tax Law (Aussensteuergezets -"AStG").

Section 1 provides that if the income of a taxpayer has been reduced as a result of an international business transaction at less than arm's length with a related person, the taxpayer's income must be adjusted upwards to reflect what the result of an arm's length transaction would have been. The section applies only to international transactions. There are separate rules dealing with constructive dividends and for constructive contributions to capital which both apply to domestic transactions.

As in the UK, there is no requirement that the taxpayer sought to avoid tax, all that is needed is that there has been a reduction in the amount of income subject to German tax. However, unlike the position in the USA, there is no requirement for a correlative adjustment and so taxpayers are dependent solely on any such relief as may be contained in the relevant tax treaties. Where there is no such tax treaty in a particular situation, the taxpayers may be in a difficult situation.

A taxpayer will be considered to be related with another person if:

(a) the person holds directly or indirectly an interest of at least 25% in the taxpayer or if the person is in a position to exercise directly or indirectly a dominating influence over the taxpayer or, conversely, if the taxpayer holds an interest of at least 25% in the person or is in a position to exercise, directly or indirectly, a dominating influence upon such person; or

(b) a third person holds an interest of at least 25% in such a person as well as in the taxpayer or if such a third person is in a position to exercise directly or indirectly a controlling influence upon both of them; or

(c) the person or a taxpayer is in a position when negotitating the conditions of the business transactions to exercise on the taxpayer or such person an influence which is based on factors outside of such business relationship, or if one of them has an interest of his own in seeing the other party generate such income.[83]

On 23rd February 1983, the German authorities published their "Administrative Principles for the Allocation of Income" in an attempt to ensure uniformity in questions of transfer pricing. The test and criteria used are very similar to those set out in the US Regulations under Section 482.

Previously, the authorities used a translation of the US Regulations and a Handbook for Examination of Foreign Operations which, although not officially published, was unofficiallly available to taxpayers and their advisers. However, with the publication of the Administrative Principles, matters were put on a more formal footing.

The Administrative Principles set out the criteria on which transfer pricing adjustments should be made. They acknowledge that every company ought to make an adequate return on its capital or a gross profit which is compatible with that of its competitors.

The "reasonable return on capital employed" method would be appropriate, for example, to manufacturing industries where a considerable amount of capital is used. Here the

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83. Section 1(2) AstG

authorities would be looking for a return of perhaps between 7.5% and 10%, although this varies from industry to industry.

Capital may not be such an important feature for many trading companies, and here the adjustment is likely to be based on the normal gross profit percentages in the particular industry.

If it is appropriate to compare prices with those used by other companies operating on an arm's length basis, then this is a third test that can be used.

It can be seen that these three tests are very similar to the three criteria set out in the 1979 OECD Report and the section 482 Regulations in the USA.

The Principles acknowledge that there may be circumstances in which low profits or, in some cases, losses might be justified. These circumstances are as follows:

(1) Where losses are incurred in introducing products in a new market.

(2) Where losses are incurred because of management error or because of error by a foreign parent company.

(3) Where there is a newly established company, it is acknowledged that it may take 5 or 6 years to become profitable.

(4) Where losses are incurred because of general market conditions, bad debts or other extreme circumstances.

If one of the above factors is not present, then the authorities will look at the reason for the losses and, if they discover artificial transfer pricing manoeuvres, they will make the appropriate adjustments.

It can be seen that, in many respects, the Administrative Principles are similar to the Regulations used in the USA which in turn are based on the criteria in the 1979 OECD Report. More and more countries are using the 1979 Report as a basis for their transfer pricing guidelines.

As regards secondary adjustments, this is achieved in Germany by postulating a constructive dividend when the benefit from the transfer pricing accrues to a parent company, and by postulating a deemed contribution to capital when the benefit from the transfer pricing goes to a subsidiary country.

Under German law, a constructive dividend occurs when there are transactions between a subsidiary and its parent which are not what a normal prudent businessman would have done in dealing with an independent party. In such cases the higher tax rate on retained earnings will be applied (56%) as opposed to the lower rate for distributed profits (36%).

The Germany authorities made a Ruling, applicable to all of its treaties, on 15 May 1974.[84] The Ruling stated that, if the German authorities reallocate profits to a German subsidiary company, the amount reallocated will be considered a constructive dividend to the foreign parent. Withholding tax at the appropriate treaty rate would then be payable.[85]

A disguised contribution to capital occurs when a subsidiary receives a benefit which would not normally be received if the two companies were acting on an arm's length basis. Where such a benefit arises, the money involved is subject to the German capital contribution tax at 1%.

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84. Ruling Oberfinanzdirektion (OFD) Frankfurt (S1301 A-A11-21-St II 4a)
85. A similar ruling was made in France on 9 April 1965, infra

The transfer pricing regulations are not, of course, restricted to goods, but also apply as in other jurisdictions, to such things as interest payments, royalties and management fees.

One topic which comes in for particular scrutiny is that of management fees. These are disallowed unless it is shown that such fees would be paid between unrelated parties. The German tax authorities make a distinction that can be found elsewhere[86] between management fees which constitute stewardship costs and those which are payable for assistance in improving the paying company's profitability. The authorities will disallow management fees which are in return for no more than overseeing functions; whereas they would normally allow fees paid in return for assistance provided in terms of local management as long as they can be established as being specifically for the benefit of the local company, and the services have been requested by the local company rather than imposed by the parent. It is also important that the fees can be clearly distinguished and quantified and adequately documented.

The Administrative Principles give examples of the sort of fees that would be allowed and the sort of fees that would be disallowed. The following are expressed as being allowable:

(1) The assumption of bookkeeping work and the performance of similar services such as specific consulting services concerning the economic and legal matters of the subsidiary.

(2) The seconding of employees for specified periods.

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86. For example, in the UK/USA double tax agreement.

(3) The training and education of personnel.

(4) Services rendered by the parent for the purpose of supplying merchandise.

As regarding the competent authority procedure, as in other jurisdictions, a taxpayer can complain to the German authorities that he is suffering double taxation in contravention of the relevant treaty. The German authorities are normally prepared to initiate the competent authority procedure where there is economic double taxation, even though there may not be double taxation from a strict legal point of view (that is, double taxation on the same income). In Germany, an agreement under the competent authority procedures will override domestic court decisions and any time limits imposed by statute.

It has been established in the courts that the authorities are not obliged to initiate the competent authority procedure if they consider that the rules have been abused.

It can be seen that, as in the USA, the German authorities have taken care to set out in detail the principles they will follow in determining transfer pricing quesions. This is of great assistance, not only to German tax officials, but also to taxpayers and their advisers and provides for much greater certainty and precision in the operation of the transfer pricing rules and in the organisation of taxpayers affairs, because taxpayers and their advisers can keep in mind the detailed guidelines set out by the tax authorities in planning their international operations. Taxpayers are therefore operating in a much more certain environment than their counterparts in the UK.

France

The relevant statutory provision in France is Article 57 of the Tax Code ("CGI"). This states as follows:

> "For the assessment of income tax due from enterprises which are controlled by or which control enterprises which are established outside of France, the income which is indirectly transferred to the latter, either through the increase or the reduction of purchase or sales prices, or through any other means, shall be added to the results shown in the financial records. The same procedure is followed with respect to enterprises which are controlled by an enterprise or a group of enterprises which also control enterprises located outside of France. If the precise data is lacking to make the adjustments provided for in the preceding paragraph, the taxable profits are determined by comparison with the profits of similar ongoing enterprises."

The French provisions are similar to those in the USA, and unlike those in Germany, in that "control" is not defined in the statute. However, guidance has been given in a Note published in the Official Bulletin which states that a French company is controlled by a foreign company where either:

(1) the latter possesses a predominant part of the former's capital; or
(2) it owns more than 50% of its voting rights; or
(3) it exercises, directly or through intermediaries, such functions that it has the power to make decisions.

The intermediaries can be the managers and directors of the controlling company, or the members of their families, any corporation which is also controlled by the controlling corporation, or any person owning an interest in the trade or other business operations of the controlled or controlling companies or in their capital.

Under the Finance Act 1982, a transfer pricing reallocation takes place even if the control test is not satisfied where the beneficiary of the transfer pricing is organised in a jurisdiction having a privileged tax system.

Case law has established that, even if legal control does not exist, de facto control can exist between two companies. This might arise, for example, where the financial interests of the two companies coincide by virtue of contractual relationships between them.

The French provision is similar to that applicable in Germany, but different to that in the USA, in that, for a transfer pricing adjustment to be made, there must be a shifting of income abroad.

As is common with most transfer pricing provisions, the French section applies not only to the sale of goods but also to things such as royalties, interest and services.

In determining an arm's length price, there are no specific regulations or guidelines setting up the method which should be used. Accordingly, the tax authorities can use any method they wish to prove that a price is not an arm's length one. In this respect, it is relevant to note that, in France, larger companies are dealt with by Inspectors who are specialised in the particular industry in question and who therefore are in a good position to form a view as to non-arm's length prices.

Although no formal regulations are used, in practice, the methods normally used are the same as the three main criteria in the 1979 OECD Report, namely, the comparable uncontrolled price method, the cost-plus method and the resale price method.

An interesting case on Article 57 CGI and its corresponding Article in French double tax agreements was heard by the Conseil d'Etat on 14 March 1984.[87] It demonstrates the point that prices below market value between associated parties can sometimes be justified. It also contains a rather unusual interpretation by the court as to the interrelation of domestic law and treaty provisions.

A French company manufactured spark plugs. It had various sales subsidiaries: one each in Belgium, Germany, Italy, Switzerland and in France itself. The French sales subsidiary was the taxpayer company in the present case.

The taxpayer company reached an agreement with Renault, with whom it was not associated, to sell spark plugs to Renault for F0.30 each but it was also agreed that Renault would buy replacement plugs for F2.27 each. The taxpayer paid the manufacturer F1.40 for the replacement plugs, so its margin was F0.87. Renault was not, however, obliged to buy the plugs from the taxpayer and the market was an extremely competitive one.

In order to canvass Renault dealers outside France, the taxpayer company decided to use its fellow overseas subsidiaries. To break into the competitive foreign markets, the taxpayer company agreed for a limited period to pay its fellow subsidiaries a commission of F0.87 per plug, ie, its entire margin. This plan, in fact, was extremely successful in generating business in the foreign markets.

The French authorities applied Article 57 and adjusted the taxpayer company's profits claiming that the commissions

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87. Req Nos 34.430 and 36.880

were excessive. Furthermore, the increased profits were treated as deemed distributions and subjected to withholding tax at the appropriate treaty rate. Penalties were also imposed.

The taxpayer company, on the other hand, claimed that it was not caught by either Article 57 or the corresponding treaty articles. It argued that the commissions paid to its fellow subsidiaries were in fact less than the costs it would have incurred if it had chosen to use its own salaried salesmen, and that its costs in countries where it had no fellow subsidiaries were higher than those in the countries where there were fellow subsidiaries.

The court held that the taxpayer company "had proved that the apparent generosity accorded by it represented payment for a commercial service which benefited its own interests, and accordingly, constituted an act of normal management". As a result, the assessments were discharged.

This is the straightforward aspect of the decision and appears to be completely justified in the circumstances. However, the court also dealt with the interrelation of domestic law and the relevant treaties. It was considered that the "Associated Enterprises" articles (which were here all based on Article 9 of the Model Treaty) allow the authorities to apply domestic law to determine whether profits have been transferred abroad.

This seems to be looking at the problem from the wrong angle in that one should first examine the domestic law to see whether a tax liability arises. If it does, then the treaty must be examined to see whether it overrides that conclusion.

Another interesting side issue related to the withholding tax levied by the tax authorities. The court noted that an earlier decision of the Conseil d'Etat (26 November 1982) had held that the levying of withholding tax on deemed distributions in such circumstances as these was, in the case of distributions to a German resident, precluded by the "Other Income" Article in the France/Germany treaty. Similar articles could be found in the treaties with Belgium, Italy and Switzerland. So even if the main assessments had stood, the withholding tax assessments would have been discharged.

If a taxpayer disagrees with a transfer pricing reallocation, he may appeal to the Commission Departementale des Impots. This body consists of three senior tax officials and four private individuals (whose role is to represent the taxpayers) and it is presided over by a magistrate who has a casting vote. If the Commission approves the adjustment, the burden of proof shifts from the tax authorities onto the taxpayer who must then, in subsequent court proceedings, prove that the adjustment is unjustified.

Even if it is established that the requisite relationship exists and that profits were shifted abroad, the taxpayer can still succeed if it can be proved that the transfer pricing was commercially justifiable and not implemented with the object of siphoning profits abroad in order to avoid French taxes.[88] For example, the French company may have had to reduce its prices in order to meet foreign competition. In fact, in a Note issued on 4th May 1973, the tax authorities recommended to its Inspectors that they should not apply Article 57 in respect of sales which, for commercial reasons, have been made to foreign companies at reduced prices to combat competition.

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88. This contrasts with the position in, say, the UK and the USA where no tax avoidance motive is required for the application of the transfer pricing rules.

However, this relaxation applies only to sales to subsidiaries and it must be proved that the competition in the country where the subsidiary is situated is intense. Furthermore, even if these two conditions are met, the tax authorities are not legally bound to accept the reduced price and, if they refuse to do so, their decision cannot be challenged in court.

This Note is indicative of a trend seen in practice that the French authorities tend to be more flexible in the administration of their transfer pricing provision than many other countries, particularly the USA.

Where profits are attributed to a French company pursuant to a transfer pricing adjustment, those profits will be deemed to have been distributed abroad and, where appropriate subject to withholding tax.[89]

As in the other countries already considered, a taxpayer in France may, in appropriate circumstances, use the competent authority provisions by asking the tax authorities in France to negotiate with the other country to avoid economic double taxation. The French authorities have not issued detailed guidance on the procedures to be followed because it is considered unnecessary in the light of the relatively small number of cases considered each year (about 40).

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89. This was confirmed in Reply to a question issued by the French authorities; Rep Chauvet (J.O deb. A.N April 9 1965 p705 No 12894 BOCD 1965-11-2966). A similar ruling was issued by the German authorities on 15 May 1974, supra.

Belgium

The relevant transfer pricing provision in Belgium is Article 24, CIR. This is nothing like as far reaching as section 482 in the USA or section 770 in the UK because the arm's length test is only applied where there are transactions between Belgian entities and foreign entities situated in a more favoured tax regime. All abnormal benefits enjoyed by these foreign entities will be disregarded for Belgian tax purposes and the profits of the foreign company may be added to those of those of the Belgian company.

The wording of Article 24 is as follows:

> "When an enterprise established in Belgium has directly or indirectly any ties of inter-dependence with an enterprise established abroad, all normal or benevolent advantages which by reason of such ties it grants to the latter or to persons and enterprises having with the latter common interests, are added to its own profits."

As with most other transfer pricing provisions, this Article deals with goods, services, the use of tangible and intagible assets and interest.

Although the Article is normally only used in an international context, there have been occasions when it has been used in transactions on a non-arm's length basis between two Belgian companies. For example, in a case heard by the Cours de Cassation on 20th September 1972, Article 24 was applied where there had been a sale of stock between a Belgian parent and its Belgian subsidiary but where the parent was controlled by a UK-company. It was held that the subsidiary was indirectly controlled by a foreign parent and a tax advantage was granted to a company having a common interest with the foreign parent.

Although, Article 24 is more restricted in its operation than, for example, section 770 in the UK, there are other provisions in the Belgian tax code that may have some bearing on artificial transfer pricing arrangement. For example, under Article 46, interest, royalties and fees for services which are paid to a foreign company subject to a privileged tax regime would not be allowed as business expenses unless the taxpayer can prove that the payments were made for bona fide commercial reasons and that they were not excessive.

This is similar to the position in the UK where the operation of section 770 may be supplemented by the application of the "wholly and exclusively" test in section 74(a) ICTA 1988. In fact, Belgian law itself contains what amounts to a "wholly and exclusively" expenses test.[90]

In determining the proper arm's length price, there have been issued no detailed guidelines or regulations as in, for example, the USA, although preference appears to be shown to the "cost-plus" method. A comparison with at least three other taxpayers in similar circumstances is allowed for this purpose.

Under Article 24 CIT, when abnormal profits are reallocated to the Belgian company, they are taxed as ordinary profits even if they did not, in fact, constitute ordinary profits (because, for example, they were long term capital gains). However, a disguised dividend to a parent company would normally be taxed as a dividend.

The transfer pricing question will initially be dealt with by the Belgian company's normal tax inspector but his decision can be challenged by the taxpayer appealing to the Director of Taxes. Any further appeal must be taken through the courts.

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90. Art 44

The Belgian competent authority procedures are somewhat different from those in the countries already considered and, in many respects, less beneficial to the taxpayer. For example, the Belgian authorities would not normally institute the procedures where there is only economic double taxation but not strict legal double taxation.

The UK/Belgium Treaty, like most of the treaties negotiated by Belgium, does not make specific provision for consultation between the competent authorities because Belgium has reserved the right to omit paragraph 2 of Article 9 of the OECD Model Treaty.[91] Belgium does, however, have a few treaties where there is specific provision for consultation between the competent authorities.[92]

As in the other countries considered so far, to initiate the competent authority procedures, a taxpayer must submit a written request to the Belgian tax authorities. The request is, in fact, sent to the Regional Tax Director of the region in which the taxpayer company has its fiscal domicile, although requests can also be sent to the Minister of Finance or the Director General of Direct Taxes. The time limit for the submission of such claims under most Belgian Tax Treaties is two years from the date on which the taxpayer first becomes aware of the assessment which creates the double taxation, although some of the more recent treaties use the three year time period of the OECD Model Treaty.

Once the taxpayer has submitted his written claim, the Regional Tax Director will first see whether he can resolve the matter without reference to the competent authority of the other country. The Regional Tax Director may decide that the taxpayer's liability should be adjusted downwards. However, if such unilateral

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91. Supra
92. See, for example, the Belgium/France and the Belgium/USA treaties.

action is inappropriate, he will refer the matter to the Director-General for Direct Taxes for the matter to be taken up with the competent authority of the other country. As in the UK, the taxpayer has no right to participate in the negotiations between the two countries nor even know how the negotiations are proceeding.

Once a decision has been made, the taxpayer can appeal against it within 40 days to his regional Court of Appeals which has the power to overturn the agreement made by the competent authorities.

Belgian competent authority negotiations tend to take about two years to resolve and around 20 requests a year are made to the Director-General for Direct Taxes.

Although Belgian law allows the Belgian tax authorities rather less scope than in many other countries, the authorities try to be as flexible as possible in the operation of the competent authority procedures and may even find indirect ways to help the taxpayer if the statute of limitations has technically expired by, for example, allowing the Belgian company to insert an additional expense in its books in accordance with the agreement made with the competent authority of the other country.

The Netherlands

There are no provisions similar to section 770 specifically aimed at transfer pricing, but the Dutch tax authorities do examine transactions between related persons to determine whether they have been carried out on an arm's length basis. If they take the view that the transaction was not on an arm's length basis, the profits of any Dutch taxpayers involved are likely to be adjusted accordingly. This right has been confirmed in a number of Court cases.[93]

In particular, where there is a parent-subsidiary relationship, hidden dividend distributions or capital contributions are ignored in arriving at taxable profits.[94]

In practice, the definition of associated companies in the OECD Model Treaty is used, although case law has tended to restrict the rules to cases where companies are connected either in a parent-subsidiary relationship or through joint shareholders.[95]

In determining an arm's length price, there are no regulations as there are in, say, the USA but the OECD recommendations in their 1979 Report tend to be used and, accordingly, the comparable uncontrolled price method, the resale price method and the cost-plus method tend to be used although, if these methods are inappropriate, any other reasonable method that establishes and arm's length price can be used.

Regarding the competent authority procedures, relatively few of the treaties negotiated by the Netherlands yet contain provisions along the lines of Article 9 (2) of the Model Treaty although virtually all of their treaties

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93. See, for example, BNB 1966 No 250; BNB 1969 No 217; and BNB 1979 No 188
94. Art 7 CITA
95. See BNB 1979 No 223

contain the mutual agreement procedure of Article 25 of the Model Treaty. However, the Dutch authorities have adopted a reasonable and liberal interpretation of Article 25, accepting that the mutual agreement procedure can be used in cases of economic double taxation. This practice is in keeping with the Dutch authorities flexible attitude on most aspects of domestic and international tax.

The authorities have issued no set procedure a taxpayer must follow to initiate the competent authority procedures although, normally, a letter to the Minister of Finance would be sufficient.

The taxpayer has no right to present his case before the meetings of the competent authorities but, in practice, he is usually given the opportunity to do so. This is different from the situation in many other countries and again demonstrates the liberal attitude of the Dutch authorities. Furthermore, no agreement reached between the competent authorities becomes effective without the taxpayers approval.

As with most other countries, the tax authorities are not obliged to initiate the competent authority procedure and, if they do not do so, the taxpayer has no right of appeal. However, in practice, the tax authorities do not tend to refuse to enter into negotiations under the competent authority procedure.

Any agreement reached under the competent authority procedure can be implemented in the Netherlands even if the domestic time limit has expired.

It can be seen that, even though there is a general absence of rules and regulations on transfer pricing and the competent authority procedure, the reasonable and liberal attitude of the Dutch authorities ensures that taxpayers are not treated unfairly.

Canada

Canada's approach to transfer pricing is influenced by the fact that is more concerned with inward rather than outward transactions as it is more often the subsidiary rather than the parent that it established there.

Section 69 of the Income Tax Act is the relevant pricing provision. Section 69(1)(a) applies where both parties are resident in Canada. It requires that transactions must be "at fair market value". If one of the parties is a non-resident sections 69(2) and (3) come into play. They require that the transaction is at a price that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length. It appears that "fair market value" and "reasonable price" are identical.[96]

The full wording of section 69(2) is as follows:

> "Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length a price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this sub-section referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this part be deemed to have been the amount that was paid or is payable therefor."

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96. See J Hofert 4d v MNR 62 DTC 50. This is born out by the Information Circular, infra, at para 5.

Non-arm's length persons are defined by Section 251(1)[97] as persons who are either "related" within the meaning of Section 251 (2),[97] or unrelated parties who in fact do not deal at arm's length, a condition which the courts consider to arise when the parties do not have separate economic interests or where one imposes its will upon and dominates the actions of the other. Under Section 251 (2), "related" persons include a corporation which controls another or two corporations controlled by the same third party.

There are no formal regulations but, in practice, Revenue Canada follow the principles set out in the 1979 OECD Report.

However, the Department of National Revenue has recently issued an Information Circular.[98] The authorities took five years to prepare this Circular, such is the importance they attach to the problem. The Circular describes Revenue Canada's procedures and policies when dealing with transfer pricing questions; it has no legislative effect.

Although the first Draft of the Circular[99] adopted the US section 482 regulations as well as the guidelines in the 1979 OECD Report, subsequent drafts and the final version, omitted references to the section 482 regulations. Nevertheless, the section 482 regulations undoubtedly had a great influence on the preparation and interpretation of the Information Circular.

The impetus for the preparation of the Information Circular actually came, not from the tax authorities, but from industry and the professions, who were anxious about the lack of any guidance or legal guidelines from decided cases.

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97. See Chapter 10
98. No 87-2, "INternational Transfer Pricing with Other International Transactions", 27 February 1987.
99. October 1983

Following the lead in the 1979 OECD Report, the Information Circular provides for the three tests to be used in determining an arm's length price, namely:

(1) the uncontrolled comparable price method;
(2) the resale price method; and
(3) the cost price method.

If none of the above is appropriate, a suitable fourth method can be proposed by either side. As in most other countries, the uncontrolled comparable price method will be used, if appropriate, in preference to the others. However, in cases which the "comparable uncontrolled price" method has been considered, the differences between the prices under attack and the comparables have been held to be too great to allow this method to be used: see J Hofert Ltd v M.N.R,[100] Central Canada Forest Products Ltd v M.N.R,[101] and Indalex v The Queen.[102]

Indalex is one of a number of cases concerning transshipment arrangements whereby a tax haven company is interposed between a Canadian company and an affiliated foreign supplier. In fact all Canadian transfer pricing cases over the last thirty years have involved such arrangements.

In this case the "comparable uncontrolled price" method was rejected and the cost plus and resale price methods were not really considered. Instead, the court chose a fourth method.

Indalex is further considered in Chapter 10 because Revenue Canada, as well as attacking the arrangements under the transfer pricing rules, also claimed (i) that the interposition of the tax haven company was a sham;

100. 62 DTC 50
101. 52 DTC 359
102. 86 DTC 6039 and, on appeal 88 DTC 6053

(ii) that the doctrine of ineffective transactions should apply; and (iii) the "artificial" expenses section[103] applied. These alternative points, which were all rejected by the court, are examined in Chapter 10.

As noted above, in determining that the price paid by the taxpayer was excessive the court held that the "comparable uncontrolled price" method could not be used. It is instructive to considered why because it is often found that, although this method is nearly always considered to be theoretically the best by countries with transfer pricing legislation, it is often found to be difficult to apply in practice.

The judge, Madame Justice Reed, even went so far as to question whether any comparables would be available in such a "highly integrated" industry as the one Indalex was involved with, namely, the aluminium industry.

The court took a different line from that often taken in the USA, that all differences between the case in question and the comparables can be quantified and factored out in accordance with the section 482 Regulations. Here, the court was reluctant to use comparables from different circumstances. The differences that would have to be ironed out included differences in location, contract terms, credit terms and discount terms.

Having decided that the differences were too great to quantify, the court determined the arm's length price by considering the relative economic contributions of the various companies in the arrangements. The court found that the tax haven intermediary ought to show some profit and allowed it to retain 20% of its mark up, reallocating the other 80% to Indalex. The retention of 20% was on the basis that, on the facts, the purchasing power of the

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103. Section 245(1), Income Tax Act; see Chapter 10

intermediary enabled it to obtain from the supply a much better price than Indalex could have obtained in direct negotiation with the supplier. However, the Federal Court of Appeal upheld an appeal by the Crown against the retained mark-up of 20% and reallocated the whole profit to Indalex.[104]

The Federal Court of Appeal rejected the ground mentioned above for allowing the intermediary to keep 20% of the mark-up. The greater bargaining power of the intermediary was exclusively due to the pooling of the purchasing power of the members of the Group, not the least of whom was Indalex itself. There was no evidence that the intermediary actually contributed anything to the pooled purchasing power.

Compare the recent case of Irving Oil Ltd v The Queen,[105] in which the Federal Court of Canada rejected Revenue Canada's claims to reallocate profits of a Bermuda subsidiary transshipment company to the Canadian parent because the subsidiary was, on the facts, established for valid business purposes and the transshipment price was a "competitive market price".

Up until the mid-1970's, Revenue Canada had little experience in dealing with transfer pricing problems. The tax affairs of multinational enterprises were dealt with by local tax offices and there was no special transfer pricing unit as in, for example, the UK, to deal with such problems. Revenue Canada, recognised the problem and they instituted the "large file" programme to look at large corporations in specific industries and undertake simultaneous audits in cooperation with the IRS in the USA.

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104. 88 DTC 6053
105. 88 DTC 6138, see Chapter 10

A special team was formed and appropriate outsiders with particular skills and experience were brought in when necessary. This team examined all large corporations in a particular industry. Industries chosen for specific examination include pharmaceuticals, textiles, scrap metals, steel, oil, chemicals and financial institutions. In fact, the authorities' attitudes towards transfer pricing, including the drafting of the Information Circular, were influenced a great deal by the investigations carried out in the late 1970's into the intercompany pricing practises in the pharmaceutical industry.

This industry by industry approach is rather different from that adopted by most other countries but, given the relative inexperience of Revenue Canada in this area, it was no doubt thought that they should initially attempt to build up their expertise in the areas that were seen as most susceptible to large scale transfer pricing manipulation.

In June 1977, Canada and the USA signed a working agreement for simultaneous audits of related Canadian and US Corporations to be carried out. This agreement was aimed particularly at tax haven activities. These audits make full use of the exchange of information article in the Canada/USA double tax treaty. Around 3 simultaneous audits have been carried out each year since the implementation of the agreement.

Artificial pricing arrangements can also be attacked, in certain circumstances, under Section 245 (1) which is a more general anti-avoidance provision considered in Chapter 10. This section denies a deduction for tax purposes in respect of an expense incured where an allowance would "unduly or artificially" reduce the taxpayers income.

Although most double tax agreements negotiated by Canada have a mutual agreement procedure, only some of them as yet allow for correlative adjustments (the more recently negotiated treaties tend to have this provision). Even where correlative adjustments are provided for, the Canadian authorities do not consider themselves bound to make such an adjustment.

The competent authority procedure is initiated by a written request being sent to the Director of the District Taxation Office for the district where the taxpayer is situated, with a copy being sent to the Head Office of the Department of National Revenue. An Information Circular has been published[106], which sets out the procedure for the assistance of taxpayers.

Where the competent authority procedure does not resolve the problem or the taxpayer is dissatisfied with the solution, the taxpayer can appeal through the domestic courts as long as the necessary steps have been taken to ensure that the domestic appeal procedures are still open.

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106. No 71-17R 3 July 1978

Republic of Ireland

There is no general transfer pricing provision in Ireland although there are more specific provisions dealing with artificial pricing arrangements in particular areas. In fact, the position in Ireland is very unusual in that, because of certain tax incentives available, it is often more beneficial for taxpayers to increase the profits accruing in Ireland rather than to decrease them.

In an international context, transfer pricing is dealt with in all of the double tax agreements negotiated by Ireland, and a mutual agreement procedure is contained in most of them.

Under section 58 of the Corporation Tax Act 1976, a company is exempt from Corporation Tax on profits made on the export of goods manufactured in Ireland. Because of this, rather than an Irish company seeking to transfer profits to a foreign company, there is an inducement to increase profits arising in Ireland at the expense of those arising elsewhere. As a result, there is a temptation to overcharge for goods rather than as in most other countries, to undercharge for them. Consequently, there is a specific anti-avoidance provision to deal with this situation, which is the reverse of the normal position.

Where a company claiming Export Sales Relief buys from another person, and either one has control over the other, or some other person has control over both of them, and the price is less than an open market arm's length price, the Revenue can substitute open market value, thereby reducing the amount of tax relief claimed by the exporting company.[107] This section applies both to transactions where two Irish companies are involved,

107. Section 62 Corporation Tax Act 1976

and also to the situation where an Irish company, say, acquires materials at below market value from an associated overseas company. The legislation does not apply to the normal transfer pricing situation wher a domestic company sells goods at an undervalue to an associated overseas company. In any case, such a transaction would rarely be attempted by an exporting company because it would reduce the amount of tax relief available.

There is a similar provision covering companies claiming exemption from tax in respect of trading operations carried on within the Shannon Customs Free Airport Area.

Another specific provision deals with the relief from tax in respect of certain manufacturing activities. Companies whose business includes the manufacture of goods can claim relief whereby its tax on the profits from the manufacturing activities are reduced to 10%.[108] There is therefore scope for manipulation by manufacturing companies inflating the profits subject to this relief and there is therefore a provision allowing the Revenue to recompute the profits of associated companies where a manufacturing corporation, for example, sells at above market value to an associated party or buys at below market value from such a company.

As in the UK, there is a general provision which disallows expenditure which is not incurred wholly and exclusively for the purposes of the trade.[109] The purchase of assets at an over-value from an overseas company could well fall foul of this provision in the same way that such a transaction could be caught by section 74(a) ICTA 1988 in the UK.

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108. s41 FA 1980
109. Section 61, Income Tax Act 1967

Regarding the mutual agreement procedures, there are no set rules on how it should be intitiated and, in practice, the Irish company would write to the Irish Revenue Commissioners who are the competent authority in that country. There is, in fact, little practical experience of the operation of these rules because relatively few Irish companies have associates overseas.

Japan

Given its place as one of the leading industrial and business centres in the world, it is surprising that it was not until 31 March 1986 that Japan introduced transfer pricing legislation. In keeping with the Japanese mentality when it comes to business matters, the Legislature (the "Diet"), in introducing the relevant provisions, made sure that they were reasonably certain, and not unduly burdensome to the business community.

Prior to the passing of the transfer pricing provisions, Japan had a general test of "reasonableness", linked to fair market value.[110] Under this test, the National Tax Administration ("NTA") could increase profits made in transactions at below the fair market value.

However, the Government became increasingly aware that profits were being siphoned out of Japan through transfer pricing arrangements, fuelled by increases in international business and the easing of foreign currency and financial controls.

The Legislative response was the Special Taxation Measures Law, Article 66-5. This legislation was influenced by the 1979 OECD Report and the US, UK, West German and French legislation. The NTA is, to a certain extent, basing its administration of the transfer pricing legislation on the US system.

The Japanese transfer pricing legislation is not drafted in general terms, with recourse being had to regulations or non-statutory guidelines; instead the legislation is specific and detailed. However, at the same time, the legislation is tending to be operated with a great deal of flexibility by the NTA.

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110. Art 22-2 of the Corporate Tax Law

Regarding the legislation itself, it applies only to "foreign affiliated transactions"[111], namely where one of the entities is Japanese and the other is not. It is also restricted to "juridical persons"[112], which term basically includes corporations, incorporated associations and cooperative associations. It does not cover individuals, partnerships, unincorporated associations etc. The two juridical persons will be affiliated so as to come within the transfer pricing rules if one owns 50% or more of the other, or if a "special relationship" exists between them. There might be a special relationship for example, where they have common officers or a high proportion of one company's business is with the other.

As with most other transfer pricing provisions, the Japanese rules extend, not only to sales of tangible assets, but also to such things as loans, royalties, rents and service fees.

Following the 1979 OECD Report, the legislation provides that the arm's length price is to be determined by:

(i) the comparable uncontrolled price method;
(ii) the resale price method;
(iii) the cost plus method; or
(iv) any other reasonable method which is prescribed by an Enforcement Order.[113]

There is, unlike the position in the USA, for example, no prescribed order in which the above methods have to be used, except that the "other method" cannot be used unless the three other methods are inappropriate.[114] The Diet felt that the absence of any order of use would provide greater flexibility to companies to meet the criteria within their particular industries.

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111. Art 66-5(1)
112. Ibid
113. Art 66-5(2)
114. Ibid

An even more striking example of the government's desire not to place onerous restrictions on genuine commercial arrangements is the planned introduction by the NTA of a system for advance clearance, whereby companies will be able to obtain prior approval for their intercompany pricing policies. Japanese companies therefore not only have the benefit of specific legislation, but they will also be able to enjoy the certainty provided by the advance clearance procedure. What is more, the NTA appears to be prepared to go to considerable lengths to negotiate a settlement with taxpayers on what the arm's length price is in any particular case, although, in the few cases where agreement cannot be reached, an appeal can be lodged with the Appeal Office.

Japan and the USA have signed a Simultaneous Examination Agreement whereby the two countries will carry out coordinated examinations of particular companies. It is too early to say how useful this procedure will be.

Looking at the Japanese system as a whole, it can be said that, although coming late into the transfer pricing arena, the Japanese have come up with a system incorporating the virtues of clarity, certainty, flexibility and equity. It seems that the Japanese have been successful in introducing a system which can curb the worse excesses of intercompany pricing abuses without being unduly burdensome to companies carrying out bona fide commercial transactions. Other countries could learn a valuable lesson from the Japanese measures.

Conclusion

Most industrial countries have legislation similar to section 770 ICTA 1988. Some, like the USA, supplement their legislation with detailed regulations and others, like Canada, have detailed published administrative guidelines. Others still, like the Netherlands, have very general provisions. It is unusual for a country to enact detailed rules as part of their main transfer pricing legislation, although Japan has successfully adopted this course.

The pervading influence is the 1979 OECD Report, the recommendations in which are followed by the tax administrations of many countries, particularly as regards the fixing of an arm's length price.

In an international context, the transfer pricing rules tend to work fairly well; international co-operation is increasing to combat the increasing sophistication shown by multinational enterprises in their international business dealings. There are, however, some problems remaining:

- delay,
- uncertainty,
- lack of taxpayer involvement in mutual agreement negotiations,
- lack of an arbitration procedure,
- lack of uniformity in the application of the rules (for example, on questions of economic double taxation).

But the governments of the developed countries are aware of the problems and bodies such as the OECD and the EEC are working to make the system more equitable, as are many individual governments.

On a domestic note, the UK falls down, in comparison with a number of other countries, in several ways. There is, for example, no published guidance on the interpretation and application of section 770 or on the competent authority procedure (apart from the brief notes issued in 1981). Instead, each case tends to be treaded on an ad hoc basis.

Disputes tend to be settled by compromise and negotiation, there being little incentive on the part of the Inland Revenue or taxpayers to go before the Special Commissioners. Smaller taxpayers can get steamrollered: they know they cannot afford the delay, expense and uncertainty of a prolonged factual argument before the Special Commissioners and probably the courts.

A more structured approach is required, at least to the extent of the publication of administrative guidelines similar to the Information Circular published in Canada; although it is probably not necessary to go as far as having detailed regulations as in the USA.

The Netherlands, with its reasonable and approachable tax authorities, have made do with very general provisions; the USA, having a much more aggressive tax authority, have very detailed regulations. The UK, with a fairly aggressive authority, however, has a system with little guidance for the taxpayer.

Nevertheless, given that there is scope for improvement in both UK domestic law and on the international scene, section 770 tends to work very well in defeating the abuses at which it was aimed, while at the same time being fairly equitable to taxpayers in its operation.

Why is it as successful as this, particularly given to extensive powers given to the Executive to adjust prices etc with, in practice, virtually no judicial scrutiny?

Such a system would not be suitable in many other areas of anti-avoidance law. A lot of credit must go to the 1979 OECD Report which sets out detailed and sensible guidelines which are acceptable to most countries, including the UK. There is also a clear objective; to fix an arm's length price, although, admittedly, this is often easier said that done.

Another feature that should not be overlooked is the high calibre of person who usually becomes involved in transfer pricing disputes. The Inland Revenue unit dealing with section 770 is manned by high-fliers with considerable expertise. On the other side, as the section is usually applied to major internation groups, they normally have very sophisticated in-house or outside advisers. Negotiations and the presentation of the facts are therefore normally carried out to a very high standard.

Overall, although there is room for improvement, section 770 ICTA 1988 is one of the more successful anti-avoidance provisions.

PART 4

REMITTANCE SCHEMES

The Remittance Basis - The General Law

When Income Tax was introduced in 1799, persons residing in Great Britain were subject to tax on income arising overseas only to the extent that it was received in Great Britain. This position continued until 1914.

In that year income of a resident from foreign stocks, shares, securities and rents became taxable on the arising basis; i.e., on the full amount arising whether received in the UK or not.[1] However, the remittance basis still applied to these sources for non-domiciled persons and British subjects not ordinarily resident in the UK. This is noticeable for another reason in that it was the first time that domicile was used to determine a person's tax liability.

Following a recommendation of the 1920 Royal Commission, the remittance basis was restricted still further by Section 19, FA 1940. Following this change, for persons who were resident and ordinarily resident or domiciled in the UK, the remittance basis applied only to trades, professions or vocations carried on outside the UK, overseas pensions and employments carried on wholly abroad. Thus the arising basis was extended to the remaining categories of investment income which were previously still on the remittance basis (such as income from foreign bank accounts and from foreign trusts).

The point about foreign trusts was that, a few years earlier it was held in Garland v Archer - Shee[2] that income received by a tenant for life from a foreign trust was not income "from stock and securities" which had been brought within the arising basis in 1914.

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1. Section 5, FA 1914
2. (1931) 15 TC 693

The circumstances of this case were that the residuary estate of a US testator was held in trust and his daughter who, with her husband, the taxpayer, were resident in the UK. The daughter had a life interest. The residuary estate consisted wholly of foreign securities, stocks and shares. The trustee was resident in the USA and no part of the income was remitted to the UK. The taxpayer was assessed on all of the income arising on the basis that it was income arising from foreign securities, stocks and shares.

Evidence was adduced that, under US law, the wife had no estate or interest in the underlying securities etc. but that her sole right was to compel the trustees to discharge their duties under the will. As a result of this evidence, the House of Lords held that the income was assessable under Case V, as being from foreign possessions other than securities, stocks and shares and that it was therefore subject to the remittance basis. This position was altered by the Finance Act 1940 changes.

In 1953 a technical change in the law was made to stop a particular tax avoidance device. The device was used successfully by the taxpayers in Hall v Marians, Wild v King Smith and IRC v Gordon which are discussed below.

It will be seen from the cases that the basic idea was that the UK taxpayer borrowed money and agreed that the lender would be repaid abroad. <u>Section 24, FA 1953</u> stopped this scheme and plus several variations and extensions of it. The provisions are now contained in <u>section 65(6)-(9) ICTA 1988</u> which are set out below. It will be seen that these provisions dealt with the above scheme by treating the sums enjoyed in the UK, which are equivalent to the foreign indebtedness, as sums remitted here.

When Capital Gains tax was introduced in 1965 the remittance basis applied to gains made on foreign-situs assets made by non-domiciled persons.

The next great reduction in the scope of the remittance basis was in 1974. Trades, professions, pensions and all UK employments were switched to the arising basis. Instead, the 1974 Finance Act introduced a series of percentage reductions which were, in most cases, abolished in 1984. After 1974 the remittance basis remained only for non-domiciled persons and certain taxpayers who were not ordinarily resident in the UK.

Following the 1974 changes, the remittance basis applied only in the following situations:

1. Persons not domiciled in the UK are entitled to the remittance basis on:
   (i) capital gains from disposals of overseas assets;
   (ii) emoluments from an employer not resident in the UK or Eire where the duties are performed wholly abroad (where the employee is also not ordinarily resident in the UK the residence of the employer is not important);
   (iii) overseas income assessable under Schedule D, Cases IV and V (but, if the income is from Eire, it is taxable on the arising basis);
   (iv) overseas pensions;
   (v) trades, professions and vocations controlled abroad (except where they are situated in Eire).

2. Persons not ordinarily resident in the UK are subject to the remittance basis on emoluments on duties performed abroad.

3. Persons who are not ordinarily resident in the UK, but are either British subjects or citizens of Eire, are subject to the remittance basis on income assessable on income assessable under Schedule D Cases iV and V, overseas pensions and trades professions or vocations controlled abroad.

The 1974 changes prevented the sort of exploitation of the rules successfully practiced by the television entertainer, David Frost in Newstead v Frost[3]. The facts were that David Frost was resident in the UK and carried on the profession of author and television personality, being assessed under Schedule D Case II. However, in 1967, following professional advice, and with the object of avoiding tax on large future overseas earnings, he entered into an "indenture of partnership" with Leander Productions Limited, a $5 Bahamian investment company, the share capital in which had been bought for the purpose by a charitable trust out of a gift by a friend of David Frost. The indenture provided that David Frost and Leander Productions Limited should be partners in the businesses of (a) exploiting copyrights, (b) television and film consultants and advisers, (c) producing television programmes, films and plays, (d) television, film and stage advisers and agents. The indenture also provided that Leander was to manage the day to day operation of the business, to take 5% of the income profits and 1% of any capital profits and to have two votes to David Frost's one vote in case of any dispute.

As expected, a large income resulted, all originating in David Frost's activities, while Leander contributed "administrative and secretarial experience and financial and fiscal advice". None of David Frost's share was remitted to the UK. Assessments to income tax were raised under Case II on David Frost's share.

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3. (1980) 53 TC 525

The Chancery Division, the Court of Appeal and the House of Lords all agreed that the assessments could not stand. The House of Lords held that there was a valid partnership between David Frost and Leander, agreeing with the Court of Appeal in holding (1) that an artiste, when exercising his artistic skill was exploiting it and that a company could exploit that skill and that, therefore and artiste and a company could carry on a partnership of exploiting that skill; and (2) that the fact that the course adopted by David Frost could reasonably be described as a device to avoid tax was irrelevant because it must also have been formed with a view to profit.

It can be seen that the avoidance was pretty blatant but it was held that what David Frost did was legitimately within the remittance basis as it then stood. It was exploitation of this kind that demonstrated the need for the 1974 changes.

The Present Position

For both Schedule D and Schedule E situations, tax liability attaches only to so much income as is "received" in the UK in the situation set out in sections 65(5) and 132(5) ICTA 1988 respectively. Similarly, by virtue of Section 14 (1) CGTA 1979, capital gains tax liability is imposed only on gains "received" in the UK within that Section. The relevant wording is as follows.

Section 65(5) ICTA 1988 states that tax shall be computed:

"(a) in the case of tax chargeable under Case IV, on the full amount, so far as the same can be computed, of the sums received in the United Kingdom in the year preceding the year of assessment, without any deduction or abatement; and

(b) in the case of tax chargeable under Case V, on the full amount of the actual sums received in the United Kingdom in the year preceding the year of assessment from remittances payable in the United Kingdom, or from property imported, or from money or value arising from property not imported, or from money or value so received on credit or on account in respect of any such remittances, property, money or value brought or to be brought into the United Kingdom, without any deduction or abatement other than is allowed under the provisions of the Income Tax Acts in respect of profits or gains charged under Case I of Schedule D."

Section 132(5) ICTA 1988 provides that:

"For the purposes of Case III of Schedule E, emoluments shall be treated as received in the United Kingdom if they are paid, used or enjoyed in, or in any manner or form transmitted or brought to, the United Kingdom, and subsections (6) to (9) of section 65 shall apply for the purposes of this subsection as they apply for the purposes of subsection (5) of that section."

Section 14 CGTA 1979 states:

"(1) In the case of individuals resident or ordinarily resident but not domiciled in the United Kingdom, capital gains tax shall not be charged in respect of gains accruing to them from the disposal of assets situated outside the United Kingdom... except that the tax shall be charged on the amounts (if any) received in the United Kingdom in respect of those chargeable gains, any such amounts being treated as gains accruing when they are received in the United Kingdom.

(2) For the purposes of this section there shall be treated as received in the United Kingdom in respect of any gain or amounts paid, used or enjoyed in or in any manner or form transmitted or brought to the United Kingdom, and subsections (6) to (9) of section 65 of the Taxes Act 1988 (under which income applied outside the United Kingdom in payment of debt is, in certain circumstances, treated as received in the United Kingdom) shall apply as they would apply for the purposes of subsection (5) of the that section if the gain were income arising from possessions out of the United Kingdom."

It can be seen that the wording applying to Schedule D, particularly Case V, is more detailed than Schedule E or CGT, but the Schedule E and CGT wording is so wide that it is likely to catch anything falling within the ambit of the Schedule D rules.

It can also be seen that, whereas Schedule D Case IV applies to the full amount received in the United Kingdom, Case V also attaches a tax liability to sums received from property imported, or from money or value arising from property not imported, or from money or value so received, or on credit, or on account in respect of such remittances, property, money or value brought or to be brought into the United Kingdom. The wording is much wider and, what is more, according to Lord Radcliffe in Thomson v Moyse,[4] the above words are merely illustrations, not exhaustive.

Taxpayers who wish to avoid liability to UK tax must therefore seek to fall outside these provisions and the key is that the money must be "received" in the UK. Consequently, it is not surprising that the question of receipt has been the point at issue in a number of cases.

It was established early on that merely taking overseas income into account when preparing balance sheets in the UK was not sufficient to give rise to a liability if the income itself was not remitted to the UK: Gresham Life Assurance Limited v Bishop.[5]

Similarly, in Forbes v Scottish Provident Institution,[6] the taxpayer company lent out money in Australia. The interest accruing was not remitted to the UK but was retained abroad and invested. It was, however, entered in the accounts of the taxpayer company as received. It

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4. Infra
5. (1902) 4 TC 464
6. (1895) 3 TC 443. The same result was reached on similar facts in Standard Life Assurance Co v Allan (1901)4
TC 446.

was held that the interest was not received in the UK; there was not a constructive remittance.

The Gresham case established that there must be an actual receipt to generate a liability under the remittance basis. However, this was only the first step along the line. It was clear that it was not necessary to bring cash or other property to the UK to constitute a remittance. This can be seen from Universal Life Assurance Society v Bishop.[7] The facts were that the taxpayer company had branches in India and received, in India, interest from securities. This interest was applied in India towards the payment of the various obligations of the taxpayer company arising for settlement in India; for example, its obligations under policies, and the interest was not remitted to England in forma specifica. It was, however, treated in the taxpayer company's accounts as if it had been remitted to England. It was held in the High Court that the interest had been constructively remitted to England.

The distinction between this case and the Gresham case can be seen from the following passage from the judgement of Kennedy J.:

> "I think that the facts stated in the case show that this Indian interest which is in question was not merely entered in the accounts of the Society, which by itself would be a matter of little consequence, but was retained in India really as a matter of commercial convenience, and that but for such retention an equal sum must have been remitted to India to discharge the society's liabilities there, and that in reality the amount of this Indian interest was treated by the society as part of the divisable property upon which ... dividends

7. (1899) 4 TC 139

according to law had been declared and paid at the society's chief office in the United Kingdom."[8]

One way taxpayers have sought to exploit the remittance rules is to ensure that the income is received by someone else. If the recipient is situated in the UK, the question arises as to whether the taxpayer has made a remittance.

The answer depends on the circumstances and how the arrangements are organised. This can be seen from the two cases of Timpson's Executors v Yerbury,[9] and Carter v Sharon.[10] The taxpayer failed in the first case but succeeded in the second.

In Timspon's Executors, the deceased, who was resident in the UK, was a life tenant under the will of her grandfather of a quarter share of his residuary estate. The trusts of the will were administered under the law of the State of New York and her income therefrom was assessable under Schedule D Case V on the remittance basis.[11]

The deceased had several children who were, with one exception, resident in the UK, and she directed the trustees to pay quarterly allowances to them out of her interest in the income of the trust. These allowances were remitted to the UK by bill of exchange drawn on London payable to the order of, and posted to, either the child or his or her bankers in the UK. All payments for the non-resident child were sent to his bank in London for his account. Upon the drawing of each bill of exchange, the deceased's account with the trustees was debited with the equivalent in dollars of the sterling value of the bill.

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8. p146
9. (1936) 20 TC 155
10. (1936) 20 TC 229
11. See Garland v Archer - Shee, supra

Income tax assessments were raised on the deceased to cover the amounts remitted to the children and/or their bankers. Her executors contended that the amounts in question were alienated in New York and were not the deceased's income when remitted to the United Kingdom.

It was held that the amounts so remitted remained income of the deceased up to the date of the encashment of the bills of exchange in the United Kingdom and that the deceased had been correctly assessed to income tax as the person "entitled to" the income when it reached the United Kingdom.

Lord Wright MR in the Court of Appeal, considered the legal effect of the transactions. He pointed out:

> "Each remittance was a voluntary allowance or gift with the consequence that the donee only acquired the remittance when the gift was perfected.... It is clear that at any time before the drafts were cashed the trustees could countermand payment, and hence there was no completed gift until payment..."[12]

What the taxpayer should have done was to direct that the money was paid into her children's accounts in America. As it was, however, the income continued to belong to her until after it entered the UK.[13]

An altogether more satisfactory arrangement from the taxpayer's point of view was implemented in <u>Carter v Sharon</u>.[14] Here the taxpayer made sure that the income ceased to belong to her before it was remitted to this country. The taxpayer was domiciled in the USA and had for many years made voluntary allowances out of the

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12. p177
13. The taxpayer failed for a similar reason in <u>Walsh v Randall</u> (1940) 23 TC 55
14. <u>(1936)</u> 20 TC 229

income from her American investments to her daughter, who was resident in the UK. The taxpayer instructed her agent in America, who had authority to draw on her Californian banking account, into which the income from the investments was paid, to pay a certain sum monthly to her daughter. The agent made such a payment, posting in California to the daughter a banker's draft drawn on a London bank to the order of the daughter and purchased with a cheque drawn by him on the Californian bank account.

The taxpayer was assessed under Schedule D Case V in respect of this amount remitted to her daughter. She claimed that the sum remitted to the daughter ceased to belong to her before the banker's draft left America and therefore it was not income of the taxpayer remitted to the United Kingdom. Evidence was given that, under Californian law, the property in the sum to be remitted, and the draft representing it, passed to the daughter, and that the gift to the daughter was complete and irrevocable at the latest when the banker's draft was posted in California. The Special Commissioners allowed the taxpayer's appeal and this decision was confirmed by the High Court.

Lawrence J noted the distinction drawn by Counsel for the taxpayer between this case and Timpson's Executors. He said:

> "Mr. Tucker [Counsel for the taxpayer] also relied upon the fact distinguishing it from the facts in Timpson's case that here it was impossible for the mother, the taxpayer, or her agent to stop the gift after it had been posted because it was not a cheque drawn by the mother or her agent but was a draft by the American Trust Company upon Barclays Bank bought by the mother's agent, and therefore once it had been bought and had been posted nothing could prevent the gift being completed or could prevent it

coming into the hands of the donee, whereas in Timson's case the mother could at any time before the actual receipt and encashment of the bill of exchange in question have stopped it."[15]

The judge thought that this was "a material distinction".

A significant hardening of judicial opinion will be noted below in the case of Thomson v Moyse,[16] but the decision in Carter v Sharon is still good law. It will be seen in Thomson v Moyse that the taxpayer drew cheques in dollars on an American bank in favour of a bank in the UK and requested them to purchase the cheques, and the UK bank sold the dollars specified in the cheques to the Bank of England and credited the sterling equivalent to his account. The UK bank presented the cheques to the American bank and the American bank transferred the relevant amount in dollars to the account of the bank of England with the Federal Reserve Bank. It was held that the proceeds from the sale of the taxpayer's cheques was money arising in the UK "from property not imported" within section 65(5)(b) ICTA 1988.[17]

The taxpayer in Carter v Sharon, on the other hand, did not receive any money in the UK because the equivalent amount had become the property of her daughter before it was remitted to the UK.

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15. pp239-40
16. (1960) 39 TC 291
17. Supra

Reviewing the Exploitation

Even though the 1974 changes removed the remittance basis for resident individuals, there was still plenty of scope for non-domiciled persons and certain persons who were not ordinarily resident to exploit the rules.

A Consultative Document on "Residence in the United Kingdom" issued by the Inland Revenue in 1988 specified what the Revenue saw as three "defects" of the remittance basis.[18]

The first defect was considered to be:

> "The broad definition of remittance in the Taxes Act and the wide interpretation which has been given to it by the courts make it extremely difficult for a taxpayer to calculate his own liability; effectively, it requires an analysis each year of almost every financial transaction undertaken.
>
> It may, for example, be necessary to follow income as it arises through as number of different bank accounts to its final destination. The compliance burden on the taxpayer can be substantial. An Inspector of Taxes faces equal difficulty when examining Tax Returns if he has reason to suspect that the full amount remitted has not been disclosed."

This is a valid criticism, perhaps more from the Inspector's point of view; he will often have great difficulty finding out exactly what is going on. Many taxpayers, particularly those with a lot of income and gains, will generally know, with the help of their professional advisers, their position. It is the taxpayers who are not aware of the rules who can

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18. Paras 4.15 to 4.18

find their situation confusing, for example, in knowing exactly what does constitute a "remittance". Some taxpayers find the very concept of "domicile", as opposed to residence and ordinary residence, confusing.

The second defect was:

> "It encourages the setting up of arrangements overseas - which may be more or less artificial - in order to secure effective exemption on income which is in reality related to a UK employment, and which would otherwise be taxed in full."

It is undeniable that there has been a lot of exploitation of the rules although normally of a straightforward kind. The rules are such that sophisticated arrangements are not required to take advantage of the remittance rules by those non-domiciled or non-ordinarily resident taxpayers who qualify for the remittance basis.

The third defect was expressed to be as follows:

> "It is easy for the well advised to arrange to bring back money from overseas to meet their expenditure in the United Kingdom without it being regarded under the present law as a 'remittance'. These arrangements include:
>
> - opening separate accounts for capital and income and remitting only from the capital account; and
> - closing an account or selling an income producing asset in one year, and remitting accumulated income in the next when there is no longer a source of income that can be charged to tax."

This "defect" sets out just two of the many ways taxpayers have been able to use the remittance rules to their advantage. Considering the ease with which the rules can be used to save tax, and the large amount of annual revenue that must inevitably be lost as a result, it is not surprising that the Revenue wanted further changes in the law.

The second of the two arrangements noted by the Consultative Document, as examples of the third defect, rely on the long established rule that, once a source of income has ceased, post-cessation receipts cannot be taxable. The specific rules attaching a tax liability to post-cessation receipts for Cases I and II of Schedule D do not apply to Schedule D Cases IV or V or, prior to the changes in the FA 1989, Schedule E.[19] This was exploited by, for example, ceasing an employment before the year of assessment in which the remuneration from it was remitted to the UK.

Under the first example noted by the Consultative Document under the third defect, a taxpayer can allow his overseas income to accumulate and remit equivalent amounts of capital.

A case illustrating the effectiveness of this kind of scheme is Kneen v Martin.[20] The taxpayer was domiciled in the United States but was resident in the UK. She owned securities, stocks and shares in America, the income from which was paid into an account, called the "Income" account, one of two separate bank accounts she had with a bank in New York, and was later spent or invested wholly in America. No income arising in America was ever credited to the taxpayer's other account, called the "Capital" account, with the New York bank. Into that account were paid from time to time the proceeds of sales of investments, and out of it were purchased new investments.

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19. See now section 19(1)4A(b) ICTA 1988, inserted by section 36(3) FA 1989
20. (1934) 19 TC 33.

During the relevant years, certain securities were sold and the proceeds of sale were, with the exception of one case in which the proceeds were credited temporarily to the "Capital" account at the New York bank, remitted direct by the stockbrokers to the credit of the taxpayer's account at the London branch of another New York bank, the amounts so received being used for the taxpayer's living expenses.

The taxpayer was assessed to income tax on the footing that she had income arising in the United States and that she was assessable in respect thereof, on the basis of the remittances made to this country. On appeal, she contended that the sums received by her from America were remittances of capital and the fact that income arose to her in America from securities, stocks and shares in the same period did not make such remittances assessable to income tax. Evidence was given as to the history of the investments realised and the Special Commissioners decided that, although the evidence was not conclusive, the proper inference to be drawn from the facts of the case was that the actual sums remitted to the taxpayer were all derived from the proceeds of realisation of investments owned by her before she came to live in this country, and not from income, or from proceeds of realisation of investments acquired out of income, arising since that date, and they discharged the assessments.

The Court of Appeal held that the liability to tax under Schedule D Case V fell to be computed only on sums received in the United Kingdom which represented income, and that there was evidence on which the Special Commissioners could properly find that, on the facts of the case, the remittances actually made were made wholly out of capital.

A taxpayer can also freely remit income which arose before he became resident in the UK, as long as it is kept in a separate account from income arising after UK residence is taken up. He can also remit income that has already been taxed on the arising basis even if he has other income which is taxable on the remittance basis which he keeps outside the country. In the case of Walsh v Randall,[21] paragraph 3 of the Case Stated discloses that the Revenue accepted this point.[22]

A loophole which the Consultative Document did not mention is that property representing invested income, such as share certificates or valuable chattels can be brought into this country without giving rise to a remittance under Schedule D Case V although a liability is likely to arise under the Schedule E wording if the original income fell within that Schedule because, the emoluments are treated as received in the UK if they are paid, used or enjoyed in or in any manner of form transmitted to the UK. Under Schedule D, only when the property is realised does a remittance arise. If, before realisation, the property has been given away, no taxable remittance will arise at all.

The Consultative Document could also have referred to the type of scheme employed in Timbrell v Lord Aldenham'sExecutors.[23] The idea behind the arrangement here was, again, to convert taxable income into a non-taxable form before any money reached this country. This case also shows how a simple rearrangement of the transactions can give UK residents the advantage of receipts arising abroad, without giving rise to a taxable remittance.

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21. (1940) 23 TC 55
22. p56
23. (1947) 28 TC 293

The facts were that partners in England were owed money by an Australian firm. At the request of the partners, the Australian firm lent an equivalent sum of money to a partnership in Chile which then remitted an equivalent sum to the partners in part satisfaction of a debt it owed them on capital account. The partners were assessed to tax under Case V on the footing that the sums were remittances of income from possessions out of the UK. However, it was held that the remittance was not of income and was not taxable.

As Morton LJ noted in the Court of Appeal:

> "It is immaterial that if the transaction had been carried out in a different way, the financial result to the partners in London might have been the same and tax might have been payable."[24]

The Revenue might now mount a challenge under section 739 ICTA 1988 in respect of such an arrangement but, apart from this, it would not be covered by any of the anti-avoidance provisions specifically aimed at remittance schemes and would appear to be safe from the Thomson v Moyse and Harmel v Wright approach.[25] This demonstrates how haphazard has been the legislative and judicial approach to the remittance schemes.

Nevertheless, considering the piecemeal process of change, on the whole, it is not now very easy for an individual ordinarily resident in the UK to enjoy the use of funds situated outside the UK without remitting them.

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24. p309
25. Infra

The Substance Doctrine - (A) Introduction[25]

The form and substance question arose in a particularly interesting context in the case of the remittance basis because the whole point of most of the avoidance schemes was to enjoy the economic benefit in the UK without triggering a tax liability by having a remittance within the relevant legislation.

The problem is exacerbated by the fact that money can be moved without any physical manifestation, and money can be represented and transferred in many forms.

This issue, and the court's attitude, can be seen from cases concerning what used to be a very popular avoidance device. As will be seen, legislation was brought in to defeat certain of these devices but there was also a shift in judicial approach which would probably have brought an end to such schemes in any case.

Form Prevails

There are three cases involving similar schemes in which the taxpayer triumphed because the court adhered to the form of the arrangement and rejected economic equivalence. The taxpayers in each case ended up in the same position as if they had remitted the funds in a straightforward manner but they still succeeded because the courts took a narrow view of the facts. Before these cases are dealt with, a number of brief preliminary points should be made.

Taxpayers have never been able to avoid a remittance simply by dressing it up in a non-taxable form; in other words, the courts have never given any weight to mere nomenclature. For example, a remittance of capital does

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25. For a detailed examination of the Substance Doctrine, see Chapter 11

not give rise to a tax liability[26] but, merely calling a receipt capital will not avoid a tax liability if, in reality it is income. This was clearly shown in the case of Scottish Provident Institution v Allan.[27] It appears that the same would be true even if the colourable label or machinery was placed on the arrangement, not by the parties to the transaction, but by foreign law. see Rae v Lazard Investment Co. Ltd.

It was originally accepted that an actual and direct remittance to the UK was required to found a tax liability and not merely a notional or constructive receipt. See, for example, Gresham Life Assurance Society Limited v Bishop.[29]

However, in that case, Lord Lindley expressed himself in somewhat different terms from the other Law Lords. He said that he was willing to accept as a receipt in the UK "what amongst business men is equivalent to a receipt of a sum of money".

This passage was taken up by many people, not least by the Revenue to justify a move away from the requirement for an actual receipt. This movement was accelerated by the rapid developments in communications in the first half of the twentieth century which caused funds to be transported physically less and less. There was even some suggestion that the communication revolution had rendered the reliance, by the Law Lords (apart from Lord Lindley) in the Gresham case, on an actual receipt obsolete.[30]

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26. See Kneen v Martin (1934) 19 TC 33, supra
27. (1903) 4 TC 409 and 591, see Lord Halsbury LC at p593
28. See Rae v Lazard Investment Co Ltd (1973) 41 TC 1
29. (1902) AC 287 at pp 291-2 per Lord Halsbury LC, p292 per Lord Macnaughten and p294 per Lord Brampton.
30. See Lord Wright in Trinidad Lake Asphalt Operating Co Ltd v Trinidad and Tobago Income Tax Commissioners [1945] AC 1 at p11

However, the support given to the Gresham approach in subsequent cases such as IRC v Gordon[31] show that it had not become obsolete by the changes in communications in the first half of the century: although legislative and judicial changes in the second half of the century did change the picture dramatically.

The first of the three cases mentioned above in which the taxpayers triumphed was Hall v Marians which was, in fact, two cases.[32] These cases both concerned the same set of facts. These facts are set out in Chapter 11, to which reference should be made for the details.

This method of circumventing the remittances rules was stopped in 1953 by Section 24 of that year's Finance Act.[33]

The Revenue had two attempts at defeating the device used here. In each case Finlay J. and, in the latter case, the Court of Appeal as well, would not support them. In the first of the two cases, the Revenue raised an assessment under Case V claiming that, when the proceeds of the sale of the bonds was credited to the taxpayers Colombo account, the debt due to the London bank from the taxpayer was extinguished, and this constituted a sum received in the UK from a remittance within the meaning of Rule 2 of Case V. The Special Commissioners and Finlay J. would have none of this. Finlay J., for instance, said:

> "I do not see my way to hold that the proceeds of these Indian bonds which were in Colombo, which were sold in Colombo and which, in Colombo, were paid into the account of [the taxpayer], were received in England merely because[the taxpayer] here was

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31. Infra
32. (1933) 18 TC 148 and (1935) 19 TC 582
33. Now section 65(6)-(9) ICTA 1988

discharged, as she was discharged, from a debt by the fact that they were paid into her account in Colombo."[34]

In other words, the economic substance of the transaction was irrelevant. In this respect, compare the attitude of the House of Lords in Thomson v Moyse.[35]

Having failed in this approach, the Revenue raised further assessments under Case V on the basis that income from foreign possessions was received by the taxpayer in the UK as and when the advances were made to her in London by the London bank and, for one year,[36] on the alternative basis that income from foreign possessions was received by her in the UK when the loan was transferred from her London account to her account at the Colombo branch.

The Court of Appeal held that neither the loans from time to time by the London bank to the taxpayer, nor the transfer by the London bank of the loan to the Colombo branch constituted the receipt by the taxpayer of income from foreign possessions within Case V.

The Crown had argued that "in substance" the loan from the London bank was extinguished by means of the sale of the Indian bonds which represented the invested proceeds of the taxpayer's share of the business in Colombo and that the credit in London which extinguished the loan was a remittance to this country.

At first instance, Finlay J. considered that, in relation to 1930-31, the debt was extinguished here by the use of the money in Colombo[37] and he found for the Revenue in respect of the assessment for that year, but for the

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34. (1933) 18 TC 148 at p155
35. Infra
36. 1930-31
37. (1935) 19 TC 582 at p593

taxpayer in respect of the assessments for the other years. The Court of Appeal, however, found for the taxpayer in respect of all of the assessments. In doing so the Revenue's economic equivalence arguments were rejected. Romer L.J., for example, said:

> "I cannot help thinking that [the taxpayer] remembered what had taken place in December 1925 when she had had remitted to her the proceeds of sale of her bonds, and decided not to have income remitted to this country, but to have capital remitted to this country. The mere fact that by so doing she was in precisely the same position financially as though income had been remitted seems to me to be beside the mark. If, by having capital remitted to this country, she escapes payment of income tax, she is entitled to do so, although in the end she is in precisely the same financial position as though she had had income remitted. In other words, it appears to me that, if she deliberately adopts a form like this, then she is entitled to all the benefits that flow from the adoption of such a form and that we are not entitled to say, 'oh yes, but in substance it is precisely the same thing as though she had adopted the other form and had had income remitted to this country'."[38]

Six years later, a similar device was held to succeed by Macnaghten J. in Wild v King Smith.[39] The taxpayer was an American citizen domiciled in the USA but resident in the UK. He retired from an appointment he held in the UK and thereafter received a pension from an American corporation which was paid into his current account at a bank in New York. In accordance with arrangements made by the taxpayer, loan facilities of up to £500 quarterly were granted to him by a London branch of his New York bank, the loans being debited to a loan account and

38. p602
39. (1941) 24 TC 86

credited to a current account on which he drew at the London branch. In the next quarter, the loan was transferred to a loan account with his New York bank and subsequently satisfied by funds representing income receipts, which were always sufficient for this purpose, standing to his credit in his current account at New York. A new loan was granted to him by the London branch on the day following the transfer. The taxpayer was assessed in respect of income from foreign possessions, under Rule 2 of Case V. It can be seen that this was essentially the same device as that used in Hall v Marians.

The Crown argued that, when the London branch made loans to the taxpayer, it was, in fact, giving him facilities to draw on amounts of income which were standing to his credit at the New York bank.

The Special Commissioners were unable to distinguish this case from Hall v Marians, and Macnaghton J. agreed. He dismissed the Crown's appeal in a very short judgement occupying little more than one and a half pages of the law reports, about half of that being a recital of the facts.

The House of Lords had an opportunity to consider such devices a decade later. The Law Lords too found for the taxpayer, prompting a rather lethargic legislature to take action in the following year's Finance Act to stop arrangements which had been around and upheld by the Courts for very many years. However, even without the input of the legislature, a change of emphasis by their Lordships in the years following this case would have made matters more difficult for aspiring avoiders.

The case in which the Law Lords first considered such schemes was IRC v Gordon.[40] The taxpayer was a partner

40. (1952) 33 TC 226

in a firm carrying on business in Ceylon. He had an account with the Colombo branch of the bank which had its head office in London. He came to the UK in 1940 and opened an account at the head office of his bank in London. By arrangement, he was allowed to overdraw his account, the overdrafts being transferred to the Colombo branch whenever they reached £500. At the Colombo branch they were converted into Rupees and satisfied by periodic payments into the Colombo account from the taxpayer's firm, representing his share of the business profits.

The Crown attempted to distinguish the two earlier cases on the basis that, here, the taxpayer had created no loans abroad, the proceeds of which were set against drawings in the UK. They claimed that the arrangement made with the bank, whereby the taxpayer was entitled to draw in London money to be set against his account in Colombo when the London drawings amounted to £500, was an arrangement for the remittance of money to this country from Colombo. They also claimed that, during the periods when the taxpayer had no funds to his credit in London, money was in effect remitted to this country from Colombo every time he drew money out of London under the arrangement that it would ultimately be set against his account in Colombo and, alternatively, money was in effect remitted to this country from Colombo every time the London account was credited with money from the Colombo account.

The Special Commissioners held that the case could not be distinguished in this way and the Court of Session and House of Lords unanimously agreed.

In the Court of Session, the Lord President (Cooper) warned that the Court should not be "led astray by an 'equivalent' to a remittance or receipt, or a 'constructive receipt'",[41] a warning echoed in the House

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41. p230

of Lords by Lord Cohen.[42] It will be noted later that Lord Cohen also presided over the next anti-remittance scheme case to come before the Lords, in which a much more broad brush approach was taken.

In the Gordon case, Lord Cohen set his face against economic equivalence[42] and cited Lord Wenslydale's well know "clear words" principle of statutory construction from the case of In re Micklethwaite,[43] where Lord Wenslydale had said that it was a well established rule that the subject is not to be taxed without clear words and also that every act of Parliament must be read according to the natural construction of its words.[44]

Lord Cohen applied that rule to the facts in Gordon saying that:

> "It is attractive to suggest that, as [the taxpayer] obtains and spent these loans in London and was, so far as the evidence goes, able to discharge them only from monies in Ceylon part of which at any rate was income, and as the loan was in fact discharged, the money he received in England must have been received at least in part from remittances of income from Ceylon. Attractive though this may be it seems to me quite impossible to bring what happened within the compass of the [Rule 2]. It is plain that the income receipts of [the taxpayer] were all received in Ceylon. It is plain that the monies he received in London were advances of capital. There is no finding that those advances were made on credit or on account in respect of income in Ceylon which it was intended should be brought to London. On the

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42. p242
42. p242
43. (1855) 11 Exch 452
44. See Chapter 14

contrary the parties expressly agreed that the debt should be discharged in Ceylon; it was so discharged and there is no evidence that the Rupees which the bank received in Ceylon were ever remitted to London."[45]

(C) The Picture Changes

The device used by the taxpayers in these three cases was countered the following year by Section 24 FA 1953.[46] Although the changes do not, in fact, apply to taxpayers who are not ordinarily resident in the UK. These subsections read as follows:

> "(6) For the purposes of subsection (5) above [which sets out the Case IV and V rules], any income arising from securities or possessions out of the United Kingdom which is applied outside the United Kingdom by a person ordinarily resident in the United Kingdom in or towards satisfaction of-
>
> (a) any debt for money lent to him in the United Kingdom or for interest on money so lent, or
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> (b) any debt for money lent to him outside the United Kingdom and received in or brought to the United Kingdom, or
>
> (c) any debt incurred for satisfying in whole or in part a debt falling within paragraph (a) or (b) above,
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> shall be treated as received by him in the United Kingdom (and, for the purposes of subsection (5)(b) above [Case V], as so received from remittances payable in the United Kingdom).

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45. p242
46. Now section 65(6)-(9) ICTA 1988

(7) Where a person ordinarily resident in the United Kingdom receives in or brings to the United Kingdom money lent to him outside the United Kingdom, but the debt for that money is wholly or partly satisfied before he does so, subsection (6) above shall apply as if the money had been received in or brought to the United Kingdom before the debt was so satisfied, except that any sums treated by virtue of that subsection as received in the United Kingdom shall be treated as so received at the time when the money so lent is actually received in or brought to the United Kingdom.

(8) Where -

(a) a person ('the borrower') is indebted for money lent to him, and

(b) income is applied by him in such a way that the money or property representing it is held by the lender on behalf of or to the account of the borrower in such circumstances as to be available to the lender for the purpose of satisfying or reducing the debt by set-off or otherwise,

that income shall be treated as applied by the borrower in or towards satisfaction of the debt if, under any arrangement between the borrower and the lender, the amount for the time being of the borrower's indebtedness to the lender, of the time at which the debt is to be repaid in whole or in part, depends in any respect directly or indirectly on the amount or value so held by the lender.

(9) For the purposes of subsections (6) to (8) above -

(a) a debt for money lent shall, to the extent to which that money is applied in or towards satisfying another debt, be deemed to be a debt incurred for satisfying that other debt, and a debt incurred for satisfying in whole or in part a debt falling within paragraph (c) of subsection (6) above shall itself be treated as falling within the paragraph; and

(b) 'lender' includes, in relation to any money lent, any person for the time being entitled to repayment."

It will be seen that these provisions stopped the scheme used in Gordon by treating the foreign sum enjoyed by the taxpayer as income remitted here. The section also caught more sophisticated schemes where a new debt was used to discharge an original debt with the new debt being discharged out of foreign income that is not needed.[47]

In any case, the next time the House of Lords came to consider a remittance scheme they did not consider themselves as contrained as in the Gordon case to look for direct or actual receipts; and this was not wholly due to the intervention of section 24.

The case that signalled this change of emphasis was Thomson v Moyse.[48] The taxpayer was a British subject resident in the UK but he was domiciled in the USA. He was entitled to life interests in the USA in trust under the will of his late father and in the residuary estate of his late mother. The income from the two life interests was paid in dollars by the executors and trustees into a New York bank. During the years 1948-1952, the taxpayer asked one or other of two UK banks to purchase or convert

47. See section 65(6)(c) and (9)(a) ICTA 1988
48. (1960) 39 TC 291

into sterling the proceeds of certain cheques which he had drawn in their favour in dollars on his New York banks. The UK bank then sold the dollars to the Bank of England, or to a person authorised by the Bank of England to purchase the dollars, and the taxpayer's account at the UK bank was credited with the sterling equivalent, less charges. The cheques were cleared on the New York bank and the proceeds credited to the account of the Bank of England with the Federal Reserve Bank.

The taxpayer was assessed to tax under both Cases IV and V for the years 1949-50 to 1951-52. The Special Commissioners, Wynn-Parry J. in High Court, and the Court of Appeal, by a majority, all found in favour of the taxpayer, holding that, following the Gordon case, there was no constructive remittance. This was unanimously rejected, however, in the House of Lords.

In the Court of Appeal, Jenkins and Romer LJJ followed the earlier cases, but Pearce LJ adopted a less restricted view of the Law, foreshadowing the approach of the House of Lords.

Jenkins L.J. was clear that the fact that the taxpayer ended up in the same position as if he had arranged a direct remittance was irrelevant. He said:

> "It is no doubt true of each of the transactions with which we are here concerned that substantially the same result was produced as if the English bank had collected the amount of the dollar cheque in New York as agent for [the taxpayer] and had then as such agent paid or credited to [the taxpayer] in this country the sterling equivalent of the dollars so received, and that if the transaction had taken that form the consequences in point of liability to tax under Case IV or V might well have been different. But this appears to me to be irrelevant. The transaction must for tax purposes be taken as it is. I repeat what

was said by Romer L.J. in Hall v Marians:[49]
'In other words, it appears to me that, if she deliberately adopts a form like this, then she is entitled to all the benefits that flow from the adoption of such a form and that we are not entitled to say, "oh yes, but in substance it is precisely the same thing as though she had adopted the other form and had had income remitted to this country'."[50]

Also, in the Court of Appeal, Romer L.J. agreed with the line taken by his namesake.[51]

The tone of Pearce L.J.'s descenting judgement was set at the very beginning when he observed that :

> "If the view which [the taxpayer] puts forward is correct it seems that for over a century many persons have without protest paid tax for which they were not liable; and during that period the fact that tax liability under Case IV and V can be avoided by a simple, normal and legitimate transaction has escaped the observation of the eagle-eyed."[52]

Apart from being beside the point, what Pearce LJ said was partly incorrect; the eagle-eyed had indeed spotted the loophole and had been exploiting it. Admittedly, those without the perception of the eagle had been paying tax "without protest".

The essence of the approach of Pearce L.J. is apparent from the following passage where one of the factors mentioned is the "nexus" between the sums in New York and in England. Pearce L.J. also appears to place some

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49. Supra
50. pp313-4
51. pp315-6
52. p317

weight on the improvements in the methods of transmitting funds since the Gresham case[53] was decided. What Pearce L.J. said was this:

> "Thus the transaction consisted in [the taxpayer's] selling for sterling in England dollar cheque drawn on his American income lying in a bank in New York. If that simple description is adequate it would at first sight appear that he had to that extent received his American income in the United Kingdom, when one gives to the word 'receive' its ordinary meaning. But one has to investigate the transaction more narrowly and consider the meaning of the word 'receive' as defined by the cases. Without disregarding the substance of a commercial transaction one has to consider its technical and exact form. Lord Simmonds observed in St. Aubyn v Attorney-General [1952] AC 15, at page 32:
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> > 'The question is not at what transaction the section is, according to some alleged general purpose, aimed, but what transaction its language, according to its natural meaning, fairly and squarely hits.'
>
> The English bank bought the cheque on the basis that the dollars would be paid out of [the taxpayer's] account at the New York bank on which the cheque was drawn by him. It can in my view hardly be said .... that there was no nexus between [the taxpayer's] dollars in his New York account and his sterling in England. He bought the latter with the former. In Gresham Life Assurance Society Limited v Bishop, 4 TC 464, at page 475, Lord Brampton said:

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53. Gresham Life Assurance Society Ltd v Bishop (1902) 4 TC 464, supra

'It is conceded that no part of the money in question was ever received in the United Kingdom in specie, or in any form known to the commercial world for the transmission of money from one country or place to another.'

It seems clear that in his view money transmitted in any form known to the commercial world to the United Kingdom from another country would have been 'received' in the United Kingdom. Here [the taxpayer] wished to have for use in the United Kingdom in sterling the income which was lying in dollars in the United States. That necessitated some form of transmission. He achieved it by a normal and old-established commercial method."[54]

Pearce L.J. is basically relying on the concept of economic equivalence.[55]

The House of Lords judgements were a continuation of the Pearce LJ approach. The speeches of the strong House of Lords contained passages which have the same broad brush feel as the speeches of a considerably weaker House of Lords in the Ramsay case.[56] Furthermore, their Lordships did not exhibit an entirely consistent approach to the earlier authorities.

Lord Reid, who gave the first substantive judgement, cited the relevant provisions of the Income Tax Act 1918, namely, Rule 2 (a) of the Rules applicable to Case IV and Rule 2 of the Rules applicable to Case V.[57]

Relating the facts of the present case to this wording,

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54. p318
55. For an examination of the concept of economic equivalence, see Chapter 11
56. W.T Ramsay Ltd v IRC (1981) 54 TC 101, see Chapter 11
57. See section 65(5) ICTA 1988, supra, for the prent provisions.

Lord Reid's immediate reaction was:

> "At first sight it would seem that the requirements of these provisions are satisfied. As regards Case IV, [the taxpayer] undoubtedly received in the United Kingdom the sums paid to him as the price of the cheques and, in each case, by virtue of the contract under which he received the sum, the amount of accrued income held by him in New York was diminished by a corresponding amount. And, as regards Case V, again he undoubtedly received such sums and they would appear to be money arising from property not imported; that is, his accrued income in New York, which he assigned in order to get these sums."[58]

Lord Reid then had to deal with the authorities on which the lower courts had found for the taxpayer. He noted that the lower courts had relied on the fact that the sums paid to the taxpayer had not been brought into the UK either directly or indirectly. Lord Reid, however, was of the opinion that there is nothing in Case IV requiring that money should be brought into the UK and that that requirement was only attached to one head of Case V which was not in point here. In other words, a sum can be "received" in the UK even though no money is ever brought into the UK in connection with the transactions in question.

To justify this assertion, Lord Reid first examined the general authorities before passing on to the specific ones which have been dealt with above. The analysis of Lord Reid discloses a much wider approach to the legislation than was apparent in the earlier cases.

Lord Reid declined to place great weight on the Gresham case, unlike other judges before him. He considered that the decision in Gresham was within a narrow compass and that previous attempts to apply the

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58. p329

case over a wider field was "a good example of the danger of applying judicial pronouncements literally to situations which cannot have been in mind when they were made".[59] Similarly, dicta in Scottish Widow's Fund Life Assurance Society v Farmer,[60] by Lord Dunedin, that only "actual" receipts would be sufficient and that money had to be brought here in specie or sent in a form which, according to the ordinary usages of commerce, is one of the known forms of remittance[61] was, according to Lord Reid, obiter. A third way to receive sums in the UK had now appeared, in Lord Reid's view.

Turning to a third authority, Pickles v Foulsham,[62] cited by Counsel for the taxpayer who, in particular, had relied on a passage from the speech of Lord Cave L.C., Lord Reid gave it little weight, noting that the words of Lord Cave should not " be applied literally to a case so far removed as the present from the case which he was then considering".[63]

It can be seen that, in dealing with general authorities which had influenced courts in the past, Lord Reid interpreted them within very narrow limits.

On the other hand, his Lordship admitted that Hall v Marians and the Gordon[64] case would have caused him "considerable difficulty" had they not been rendered ineffective by section 24. He said that:

> "They do not add much to the general statements in the earlier authorities, but they do apply those statements to facts which, thought distinguishable, are not very far removed from the facts of the

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59. p330
60. (1909) 5 TC 502
61. Ibid p508
62. (1925) 9 TC 261
63. p330
64. Supra

present case. The fact that the decisions are no longer valid in my view diminishes the authority of the rationes decidendi, but if I had been sitting in a lower court I would have hesitated before reaching the decision which I think I ought now to take."[65]

As this was before the House of Lords could overrule their earlier decisions, it appears that the Gordon case may have prevented Lord Reid reaching the decision which he must have felt was justified on the wording of the relevant legislation, had section 24 not intervened. The other Lords in the present case would not have felt the same reticence although Lord Denning did say that he did not have to deal with the cases because they had been reversed by the legislation and they could no longer be considered as good law.[66] What Lord Reid and Lord Denning appear to have overlooked was that the law had not been changed in the years in which the transactions they were concerned with took place, so the three cases ought to have still had full weight, and Gordon, in particular should have been fully respected because it was not until six years after this case that the House Lords gave itself power to overrule its own decisions.[67]

Another point that all of the Law Lords missed was that the legislation did not cover the whole picture because, as mentioned above, it did not apply to persons not ordinarily resident in the UK.

Basically, Lord Reid's view was that, as regards Case IV, a person could "receive" a sum in this country even though no money was actually brought into the country. He did not consider that this was going against anything

65. p331
66. p342
67. In 1966

he said in previous cases; it was "most improbable" that the judges in those cases would, in Lord Reid's opinion, have disagreed with this view.[68]

Similarly Case V required and additional element. For it to apply, a sum must be received in one of the four ways set out in the legislation. The method in point here was "money or value arising from property not imported". The taxpayer argued that the "money or value" itself must have been imported. Lord Reid had no difficulty in rejecting this.[69]

Lord Radcliffe also declared at the very beginning of his judgement that, on the "plain meaning of the language", the sums were received within Cases IV and V and then expressed himself as being puzzled as to how it could have been considered otherwise.[70] Like Lord Reid, he seemed to espouse the economic equivalence doctrine in his interpretation:

> "He [i.e. the taxpayer] parted with his dollars; he got his sterling. He emptied one pocket of dollars in order to fill another pocket with sterling. It is true that the cheques in question were written out and signed in London and, if you please, sold here, so that the instruments themselves did not cross the Atlantic until he had made this sale and, even then, only in the outward direction; but what importance can there be in the actual place of making the instrument, or in its physical movements, if the direct result of the mechanism employed was to turn the taxpayer's income in one country into money or value in the other country, to which he had decided to transfer it?"[71]

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68. p331
69. See p332
70. p333
71. p333

Lord Radcliffe rejected the notion that "remitting" involved "bringing in",[72] whereas the courts in the previous cases, and the courts below in this case, had allied the two phrases in their reasoning. For Lord Radcliffe, "bringing in", as required by previous courts, was not in accordance with the legislation and that all that was required was "nothing more than the effecting of its [i.e. the taxpayer's income] transmission from one country to the other by whatever means the agencies of commerce or finance may make available for that purpose".[73] This is reverting back to the concept rejected in earlier cases.

Unlike Lord Reid, Lord Radcliffe had no difficulty with the earlier cases, regardless of the intervention of statute. In dismissing the earlier cases, his Lordship admitted that, although "the strict grammar" of the legislation tended to support views held by the previous courts, "it would be wrong to give any weight to this" because it was contrary to what Lord Radcliffe perceived to be the intention of the legislature. The relevant provisions should "be construed according to the general sense and without too much nicety of language."[74]

There was here a radical shift away from the approach adopted by earlier courts. Lord Radcliffe was going much further than Lord Reid. It is noticeable that Viscount Simmons expressed himself as being "in complete agreement" with Lord Radcliffe's reasoning; he did not mention Lord Reid's opinion.[75] Similarly, Lord Cohen agreed with Lord Radcliffe, not mentioning Lord Reid.[76] An examination of Lord Radcliffe's judgement shows that, in this context, he is fully espousing the concept of

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72. See pp333-4
73. pp334-5
74. p335
75. see p328
76. see p338

economic equivalence; an approach specifically rejected in the earlier cases.

The judgement of Lord Cohen is interesting in that he was a member of the House of Lords which found for the taxpayer in the Gordon case. As noted above, in this case he agreed with Lord Radcliffe, his judgement here being confined to explaining his dicta in Gordon's case.

Lord Cohen fixed the Gordon case within a narrow compass, namely, that the value received in England was a receipt on capital account and that there was no nexus between it and the income receipt in Ceylon.[77] He claimed that he had not been saying that money must actually be brought into this country from abroad and that, by so construing his words, the lower courts in this case had misled themselves. He further added that a construction such as was applied by the lower courts ignored "the ordinary commercial practice prevailing among businessmen".[78] He was, therefore, like Lord Radcliffe, reverting to the concept rejected in the earlier cases.

Lord Denning too was content to rely on economic equivalence. For him it was sufficient if the taxpayer's New York income "is seen to be the provider of the sums received in England".[79]

It can therefore be seen that the judgments of the Law Lords in this case showed a definite swing in the attitude of the courts. They were, in fact, responding to the more sophisticated business environment than was current when the original ground rules were set down by the courts, and it is surprising how long the Judiciary took to respond

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77. p339
78. Ibid
79. p340

to the changing business methods, particularly in communications, and also how long the Legislature took to stop an obvious and well-used method of exploiting the remittance basis.

As far as the Judiciary was concerned, the trend having been set by the House of Lords in Thomson v Moyse, there was no going back to the narrow, formalistic construction given in the early cases. Given that the next case was presided over by Templeman J., this is not at all surprising.[80] In any case, a judge much less antagonistic to tax avoidance would have found it difficult to find for the taxpayer in the light of Thomson v Moyse.

The case in question was Harmel v Wright.[81] This decision underlines the broad interpretation given to the definition of a remittance. This widening of the definition was a product of the change in judicial attitudes that has been noted above, rather than a result of legislative change.

The facts of the case were that the taxpayer was a domiciled South African employed in the United Kingdom by two South African companies at salaries of £25,000 and £10,000 per annum. He was resident in the UK from 1960 onwards. Before coming to the UK he formed two companies, Artemis Limited and Lodestar Limited in South Africa. Artemis was controlled by him but he had no interest in Lodestar, which was controlled by business associates who had substantial interests in the companies which employed him. Out of his salaries, £5,000 per annum was remitted as such to him in the United Kingdom. He applied the balance in South Africa in subscribing for shares in Artemis. Whenever the amount so subscribed

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80. Lord Templeman's attitude to tax avoidance is examined in Chapter 11
81. (1973) 49 TC 149

reached £20,000, Artemis, which had no other function, lent that sum to Lodestar, which in turn lent it to the taxpayer in London. The loans by Artemis and Lodestar were both interest-free and repayable on demand, and the taxpayer at all times had sufficient funds to discharge his indebtedness to Lodestar.

The taxpayer was assessed under Schedule E on the footing that the sums received by him from Lodestar constituted emoluments received in the UK within Case III. He contended that the emoluments had been invested in shares in Artemis and that there was no nexus between them and the loans from Lodestar, which was an independent company which he did not control.

The Special Commissioners found that there was a nexus between the salary and the loans and that it was part of a pre-arranged plan that the money received from the taxpayer by Artemis should be loaned to Lodestar, and the same amounts loaned by Lodestar to the taxpayer. In the circumstances, Templeman J., in the prevailing judicial climate, was bound to find that the emoluments went into "one end of a conduit pipe", passed through "certain traceable pipes" and came out "at the other end to the taxpayer".[82]

Templeman J.'s decision was based on the fact that one could trace the emoluments from beginning to end through the conduit. He made no decision on the position where it was not possible to follow one sum of money through the "traceable pipes", namely where it disappears. There would therefore appear to be some scope for still exploiting the remittance rules artificially. There is also scope remaining for remittances of capital to be made instead of income. Capital can be remitted free of tax even though there is income available; the economic

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82. p157

equivalence concept used by the House of Lords in Thomson v Moyse does not stretch as far as recharacterising capital as income. Furthermore, one type of income can not be recharacterised as another: a taxpayer having income taxable on the arising basis, and other income taxable on the remittance basis can bring in the arising-basis income instead of the remittance basis income without incurring a liability on the remittance-basis income remaining outside the UK. It is also possible to wait until the source of the income has ceased before remitting it.

It can therefore be seen that the remittance basis has, since income tax was first introduced, offered opportunities to avoid UK tax. The categories of taxpayers and sources to which the basis applies have been progressively reduced, but there is still plenty of scope for certain taxpayers to avoid UK tax, even though they are resident here.

The Inland Revenue Consultative Document[83] highlighted certain defects but, as the discussion of the substance doctrine[84] shows, there are even more problems than recognised in the document.

The Inland Revenue are clearly concerned and further major restrictions on, or perhaps complete abolition of, the remittance basis could well be built into future provisions altering the residence rules.

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83. Supra
84. In Chapter 11

PART 5

MANIPULATING THE RESIDENCE OF COMPANIES

Introduction

The nexus between a taxpayer and a country can be broken in a number of ways. The most straightforward is for the taxpayer actually to leave the country. He must make sure that the country he goes to does not tax him as heavily or heavier than the country he is leaving, and also that his sources of income do not remain in that country so as to give rise to a continued heavy tax liability on those sources.

Where an individual is concerned, he might emigrate, not permanently, but just long enough to avoid tax. This concept was taken to extremes by the 1960's "pop" star, Dave Clark, who timed his temporary move from one high tax country (the United Kingdom) to another (the U.S.A.) so that a substantial one-off lump sum escaped tax in both countries.[1]

Where the taxpayer is a company, emigration from the United Kingdom was, for a long time, restricted by the ultimate "in terrorem" provision, section 765 ICTA 1988, whereby to transfer a company's residence or trade abroad, without prior consent of the Treasury, was a criminal offence.[2]

In general, taxpayers have sought, and often found, many ways to break the nexus between themselves and the United Kingdom, by placing themselves, or the profit making apparatus, in a more favourable jurisdiction. In so doing, they have often used other entities to achieve this; principally, companies, trusts and partnerships.

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1. See Part 7
2. Infra

They have relied on the fact that companies and trusts and, in most jurisdictions, partnerships, have a separate legal existence.

The ways various countries have combatted these mechanisms, from wide "substance" doctrines and abuse of law principles, to more specific anti-avoidance provisions, are examined in Chapter 10.

The schemes adopted by United Kingdom taxpayers, and the responses of the Judiciary and the Legislature, examined are examined in this and the remaining Parts of this Chapter.

In the United Kingdom, and in most other jurisdictions, the main connecting factor on which tax ability is dependent is residence. Ensuring that the residence of the entity or person earning the profit or making the gain is outside the United Kingdom, and in a more advantageous jurisdiction, has been the object of many avoidance schemes throughout the years.

United Kingdom law prescribes different criteria for the residence of companies, trusts and individuals and so avoiders have had to use different techniques in relation to each type of entity and, as a result, the counteracting measures have also varied.

The central reason why companies have been so popular with potential avoiders over the years is that companies are separate legal persons and, as is shown in Chapter 12, the courts have only in very rare circumstances been prepared to ignore the existence of a company (in other words, to pierce the corporate veil).

Because of the traditional reliance in this country on central management and control, the residence of a company could easily be manipulated so that its place of residence need bear no relationship whatsoever to where the business was carried on.[3]

The tax avoider had three basic alternatives:

(1) He could move the residence of an existing company abroad.

(2) He could keep the residence of the existing company in the United Kingdom but ensure that the profit making apparatus was abroad (for example, by setting up an overseas branch).

(3) He could set up a separate company, usually a subsidiary, abroad.

As regards the moving of the residence of an existing company abroad, there were two main problems. One was a strictly legal one in that, from 1951, when section 36 FA 1951 was passed, until 1988, it was illegal to move a company's residence abroad without Treasury consent.[4] Although this consent was originally largely linked to exchange control and balance of payments considerations, the Inland Revenue had a major say in whether permission should be granted, so that emigration of a company for what appeared to be tax avoidance motives could be prevented.

The other problem was a much more practical one. The main test or residence under UK law has always been where central management and control rests. This is determined by a number of factors, but a major consideration is where major policy decisions are made. This is normally where the board of directors meets to make important decisions, as opposed to where day to day management decisions are made.

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3. The detailed rules determining the residence of companies are not set out here except where they are relevant to a particular point being considered. The rules can be found in any standard text book on international tax. See also the Inland Revenue Statement of Practice SP1/90 on "Company Residence" issued on 9 January 1990.

4. Infra

Given that, usually, UK companies have been run by UK individuals who have, in reality, made these major decisions in the UK, even though foreign managers may have been employed to run the company on a daily basis, the residence of those companies has been in the UK. Some boards have sought to overcome this problem by jetting off to another location every so often to hold board meetings outside the UK. Even here, there are problems. One is that the UK Revenue's suspicion often was that the actual decisions were made in the UK but that the directors just had a day outside the UK when appropriate board minutes would be signed, for appearances.

Another problem for avoiders is that, even if the decisions were genuinely made abroad - and they could persuade the UK Revenue that this was so - they had to find a jurisdiction either:

(a) that did not tax companies with similar criteria to the UK; or

(b) that, even if it did, the domestic taxes were so low that it did not matter.

For UK individuals, France has been an ideal location because France taxes companies according to their place of incorporation, rather than central management and control, and directors have always been attracted to a day trip to Paris.

An early attempt to move the residence of a company abroad can be seen in <u>Egyptian Hotels Limited v Mitchell</u>.[5] The taxpayer company was incorporated in England and carried on its business (the running of a hotel business in Egypt) in the UK until 1908. In that year, the company amended its Articles of Association to the effect that the business should be carried on and managed by a local board, to the exclusion of any other

5. (1914) 6 TC 542

directors. The local board were to meet only in Egypt, the directors were to be affected only by resolutions of general meetings held in Egypt, and they were to exercise all the powers of the company requisite for the business. All that was remitted to the UK were dividends and any expenses of the London board. The London Board kept the accounts, recommended the dividends and controlled the capital.

Following the alteration of the Articles, all that the London board had done had been to recommend a dividend and to authorise the borrowing of a sum of money for that purpose. Nevertheless, the company was assessed to income tax on the full amount of the company's profits under Schedule D Case I, on the basis that the controlling power of the company remained with the London board.

This was overturned in the courts but, to show how difficult it can be to lose UK residence when the top men remain in the UK, the four Law Lords were equally divided, Lord Parker and Lord Sumner finding for the taxpayer, Lords Loreburn and Parmoor, for the Crown. Because of this deadlock, the decision of the Court of Appeal stood. The Court of Appeal judges had found in favour of the taxpayer company.

The facts of the case are rather specialised, but it is authority for the proposition that, the fact that the directors are resident in the UK, does not necessarily mean that the company is resident here. The basic distinction was enunciated by Lord Parker between the place where the business - the profit making apparatus - is run, and the place where the decisions are made as to what happens to those profits once they have been earned.[6]

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6. p550

Furthermore, in the Court of Appeal Cozens - Hardy MR distinguished the conduct of the trade from mere adminsitrative powers. For example, it could be said that the London board had indirect control, in that the London directors could exert considerable pressure on the local board by, for instance, stopping the salaries of the Egyptian directors. This was not enough to establish central management and control in the UK.[7]

Similarly, residence could not be shown to be in the UK merely because the accounts were prepared here. This was not running the business, but just recording the results of the business. As to the declaration of dividends, this was not earning the profits, but dividing them among the shareholders after they had been earned.[8]

In addition, the company could, in general meeting, alter the arrangements whereby control had been transferred to Egypt. Buckley LJ ruled that this too was irrelevant because the court had to look at what the position actually was in the year in question.[9]

Lord Parker, in the House of Lords, agreed, saying of this power of the London board: "It is not what they have power to do but what they have actually done".[10] Lord Sumner agreed that the fact that directors had power which they did not exercise, did not amount to controlling the business, although he did go on to point out[11] that regular oversight to intervene would amount to control, on the authority of Ogilvie v Kitton.[12]

The point is clearly a fine one and, in fact, a close examination of the judgements shows that the point at which the various judges were addressing their minds was

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7. p554
8. Per Buckley LJ at p545
9. Ibid
10. p550
11. P551
12. (1908) 5 TC 338

central management and control and not residence as such.

Central management and control of the business here was relevant because if, as the company successfully established, the business was carried on wholly abroad, its profits were taxable on the remittance basis under Case V rather than on the arising basis under Case I. However, it became clear in later cases that a finding that central management and control was abroad would mean that residence was also abroad. It is possible, of course, for a company to have two residences, but there was no indication in the judgements in the Egyptian Hotels case that the taxpayer company there was a dual resident company.

Another attempt to move the residence of a company abroad failed in Swedish Central Railway Co Limited v Thompson.[13] The taxpayer company was incorporated in the United Kingdom in 1870 and had its registered office here. It was established with the object of constructing and running a railway in Sweden. In 1900, the company leased its railway to a Swedish traffic company for 50 years at an annual rent of £33,500, which was paid to the company in England. Subsequently, the taxpayer company's Articles were altered to remove the control and management of its business to Sweden. It was admitted that the company's business had thereby effectively been transferred to the Head Office in Sweden.

In 1920, a committee was appointed by the directors of the company to transact formal administrative business only in the UK, such as dealing with transfers of shares in the UK, affixing the company's seal to share certificates, and signing cheques on the company's London bank account. After 1920, no meetings of the company were held in the UK. All dividends were declared in Sweden and no profits were transmitted to the UK except

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13. (1925) 9 TC 342

in paying dividends to Uk shareholders. Also, since 1920, the annual rent under the lease to the traffic company had been paid to the company in Sweden.

The company was assessed to income tax under Case V on the rent for the years ended 5th April 1921 and 1922. The Special Commissioners accepted that the business was controlled and managed in Sweden, but held that the company was resident in the United Kingdom and affirmed the assessment.

The law at that time was that, although the profits from the operation of the railway, if controlled exclusively in Sweden, would have been taxed on the remittance basis,[14] rent was taxable on the arising basis, so, to escape tax on it, the taxpayer company had to establish that it was not resident in the UK.

The House of Lords decided that a company could have two residences and that there was sufficient evidence to support the Special Commissioners' decision that the company had a dual residence. Lord Cave LC said:

> "When the central management and control of a company abides in a particular place the company is held for the purposes of income tax to have a residence in that place; but it does not follow that it cannot have a residence elsewhere. An individual may clearly have more than one residence (see Cooper v Cadwalader[15]); and in principle their appears to be no reason why a company should not be in the same position. The central management and control of the company may be divided and it may 'keep house and do business' in more than one place; and if so it may have more than one residence".[16]

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14. Colquhoun v Brooks (1889) 2 TC 490. In this case the business was carried on wholly abroad and the House of Lords held that it was taxable under Case V on the remittance basis because the English company's profits arose from foreign possessions.
15. (1904) 5 TC 101
16. p372

The decision should not be given more significance than it deserves. It is true that it did establish that a company could have more than one residence under UK domestic law, but that was all it really decided. The findings of fact by the Special Commissioners were accepted as showing that, in this case, a dual residence existed, although the Law Lords did not clarify which of the Special Commissioners' findings led them to this decision. It does show, however, that it has never been easy to lose UK residence without moving the whole management and policy structure abroad.

A more straightforward way of breaking the nexus is to set up a subsidiary in a more favourable jurisdiction. This, of course, relies on the fact that the subsidiary is a separate legal entity and, in the absence of legislation specifically allowing them to do so, the courts in the UK have been reluctant to pierce the corporate veil. This is subject to the fundamental assumption that the existence of the subsidiary, or the operations purported to be carried out by it, are not shams. This will be assumed in what follows.

The outcome of the early cases on foreign subsidiaries is examined in Chapter 12. A summary of the main points, insofar as they relate to the matter under consideration here, is given below.

In St. Louis Breweries v Apthorpe[17], an English company was set up to acquire the shares of an American company which had purchased breweries in the U.S.A. The American directors had the general management and control of the U.S. company, the books and account were kept in America and audited there by an accountant sent over there by the English company. The directors of the English company, however, decided on what dividend should be declared.

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17. (1898) 4 TC 111

It was decided that the business of the American company was carried on by the English company which was therefore assessable under Case I on the whole of the profits, and not under Cases IV and V only on the amounts remitted to the UK.

So the English company was carrying on the business, despite the existence of the separate U.S. company, because the U.S. board acted in accordance with the decisions of the UK board. The U.S. company was treated as acting at the behest of the UK board or, according to one judge, as managers/agents. In other words, the U.S. directors were effectively puppets of the UK board.

The finding of an agency in this case followed the slightly earlier one of Apthorpe v Peter Schoenhofen Brewing Co. Ltd.[18] The facts were similar to those in the St. Louis Brewery case. Here, the English company found the capital for carrying on the Brewery business in the U.S.A. The directors of the English company had the entire right of control of the affairs of the U.S. company and of its staff and business, with full power to appoint or dismiss any of the managers or officials of the U.S. business. These powers were, in fact, delegated to the managers of the brewery in America who were also directors of the US company. All that was done in the UK was the passing of share transfers, deciding on the level of dividends, keeping accounts and considering reports received from America and the holding of shareholders' meetings.

The case turned on the Commissioners' finding that the head and seat and directing power of the UK company were in the UK, and the US company, in carrying on the Brewery business and earning profits, was the agent of the UK company.[19]

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18. (1899) 4 TC 41
19. Similar decisions were made in Frank Jones Brewing Co Ltd v Apthorpe (1898) 4 TC 6 and United States Brewing Co Ltd v Apthorpe (1895) 4 TC 17.

These cases show that the nexus could not be broken merely by setting up a subsidiary in another jurisdiction, if the subsidiary could be seen as merely an agent or puppet of the UK company. In fact, the courts are much less likely to find an agency relationship these days in parent/subsidiary situations.[20]

Furthermore, even in the early days, the courts were not consistent in their approach to the agency point where overseas subsidiaries were established to carry on a business outside the UK, as can be seen from the decisions of Bartholomay Brewing Co (of Rochester) v Wyatt[21] and Nobel Dynamite Trust Co v Wyatt[22], the first of which had facts similar to the above brewery cases in which the nexus had been found not to have been broken.

In the Bartholomay case, an English company with an office in London, was formed to acquire brewing businesses in the State of New York. By the laws of that State, an English company was prohibited from owning and carrying on a brewery there and so the English company arranged for the formation of an American company with seven trustees appointed to manage the businesses in America on behalf of the English company. Virtually all of the shares in the American company were held by the English company. The brewing trade was carried on exclusively in the city of Rochester in New York. At the end of each financial year, the trustees of the American company sent the English company the accounts of the breweries and the English directors, having agreed upon the amount to be distributed out of the profits, informed the American company of the rate of dividend which the directors thought should be declared by that company on

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20. See Burman v Hedges and Butler (1978) 52 TC 501, considered in Chapter 12
21. (1893) 3 TC 213
22. (1893) 3 TC 224

their shares. When the American company declared the dividend, the English directors declared a dividend of a similar value upon the shares in the English company. No dividend warrant was issued by the American company, but the amount of profits to be divided on the shares held by the English company, so far as it was required for distribution among the shareholders of the English company, was sent over to the English company in London; such proportion of the dividend as was required for American shareholders in the English company, being retained by the American company and distributed by them direct in America on behalf of the English company.

It was held that the profits of the English company arose from "foreign possessions", so as to be taxable under Case V. The portion of the profits retained in America, for distribution among the American shareholders of the English company, was not received by that company in England within the meaning of Case V. The business generating the profits was carried on wholly abroad and so the case of Calquhoun v Brooks applied.[23]

In the Nobel Dynamite case, an English company, having an office in London, was formed to acquire shares of various companies trading in explosives in England and Germany. The affairs of the company were managed and controlled wholly by its directors. It did not carry on any manufacturing business, nor sell any materials or goods, in the United Kingdom or elsewhere. In dividing any profits made, the directors declared a dividend in London on all of the taxpayer company shares, of which a large number were held by foreigners living in Germany. The dividend due to the taxpayer company in respect of its shares in the German companies were, at the request of the directors, paid by those companies into banks abroad

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23. Supra

and applied in paying the dividend, when declared, to the foreign shareholders of the taxpayer company. It was held that this case was also within the decision in Calquhoun v Brooks and that the taxpayer company was not liable to pay income tax on the profits paid by way of dividend to the foreign shareholders of that company in Germany.

It appears that it would have been open to the court, particularly in the Bartholomay case, to have reached a decision similar to that in the St. Louis Breweries and the other three "agency" brewery cases, but it seems that the courts, at this early stage, had not yet formulated a consistent approach to parent/subsidiary relationships.[24]

These decisions considerably weakened the authority of the "agency" brewery cases, and accordingly made it easier for UK companies to set up foreign subsidiaries to break the nexus between the UK and the actor producing the taxable income or gains.

The present view appears to be that there is nothing to prevent an overseas subsidiary from being an agent of a UK parent if the normal principal/agent criteria are satisfied, but an agency relationship cannot be assumed merely because one company is a subsidiary of another. Furthermore, as has already been mentioned, subsequent courts appear to have taken a narrower view of agency than the judges in the early brewery cases.

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24. See also the cases of Kodak Ltd v Clarke (1901) 4 TC 549 and Gramophone and Typewriter Ltd v Stanley (1908) 5 TC 358. In the case of IRC v The Gas Lighting Improvement Co Ltd (1923) 7 TC 551, considered in Chapter 12, the courts refused to treat an overseas subsidiary as a mere agent even though the taxpayer had argued for it to be treated as such. It will be seen that the judges of the House of Lords were particularly forthright in their rejection of the agency argument.

So, companies seeking to break the nexus with the UK can do so by setting up an overseas subsidiary to run an overseas business, but the foreign subsidiary must be given some substance and it must not be seen to be merely a puppet of the UK company. But, as long as this basic pitfall is avoided, the profits of an overseas subsidiary cannot be taxed in the hands of the parent in the absence of specific statutory rules such as the "Controlled Foreign Companies" legislation which is considered in Part 6.

Due to the unreliability of the agency argument as a tool in the hands of the Revenue to tax the profits of overseas subsidiaries, they had to resort to other weapons, as will be seen below.

The importance of establishing the independent operations of an overseas subsidiary are even greater than they were, now that companies are always taxed on the arising basis, rather than on the remittance basis.

The Finance Act 1988 Changes

The Revenue for many years were concerned that the rules governing company residence were rather uncertain and out of date, being based on cases decided before communications became as sophisticated as they are today and before international business operations became so wide spread. They were worried that the central management and control test allowed great scope for tax avoidance. It was far too easy to manipulate residence, and a company's place of residence did not have to bear any relation to where its activities were carried on or where the company was actually run. This, and the pressures to abolish what is now section 765 ICTA 1988, caused them to give much thought, over many years, to altering, simplifying and tightening up the rules relating to company residence.

What the Revenue ought to have borne in mind is that the central management control test could have been made to work much better, tighter and more accurately than it had previously. Despite judicial warnings to the contrary,[25] far too much reliance came to be placed on where board meetings were held. In fairness, it was usually very difficult, and sometimes impossible, for the Revenue to prove where real control was being wielded but, nevertheless, the strict application of the central management and control test (i.e. the place where the main policy decisions were taken) would have severely curtailed the opportunities for manipulation.

The Revenue's deliberations and consultations culminated in the radical changes to be found in section 66 and Schedule 7 FA 1988. The new rules are as follows:

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25. For example, in Bullock v Unit Construction Co Ltd (1959) 38 TC 712

1. Companies incorporated in the UK will be resident in the UK.

2. Companies incorporated in the UK before 15th March 1988 and carrying on business before that date, but which are non-resident here under the old central management and control rules, will become resident in the UK after five years from 15th March 1988,[26] unless central management and control is transferred to the UK within that five year transitional period.

The central management and control test is, of course, still important in the case of companies incorporated outside the UK, and companies incorporated in the UK but to which the transitional rules are applicable. Furthermore, a company incorporated in the UK could still become non-resident under a double tax agreement if, for example, it moves its place of management to the other country (or fulfils whatever conditions the other country's laws and the double tax agreement may provide before a company can become resident in that other country).

Under the transitional rules, two types of company will continue to have their residence determined by the central management and control test. These are:

1. Companies incorporated in the UK which ceased to be resident here with Treasury consent (and which satisfy certain other conditions). These companies can remain non-resident indefinitely.

2. Companies incorporated in the UK which have already been non-resident, or which have ceased to be non-resident, but which cannot satisfy the additional conditions. These companies will become resident in the UK on 15th March 1993 (or sooner if they move

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26. The date of the 1988 Budget and the Inland Revenue Press Releases setting out the changes.

their central management and control here before then).

The transitional rules only apply to companies of either of the above types if they carried on business before 15th March 1988. This additional requirement was not contained in the Budget Press Release but was introduced later. This foiled one enterprising person who purchased the entire stock of off-the-shelf companies of a particular company formation agency in the hope that they could be sold as offering the opportunity to exploit the transitional rules (as indeed they probably could have been under the proposals as originally published).

It is to be questioned whether the new test is the most appropriate. It is suggested that it is really too inflexible to be commercially appropriate. Just when the business world is becoming more integrated, particularly in the EEC, a great impediment is being placed on the use of non-resident English-incorporated companies by foreigners. These vehicles, which help to bolster the prominent position of the UK in the international business community, all of a sudden are eliminated.

The Transfer of a Company's Residence Abroad

As tax rates in the UK increased, so did the incentive to move the residence of UK companies abroad to break the nexus between the UK and the income earning or gain producing entity. A company could also be taken outside the apportionment legislation by ceasing to be resident in the UK.[27] Widespread emigration was particularly prevalent after the First World War and again after the Second especially in the mining industry, with the accompanying avoidance of UK tax. With the major improvements in communications, particularly air travel, it became easy to arrange for board meetings to be held outside the UK so as to move the central management and control of a company to another country.

Public concern at the scale of avoidance grew. For example, in 1950, "Reynolds News" carried an article with the uncompromising title: "How Long Must This Scandal Go On?". The article cited a number of noteable emigrations and then commented:

> "Now all these transfers are quite legal and proper. But two questions arise. The first is whether the Treasury is not being too easy going in permitting the transfers.[28] On what principles are applications granted? How does the Treasury justify tax dodging on this scale at a time when the ordinary taxpayer is bearing increasing burdens? How much tax revenue has been lost in the last four years? Since the press is refused information on these questions, I suggest that MPs might try to secure information in Parliament. The second question is: should not the law be changed to stop all these transfers on grounds of public interest?"

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27. Section 414(1)(a) ICTA 1988
28. This refers to Treasury permission under the Exchange Control Act 1947.

Such calls did not go unheeded because, in the next Finance Bill, legislation that was to become section 765 ICTA 1988 was introduced.

The anti-avoidance provision introduced by the Finance Act 1951 was drafted in very wide terms and imposed the most sever penalties of any anti-avoidance provision ever introduced in the UK, in that it created a criminal offence punishable by fines and/or imprisonment. The penalties were imprisonment for up to two years and/or a fine of up to £10,000 (although, in the case of the company, the maximum fine was the greater of £10,000 or three times the corporation tax, profits tax, capital gains tax and income tax for the thirty six months preceding the offence). These criminal offences have not tended to be used in practice; their mere existence has proved sufficient to deter would be avoiders: it has been the ultimate "in terrorem" weapon.

The Exchange Control Act 1947 provided that Treasury permission was required for a company's residence to be moved abroad, but these powers were exercised with reference to exchange control considerations; emigration could not be refused merely on tax avoidance grounds. The government found this too much to swallow, particularly in the face of mounting resentment among "ordinary" taxpayers.

During the debates on the Finance Bill in 1951, the Chancellor, in relation to Clause 32 (which was to become Section 36 FA 1951), said that the provision was mainly directed at stopping the growing tendency on the part of companies with overseas activities to migrate. He commented that "there are signs that the rate of migration has been increasing, and representations made to us before the Budget by the British Overseas Mining Association indicated that further migration must be expected unless some relief from taxation were granted."

Whether the level of avoidance ever called for such draconian measures is, however, questionable. Most of the companies involved carried on their business and earned their profits wholly abroad and, in many cases, the companies had UK shareholders who would have to pay income tax and, in those days, sur-tax on their dividends. Obviously, some counteracting measures were required, but the case for the heavy criminal penalties appears never to have been convincingly made out by the Government. After all, some critics of clause 32 pointed to the restriction of the liberty of the subject. For example, "Taxation" magazine,[29] was of the opinion that "it is better that a few companies should take steps to minimise their liabilities to income tax within the law, rather than have a provision which not only interferes drastically with the reasonable right of a person to carry on his trade where he will, but also provides for substantial penalties to be inflicted on the basis that a person is guilty until he proves his innocence".

Furthermore, the Royal Commission on the Taxation of Profits and Income[30], considered that the provision should be:

> "A temporary regulation to deal with an emergency, the existence of which made it imperative for the Government to take measures to maintain the yield of revenue even at the cost of an interference as extreme as this."[31]

The Commission suggested that it should be a requirement that the legislation ought to be freshly enacted every year. Of course, no such action was taken and the legislation remained intact on the statute books until 1988. Considering the Government only had small minorities in votes on the clause, and the fact that it generated strong feelings within and outside Parliament, the legislation lasted a surprisingly long time.

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29. 5 May 1951, p4
30. Final Report (1955) Cmd 9474
31. Para 1046

The original 1951 legislation was aimed at stopping avoidance of profits tax. The scope of the legislation was widened on the abolition of profits tax and the introduction of corporation tax, in particular, by the abolition of the requirement that, for the provision to apply, the transaction in question had to result (or might result) in the avoidance of tax.[32] Also, avoiding tax on capital gains was brought into its ambit in 1965.[33]

The legislation prohibited four types of transaction unless prior Treasury consent was obtained. The section dealt only with transactions by companies; it did not apply to individuals. The four categories were:

1. A body corporate resident in the United Kingdom ceasing to be so resident.
2. The trade or business of a body corporate resident in the UK being transferred from that body corporate to a person resident outside the UK.
3. A body corporate resident in the UK causing or permitting a body corporate resident outside the UK over which it has control to create or issue shares or debentures.
4. Except for the purpose of enabling a person to be qualified as a director, a body corporate resident in the UK transferring to any person, or causing or permitting to be transferred to any person, any shares or debentures of a non-resident body corporate over which it has control, being shares or debentures which it owns or in which it has an interest.[34]

Category 1 is the main one in issue here. As regards the meaning of "residence", it was enacted that:

> "A body corporate shall be deemed for the purposes of this section to be resident or not to be resident in the United Kingdom according as the central

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32. Section 97(5) and Sch 22, Part IV FA 1965
33. Section 63 and Sch 15 Part I ibid
34. Section 765(1) ICTA 1988 prior to the introduction of section 105 FA 1988.

management and control of its trade or business is or is not exercised in the United Kingdom..."[35]

The ambit of this category was therefore fairly clear: in most cases it would be easy to identify a company's country of residence and to say whether it was going to change.

This category, as with the other three, was capable of catching innocent transactions; there was no condition that the taxpayer was seeking to avoid tax by moving the residence of the company abroad. This was a worrying factor given the wide range of persons who could be prosecuted under the section. The net was thrown wide because it was stated that:

> "Any person who, whether within or outside the United Kingdom, does or is a party to the doing of any act which to his knowledge amounts to or results in, or forms part of a series of acts which together amount to or result in, or will amount to or result in, something which is unlawful under subsection (1) of this section[36] shall be guilty of an offence under this section, and in any proceedings in respect of such an offence against a director of the body corporate in question (that is to say the body corporate which is or was resident in the United Kingdom) or against any person who was purporting to act in that capacity -

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35. Section 36(7) FA 1951, later consolidated as section 767 ICTA 1988, now repealed by Sch 14, Part IV FA 1988. This definition gives statutory recognition to the rule established by case law; see De Beers Consolidated Gold Mines Ltd v Howe (1906) 5 TC 198; Egyptian Delta Land and Investment Co Ltd v Todd (1928) 14 TC 119; and Bullock v Unit Construction Co Ltd (1960 38 TC 712.
36. Now section 765(1) ibid

(a) it shall be presumed that he was a party to every act of that body corporate unless he proves that it was done without his consent or connivance;

(b) it shall, unless the contrary is proved, be presumed that any act which in fact amounted to or resulted in, or formed part of a series of acts which together amounted to or resulted in or would amount to or result in, something which is unlawful under sub-section (1) of this section was to his knowledge such an act."[37]

This subsection is wide enough to catch foreign professional advisers who act on a professional basis in, say, the formation of an overseas subsidiary.

Innocent persons could find themselves caught. For example, a company might be resident in the United Kingdom but have had both UK resident and non-UK resident directors. If one or more of the UK directors resigned for perfectly legitimate reasons, the residence of the company might thereby have shifted automatically abroad under the cetral management and control test. The resigning directors might have found themselves liable under the above criteria, particularly as the onus was on the taxpayers to prove their innocence.

In fact, no prosecutions ever arose. People who were aware of the section no doubt made sure they did not infringe it, either by refraining from committing a prohibited act, or seeking Treasury permission first. Other actions would be covered by general consents and, if a genuinely innocent person was caught by the section, presumably the Attorney-General, who is the only person who can institute proceedings, would not proceed. In practice, the Revenue appear to have used the section in a common sense way and there are no reported instances of

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37. Now section 766(1) and (2) ICTA 1988

substantial injustice being suffered by taxpayers by the unfair application of the section.

Category 2 was rather less clearly defined. Section 767(4) ICTA 1988[37A]. Subsection (9) sets out a distinction between the transfer of an asset and the transfer of a trade or part of trade. This distinction crops up elsewhere, for example:

(1) the transfer of a business as a going concern for VAT.
(2) stamp duty reorganisation relief and the definition of an "undertaking".
(3) the reconstruction of a company under Section 267 ICTA 1970;
(4) CGT retirement relief.

Cases and disputes that arise under these, and similar, provisions show that the distinction is often not clear cut and, again, there was scope for innocent taxpayers to be caught.

Section 767(4) stated:

> "Notwithstanding anything in the preceding provisions of this section or in sections 765 and 766, in no event shall a mere transfer of assets by a body corporate not resulting in a substantial change in the character or extent of the trade or business of that body corporate be treated for the purposes of sections 765 and 766 as a transfer of part of its trade or business."

Whether a "substantial change" occurred was a question of fact in each case.

37A. Now repealed by Sch 14 Part IV FA 1988, with effect from 15 March 1988

This subsection has been used by taxpayers to their advantage because, by transferring assets only abroad, they were not caught by the section if the transfer was not substantial in relation to the company's overall activities. For example, a company could set up an investment company in a tax haven and transfer assets to it. The investment company would be used to invest, at a low or nil tax rate, the surplus cash of the UK company. The accumulated income could then be used to fund other overseas activities of the United Kingdom company or other companies in its group or borrowed back by way of an "upstream" loan.

Another common transaction not caught by this category was the setting up, by a United Kingdom company, of an overseas branch. A branch, not being a separate entity, is part of the United Kingdom company.

However, often it is desired subsequently to change the branch into a local subsidiary, particularly once the overseas operation becomes profitable. A branch is normally preferred to begin with because the start up costs can be set against United Kingdom profits but, once the overseas operation begins to run at a substantial profit, if the location of the operation has lower tax rates than the United Kingdom, a subsidiary would usually be preferable to shelter the overseas profits from the higher United Kingdom tax rates.

This common situation was within the second category and Treasury consent had to be sought. The Revenue were sometimes not enthusiastic about the losing-branch -profitable- subsidiary sequence because the United Kingdom company could save United Kingdom tax by setting off the high expenses in the early years of the overseas operation, but escape United Kingdom tax on the subsequent profits.

At least the situation here would be clear: the company would have known - or should have known - that Treasury consent was required. The same would be true if some other substantial part of its trading operations were to be transferred abroad - such as the company's sales division, or manufacturing activities.

Other situations were not, however, so clear cut, such as where a major contract was assigned to a non-resident company. The assignment of a minor contract or the sub-contracting of a major contract would presumably not constitute the transfer of part of the trade, but the dividing line was often far from clear. In cases of doubt, it was always essential to seek Treasury consent.

As the section only applies to transactions by companies, instead of a United Kingdom company setting up an overseas subsidiary, the United Kingdom company's shareholders, assuming they are individuals, could set up an associated overseas company without having to seek Treasury permission. Individuals would, however, have to consider the possible impact of section 739 ICTA 1988.[38]

The first and second categories were abolished in 1988,[39] the third and fourth categories remain.

Category 3 prohibits a United Kingdom company from losing control of a non-resident company by the non-resident company issuing shares or debentures unless the non-resident company gives security to a bank or insurance company in the ordinary course of business.[40] This category prevents the overseas company issuing redeemable shares or debentures in circumstances that would give rise to a distribution if they had been issued by a United Kingdom company. Thus, a fairly

38. See Part 2
39. By section 105(6), (7) and Sch 14 Part IV FA 1988
40. Section 765(2),(3) ICTA 1988

straightforward tax avoidance scheme is prevented.

Category 4 prohibits a United Kingdom resident company from losing control of a non-resident company by transferring shares or debentures to another person. This stops avoidance devices involving the capitalisation of income by the satisfaction of deferred purchase price out of the company's income.

Section 765(4) allows the Treasury to issue general consents so that, if the proposed transaction is covered by a general consent, the taxpayer company does not have to seek specific prior approval from the Treasury.

In summary, the general consents prior to the abolition of the first two categories in 1988, were:

1. Regarding categories 1 and 2, the setting up of a company after the passing of the ICTA 1970 to carry on a new trade where 50% of the new company's shares were held by persons not ordinarily resident in the United Kingdom.
2. Regarding category 3, the issue of shares or debentures in an overseas company is permitted if the issue is for full consideration in cash or the issue is in payment for any business or property acquired for full consideration. The shares must not be redeemable preference shares; the issue to trustees for a non-resident company over which the United Kingdom company has control, or to trustees for any individual or individuals having control over that United Kingdom resident company; or shares the effect of whose issue is that the United Kingdom company loses control over the overseas company.
3. Regarding category 4, the transaction is permitted provided the United Kingdom company retains control of the overseas company.
4. An overseas company incorporated after 31st December 1951 may issue shares or debentures for the purposes of commencing and carrying on a new industrial

activity in any Commonwealth territory provided that it is resident in that territory.

5. The outright sale of shares or debentures in any overseas company is allowed as long as it is for full consideration in cash which must not exceed £50,000, the company is not a company over which persons ordinarily resident in the United Kingdom have control, the buyer has no interest in the business of the seller (and vice versa) and the sale is not associated with any other transaction whereby the business is sold and an interest in that business may revert to the seller or to anyone who has an interest in the business of the seller.

As regards specific consents, in practice the granting of consents depends on a number of factors but, perhaps, the two main ones are that the Treasury will want to be satisfied that the transaction would not have any unduly adverse effect on the United Kingdom balance of payments and the Revenue will, of course, be interested in the effect of the proposed transaction on the United Kingdom liability of the taxpayer.

It was often a condition of approval being given that a certain specified proportion of the overseas profits were repatriated to the United Kingdom.

The Treasury and the Inland Revenue have normally been realistic and fair in their application of this section to genuine commercial operations and have not tended to be too narrow sighted in granting or refusion permission. Where conditions are imposed, such as the repatriation of a specified percentage of the company's profits, the conditions have not tended to be prohibitive or unreasonable.

It would have been easy for such a wide and penal section to have been operated so as to be oppressive and unreasonably restrictive to bona fide commercial arrangements, but the authorities have tended to take a responsible and realistic attitude to the application of the considerable powers given to them by the section.

As noted above, categories 1 and 2 were abolished by the FA 1988 and the general consents were amended. This followed a number of years of different proposals for tackling international tax avoidance and a number of consultative documents. There had been pressure to repeal what was then section 482 ICTA 1970 since exchange control was abolished in 1979; the section had originally been enacted to work alongside the exchange control legislation.

The abolition of the first two categories in section 765(1) ICTA 1988 means that companies can transfer their residence and/or trades abroad without Treasury consent. This would have left some scope for avoidance, particularly in the area of capital gains, in that a company resident in the United Kingdom with capital assets on which substantial capital gains would arise on disposal, could become resident outside the United Kingdom and dispose of those assets free of corporation tax. For this reason, FA 1988 introduced a new tax charge when company's ceased to be resident in the United Kingdom.

The abolition of the requirement for Treasury consent for company migration and these new tax charges were introduced as part of a package along with the new test for company residence considered above.

The new tax charges are contained in sections 105-107 FA 1988. When a company, after 14th March 1988, ceases to be resident in the United Kingdom, it is deemed to dispose of, and immediately reacquire, all of its assets at market value except those assets situated in the United Kingdom which are used or held for a branch or agency in the United Kingdom. Furthermore, where a

United Kingdom resident company commences to be regarded, for the purposes of any double taxation agreement, as resident in a territory outside the United Kingdom, and as not liable to United Kingdom tax on gains on disposals of assets specified in the double taxation agreement, a similar deemed disposal occurs. This prevents companies circumventing the provisions by using an appropriate double tax agreement by becoming dual resident.[41] In other words, domestic law is, in effect, being made to override double taxation agreements. It will be seen that emigration will give rise to a tax charge - often very substantial - when there are no disposal proceeds out of which to pay the tax.

A company intending to cease to be resident in the United Kingdom must notify the Board of Inland Revenue and make satisfactory arrangements for the payment of its tax liabilities.[42] If a company migrates without this requirement being fulfilled, the persons responsible, including individual directors, may be liable for substantial penalties (i.e., equal to the amount of tax due).[43] The Revenue may assess a company which controls the migrating company or a director of the migrating company or of the controlling company, provided they, to their knowledge, contributed to the avoidance of tax.[44] The onus is on the directors, so they therefore have to prove a negative, which might not be very easy. If the tax is not paid within six months from the company emigrating, the Revenue can serve a notice on any company which was in the migrating company's group.

This is much more stringent than under the old regime, where the Revenue were usually satisfied to have a United Kingdom guarantor to cover the migrant company's tax.

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41. Further devices using dual resident companies are described below
42. Section 130 FA 1988
43. Section 131 ibid
44. Section 132 ibid

It can be seen that Parliament has not allowed the abolition of the first two categories of section 765 to open the door for widespread avoidance by companies ceasing to be resident in the United Kingdom. In any case, as has been explained above, the number of companies which are now able to move their residence abroad has been severely restricted by the change in the residence rules.

The new charge regarding the abolition of category 1 of section 765 covers capital gains. As far as trading and other United Kingdom source income is concerned, that would, of course, generally remain subject to United Kingdom tax (in the absence of a double tax agreement). In the case of category 2, it has now become possible to transfer a trade to a non-resident person without first obtaining Treasury consent and without suffering a tax penalty.

The charge imposed on the migration of companies did leave a major loophole that had to be closed up in the following year. The migration charge did not apply to assets of a branch or agency of the migrating company which remains in the United Kingdom. A company intending to migrate could arrange for its capital assets standing at a gain to remain in the United Kingdom as assets of the branch or agency. The assets would, at that stage, avoid the emigration charge. The assets could then subsequently be taken outside the United Kingdom tax net.

The rule as regards capital assets of a branch or agency before the 1989 changes was that a capital gains tax charge arose on the disposal of those assets if they were situated in the United Kingdom and used for the business of a branch or agency. However, if a trade ceased before the disposal of the asset, a charge would not normally arise. A charge could also be avoided by removing the asset from the United Kingdom before disposal or disposing of it in the United Kingdom but rolling the gain over into an overseas asset which, on its disposal, was outside the United Kingdom tax net. The migration rules, therefore, contained large and fairly obvious shortcomings. In 1989, therefore, an additional charge was imposed on unrealised gains of the branch or agency if the United Kingdom business of the branch or agency ceased or the assets were removed from the United Kingdom. Capital gains tax roll-over relief was also withdrawn where the replacement asset was outside the United Kingdom tax net.[45]

Similarly, the rules regarding dual resident companies were tightened up in 1989. The 1988 changes imposed a charge when a company becomes a dual resident company[46] and the 1989 changes supplemented this by imposing a charge on unrealised gains where assets of a dual resident company change from being within the charge to United Kingdom tax to being outside it.[47] This change would stop, for example, the dual resident company/CGT device described below. This would not have been stopped by the 1988 avoidance rules.

Before the abolition of categories 1 and 2 of section 765, an interesting case was heard in the Court of Justice of the European Communities on the question of whether under community law, the United Kingdom were allowed to impose the restrictions then contained in section 482(1) ICTA 1970. This case was <u>R v HM Treasury and Inland Revenue Commissioners ex parte Daily Mail and General Trust Plc</u>.[48]

The facts were that the company applied for Treasury consent under section 482(1) to transfer its central management and control to the Netherlands. It was common

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45. Section 126-129 FA 1989
46. Section 106 FA 1988
47. Section 132 FA 1989
48. [1988] STC 787

ground that the principal reason for the proposed transfer was to enable the company, once its residence had been established in the Netherlands, to sell assets and use the proceeds to buy its own shares, without incurring capital gains tax and advance corporation tax to which it would be liable in the United Kingdom. Corporation tax would be payable in the Netherlands but a liability would only arise on any capital gains accruing after the transfer of residence. The company provided information which showed that the loss of tax revenue as a result of the transfer of residence (excluding income tax revenue of around £500,000 per year) would be almost £25,000,000.

It would presumably have been possible for the company to have presented arguments that there were bona fide commercial reasons for the transfer of residence but they decided not to take this course, openly admitting that their main purpose was to save UK tax.

The Treasury proposed that the company should sell at least some of the assets before transferring its residence out of the United Kingdom, but the company was not ready to accept any such compromise and brought proceedings in the High Court claiming that it was entitled under the EEC Treaty to be incorporated in any member state and that it had the right to transfer its central management and control to another member state.

In the High Court, Macpherson J was of the opinion that:

> "My own inclination has been to doubt whether section 482 should be allowed to prevent or to fetter the voluntary movement of residence of a corporation which wishes to take advantage of a better fiscal climate in another member state within the EEC... the object of the Treaty being the removal of barriers and the creation of an economic community without protective barriers of any kind either for persons or for corporations or for trade

generally. The creation in other words of a true Common Market."[49]

The judge stayed the proceedings and requested a preliminary ruling from the European court on the following questions:

1. Do Articles 52 and 58 of the EEC Treaty preclude a member state from prohibiting a body corporate with its central management and control in that member state from transferring, without prior consent or approval, that central management and control to another member state?
2. Does EC Council Directive 73/148 give a company a right to do so?

Article 52 states:

"Within the framework of the provisions set out below: restrictions on the freedom of establishment of nationals of a member state in the territory of another member state shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member state established in the territory of any member state. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies of firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital."

Article 58, so far a relevant, states:

"Companies or firms formed in accordance with the law of a member state and having their registered office, central administration or principal place of

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49. p161

business within the community shall, for the purposes of this chapter, be treated in the same way as natural persons who are nationals of member states."

Directive 73/148 prohibits restrictions on the emigration of EEC nationals within the EEC.

The European Court held that Articles 52 and 58 conferred no right on a company incorporated within one member state, and having its registered office there, to transfer its central management and control to another member state and that, similarly, Directive 73/148 conferred no such right.

The court, in its judgement, accepted that freedom of establishment constitutes one of the fundamental principles of the Community.[50] The provisions of the Treaty prohibit a member state from hindering the establishment in another member state of a company incorporated under its legislation.[51] The right of establishment is generally exercised by the setting up of agencies, branches or subsidiaries, or by incorporating a company in another member state.[52] They noted that United Kingdom law imposes no restriction on such activities.[53] The court then stated that United Kingdom law does not "stand in the way of a partial or total transfer of the activities of a company incorporated in the United Kingdom to a company newly incorporated in another member state.... It requires Treasury consent only where such a company seeks to transfer its central management and control out of the United Kingdom while maintaining its legal personality and its status as a United Kingdom company". As the law then stood, this was, of course, completely wrong.

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50. Para 15
51. Para 16
52. Para 17
53. Para 18

The Court noted that the legislation of the member states varies widely regarding the factors connecting a company to a national territory and on the question of whether a company incorporated under its legislation can subsequently modify that connecting factor.[54] The conclusion of the court was that:

> "23. It must therefore be held that the Treaty regards differences in national legislation concerning the required connecting factor and the question whether, and if so how, the registered office or real head office of a company incorporated under national rule may be transferred from one member state to another as problems which are not resolved by the rules governing the right of establishment but must be dealt with by future legislation or conventions.
>
> 24. Under those circumstances, Articles 52 and 58 of the Treaty cannot be interpreted as conferring on companies incorporated under the law of a member state a right to transfer their central management and control and their central administration to another member state while retaining their status as companies incorporated under the legislation of the first member state.
>
> 25. The answer to the .... first question must therefore be that in the present state of community law Articles 52 and 58 of the Treaty, properly construed, confer no right on a company incorporated under the legislation of a member state and having its registered office there to transfer its central management and control to another member state."

The court also decided that Directive 73/148 applied only to natural persons, not to companies.

This case is no longer of practical significance in relation to categories 1 and 2 but it is of academic

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54. Para 20

interest in showing that these domestic restrictions were legitimate in the face of EEC law. The facts are also of interest in demonstrating the enormous sums of money often involved in international tax avoidance arrangements. Another significant feature arising from the facts is that the Treasury, faced with the taxpayer company's proposals, which were admitted to have as their main object the avoidance of a very large amount of UK tax, did not simply prohibit the transactions, but did try to agree a compromise that would allow the taxpayer company to carry out its proposals but would limit (but not eliminate) the loss of tax to the UK Inland Revenue.

Section 765 applied only to regulate companies moving their residence abroad. Neither section 765, nor any other provision, has ever prevented the manipulation of the residence rules by transferring a company's residence to the UK, with one specific exception: in 1987 an amendment was made to the Controlled Foreign Companies legislation to stop a particular loophole in the acceptable distribution policy test.[55]

Tax could be avoided by bringing a company's residence to the United Kingdom in a number of ways. For example, if an overseas subsidiary made substantial losses, it could ensure that it was treated as resident in the United Kingdom by switching its central management and control to the United Kingdom. Those losses would then be available for group relief and so could reduce the taxable profits of UK resident companies in the same group. On the other hand, an overseas subsidiary with substantial accumulated profits could become resident in the United Kingdom and then distribute the profits among other group companies under a group election without giving rise to any United Kingdom tax. In the Inland Revenue Consultative Document, "Taxation of International Business"[56] it was estimated that such devices gave rise

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55. See Part 6
56. December 1982

to a loss of tax of about £50,000,000 a year.[57] The Government, in the Consultative Document, expressed their intention of bringing forward specific measures to deal with these arrangements. However, as yet, no such provisions have been introduced.

57. Para 8

Dual Resident Companies and Group Relief

One particular way the company residence rules were manipulated and which called for specific counteracting measures was the use of the "dual resident company".

The abuse was well known to the Inland Revenue but it took them a number of years before they introduced anti-avoidance measures. To the Government's credit, they issued a Consultative Document in 1984 with a view to introducing provisions in the Finance Act 1985. The Consultative Document was: "Taxation of International Business: Dual Resident Companies". The Revenue were clearly worried by the size of the problem. For instance, in the Consultative Document it was noted that, in 1983, over 50 multinationals were identified where the United Kingdom was giving interest relief for interest payments of about £250,000,000 a year for UK companies investing abroad.[58] The Consultative Document also stated that the number of cases they found of foreign investment in the UK through dual resident companies was about the same, with total interest at about £150,000,000 a year. With a corporation tax rate of 35%, the tax loss would be over £100,000,000.

However, in the light of substantial representations made to the Government in response to the Consultative Document, they decided not to introduce legislation in 1985 and asked the Inland Revenue to keep the subject under review. The exploitation of the rules continued and, in fact, increased - perhaps fuelled by the publicity given to the scheme by the Consultative Document itself.

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58. Para 8

This subject is also an interesting example of cooperation between tax authorities on exchanges of information.[59] At the request of the Inland Revenue, the United States IRS requested from U.S. based multinationals information relevant to the review.

A dual resident company, as its name suggests, is a company incorporated under the laws of one country, but subject to tax by virtue of the relevant residence rules in two countries. Countries with suitable group relief laws for this scheme were the USA, Australia, New Zealand, West Germany and the Netherlands, although there were practical difficulties about using West Germany and the Netherlands. The most common type was a company incorporated in the USA (and often in Deleware, which has fairly lenient tax and reporting requirements) but with its central management and control in the UK. The current UK/USA double tax agreement does not resolve the residence status of a dual resident company, in other words, there is no "tie breaker" article. This contrasts with the earlier 1945 treaty under which a company incorporated in the USA and managed and controlled in the UK was specifically deemed to be resident in the U.S.A. The lack of a residence "tie breaker" article means that a company's dual resident status is not resolved by the treaty. In any case, it should be noted that a tie breaker article would not prevent a dual resident company structure from operating because a company could still claim the reliefs to which it was entitled under domestic law; this would not be prevented by the treaty, even if a tie breaker article deemed the company to be resident only of another country for the purposes of preventing double taxation.

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59. See Part 1

The basic idea was that tax benefits would be available in both countries, so the benefits would effectively be doubled up. In the US/UK situation, the company could obtain exemption from tax on intra-group dividends, the elimination of withholding tax on interest and royalties and of advance corporation tax on distributions by UK resident companies. This, of course, assumes that the requisite percentage shareholding requirements are met. Benefits are usually also available to shareholders under the double tax agreement.

It is a fact, which was recognised by the Inland Revenue in their Consultative Document, that not all dual resident companies are set up to gain tax advantages; some are genuinely trading with a view to profit. Any anti-avoidance rules ought not to restrict unduly the operations of these legitimate dual resident companies. If they make losses in the normal course of their business, they should be able to obtain the appropriate relief. Of course, the rules would have to be drafted so that they could not easily be circumvented by a company carrying on a nominal trade.

In any case, genuine trading operations likely to suffer losses (for example, in the early years) can normally be more effectively run through a branch than a dual resident company. A genuine dual resident company would not usually be preferable unless the loss making period is likely to be prolonged. So, all in all, bona fide trading dual resident companies are fairly rare. Most dual resident companies are investment holding companies.

A dual resident company would be subject to tax in both countries on its worldwide profits but, by the same token, its losses can be used in both countries. Consequently, the object was to generate tax losses. This was normally achieved by the dual resident company borrowing money from outside the group to finance investment by the group. The interest payments were funded by receipts which did not give rise to taxable profits. As the dual resident company would have no taxable profits, the interest payments would generate tax losses.

Money could be received by the dual resident company for paying the interest in a non-taxable form in a number of ways. For example, the dual resident company could be paid for the losses surrendered by the dual resident company. A payment by a member of the UK group would not give rise to any UK tax consequences by virtue of what is now section 402(6) ICTA 1988. For US tax purposes, as long as the US payer and the dual resident had a tax sharing agreement, there would be no adverse US tax consequences.

Another way the debt could be serviced was for the dual resident company to borrow additional funds, either from within the group, or from outside. With inter group loans, the thin capitalisation rules had to be taken into account.[60]

The Consultative Document discussed the artificiality of such internal borrowing arrangements. It noted:

> "At the extreme, a dual resident may be interposed in an existing multinational structure, in effect converting equity financing of a subsidiary to loan financing from another group member: the dual resident is financed by internal borrowing to 'acquire' a subsidiary which the multinational already owns. The result is a paper shifting of finance between different companies owned by the multinational which creates an interest deduction, and hence a tax loss, in the dual resident. While the interest payments by the dual resident will give rise to taxable profits elsewhere within the multinational, these profits will be taxed only once whereas the dual residence tax loss is available for

60. See Part 9

use twice. A tax benefit is therefore obtained."[61]

Furthermore, there is always the opportunity for the dual resident company to be funded by the injection of additional equity capital from the UK or the USA.

The Consultative Document identified two possible solutions, namely:

(i) to deny or restrict the deduction for interest paid by the dual resident company; or

(ii) to restrict group relief.[62]

The two countries mainly involved in dual resident company activities, the USA and the UK, have each taken action independently, so that it can now happen that, whereas relief might previously have been given twice; it might now not be available at all. The problem is that, although the UK legislation is supposed to compliment the US legislation, the two countries attempted to solve the problem in different ways.[63]

The US changes were made by <u>section 1249 of the Tax Reform Act 1986</u> which amended <u>section 1503 of the Inland Revenue Code</u>[64]. The new provisions basically allow interest relief only if group relief is not available overseas.[65] Before the provision can operate, there must be a "dual consolidated loss" which is "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside such foreign country or is subject to tax on a residence basis."

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61. Para 7
62. Para 11
63 Australia has also taken action against dual resident companies with effect from 1st July 1986, similar to the US and UK legislation.
64. The provision allowing losses ect to be used to reduce the income of an affiliated company.
65. Infra

The section provides that the loss "shall not be allowed to reduce the taxable income of any other member of the affiliated group." The loss is, however, available to offset future profits of the dual resident companies. As mentioned above, the restricted losses do not include any losses which, under the law of the other country, are not offset against the income of any overseas company. In some circumstances then, the taxpayer company may be able to choose whether the US restrictions apply. For example, group relief may have to be claimed in the other country. If the dual resident company decides not to claim group relief in the other country, its relief will not be restricted in the USA. Such a choice is not open to the dual resident company under the UK legislation.

The UK changes were contained in the section 63 and 64 and Schedule 4 F(No2)A 1987[66] following a second Consultative Document issued on 5th December 1986, which contained draft clauses. The solution adopted was the second suggested in the earlier Consultative Document, namely, the restriction of group relief. The restrictions came into effect on 1st April 1987.

Unlike the US reforms, the UK changes operate regardless of the question of whether the dual residence company has obtained relief in respect of the same loss anywhere else. It would have been fairer to have incorporated such a provision into the UK changes because it would have prevented the dual resident company obtaining double relief, without being unduly restrictive or inflexible.

The changes operate by providing that losses and other amounts that previously could be surrendered by way of group relief, such as excess charges on income, cannot now be surrendered by a dual resident investing company. The changes do not prevent the surrender to a dual resident investing company of losses etc., or to

66. See now section 404 and Sch 17 ICTA 1988

surrenders by or to dual resident trading companies. It should be noted that the new provisions are not confined to the most popular dual resident company structure, the company incorporated in the USA but managed and controlled in the UK. The provisions also catch a company which is resident in the UK and another country for any other reason (perhaps, because its place of "effective management" is there).

It should further be noted that there is no exclusion for genuine commercial arrangements other than the rough and ready one of excluding dual resident trading companies from the new restrictions. It is quite possible for a UK resident company to acquire a residence in another country inadvertently. This danger was increased with the introduction of the new UK residence rules in the FA 1988; a UK company can now be resident in the UK because it is incorporated here and resident in another country because its central management and control or effective management etc. is abroad.

Even the exclusion for trading companies is quite narrow and the provisions that attempt to exclude genuine business activities are rather elaborate. The provisions only apply to an investment company which is defined as any company which is, throughout the accounting period in question, not a trading company. In practice, some genuine trading companies might find it difficult to prove that they are trading. For example, property holding companies might face a problem here. But a company carrying on a trade can still be deemed to be an investment company if its main "function" or one of its main "functions" is:

(i) to hold shares in companies with which the dual resident company is connected (this is to prevent the rules being side stepped by the interposition of a holding company);

(ii) to make payments which are charges on income (this is aimed at the "classic" dual resident company structure);

(iii) the make payments which are deductible in computing its profits; or

(iv) to obtain by borrowing funds for the purposes specified in (i) to (iii) above (for example, a dual resident financing company).

This is reinforced by a second rule which deems a dual resident company to be an investment company if its carries on such activities as are mentioned above to an extent which does not appear to be justified by any trade it does carry on or for a purpose which does not appear to be appropriate to any such trade.

If a trading company has passed the above two test, there is a third hurdle to overcome. A company will be treated as an investing company if all of the following conditions apply:

(1) the amount paid by the company by way of charges on income exceed its profits as determined under section 403(8) ICTA 1988; and
(2) the payments include amounts treated as charges on income under the provisions relating to bills of exchange or deep discount securities; and
(3) the paying of those charges is the company's main or one of its main activities.

There is a further anti-avoidance provision built into the legislation to stop companies avoiding the rules before they came fully operational. The restrictions apply to accounting periods commencing after 31st March 1987 and accounting periods which straddle this date are split and losses etc. are apportioned between the two separate periods.

Without appropriate provisions, it would have been possible to make a payment early of interest or charges on income. There are anti-avoidance rules which apply to arrangements made on or after 5 December 1986[67] which

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67. The date the changes were announced.

varied the date for payment. Under these rules, if such an early payment was made and it appeared to the Inland Revenue that the sole or main benefit of the early payment was the obtaining of group relief, they could serve a direction deeming the early payment to have been made after 31st March 1987 for the purposes of group relief (but not for altering the dual resident investing company's own tax position).

Section 64 F(No.2)A 1987 introduced further restrictions on dual resident companies after 31st March 1987. Briefly, they are as follows:

1. No election can be made to substitute sale price for market value under paragraph 4, Schedule 7 CAA 1968 where the buyer is a dual resident investing company.
2. Section 343(2) ICTA 1988, which applies on the transfer of a trade to a company in the same ownership and deems the transferee company to have taken over assets qualifying for capital allowances at their written down value, does not apply where that transferee company is a dual resident investing company. Similarly, no election may be made under paragraph 13, Schedule 8 FA 1971 where the successor is a dual resident investing company.
3. A disposal of an asset on a no gain no loss basis under section 273 ICTA 1970 does not apply where the capital asset is disposed of to a dual resident investing company.
4. For CGT roll-over under section 115 CGTA 1979, a dual resident investing company is treated as being outside the group, and so no roll-over is available where the proceeds of the disposal of qualifying assets by another group member is made by a dual resident investing company. However, a dual resident investing company is entitled to roll-over relief if its reinvests the proceeds of its own disposal.

5. Section 44(6) FA 1971, under which, for capital allowances purposes, a sale of machinery and plant at an under value is not treated as being at market value, does not apply where the buyer is a dual resident investing company.

In the first test described above for determining whether a company is an investing company it is interesting to note the use of the word "function". It must be the main "function" or one of the main "functions" of the company to carry out one of the specified activities. Compare the third test where the paying of charges must be the company's main or one of its main, "activities". The addition of "functions" in the first test must be intended to add something to "activities".

If the legislature had intended to lay down a subjective test, it would be more usual for them to have used "object" or "purpose" rather than "function". Indeed, "purpose" was used in the second test. It is not at all clear what different test is to be implied by the use of "functions" in the first test, compared with the "purpose" criterion in the second test. Furthermore, as noted above, the third test uses neither the "function" nor the "purpose" criteria, but merely refers to "activities".

It is not clear whether the draftsman had some subtle distinction in mind between the "function" and the "purpose" test or whether he was merely guilty of sloppy drafting.

If a subjective test is not imported into the first test, which might be suggested by the failure to use "purpose" or "object", the first test would, it seems, be unjustifiably harsh, given that the legislation as a whole does not require the dual resident company to have a tax avoidance motive. On the other hand, the third test containing neither a "function" nor a "purpose" test is not excessive, given that it is definitely not subjective because the actual terms of the third test are very specific and narrow.

Viewed as a whole, the UK legislation is extremely wide ranging and complicated. The abuse constituted by the most blatant types of dual resident company structure was not an unreasonable target for anti-avoidance provisions and, indeed, the Consultative Document highlighted the extreme cases at which they wanted the legislation aimed. However, the provisions now on the statue books are much wider than required to stop the schemes highlighted in the Consultative Document and there is a real danger that they will impinge on legitimate commercial activity.

The legislation is also inflexible and operates whether or not relief is actually being claimed in another country, so it is not truly aimed at the schemes mentioned in the Consultative Document, but at the bodies involved in those activities. The width and inflexibility of the provisions are exacerbated by the fact that no tax avoidance is required to trigger the provisions.

So, a dual resident investing company is caught and loses its UK group relief, even if:

(a) it is not getting relief elsewhere;

(b) it has no intention of avoiding tax.

It would not have been difficult to draft legislation which was narrower and more accurately aimed at the targeted avoidance schemes, and which did not adversely affect genuine commercial ventures.

What the UK provisions mean for many groups is that, to obtain any group relief at all, they will have to restructure their operations or the group structure by, for example, changing the residence of the dual resident company (which cannot now be done if it is incorporated in the UK), changing its operations so that it is not a dual resident investing company, or restructuring the debt arrangements, so that the interest is paid by a company which is resident in only one country.

Dual Resident Companies and CGT[68]

Another method of using a company resident in more than one country to avoid tax is aimed at saving CGT. There are a number of variations both for companies and for individuals. The scheme for individuals, using trusts, is described below.[69] The company scheme usually used a dual resident subsidiary and the basic arrangements were as follows.

1. The transferor company ("T") formed a subsidiary ("S") which was registered in a country with a suitable domestic law and suitable double tax agreement with the UK. The country most commonly used was Belgium. S had its "statutory seat" in Belgium but its "management and control" in the UK. This meant that it was resident in both countries under their respective domestic laws.
2. T transferred the asset in question to S. As T and S were in the same group under UK law, no chargeable gain arose.[70]
3. When a purchaser was found, S sold the property at full market value. Under UK domestic law, the whole gain crystalised on this disposal but, under Belgian law, the base cost was the market value when the property was acquired by S. Under the UK/Belgium double tax agreement, where a company is resident in both countries, it will be treated as a resident only of the country in which its place of "effective management" is situated. As long as the company ensured that its effective management was in Belgium, for the purposes of the double tax agreement S would be resident only in Belgium and the gains would only be taxable in the country in which the transferor was resident[72], namely, only in

68. Strictly, of course, this is corporation tax on capital gains but, as in Chapter 8, the term "CGT" will be used for convenience.
69. See Part 8
70. Section 273 ICTA 1970
71. Article IV(3)
72. Article VII(2)

Belgium, where little or no gain would in fact arise.

The 1989 anti-avoidance provisions explained above would now stop this particular scheme.[73]

73. Section 132 FA 1989

Operations in Other Countries

Assuming that a company does not have a residence in another country, the normal basis on which that country can levy taxation is in respect of sources of income in that country. This applies not only to companies, but also to individuals and other entities. It is subject to relief under a double tax agreement in appropriate cases. The issue of "treaty shopping" is examined above[74] from which it can be seen that double tax agreements are used in international structures to ensure that total worldwide taxes on a particular source are kept to a minimum.

The matter considered here is the case of a company resident in one country, carrying out business operations in another. The most common criterion used for the purpose of determining the tax liability of an entity resident in one country carrying on business in another is that of "permanent establishment". This concept is also used in double tax agreements as a basis for the apportionment of taxable income. If the entity ensures that its activities in the other country do not constitute a permanent establishment, a tax liability in that country will be avoided. An example of this can be seen in 3 New Zealand Board of Review Decisions 49 (Case 5). An Australian company, which promoted theatrical enterprises, planned a number of touring shows in New Zealand. It would not be subject to tax in New Zealand on industrial or commercial profits with their source in New Zealand unless they were derived through a permanent establishment in New Zealand.[75] Under article II(1)(h) of the Australia/New Zealand double tax agreement, "Industrial or Commercial Profits" does not include

74. See Part 1
75. Australia/New Zealand double tax agreement, Article III(1)

"income arising from, or in relation to, contracts or obligations to provide the services of public entertainers, such as stage, motion picture, television or radio artistes, musicians and athletes". "Permanent establishment" was defined as "a branch agency or other place of business" including a "management".[76] By article II(1)(m)(9) it was provided that "where an enterprise of one of the Contracting States...has an agent in that other state other than an agent who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of that enterprise... that enterprise shall not, merely by reason thereof, be deemed to have a permanent establishment in that other contracting state".

The Australian company therefore arranged its activities so that it would not be treated as carrying on a trade or business in New Zealand through a permanent establishment. It bought its artistes overseas and did not open an office in New Zealand. The duties of the manager who accompanied each show were restricted to carrying out minor tasks relating to the day to day production of the show. If there was a major decision to be made, the manager had to refer to his principals in Australia who were the only people who could make these decisions. The only New Zealand staff used were such people as ushers, stage staff and other casual workers. Having arranged its operations in this way, it was held that the Australian company did not have a permanent establishment in New Zealand and that it was not subject to New Zealand tax on the profits derived from its theatrical productions in that country.

A taxpayer was similarly successful in the US case of <u>CIR v Consolidated Premium Iron Ores Limited</u>.[77] Here, the

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76. Ibid Article II(1)(m)
77. 265 F 2d 320

taxpayer company was resident in Canada and did not want to suffer US tax on income from its operations in that country. Again, it had to avoid having a permanent establishment in the US, because such an establishment would have given rise to a liability to US tax. Under the double tax agreement then in force, "permanent establishment" included branches and fixed places of business. It was also stated that: "When an enterprise of one of the Contracating States carries on business in the other Contracting State through an employee or agent established there, who has general authority to contract for his employer or principal, or has a stock of merchandise from which he regularly fills orders which he receives, such enterprise shall be deemed to have a permanent establishment in the latter state. The fact that an enterprise of one of the Contracting States has business dealings in the other Contracting State through a commission agent, broker or other independent agent or maintains therein an office used solely for the purchase of merchandise shall not be held to mean that such enterprise has a permanent establishment in the latter state".[78] The Canadian company therefore organised its activities in the US so that it did not have an office, directors or employees, a bank account, a telephone listing, its name on any door or office or an employee or agent with general authority to contract for it. In the circumstances, it was held that it did not have a permanent establishment and that its profits in the United States were not subject to tax in that country.

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78. Art V

PART 6

CONTROLLED FOREIGN COMPANIES

Introduction

The Finance Act 1984 contained detailed provisions relating to Controlled Foreign Companies ("CFCs").[1] Under these provisions, a company resident in the UK can be taxed on the profits earned by an overseas company in which it has an interest. This legislation was in reaction to what was seen as the widespread use of companies set up in tax havens to avoid UK tax.

Similar legislation was already in place in other countries, namely, the USA, West Germany, Canada, Japan and France. The UK was relatively late in taking such action and the legislation followed three years of consultation. Australia and New Zealand have also now introduced CFC legislation. These CFC provisions constitute the most direct and important attack on avoidance by the use of tax haven subsidiaries.

The basic starting point in considering this legislation and the abuses at which it was aimed, is that a company resident outside the UK is not liable to UK tax except on profits arising from a trade carried on here through a branch or agency, or on gains arising from a disposal of UK assets related to the trade.[2]

It is a fundamental rule of UK tax law that profits earned by a company which is not resident in the UK from outside the UK are not subject to UK tax except indirectly when they are distributed as a dividend to a UK resident.

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1. Sections 82-91 and Schs 16-18 FA 1984, now section 747-756 and Schs 24-26 ICTA 1988.
2. Sections 6 and 11 ICTA 1988

This basic rule is subject to only very specific exceptions (which are each dealt with in different chapters).

1. Offshore funds.[3]
2. Transfer of assets abroad under section 739 ICTA 1988 and section 45 FA 1981 (this only catches UK individuals on income of an overseas company - or other entity - there is no similar provision to catch UK companies).
3. The apportionment of the gains of non-resident companies under section 15 CGTA 1979 (again, this only catches UK individuals).

In the absence of these specific exceptions, the non-UK source profits of a non-resident company escapted tax in the UK.

The UK Government was concerned that this fundamental rule gave enormous scope for the avoidance of tax, because companies were being set up in tax havens purely for tax reasons. The scope for avoidance increased with the abolition of exchange controls in 1979, after which the absence of restraints the controls previously imposed on the setting up of tax haven companies, and the enforced remittance of profits, meant that there were more opportunities to retain profits outside the UK tax net.

In the 1982 Consultative Document "Taxation of International Business",[4] the Government outlined a number of common arrangements that were of particular concern to them.[5]

1. "Money box companies". A UK company with surplus funds could put those funds into a company established in a low tax area, perhaps by way of subscription for shares. The subsidiary would then

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3. Sections 757-764 ICTA 1988
4. Supra
5. Para 23

invest these funds, and the resulting income would be taxed at a nil or low tax rate.

2. "Dividend trap companies". These are companies interposed between a UK parent and an overseas trading subsidiary. The subsidiary would pay up dividends to the dividend trap company, rather than to the UK parent, in whose hands they would suffer lower tax than if they had been paid directly to the UK.
3. Offshore captive insurance companies. These are dealt with separately in Part 9 of this Chapter.
4. Sales, distribution or service companies. These are companies set up as subsidiaries in a low tax area, into which are diverted business or commercial activities from the UK. In practice, they often make little real contribution towards the business of the group but they reduce the amount of UK tax paid.
5. Patent holding companies. These companies are set up in low tax areas to hold patent rights originally established by UK companies. The royalty income would suffer a lower rate of tax than if the royalties were received in the UK.

The Government's concern at the amount of tax apparently lost by these means, which they viewed as abusive, can be seen from paragraphs 26 and 27 of the Consultative Document. The Inland Reveneu made a survey of 130 groups and they found over 220 non-resident companies which it appeared had, as one of their main purposes, the reduction of the UK tax. The capital of money box companies in low tax areas amounted to £436,000,000. At least 99 groups (including 35 of the 130 covered by the survey) had offshore captive investment companies. Figures were available for around 2/3rds of these which showed that total undistributed profits amounted to £108,000,000. The Inland Revenue identified almost 50 dividend trap companies and the number of distribution, sales, service or patent holding companies was said to be "significant". It was estimated that the annual loss to the exchequer could have been around £100,000,000.

Despite the Government's concern over the extent of the exploitation of tax havens by UK companies, and the fact that other major industrial countries had already introduced anti-avoidance legislation against such abuses, the Government did not rush into introducing counteracting measures. Instead, it entered into a consultative process that began in January 1981 and culminated in the introduction of the controlled foreign companies legislation in the Finance Act 1984. In this respect, the Government showed commendable common sense and patience, given the large amounts of money involved.

In January 1981 two Consultative Documents were published, "Company Residence" and "Tax Havens in the Corporate Sector" which were followed, in November 1981, with draft legislation which was intended for inclusion in the Finance Bill 1982. Three areas were targeted for remedial action:

1. CFC's.
2. Company residence (it was not until 1988 that legislation was introduced on this and, even then, not in the form envisaged in 1981).[6]
3. Upstream loans (no action has been taken on this at all).

As with CFC's, the government were not rushed into introducing hasty legislation on company residence and upstream loans. The proposals produced a great deal of protest and, as a result, the draft legislation did not find its way into the Finance Bill in 1982. Instead, the Revenue issued papers to selective groups on the subject and this was followed, in December 1982, by the Inland Revenue Consultative Document, "Taxation of International Business" referred to above. This was mainly concerned with CFC's and the draft legislation it contained, and which was incoporated into the Finance Bill 1983, showed little real change from the original proposals, despite the great deal of protest those original proposals

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6. See Part 5

generated. As it happened, the calling of the General Election in June 1983 meant that the CFC legislation was not enacted. Instead, even more draft legislation was publisehd in October 1983 and the barrage of protest continued. Nevertheless, the legislation was contained in the F(No.2) Bill 1984.

Measures Adopted in Other Countries

The provisions enacted by the first six major industrial countries to have introduced CFC legislation (USA, West Germany, Canada, Japan, France and the UK) are all on similar lines but there are significant differences.[7]

As in other areas of anti-avoidance activity, the USA was ahead of the other countries. Its present CFC rules, the Subpart F legislation, was enacted in 1962 but partial CFC legislation had already existed for many years.[8] In 1934, the personal holding company provisions were enacted, followed in 1937 by the foreign personal holding company provisions.[9] A foreign personal holding company is a company established outside the USA with at least 60% of its income being foreign personal holding company income (for example, dividends, interest, royalties etc.), and with more than 50% in value of its stock owned by not more than 5 individuals who are citizens or residents of the USA. The US shareholders are taxed on their proportionate share of the corporation's undistributed foreign personal holding company income. If the foreign personal holding company legislation and the Subpart F provisions conflict, the latter take precedence.

The next country to introduce such legislation was Germany in 1972.[10] Canada also enacted CFC legislation in 1972,[11] although it did not come fully into force until 1976. Japan's CFC provisions were enacted in 1978[12] and France's date from 1980.[13]

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7. The Australian and New Zealand provisions are not examined here, but they are essentially on the same basis.
8. Section 951, Internal Revenue Code.
9. Section 551 ibid
10. Section 7-14. Foreign Tax Law (1972) ("AstG")
11. The Foreign Accrual Property Income ("FAPI") rules
12. Special Taxation Measures Law of 31 March 1978
13. Article 2093 CGI

In the Report issued by the OECD in 1987, "International Tax Avoidance and Evasion", there is a table outlining some important features of the CFC legislation in the six countries mentioned above.[14] The main points contained in the table are set out in the appendix to this Part. From this table, it can be seen that, although the basic approach and a lot of the detail is similar, there are other details which differ from country to country.

1. Persons chargeable. France and the UK restrict their legislation to companies, whereas the others include individuals and, in the case of the USA and Canada, trusts as well. UK individuals, of course, have to contend with sections 739 and 740 ICTA 1988.[15]
2. Shareholding qualifications. As might be expected, these vary in detail, but they mostly require more than 50% of the overseas subsidiary to be held by resident taxpayers. The exception is France where a 25% holding only is required.
3. Tax havens. There is even more variation over what level of taxation in the tax haven will trigger a liability. Approaches differ between the various countries. The US and Canadian legislation, for example, applies regardless of the country of incorporation of the overseas company, subject to certain exclusions. Japan, on the other hand, relies on an exhaustive list of countries with "substantially lower taxation" than Japan. Germany and France rely on numerical comparisons between their own tax rates and those of the overseas country and the UK combine these last two criteria, having a test of less than 50% of the UK tax rate plus a non-exhaustive list of countries in respect of which the legislation cannot operate.

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14. pp56-7
15. See Part 2

4. Target income. There are two approaches here. The UK, Japanese and French legislation potentially apportions all of the income of the overseas subsidiary (subject to certain exemptions); whereas, the US, Canadian and German legislation only apportions income from certain sources within the overseas country, such as dividends, interest, royalties and capital gains. There is a fair amount of inconsistency even among those countries using the "tainted income" principle. Captive insurance companies, for example, are caught by the US provisions, but not by the Canadian legislation. Similarly invoicing (in other words "buy and sell" companies) are tainted in the USA, but not in Canada.

One respect in which the UK legislation differs from that of the other five countries is in respect of the reporting requirements. In each of the other countries, resident taxpayers covered by the CFC legislation must report details of the overseas companies and their activities, with sometimes heavy penalties for non-compliance (for example, in the USA and Canada). Such information does not have to be returned in the UK unless the Inland Revenue specifically asks for it, although the Revenue powers to obtain information are extensive.

Effect of the CFC Provisions

The OECD Report, "International Tax Avoidance and Evasion" contains some interesting statistics about the effect of the various CFC provisions in practice.[16] The Report pointed out something that is a factor in assessing this and many other types of anti-avoidance provision: it is difficult to guage the deterrent effect. This was taken to its extreme by the criminal penalties in section 765 ICTA 1988.[17] The criminal penalties were never actually used but it is undeniable that, throughout the life of that provision, it has had an enormous deterrent effect. Furthermore, as far as the CFC provisions are concerned, those of the UK, France and Japan are fairly recent, and there is only a limited amount of information on how the provisions have worked.

The Report quoted the following statistics:

1. As a result of the US subpart F legislation, corporations reported over $14 billion in subpart F income for the period 1978 to 1982.
2. In Germany, from the introduction of the CFC legislation in 1972 to 30th June 1979, additional income of DM 170 million was brought within the tax net, with a peak in 1973 when DM 50 million was taxed from about 500 cases in that year. During the first two years, the average extra tax per case was DM 180,000 but this then dropped sharply; in 1977, for example, it was DM37,000. The Report observed, undboubtedly correctly, that this was probably because taxpayers, either divested themselves of their holdings in the overseas companies, or made distributions from those companies.

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16. See pp42-45
17. See Part 5

3. In Japan, 425 domestic corporations in 1982, and 428 in 1983, submitted the required returns with respect to 1,736 (in 1982) and 1,914 (in 1983) overseas subsidiaries located in 17 tax havens. The additional income from these returns was Y 17.4 billion in 1982 and almost twice that, Y 31.4 billion, in 1983.
4. The German experience has been that the number of cases, and the income yield, has been far below what was expected. The German authorities think that there are three possible explanations for this:
   (i) the number of situations covered by the provisions might have been over-estimated at the outset;
   (ii) the introduction of the law led to the dissolution of some intermediary companies;
   (iii) the true figures might actually be higher than recorded because the audit division had investigated only 15 to 25% of the suspected cases.

In fact, probably the greatest reason for the fact that the CFC provisions have generated less income than was originally expected was an extension of 4(ii) above: taxpayers have been able to reorganise their operations so as to minimise the impact of the legislation. Often it is the innocent, unwary taxpayer who is affected more than the well advised company which can take suitable action to avoid coming within the provisions. This was recognised by the OECD Report itself, which noted that, by the time the Canadian FAPI legislation was fully operated in 1976, some taxpayers had set up offshore investment funds to circumvent the new rules.[18] Canadian taxpayers did, of course, have plenty of opportunity to establish alternative arrangements, the legislation having been introduced in 1972, four years before it became fully operative. These offshore funds became so popular that they came to be widely promoted by brokerage

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18. p44

firms. The Report disclosed that these funds were normally based on the following structure. The corporations are incorporated, usually in Panama, and operate from another no-tax jurisdiction, such as the Bahamas or Bermuda. No investor owns more than 9.9% of the shares, to avoid the 10% holding qualification for the operation of the FAPI rules. The fund pays no or only nominal cash dividends, or distributes earnings in the form of non-taxable stock dividends. The funds accumulate and reinvest tax-free income, increasing the value of the funds shares, thus converting income into capital gains on the redemption by the investor of his shares in the fund.

An estimated $200 million had been invested in such funds by the end of 1983. This drew anti-avoidance legislation effective from 1st January 1985, which requires Canadian participants to include in their income an amount equal to the cost of their investments multiplied by a prescribed interest rate.

The Report also noted that income from certain manufacturing operations in the USA is excluded from the Subpart F provisions. Foreign based company sales income does not include income from the sale of property manufactured by a CFC from property which it purchased. To take advantage of this, a US company could form a subsidiary in a tax haven, sell components to it for assembly, and claim that no foreign base company sales income is earned on the sale of the completed product. There are regulations which are intended to distinguish between genuine manufacturing operations and mere assembly, but the effect of these regulations is often blunted by the difficulty of obtaining sufficient information.

In an attempt to increase the powers of the IRS in the USA to enforce the Subpart F provisions, legislation has been introduced which prevents a taxpayer introducing into civil court proceedings any information requested by the IRS and not disclosed, unless the taxpayer can show a reasonable excuse for not having disclosed it.

Japan's main problem in enforcing their CFC legislation, arises from the exhaustive list of tax havens. This list is legally binding on the tax authorities and taxpayers, which means that potential avoiders escape if they can use a country not on the list. Given the rapid pace of change, the multiplicity of combinations of circumstances in using overseas countries, and the rate at which taxpayers and their advisers come up with new ideas, it has proved difficult to revise the list to keep up with modern developments and the many ways taxpayers can use different jurisdictions to save tax. It seems that, as with the transfer pricing legislation discussed in Part 3, the Japanese Government was determined to make their CFC legislation precise and certain so as not to be unduly burdensome to the business community.

The UK list system is a much better one, being non-exhaustive and flexible in that it is divided into two parts, the first containing countries in which companies are safe from the application of the CFC provisions and a second specifying certain countries in which companies are safe from the CFC provisions as long as they are not involved in particular stated activities.

The UK Legislation

(1) General Review

The basic conditions for the operation are that:

(a) there must be a company not resident in the UK;

(b) subject to a "lower level of taxation";

(c) which is controlled by UK residents.[19]

Control can be by individuals or companies or a combination of both. The UK residents do not have to be connected, associated, acting together or even aware of each others existence. This last fact could lead to a problem. A UK resident company might have a minority interest in an overseas company, and an independent individual may also have an interest which, when aggregated with that of the company, constitutes control. Even if the UK company knows of the existence of the individual, it may well be unaware that he is resident in the UK. The individual may be a foreign national who virtually never comes to the UK but who might technically be resident here because of, for example, available accommodation. The UK company may suddenly find that it is liable to tax on profits of the overseas company in which it has a minority interest and over which it has little real influence.

The legislation will only apply to UK companies which have at least a 10% interest in the CFC,[20] so it is not restricted to true subsidiaries. To have confined the charge to situations where the UK company held a controlling interest in the overseas company would have been susceptible to considerable exploitation by means of fragmenting ownership. With a 10% holding, this is still possible, of course, but nothing like to the same extent.

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19. Section 747(1) ICTA 1988
20. Section 747(5) ibid

The interest the UK company holds may be direct or indirect (i.e., through other ocmpanies, individuals or trustees). A company has an interest in another company if it possesses (or is entitled to acquire) share capital, voting rights, rights to participate in distributions, rights to secure that income or assets are applied for its benefit or if it can, alone or with others, control the company.[21] This is throwing the net very wide in an attempt to catch every way in which a UK company may have a real interest in an overseas company.

It is noticeable that the CFC legislation can be applied if the Board of Inland Revenue "have reason to believe" that the above conditions apply and they make a direction that the provisions are to operate. The Inland Revenue, therefore, have a measure of discretion in the operation of the new charge. However, it takes a decision of the Board, rather than just the local inspector, to bring about a charge under the legislation.

There is no requirement for a UK company to make an annual return of the profits of the CFC in which it has an interest. As mentioned above, the UK here differs from the other countries that have CFC provisions.

A "lower level of taxation" is deemed to exist where the overseas tax charge is less than half the tax that would be payable in the UK in the same circumstances.[22]

The Inland Revenue have issued a list of countries which will not be regarded as being "low tax" countries (i.e., those countries which do not impose a "lower level of taxation"). Subject to certain specified qualifications, companies resident in the countries shown in the list will not be subject to the new legislation. When the

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21. Section 749(5) ibid
22. Section 750 ibid

legislation was introduced, it was estimated that 90% of all overseas subsidiaries of UK companies would be exempt from the CFC legislation because they are situated in one of these countries. To keep pace with changes in the laws of the UK or overseas countries, or the ways those laws are exploited, the excluded countries list is amended from time to time. It is interesting to note that, when the provisional list of excluded countries was published in a Press Release of 29th March 1984, the Press Release contained an anti-avoidance caveat:

> "Where a company is resident and carrying on business in a country on a list, no charge will arise. This is subject only to the need for further examination if it should appear that a deliberate attempt has been made to protect arrangements which are in fact designed to achieve a reduction in UK tax or a diversion of profits from the UK."[23]

This warning was dropped from the subsequent Press Release[24] setting out the definitive list so that, according to the later Press Release "the protection of the list... can thus no longer be regarded as conditional".[25] This is important, especially considering what happened to Mr. Fulford-Dobson in relation to the anti-avoidance warning applied to extra statutory concessions.[26] One direct consequence of making the protection of the list unconditional was that the government felt that it had to reduce the number of countries on the list from 92 to 76.

As the list is not statutory, there is technically nothing to stop the Inland Revenue attacking a company in a country on the list if they thought avoidance was

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23. Para 2
24. 16 July 1984
25. Para 3
26. See Part 7

particularly blatant but, considering the fact that they have specifically stated that they would not do so, presumably this will not happen in practice. It would be most interesting to see what the courts' reaction would be if they went back on their word.

It would have been preferable to have incorporated the list in the legislation. It could still have been altered at short notice by a statutory instrument and it would have placed the list on a proper statutory basis rather than left it on a quasi-concessionary basis.

There is a non-statutory clearance procedure available to UK groups operating in countries other than shown on the list. Although the CFC legislation contains no procedure for clearance to be given, it was decided that it would be appropriate for an informal clearance procedure to be instigated: see Inland Revenue Press Release, 16th July 1984 which stated:

> "To supplement this list of excluded countries, the Inland Revenue will make available a clearance facility for those UK groups operating in countries not on the list. As the Economic Secretary made clear in the course of the Committee Stage debates, once the controlled foreign company legislation is enacted a technical unit in the Inland Revenue's Head Office will be available to provide:
>
> (i) Advice on technical points in the interpretation of the legislation;
>
> (ii) Advice on the application of the provisions to group structures, both existing and proposed (though not purely hypothetical);
>
> (iii) Guidance on the treatment of other group subsidiaries where a UK company has been subject to a direction in respect of one of its overseas subsidiaries; and
>
> (iv) Advance clearance where shares in a controlled foreign company are sold."[27]

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27. Para 5

It is not clear why it was felt inappropriate to incorporate a statutory clearance procedure, especially given the potentially serious consequences of being caught and the complexity and obscurity of some of the legislation. Such a procedure would have introduced a welcome degree of certainty for those companies that wished to seek clearance. Such a procedure would not have been open to exploitation because it would have been clear that the clearance would only remain valid so long as the company kept strictly to the activities disclosed in the clearance application.

The tax charge arises by the taxable profits (other than capital gains) of the CFC being computed as if it were resident in the UK,[28] and the UK companies which have 10% or more of the CFC are assessed to UK tax on the appropriate proportion of the profits. Profits are normally apportioned in proportion to the UK companies shareholding in the CFC's. There are, however, rules that apply where other kinds of interest exist. If no specific rule applies, the Inland Revenue will make the apportionment on a "just and reasonable" basis.[29]

However, if the total profits of the CFC for an accounting period do not exceed £20,000, no UK tax charge will arise. If the chargeable profits are above £20,000,[30] no UK charge arises on a UK company if the apportioned profits to which it (plus connected or associated companies) is entitled is less than 10% of the chargeable profits.[31]

If the CFC has trading losses brought forward from earlier years, these losses may be set against the profits subject to an apportionment.[32] In addition, if

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28. Para 1, Sch 24, ICTA 1988
29. Section 752 ibid
30. Section 748(1)(d) ibid
31. Section 747(5) ibid
32. Para 9, Sch 24 ibid

any tax is suffered in the other country on the profits chargeable under the CFC rules, a proportion of that tax may be credited against the UK corporation tax liability.[33]

A UK company subject to tax under the CFC legislation is able to set off ACT against the apportioned profits subject to the normal restrictions. It will also be able to obtain relief for trading losses, excess charges, excess management expenses and losses available by way of group relief.[34]

(2) Exemptions - Introduction

Apart from the de minimus limit, there are four main defences to a charge under the CFC legislation: the "acceptable distribution" test, the "motive" test, the "exempt activities" test and the "public quotation" test.[35]

In the December 1982 Consultative Document, the Inland Revenue claimed that "they recognised the importance of avoiding even the appearance of anything that would affect legitimate business operations and so perhaps deter multinationals from setting up in the UK."[36] The question is whether and to what extent the various exemptions have succeeded in respecting legitimate commercial activities.

The "exempt activities"[37] test is the one intended to cover genuine trading and certain other activities. In fact, it was, in the November 1981 draft legislation, restricted to "genuine trading", but the subsequent "exempt activities" test took bona fide banking and insurance activities outside the CFC rules.

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33. Section 751(b) ibid
34. Sch 26 ibid
35. Section 748 and Sch 25 ibid
36. Para 28
37. Section 748(1)(b) and Part II, Sch 25 ICTA 1988

It was recognised that the exempt activities test alone would not cover all companies who ought not to be caught by the CFC rules. Consequently, the motive test was also introduced basically to exclude companies where the object of their activities was not aimed at achieving a significant reduction in UK tax.[38] However, the motive test is very subjective and not many companies will satisfy the conditions. At a meeting of the International Fiscal Association, British branch on 14th February 1989, controlled foreign companies were discussed. At this meeting no member of the Association could site a single case they had dealt with where the motive test had succeeded. As the meeting was attended by CFC experts from most of the large accounting firms and many multinational groups, this was an enlightening discovery. The various exemptions are now dealt with in further detail.

(3) The Acceptable Distribution Test[39]

No charge to UK tax under the CFC provisions will arise if a trading company distributes at least 50% of the "relevant" profits available for distributions to UK resident shareholders. An investment company must distribute 90% of its relevant income for a charge not to arise. The distribution in each case must be made within 18 months of the end of the accounting period in question, or such longer period as the Inland Revenue may allow. When a CFC also has non-UK resident shareholders, the figures of 50% and 90% that must be distributed to UK residents are reduced accordingly. The term "relevant" profits excludes capital profits.

This is the most straightforward of all of the exemptions. The principle behind it and the mechanics of

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38. Section 748(3) ibid
39. Section 748(1)(a) and Part I Sch 25 ibid

its operation are clear. The actual conditions, as might be expected, are detailed, in order to prevent easy avoidance arrangements being formulated to circumvent the acceptable distribution test provisions. The test is not without its complications. Not all dividends qualify and there are complex rules about the profits against which the dividends must be compared.

It may well happen that it will not be for some time after the relevant year that it will be clear whether or not the CFC has distributed sufficient dividends to satisfy this test. In the meantime, the Inland Revenue are free to make a direction leaving the UK company to appeal if appropriate. Furthermore, they tend to apply the 18 month limit fairly strictly.

A loophole by virtue of which some groups were misusing the acceptable distribution test rules were stopped by section 65 F(No2)A 1987. The basis of the acceptable distribution test was that the dividends, when received by the UK company, would suffer corporation tax as income from foreign possessions. Under the acceptable distribution test the CFC has 18 months after the end of the period to pay the dividend. Some groups were, during this 18 month period, transferring the residence of the CFC to the UK before the dividend was paid, with the result that the dividend did not suffer corporation tax and, following a section 247 ICTA 1988 group income election (in the case of a subsidiary) no ACT would be payable either. To prevent this, section 65 amended what is now Schedule 25 ICTA 1988 so that dividends paid after 16th March 1987, at a time when the paying company is resident in the UK, will not be taken into account in calculating whether there is an acceptable distribution for the period for which the dividend was paid. This is a sensible amendment to prevent a simple device which was negativing the basis on which the acceptable distribution test worked.

(4) The Motive Test

No direction may be given in respect of an accounting period of a CFC if it appears to the Board of Inland Revenue that:

(a) insofar as any of the transactions, the results of which are reflected in the profits arising in that accounting period, or any two or more of those transactions taken together, achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal, or it was not the main purpose, or one of the main purposes, of that transaction or, as the case may be, of those transactions taken togegther to achieve that reduction, and

(b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom.

It should be noted that the morive test will only be satisfied "if it appears to the Board" that the conditions are satisfied.

In considering this test it should be borne in mind that, if there are two ways of arranging a real commercial transaction, and the way giving rise to the lesser amount of tax is chosen, that does not normally mean, by itself, that the main reason the transaction was carried out was the avoidance of tax.

The clear object of including the motive test is that a direction should not be made where tax avoidance was not the motive for setting up the CFC. However, the subjectivity of the test makes it a very uncertain tool to achieve this.

Examination of the two limbs of the motive test disclose that two completely separate matters must be considered.

The first limb looks at the transactions of the CFC, and asks whether they were entered into for bona fide commercial reasons. The second limb, on the other hand, looks at the reason the CFC was set up in the first place, and why it continues to exist. In the first limb, one is looking at the motives of those who run the company and who have responsibility for its activities; in the second, one is looking at the motives of the owners of the company.

The actual workings of the first limb are somewhat more straightforward than the second. What the first limb comes down to is that one asks whether, if the transactions in question had not been implemented, more UK tax would have been payable.

The second limb is conceptually more difficult, being based on a statutory hypothesis, namely, is it reasonable to suppose that a substantial part of the CFC's receipts would have been received by a UK company if the CFC did not exist? There need not actually be a UK company in existence for the purposes of this hypothesis. If it is reasonable to assume that the actual or imaginary UK company would have received the CFC's income if the CFC did not exist, then, as long as this assumption would have resulted in a greater UK tax liability for the UK company, or anyone else, there is "a reduction in United Kingdom tax by a diversion of profits from the United Kingdom." It must then be considered whether this reduction was the "main reason or...one of the main reasons" for the CFC's existence. This is a very wide and complicated test.

When the CFC legislation was being introduced, the motive test was widely presented by the Inland Revenue and the Government as ensuring that the CFC legislation would leave bona fide commercial companies unmolested. However, the way the motive test has been drafted, with wide definitions and complicated tests, suggests that it can be difficult for many bona fide commercial activities to satisfy the requirements of the test. At the International Fiscal Association meeting mentioned above, Ian Hunter, sometime head of the CFC Unit at the Inland Revenue pointed out, in response to criticisms of the motive test, that, as originally drafted, it was a benefit, as opposed to a purpose test, but that this was changed in response to criticisms from industry.

(5) <u>The Exempt Activities Test</u>

The objective of this test, in the Inland Revenue's view, is to exclude from the CFC rules those overseas companies which, because of their activities, can reasonably be assumed not to be used for the purposes of avoiding UK tax.[40]

This test concerns two aspects of a non-UK resident company's activities: the degree of work actually carried out in the overseas countries, and the nature of the work. This test is more straightforward than the motive test. A CFC with a genuine commercial reason for being set up in a particular country, with a real presence there, and proper business activities with independent parties, will probably satisfy the relevant conditions.

Despite the fact that it is more straightforward than the motive test, the exempt activities test is complex and contains several hurdles to be overcome before exemption is obtained.

The first requirement is satisfied where the company's business affairs are "effectively managed" from the business establishment in the overseas country. The business establishment must consist of premises occupied and used with a reasonable degree of permanence.

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40. See para 8.1 of "Controlled Foreign Companies - Explanatory Notes", Inland Revenue (Feb 1985)

"Premises" is widely defined and means an office, shop, factory or other building, and the term also includes mines, oil wells, quarries and long term building sites.

The premises must be staffed by such a number of employees as is adequate to deal with the volume of the country's business. In addition, the test will not be satisfied if any services provided by the company for persons resident outside that territory are performed in the UK unless, either the UK services are merely incidental, or they are subject to UK tax.

Because of this "premises" test, "name plate companies" will not satisfy the exempt activities test. These requirements are very effective: it is difficult to get round them artificially.

In connection with this first limb of the exempt activities test, it is important to realise that the company must have a real presence in its country of residence. If a company has branches in other countries with, in each case, adequate staff and premises in those countries, but no real presence or staff in its country of residence, it will not satisfy the exempt activities test. However, a company with branches in other countries and, in its country of residence staff sufficient (in numbers, qualifications and experience) to supervise and control its profit making activities, would meet the relevant criteria.

This test means that a company whose day to day management is organised by telex or telephone, and by occasional visits by directors, will not satisfy the exempt activities test. A great many tax haven companies will fail to satisfy this test.

In addition to the above conditions, the company's business must not consist of:

(a) an "investment business"; or

(b) dealing in goods for delivery to or from the United Kingdom or to or from connected or associated persons; or

(c) in the case of a company which is mainly engaged in wholesale, distributive or financial business in the relevant accounting period, 50% or more of its gross trading receipts from that business is derived directly or indirectly from connected or associated persons.

The following are treated as constituting an "investment business":

(i) The holding of securities, patents or copyrights;

(ii) Dealing in securities, other than in the capacity of a broker

(iii) The leasing of any description of property or rights; and

(iv) The investment in any manner of funds which would otherwise be available, directly or indirectly, for investment by or on behalf of any person (whether resident in the UK or not) who has, or is connected or associated with a person who has, control, either alone or together with other persons, of the CFC.

It will be noted that the fourth category, like the second limb of the motive test, is built on a hypothesis in that it covers funds "which would otherwise be available for investment by, or on behalf of, any person". It is clear that this exclusion is aimed at "money box" companies, but it is not clear what else may be caught. The legislation contains no guidance on the circumstances in which funds might "otherwise" be available.

The phrase "wholesale, distributive or financial business" comprises a wide range of activities, namely:

(a) dealing in goods wholesale;

(b) shipping or air transport;

(c) administering trusts;
(d) banking;
(e) dealing in securities as a broker;
(f) dealing in commodity or financial futures;
(g) conducting "long term" or "general" insurance business (as defined by section 1 the Insurance Companies Act 1982).

Certain holding companies can satisfy the exempt activities test. They must comply with the conditions mentioned above relating to premises and staff: "name plate" holding companies will not be exempt. In addition, they must derive at least 90% of their gross income from subsidiaries which themselves satisfy the exempt activities test. Holding companies can also carry out exempt activities themselves.

On the whole, of all activities, manufacturing businesses will probably find it easiest, by virtue of the very nature of their operations, to pass the exempt activities test.

(6) <u>The Public Quotation Test</u>[41]

This exemption applies to a company whose shares are dealt with on a recognised stock exchange situated in the company's country of residence. To qualify, shares carrying at least 35% of the voting power must be held by the public. Shares are treated as held by the public as long as they are not held by persons connected or associated with the company or a "principle member" of the company. An additional qualification is that "principle members" must not hold more than 85% of the voting power of the company. A person is regarded as a "principle member" basically if he possesses more than 5% of the voting power of the company and is one of the 5 persons who possess the greatest percentages of the voting power in the company.

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41. Section 748(1)(c) and Part III Sch 25 ibid

A "recognised stock exchange" means The Stock Exchange (namely the London and Provincial Exchanges in the UK and the Exchanges in the Republic of Ireland) and any stock exchange outside the UK designated as a recognised stock exchange by the Board of Inland Revenue.

This test is fairly restricted (presumably because the Government was worried that it might be used as a way of circumventing the CFC provisions by the setting up of a quoted company with negligible real ownership by the general public). As a result there are a number of conditions to be fulfilled. What is more, only the quoted company itself is exempted; any subsidiaries it has are not covered.

All in all, this test is not too much help to taxpayers. Many overseas quoted companies with substantial public ownership will fail this test. The "principle member" provision could well work unfairly because the holdings of principle members have to be excluded from the 35% public ownership calculation. A holding of 5% is a low figure to make a person a principle member.

The fact that subsidiaries of quoted companies are not covered is a major restricting factor because many overseas quoted companies do conduct most of their business through subsidiaries.

(7) <u>Tax Planning For Offshore Companies</u>

Despite the CFC legislation, there is still plenty of scope for using offshore companies in tax planning. On the whole, the legislation has prevented many of the more artificial arrangements while leaving many opportunities for what might be termed "acceptable" tax planning.

One possibility is to keep the profits of each CFC below the de minimus limit of £20,000 by fragmenting overseas operations but this must be subject to considerations of cost of setting up and running overseas companies.

A trading company will be outside the charge if it distributes half of its profits. This means that the effective UK tax rate will be as low as 17½% (or, if the small companies rate applies, 12½%). In any case, there will be a considerable cash flow advantage in paying dividends under Case V of Schedule D in a later accounting period; there could be a delay of up to two years between the date when the UK company would have been assessed on its trading profits, and the due date for payment of corporation tax on the dividends.

As mentioned above, the charge does not apply to capital gains. The provisions in the CGTA 1979 which impose a similar apportionment in the case of capital gains[42] only applies if the non-resident company would be a close company if it were resident in the UK. Therefore, savings will remain possible for non-close companies which hold investments through a non-resident subsidiary.

One use of a non-resident company will remain as tax efficient as before: that of dividend "averaging", whereby a non-resident company is formed to receive dividends from a number of foreign subsidiaries. The non-resident company would receive dividends from those foreign subsidiaries and then pay up a dividend to the UK parent. This is appropriate where some of the foreign subsidiaries are subject to lower tax rates than the UK and some to higher rates. Payment of dividends direct to the UK would entail partial loss of double tax relief as the UK company would not be able to set the overpayment of foreign tax on some dividends against the underpayment of tax on others where UK tax remains to be paid. Routing the dividends through a non-resident company usually avoids this problem. However, this is, in reality, not tax avoidance, but merely taking action to avoid

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42. Section 15

injustice arising out of the double tax relief rules.

There is still scope for a UK company to own what would otherwise be a CFC through a consortium of 11 or more unrelated companies, each earning less than 10% in the overseas company.

The new legislation does not apply to overseas entities falling outside the definition of "company".[43] It may therefore be possible for UK companies to use offshore partnerships or trusts in appropriate circumstances.

(8) CFC/Section 739 Set Off

It is possible for a charge to arise under both the CFC provisions and section 739 ICTA 1988[44] in respect of the same profits. To avoid the possibility of a double charge arising, section 747(4)(b) ICTA 1988 gives relief. However, this relief is not straightforward because income apportioned for the purposes of section 739 is not the same as chargeable profits for CFC purposes. If the UK individual would have less than 100% of the CFC's income apportioned to him under section 739 (because, for example, he did not have power to enjoy all of the CFC's income), the process is that section 739 will not apply to such proportion of the CFC's chargeable profits, treated as the individual's income under section 739, as corresponds to the part of those chargeable profits which is apportioned to UK companies, resulting in a tax charge. For example, assume that the CFC has income of £200,000 and that an individual has power to enjoy £150,000 of that income. The chargeable profits are £300,000 of which £200,000 is apportioned to UK companies, resulting in a charge to tax. The sum deemed to be the income of the individual under section 739 will be:

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43. Section 832(1) ICTA 1988
44. See Part 2

Sum normally deemed to be his income		£150,000
Sum not deemed to be his income under the above set off rules, i.e. £150,000 x 200,000 / 300,000 =	£100,000	
		£ 50,000

This is a rather clumsy set off rule. It is not clear whether this was intended or not. It remains to be seen whether it will cause significant problems in practice, but clearly it has the potential to do so.

(9) The Question of Residence

One particulalry interesting aspect of the CFC rules is that of residence, because there are four completely separate meanings, depending on the context in the term which it is being used.

These four uses of the concept of residence are as follows:

1. In determining whether the company is resident outside the UK so that the CFC legislation can apply to it at all. Here the normal residence rules apply, namely, place of incorporation and central management and control.
2. In determining whether the company is subject to a "lower level of taxation". Here "the territory in which the company is resident" has to be found, so that the tax can be calculated which is to be compared with the notional UK tax.
3. In determining whether the company is resident in a country in the excluded countries list.
4. In determining whether the company satisfies the exempt activities test.

No more needs to be said about the first of the four tests because the normal criteria are applied. The other three tests are now considered.

Lower Level of Taxation Usage.
For this purpose a statutory definition is provided in section 749(1) ICTA 1988. The domestic law of other countries and the provisions of double tax agreements are totally irrelevant here.

The important of residence in this context is that it is only the tax suffered by the company in "the territory in which it is resident" which can be compared with the notional UK tax.

The section 749(1) test is that the company is treated as resident in the territory in which "it is liable to tax by reason of domicile, residence or place of management". Here, "liable to tax" means liable to tax on profits. If liability arises on some other basis, that liabliity is irrelevant. For example, an obligation to pay a flat rate tax (such as the £500 paid by exempt companies in Jersey) will not do.

If there is more than one territory in which the company pays tax "by reason of domicile, residence or place of management", section 749(2) contains a tie-breaker provision which introduces yet another concept, namely, "place of effective management". At least this is a concept which is fairly familiar, originating from the OECD, although it is not without its difficulties. It is now clear that it does not mean the same as central management and control, "effective management" being more concerned with management of the day to day activities, rather than the main policy decisions. The dividing line between effective management and central management and control can, however, often be unclear. If there is no country in which the company is liable to tax "by reason of domicile, residence or place of management", then the legislation states that the company is "conclusively presumed" to be resident in a territory in which it is subject to a lower level of taxation.[45] It should be noted that this presumption applies regardless of any tax the company may be paying elsewhere for some other reason (for example, by virtue of a flat rate tax, or on turnover, or because a country levies tax on a source basis regardless of residence, such as Hong Kong). It would also happen, for instance, that the company suffers heavy withholding tax. It is possible that a company could be paying fairly heavy tax but still be deemed to be subject to a lower level of taxation. This can produce very unfair results.

Excluded Countries List Usage.

The starting point here is again section 749(1). If there is only one territory in which the company is resident under this test, that is the one relevant for determining whether the company is resident in a listed country. However, if there is more than one country in which the company is resident, a country can only count if 90% of the company's income accrues in that country. If there is no country in which the company is resident under the statutory test, the country of incorporation is taken.

Exempt Activities Test Usage.

Once again, the starting point is section 749(1). If the statutory test produces one country of residence, that country is taken for the purposes of applying the various elements of the exempt activities test. If the statutory test produces no country of residence, paragraph 5(2), Schedule 25 provides that the company will be treated as resident where its business affairs are effectively managed throughout the accounting period. It is noticeable that, for the purpose of the lower level of taxation useage, one looks at the "company's place of

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45. Section 749(3) ibid

effective management". whereas here, one has to see where "the business affairs" of the company are "effectively managed". This distinction is logical in that the lower level of taxation test is looking at the location of the company, where as the exempt activities test is looking at the location of the activities but, nevertheless, it does add another complication to this highly complex subject.

If the statutory test produces more than one country, a UK company having a majority holding in the CFC may nominate which country is to be taken for the purposes of the exempt activities test.

It can be seen that the question of residence is extremely complicated, meaning one of four things depending on how the word is being used and, furthermore, each of the tests is capable of throwing up its own grey areas and difficulties. This does seen an unduly complicated situation.

(10) <u>Inland Revenue's View</u>

At a meeting of the International Fiscal Association mentioned above, Ian Hunter said that, from the Inland Revenue's point of view, the CFC legislation had more or less achieved what the Inland Revenue had hoped: namely, eradicating the worst abuses.

It seems that the Revenue's satisfaction is mainly justified. Most of the more extreme arrangements have been stopped. Inevitably the legislation is complex and it has interfered with some genuine commercial operations. The problem for the draftsman was, of course, that if the operations had been more tightly worded, more avoidance devices would have escaped. On the whole, apart from the reservations over the motive test set out above, the legislation has done as well as could resonably be expected in distinguishing between tax avoidance devices and genuine commercial arrangements.

(11) Related Matters

A different approach to the same problem can be seen in the two Europa Oil cases already considered: IRC v Europa Oil (NZ) Limited[46] and Europa Oil (NZ) Limited v IRC (No. 2).[47]

It will be recalled that the taxpayer company was siphoning off profits to a tax haven company. The New Zealand authorities had no specific CFC or transfer of assets abroad legislation at that time. Instead, they attacked the arrangement by attempting to deny a deduction for the relevant expenditure. On a proper construction of the particular contractual arrangements in the two cases, no deduction was allowed in the first case but, in the second, the expenditure was eligible for relief.

The enactment in issue here was section 111 of the Land and Income Tax Act 1954, which read:

> "Expenditure or loss exclusively incurred in production of assessable income -
>
> (1) In calculating the assessable income of any person deriving assessable income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income tax year may, except as otherwise provided in this Act, be deducted from the total income derived for that year.
>
> (2) In calculating the assessable income of any person deriving assessable income from two or more sources, any expenditure or loss exclusively incurred in the production of assessable income for any income tax year may, except as otherwise provided in this Act, be

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46. [1971] AC 760 see Part 3
47. [1976] STC 37, see Part 3

deducted from the total income derived by the taxpayer for that year from all such sources as aforesaid."

The section was amended in 1968, but the Privy Council held that the amendment did not alter the application of the section to the facts.

The fact that the two cases, dealing with slightly different arrangements, gave rise to different results demonstrates that the application of this basically domestic provision to an international avoidance arrangement was very arbitrary. This appears also to have been the experience of most of the major industrial countries who, as international avoidance techniques of this sort became more sophisticated, found the need for CFC legislation of the type considered above.

The failure of another New Zealand provision to prevent avoidance of tax on the international stage can be seen in another Privy Council appeal: IRC v Associated Motorists Petrol Co Limited.[48] This case involved the same set of facts as the Europa Oil Cases.

The provision in question was section 138 of the Land and Income Tax Act 1954 which was basically an apportionment provision. However, as with the UK apportionement provisions considered in Lord Howard de Walden v IRC,[49] it was held by the Privy Council that this New Zealand domestic apportionment provision did not cover the overseas company in question.

Section 138, so far as relevant here, stated:

"Income of proprietary company in certain cases assessable as income of shareholders -

(1) The following provisions shall apply for the purposes of this section, namely:

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48. [1971] AC 784
49. (1948) 30 TC 345 see Chapter 1

(a) The term 'proprietory company', in relation to any income year, means a company which at the end of that year is under the control of not more than four persons...(f) the term 'residual taxable income', in relation to any proprietary company and any income year, means the amount by which the taxable income of the company for that year (including taxable proprietary income) exceeds the total amount of the income tax....payable by the company in respect of income derived by it during that year...(g) the term 'total income', in relation to any proprietary company and any income year, means the total amount of the residual taxable income and non-assessable income of the company for that year, (h) the total income derived in any income year by a proprietary company shall be deemed to be income derived in that year from the company by the shareholders of the company...(i) the term 'proprietary income', in relation to any shareholder in any proprietary company and any income year, means the income deemed under this sub-section 2 has been derived by the shareholder from the company in that year... where that income... is not less than 1/4th of the total income of the company for that year. The proprietary income derived by a shareholder from any proprietary company.... shall be deemed to consist of assessable and non-assessable income in the proportions in which the total income of the company for that year consists of residual taxable income and non-assessable income..."

The facts of the case were that the taxpayer company was incorporated in New Zealand and all of its shares were held by or on behalf of Europa Oil (NZ) Limited. The taxpayer company was a shareholder in Pan Eastern Refining Co Limited, a Panamanian Co. The taxpayer company held half of Pan Eastern's shares, the other half being held by Propet Co Limited, a subsidiary of Gulf Oil Corporation of America. Pan Eastern derived no income or profits from New Zealand but, in the relevant years, made large profits under a processing contract with Gulf Oil Corporation. Since Pan Eastern was an overseas corporation, Pan Eastern's profits were not chargeable with New Zealand income tax. However, the taxpayer company was assessed in respect of one half of those profits on the basis that they were "proprietary income" of the taxpayer company. The taxpayer company, while admitting that it had received substantial dividends from Pan Eastern in respect of its shareholding, contended that these dividends represented "non-assessable income", and that it ought not to be assessed in respect of any "proprietary income". It was not disputed that the dividends were non-assessable, but the issue was whether Pan Eastern was a "proprietary company" and whether its income was "proprietary income" of the taxpayer company. It was held in the Privy Council that, although Pan Eastern was a "proprietary company", if a company was neither resident in New Zealand nor derived income from New Zealand, it derived no income assessable for tax and could therefore derive no taxable income. Accordingly, it could not have a total income and, without a total income, it was impossible to apply the provisions of section 138.

Lord Wilberforce, giving the judgement of the Privy Council, adopted the following passage of Turner and McCarthy JJ in the Court of Appeal of New Zealand for rejecting the application of section 138 to the present facts:

"It seems to us impossible to make any sense out of attempting to carry out, in regard to a company which neither is resident in New Zealand nor derives income from New Zealand, the calculation of its 'total income' as defined by section 23 of the Act 1939[50]-i.e., to ascertain and add together its 'taxable income' and its 'non-assessable income'. Non-assessable income it may have, for by this term is to be understood, not simply income which is not assessable, but income of one or more of the special categories expressly defined in the Act. But taxable income, so its seems to us, is something that such a company cannot have.... It seems to us inescapable that if a company neither is resident in New Zealand, nor derives income from New Zealand, it derives no income assessable for tax. This is merely another way of saying that it derives no assessable income. Not deriving assessable income, it can derive no taxable income, for taxable income is only the residue of assessable income. Deriving no taxable income, it cannot have a total income, unless by straining the provisions of the section so as to catch companies which derive only unassesasble income. If it has no total income, it is impossible to apply to it the provisions of section 138."[51]

It is, therefore, apparent that the domestic provision was unsuitable to create a nexus between the taxing jurisdiction and the offshore entity and its profit making apparatus.

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50. The predecessor to section 138
51. pp792-3

APPENDIX TO PART 6

Summary of CFC Legislation

		United States	
1.	Short title	Foreign Personal Holding Company Provisions	Subpart F Provisions
2.	Residents chargeable	US shareholders - includes US citizens, residents, domestic corporations, domestic trusts and estates, and domestic partnerships.	
3.	Minimum holding	More than 50 per cent in value of outstanding stock is, directly or indirectly, owned by five or less US individuals or residents.	More than 50 per cent of the total combined voting power is directly or indirectly, by US shareholder; a US shareholder owns 10 per cent or more of stock.
4.	Low taxation	Applies regardless of tax rate of country of incorporation; however, exclusions and special rules for exceptions apply.	
5.	Income attributable to share-holders	- Dividends, interest, annuities, royalties - Stock and security transactions - Commodity transac-actions - Personal services contracts - Use of corporate property - Rents - Income from estates and trusts	- Foreign personal holding company income - Sales income - Services income - Shipping income - Oil related income - Income from insurance risks - Illegal bribes, or other payments to government officials or agents - Increase in earnings invested in US property.

6.	Situation when dividends are paid out of accumulated income already tax under Subpart F-type legislation.	If actual dividend is paid, a foreign corporation may deduct the dividend in computing undistribted income.	Excluded from the gross income of the shareholder ie not subjected to tax.

		Germany	Canada
1.	Short title	Taxation of foreign "intermediate" companies	The "foreign accrual property income" or "FAPI" and "offshore mutual" rules
2.	Residents chargeable	Individuals and corporate bodies	The FAPI and offshore mutual rules apply to individuals, trusts and corporations.
3.	Minimum holding	Over 50 per cent of shares or voting rights must be held by resident taxpayers	Control of foreign company results in accrual taxation of FAPI. Holdings between 10 and more than 50 per cent result in taxation of FAPI when it is repatriated. Holdings in foreign corporations of 10 per cent or more are subject to Canada's foreign affiliate rules for taxation of dividends received. Offshore mutual: no minimum.
4.	Low taxation	Tax levied by country of establishment less than 30 per cent of intermediate income tax.	Canadian taxation applies regardless of the level of tax in the country of establishment.

		Germany	Canada
5.	Income attributable to shareholders	List of active income categories which are not subject to this legislation. Passive income is primarily: - Dividends, interest or licensing fees, where no specific connections with genuine foreign activities exist - Low-activity trading - Low-activity provision of services - other asset-holding and management	All types of income set out in a list and in particular: - Income from property - Non-active business income - One-half of capital gains from sales of non-active business assets - Offshore mutuals specified rate of interest is applied to the cost of investment and the resulting amount is included income.
6.	Situation when dividends are paid out of accumulated income already taxed under Subpart F-type legislation	Tax paid on dividends in previous four years is reimbursed	Dividends may be deducted from shareholder's taxable income. Source countries' taxation (corporate) reduces the amount of income taxed on an accrual basis before dividend received. Source country's taxation (withholding) reduces the amount of income taxed in the year the dividend is paid. Offshore mutuals: dividends received on those holdings in Canada reduce the amount described in Item 3.

		Japan	France	United Kingdom
1.	Short title	Taxation of the income retained by "Special foreign subsidiaries"	Special regulation regarding base companies in Article 209B of CGI	Controlled Foreign Companies (CFCs)
2.	Residents chargeable	Individuals and corporations	Entities liable to corporation tax only	Companies only
3.	Minimum holding	Over 50 per must be held by resident taxpayers. Shareholdings of under 10 per cent are in principle not liable to taxation	Over 25 per cent direct or indirect holdings of of a French company in in a company in a low-tax country	Only foreign companies controlled by United Kingdom residents (companies or individuals) can be CFCs. A charge may only be made, however, where 10 per cent or more of the CFC's chargeable profits can be apportioned to a company and its associates
4.	Low Taxation	Countries with "substantially lower taxation than Japan" (government publishes an exhaustive list of areas designated as tax havens)	General definition is 2/3 of French tax rate test in practice	If tax payable in the foreign territory of residence is less than 50 per cent of the corresponding United Kingdom tax (Government publishes non-exhaustive non-tax haven list)

		Japan	France	United Kingdom
5.	Income attributable to shareholders	All types of retained income where no proof of activity is produced, such proof includes: - the running of a business with its own management; - In the case of wholesale, banking, trust securities business, insurance shipping or air transport the principal part of their activities must be conducted with non-related persons; other businesses must conduct the principal part of of their activities within the country in which the foreign subsidiary is located; a) The holding of stocks and bonds, b) The provision of industrial, property rights, or	Applies in all cases is given that the activity of the company in the low-tax country is not aimed primarily at the transfer of profits. Sufficient evidence would be that the foreign company is effectively engaged in trade or business activities and carries on its business mainly in the local market or with third parties	The provisions apply by reference to the main business of a CFC, not by reference to particular types of income received. If there is sufficient physical presence in the territory of residence and the main business is not one of the following no charge can arise: a) Holding securities patents or copyrights b) Dealing in securities c) Leasing of any property or rights; d) Investment of funds which would otherwise be be available for investment by associates; e) Dealing in goods involving the UK or associated persons; f) Dealing in any goods as wholesaler rather than retailer;

		copy-rights, etc or c) The leasing of ships or aircraft		g) Shipping or air transport h) Banking or similar business; i) Administr-ation of trusts; j) Dealing in commodity or financ-ial futures k) Insurance business
6.	Situation when divi-dends are paid out of accum-ulated in-come alrea-dy taxed under Sub-part F-type legislation	Dividends are deductible up to the level of the amoun-ts imputed over the prev-ious five years	Dividends are deduc-tible from the French company's results up to the level of the (recon-structed) income liable to corporation tax	The charge made in respect of the CFC's profits is treated as (added to) underlying tax and credit given accord-ingly against the tax on the dividend

PART 7

THE RESIDENCE OF INDIVIDUALS AND EMIGRATION

There is no provision similar to section 765 ICTA 1988 applicable to individuals, preventing them from emigrating for income tax reasons; such a measure would be an unthinkable restriction on an individual's personal liberty.

In practice, individuals are much less likely to move abroad to save tax than companies because, whereas with companies, UK directors can live in the UK and fly out to, say, Paris for board meetings, the residence rules applicable to an individual mean that he must actually leave the UK and live abroad for a considerable period.

What is more, he may well become a resident in another country (often after only 6 months and sometimes less) and could end up paying foreign tax at a level equal to or exceeding the UK rates. He must therefore either choose his location with care, or work his timing out with precision, as did the entertainer, Dave Clark[1] or not stay in one single country long enough to become a tax resident there.

A potential tax exile has three matters to consider as regards UK tax law: residence, ordinary residence and domicile. He must also consider the corresponding concepts in his country of destination (which will invariably be different), and he must also consider the double taxation implications. It is rarely a simple matter.

In the days of UK tax at, say, 98%, anywhere was better for potential tax exiles than the UK, and high earners such as sportsmen and entertainers would leave for

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1. Infra

other "high tax" countries such as the USA. In these days of 40% income tax in the UK, it is a much more difficult equation.

The Inland Revenue have always been on their guard against individuals who might want to leave the country for just long enough, for example, to escape tax on a large capital gain or on unusually high earnings for a particular year. They are helped by the concept of ordinary residence; although, as will be seen below, after the Dave Clark case, this concept is not as helpful as the Inland Revenue had for many years thought.

What follows is not a detailed analysis of the factors establishing residence, ordinary residence and domicile: these can be found in any standard text book. These rules will only be considered in so far as they concern the matters under consideration here: emigration for the purpose of breaking the appropriate nexus.

There is scope for tax avoidance by the manipulation of the various rules. Among the popular devices are the following:

1. Leaving the UK for just long enough to become neither resident nor ordinarily resident, and disposing of an asset ripe with capital gain or escaping tax on non-UK source income.
2. Working abroad full-time in an employment so as to be neither resident nor ordinarily resident under the extra-statutory practice, which says that an individual who goes abroad for full-time service under a contract of employment is treated as neither resident nor orindarily resident from the day after his departure until the day before his return. This applies as long as all of the duties, apart from merely incidental duties, are performed outside the UK and the time spent abroad includes a complete tax year. Furthermore, visits to the UK during the period must not exceed 6 months in one year or an

average of 3 months or more a year. Schedule E income tax on the employment income would thereby be avoided and the individual could dispose of capital assets free of CGT during his period abroad.

3. Switching from self-employed to employed status (perhaps with a "one man" company[2]) to take advantage of these rules in an artificial way.

The most extreme example of leaving the UK for just long enough to become neither resident neither ordinarily resident was Reed v Clark[3]. The timing here was so precise that the taxpayer not only escaped UK tax, but he also escaped tax in the USA, which is where he went during his absence from the UK. The Revenue's defeat prompted them to propose changes in the residence rules and to issue a Consultative Document in 1988.

The facts of the case were that, in the 1960's "the Dave Clark Five" enjoyed considerable success in the music business. Since the group disbanded in 1970, Dave Clark's principle activity had been promoting the group's songs and recordings. This entailed frequent travelling, particularly to the USA. On 16th December 1977, the recording company, Polydor Limited, signed an agreement with Dave Clark under which the company was to pay him $500,000 upon delivery of copy "master" of certain recordings, of this sum, $450,000 was attributable to recordings in which the copyright belonged to Dave Clark personally.

For all years before 1978/79, Dave Clark was resident and ordinarily resident in the UK. Before entering into the Polydor agreement, he was advised that, as he wished in any event to go to the USA for a protracted period during the 1978/79 year of assessment, it would be possible for him to avoid tax completely in both the UK and the USA on the Polydor payment of $450,000 provided that, (a) he did

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2. See Part 9
3. [1985] STC 323

not set foot in the UK during the 1978/79 year of assessment and became resident (under UK tax law) in the USA for that year, and (b) he received the whole payment prior to 1st January 1978 (so as not to suffer US tax on the sum which was assessed on a calendar year basis).

Accordingly, it was agreed that Polydor would pay the sum of $500,000 on 19th December 1977, and Dave Clark left the UK and travelled to the USA on 3rd April 1978. He did not set foot in the UK again until 2nd May 1979. During this period of 13 months he spent his whole time in the USA apart from a few days in October 1978, which he spent in Canada.

When Dave Clark left the UK on 3rd April 1978, he did so with the firm intention of living in the USA throughout the 1978/79 year of assessment, but that he would return to the UK to live shortly after the end of that year. During his stay in the USA, Dave Clark's UK business interests were looked after by his secretary and his accountant with whom he was in contact by telephone. After his return from the USA on 2nd May 1979, he continued to carry on the same profession as before without any cessation.

In the High Court, Nicholls J held, perhaps surprisingly, that Dave Clark's scheme had succeeded. He said:

> "The Crown also submitted, and I suspect that this submission reaches nearer to the heart of what the present case is all about, that there was an artificialitay and contrivance in the length of Mr. Clark's absence and in the timing of his departure and his return: the dates had been carefully chosen with United Kingomd income tax in mind, the object being to avoid bringing into charge under Schedule D in the year 1978/79 the Polydor payment of $450,000 received in the preceding year.

Artificial tax avoidance schemes do not find much favour with the Courts today. In this case the position, as I see it, is that when deciding issues of residence, ordinary residence and occasional residence all the reasons (including any desire to avoid a liability to United Kingdom income tax) underlying a person's being in a particular place are part of the overall picture. They are part of the material to be looked at and considered when deciding those issues. The presence of a tax avoidance intention may help to show, for instance, why a person went abroad at all, or at the particular time he did, how long he intended to remain away, or where his home in fact was in the year of assessment. But residence abroad for a carefully chosen limited period of work there (if that is what the facts establish) is no less residence abroad for that period because the major reason for it was the avoidance of tax. Likewise with ordinary residence."[4]

As the judge's analysis showed, the existing law is rather uncertain and has been built up largely on a case by case basis over many years. The question of residence is a question of fact and many of the cases have not given any clear guidance, the Courts being reluctant to overturn the findings of fact by the Commissioners, even if the judges might have been inclined to come to a different conclusion. As a result, the law is in many areas obscure. There is little help from statute. Nicholls J in this case and, in rather more detail, the Inland Revenue Consultative Document on "Residence in the United Kingdom"[5] traced the development of the law.[6] The old court decisions and the little statute law clearly has been overtaken by the ease of communication and increased international business in modern times.

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4. p346
5. (1988)
6. See Annex B of the Consultative Document

Faced with this defeat at first instance, the Revenue did not appeal; probably they considered the uncertain state of the law and feared establishing a precedent adverse to them. Instead they though that it was time that the law was clarified, simplified and changed and put on a more certain footing. In July 1988 the Revenue issued their Consultative Document.

The Consultative Document pointed out, quite correctly, that the system based on the three main concepts of residence, ordinary residence and domicile had become complicated and it pointed out that it was possible to have eight different combinations, each giving rise to differnt tax liabilities, contrasting with the simpler residence rules of most other countries.[7]

This piecemeal accumulation of old case law and sketchy statutory provisions is supplemented by a number of Inland Revenue practices and concessions. The uncertain state of the law provided both opporunities for well informed tax avoiders such as Dave Clark and dangers for the rather less sophisticated like Mr. and Mrs. Fulford-Dobson. They tried to use, or, as the Inland Revenue saw it, exploit, an extra statutory concession. It was held in R v HM Inspector of Taxes ex parte Fulford-Dobson[8] that they failed in their attempt.

This case concerned section 2(1) CGTA 1979 and ESC D2. Section 2(1) reads:

> "... a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident in the United Kingdom, or during which he is ordinarily resident in the United Kingdom."

However, this is qualified by ESC D2, the relevant part of which is in the following terms:

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7. Para 4.3
8. [1987] STC 344

> "Where a person leaves the United Kingdom and is treated on his departure as not resident and not ordinarily resident in the United Kingdom he is not charged to capital gains tax on gains accruing to him from disposals made after the date of his departure."

The facts were that Mrs. Fulford-Dobson had inherited a valuable property in 1977 which she considered selling in 1980. Her husband was then unemployed but, on 18th August in that year, he accepted an offer of work in Germany. Eleven days later, following professional advice, she transferred the property by deed of gift to her husband who then left to take up employment in Germany. Four days after his departure the property was sold. It was admitted that one of the reasons for the transfer of the property to the husband was to ensure that, when the sale took place, it would be outside the scope of CGT under ESC D2 by virtue of the fact that, at the time of the sale, the taxpayer would not be resident in the United Kingdom.

The booklet issued by the Inland Revenue in which the concession was printed contained, on the inside cover, the following: "A concession will not be given in any case where an attempt is made to use it for tax avoidance." The Inland Revenue considered that the gift of the property by Mr. Fulford-Dobson to her husband eleven days after his acceptance of employment outside the United Kingdom, and its sale four days after he had left the country was an attempt to use the concession for tax avoidance, and they therefore refused to operate the concession in favour of the taxpayer. An assessment to CGT was therefore made.

Mr. Fulford-Dobson applied for judicial review and for an order for certiorari to quash the CGT assessment. He contended that: (a) extra statutory concessions were legally invalid, but, if valid, a taxpayer could not be deprived of a concession, otherwise applicable, by the conditions printed on the inner cover of the booklet; (b) that these conditions, like the concessions themselves, were unauthorised by statute and their inclusion was an unlawful assumption of authority by the Inland Revenue; (c) if the words were to be read as part of the concession, they were discriminatory in that they did not apply to all who fell within the scope of the concession, but only applied to a selected number of taxpayers; and (d) that the Inland Revenue was guilty of procedural impropriety by its failure to issue guidelines regarding the operation of extra statutory concessions, and that its decision was unfair and in breach of natural justice.

McNeill J held that the extra statutory concessions offered by the Inland Revenue were lawful and were within the proper exercise of managerial discretion, and the conditions that they might not be used for tax avoidance was not in any way discriminatory. The Inland Revenue, having offered extra statutory concessions, was entitled to take steps to avoid their abuse. There was nothing contrary to procedural propriety in the Revenue's failure to issue a series of guidelines relating to the operation of extra statutory concessions, as applied to particular sets of facts, in order to assist professional advisers by way of precedents. He therefore dismissed the application.

It is not intended here to further the debate over the legality of extra-statutory concessions. A useful review of the position can be found in "Judicial Review in Taxation: A Modern Perspective" by R. Bartlett,[9] and "Extra Statutory Concessions" by D.W. Williams.[10]

The judge had to decide how to deal with a clear published concession on which the taxpayer had acted, and what effect the warning on the inside cover had. His

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9. [1987] BTR 10
10. [1979] BTR 137

task appears to have been made easier by the fact that both the taxpayer and the Inland Revenue, in effect, accepted the legality of the concession. The taxpayer did so, of course, because he was trying to enforce it. The Revenue accepted that it was legal, but relied on the clear warning about tax avoidance to justify their decision not to apply the concession here.

MacNeil J accepted that the concession was lawful. He said:

> "I am not prepared to hold that concession D2 is unlawful. I consider it as falling well within the concept of good management or of administrative common sense... and they are within the proper exercise of managerial discretion".[11]

Given that the concession was lawful, the judge then had to decide whether the Inland Revenue had acted fairly in denying its application in the present case. In view of the clear warning, MacNeil J held that the concession did not apply to the taxpayer. The warning could not be ignored, said the Judge: it formed "an effective part" of every concession in the booklet in which the warning appeared.

The next step was for the judge to consider the meaning of the term "tax avoidance" as used in the warning. He cited Lord Tomlin's famous dictum from Duke of Westminster v IRC:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".[12]

MacNeil J's first reaction was:

> "I comment that the words 'if he can' are sometimes conveniently forgotten."[13]

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11. p351
12. (1936) 19 TC 490 at p520
13. p351

He accepted the proposition of counsel for the taxpayer that tax planning to reduce the instance of tax is a legitimate exercise but he had to consider whether the actions of the Fulford- Dobsons were "legitimate".

On the question of any distinction between avoidance and planning or mitigation, it is understandable that the judge turned his attention to the decision of the Privy Council in IRC v Challence Corporation Limited[14]. The unsatisfactory nature of the distinction drawn by Lord Templeman, delivering the judgement of the majority, is dealt with in Chapter 11[15] but, as it is the only real attempt at a distinction in UK tax law then - for better or worse - Lord Templeman's distinction was the appropriate yardstick for MacNeil J here.

It will be seen that Lord Templeman's distinction was based on whether there is a real loss. Lord Templeman said:

> "In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax."[16]

Even adopting Lord Templeman's flawed test, it is perhaps difficult to agree with MacNeil J that what the Fulford-Dobsons did was tax avoidance. The taxpayer made no secret of the fact that his intention was to avoid tax, but that is not enough, by itself, to bring the transaction within Lord Templeman's defintion of tax avoidance. MacNeil J said:

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14. [1986] STC 548
15. See also Part 1 of this Chapter
16. p555

> "If she [i.e. Mrs. Fulford-Dobson] had not given [the property] to her husband and the auction had continued while it was still in her name, she would undoubtedly have been chargeable to tax on her gain. The clear inferance from the papers was that that was in contemplation until her husband was offered the job in Germany.... The trigger to the whole arrangement or operation, misconceived as I am now satisfied it was, was the prospect of saving the capital gains tax on the sale of [the property] once the husband was to become non-resident before the date of the auction. That was the tax advantage which could not otherwise be secured. The gift, as counsel for the Revenue put it, lacked all elements of bounty. It was part of a scheme devised by the accountants and the bankers to avoid tax."[17]

This highlights the problems of judges in the highest courts creating distinctions or propounding principles based on unsound or misguided premises: they are likely to confuse their brethren who have subsequently to apply these distinctions or principles.

MacNeil J considered that:

> "It seems to be plain as a pikestaff upon the facts that this was tax avoidance as that term is used in the rubric. The taxpayer here, Mr. Fulford Dobson, suffered no reduction in income, suffered no loss, incurred no expenditure (save his professional advisers fees and expenses), nothing which, in Lord Templeman's words on the legislation here in point, Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability for tax."[18]

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17. pp353-4
18. p354

This analysis is, however, flawed. Earlier, the judge had stated that "the very simple arrangement" which made up the tax avoidance transactions comprised "the gift to the husband, the departure of the husband to Germany, and the sale four days afterwards.[19]

He should therefore not have overlooked the important point that one should start with Mrs. Fulford-Dobson, and not her husband, in examining these transactions. After all, she originally owned the farm, not her husband. She had given it to her husband and there was no evidence of any intention that she should get the proceeds back (and it appears that she did not, in fact, get the proceeds back). She certainly did suffer a loss or depletion of her assets, nothing came back to her at the end of the arrangement to cancel out the loss. It is not legitimate in this analysis to treat Mr and Mrs. Fulford-Dobson as effectively one and the same, because they are not, particularly as their relationship did become strained at one point. She suffered a loss in a very real sense. Furthermore, any element of pretence (an element identified by Lord Templeman as being part of "most tax avoidance"[20]) was wholly absent here.

The Inland Revenue could probably have attacked the transaction on the basis of the "Ramsay" principle[21] by saying that Mrs. Fulford-Dobson made the disposal on which her husband was being taxed.[22] Even in the restricted form of the "new approach" as confirmed by the subsequent House of Lords decisions in Craven v White etal,[23] they would have had a good chance of success given that the ultimate sale was at auction. The Inland Revenue did not have the benefit of the House of Lords, or even the Court of Appeal decisions in the Craven v

19. Ibid
20. IRC v Challenge Corporation Ltd [1986] STC 548 at p555
21. See Chapter 11
22. Under section 4(2) CGTA 1979
23. [1988] STC 476

White case at the time they were presenting their case to MacNeil J but, as it happened, they won anyway, although perhaps they should not strictly have done so on the arguments they advanced in this case.

This case emphasises the fact that an individual seeking to sever his connections with a former country of residence has to make sure that he takes sufficient action to achieve this in accordance with the law of that country and, if appropriate, any applicable double tax agreements.

In Canada there is a special provision relating to the capital property of a person who leaves the country.[24] Such a person is deemed to dispose of his property at market value immediately prior to his departure, subject to certain exceptions such as "taxable Canadian property" on which persons not resident in Canada are subject to Canadian tax. There is also an exclusion for individuals who are resident in Canada for 60 months or less in the ten years immediately preceding their departure from Canada. This allows multinational companies to assign personnel to Canada for up to five years without falling within this taxing provision.

Other countries have legislation applicable to individuals leaving on a permanent basis, whereby they remain subject to tax in their former country of residence for a certain period. Such provisions apply in, for example, Denmark, Sweden, the USA and West Germany.

The German provisions, for instance, apply for income tax, wealth tax and inheritance tax and applies to German citizens or individuals who used to be German citizens, but who transferred their residence to a low tax country and who, for five out of the previous ten years, were

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24. Section 48, Income Tax Act

citizens or residents of Germany.[25] A low tax country is defined as a country where the tax is less than 2/3rd of the tax in Germany. If an individual retains a significant economic interest in Germany after transferring his residence to such a country, he remains subject to German income tax for ten years after his emigration on all of his income that would not be considered as foreign source income for the purpose of the foreign tax credit provision for the purposes of income tax.

The German provisions are different from those applying in Canada, Denmark, Sweden and the USA in that they are specifically directed at emigration to low tax countries. The UK has no such provisions relating to individuals although, following the Finance Act 1988, such a charge will arise in respect of the emigration of companies.[26]

As well as considering the tax provisions in the country he is leaving, an individual will also have to think about the taxes in the country to which he is moving. Some countries have special tax rules for individuals who move to those countries. For example, in the Netherlands, a person can be a "deemed non-resident" for up to five years if he is sent there on a short term basis by an overseas company. If he qualifies for such status, he will be subject to Dutch tax on his Dutch source income, but he will not incur any liability in respect of income from overseas sources.

Switzerland has the reputation of being one of the most glamorous destinations but, in fact, only a limited number of people are allowed into the country, such as employees of multinational companies and those who have retired. However, if a person can obtain permission to live in Switzerland, he may well qualify for beneficial

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25. Section 2-5 of the Foreign Tax Law
26. See Part 5

tax treatment. If he has never been engaged in an income producing activity in Switzerland he may qualify for the Pauschalsteuer which is a special tax which is payable instead of the federal tax. The actual rate is the same as the federal tax rate but, in any case, that is relatively low compared to most other European countries. However, this special tax is only payable on the individuals living expenses, subject to a minimum which is the greatest of:

(i) five times the annual rental value of his Swiss home;

(ii) one and a half times the annual rental, if he is living in a hotel or boarding house; or

(iii) the annual gross income received from certain sources within Switzerland, plus income from foreign sources, if it is subject to relief from withholding tax pursuant to a double tax agreement, and the taxpayer has applied for this relief.

Certain cantons also give similar treatment to persons who do not carry on a trade or business in the cantons in question.

Where the country of destination is a high tax country and does not provide special tax treatment along the lines of the Swiss provisions, the individual can often take appropriate steps to divest himself of assets (perhaps by setting up a trust) prior to establishing residence in that country.

PART 8

MANIPULATING THE RESIDENCE OF TRUSTS

Introduction

Trusts are often used to sever a nexus between taxpayers and a taxing jurisdiction or to prevent such a nexus arising in the first place. Many tax avoidance devices have therefore used trusts over the years with the result that the Legislature has been forced to step in with complex and wide ranging anti-avoidance legislation. The UK, like many countries, now has a body of such provisions aimed at stopping the exploitation of trusts for tax reasons.

Trusts have been used extensively, for example, by UK individuals attempting to transfer assets abroad to take them out of the UK tax net.[1]

Tax havens, in particular, have not been slow to realise the use of trusts in international tax planning. The Cayman Islands, for example, has specific legislation by virtue of which trusts can be exempt from tax. The Registrar of Trusts can register a trust as exempt if he is satisfied that the beneficiaires do not include persons resident or domiciled in the Cayman Islands.[2] In fact, so much use was being made of the Cayman Islands and its helpful trust regime that UK law had to be changed to reduce this exploitation.[3]

Much use has been made, and continues to be made, of trusts set up overseas or of the emigration of UK trusts. There is no provision similar to measures that used to be contained in section 765 ICTA 1988, prior to its amendment IV FA 1988, relating to companies, preventing the emigration of trusts from the UK.

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1. See Part 2
2. Trusts Law (No 6 of 1967), as amended
3. See Part 2

Residence Explained

It is first necessary to mention the tests used in determining the residence of a trust for UK tax purposes. There are, in fact, different rules for income tax, CGT and inheritance tax. It is not necessary to examine these rules here; they will be considered only insofar as they are relevant to the matters under discussion.

The residence rules for CGT and inheritance tax are statutory, but there are no similar statutory provisions relating to income tax.

The CGT rule is set out in section 52(1) CGTA 1979. This states:

> "In relation to settled property, the trustees of the settlement shall for the purposes of this Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be the trustees), and that body shall be treated as being resident and ordinarily resident in the United Kingdom unless the general administration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or a majority of them for the time being are not resident or not ordinarily resident in the United Kingdom."

For income tax purposes it was the Inland Revenue's view, which it is believed was backed up by a decision of the Special Commissioners, that trustees are resident in the UK if any one of them is resident here. This view receives some support from the rule in English trust Law that the trustees must act unanimously, and that a majority decision is not sufficient so that, if a majority of the trustees are non-resident, they still cannot be deemed to be non-resident as a body of persons. The Inland Revenue's view was, therefore, that all the trustees had to be non-resident and the administration of the trust had to be carried on outside the UK as well.

The Inland Revenue's view was tested for the first time when Vinelott J considered the case of IRC v Dawson[4], whose decision was upheld by the Court of Appeal[5] and the House of Lords.[6]

The facts were that UK domiciled and resident settlors created three trusts between 1949 and 1965 in favour of members of the family of Mr. Gordon Cotton. In 1969 he emigrated with his family and became permanently resident in Switzerland. Between 12th February 1974 and 14th March 1977, the taxpayer was the only trustee who was resident in the UK, the others being a Swiss bank and a Lichtenstein company. During these three years most of the funds of the trusts were invested in shares of non-UK companies, the income being paid into accounts in the name of the Swiss bank. Distributions of income were decided at meetings of the trustees held in Switzerland, no beneficiary having any absolute vested interest in any of the income, and none of that income being remitted to the UK.

The taxpayer was assessed to basic rate income tax under Schedule D Case V and to additional rate tax under section 16 FA 1973[7] in respect of the trust's income. He appealed against this assessment, contending that, even it were accepted that the trust income arose or accrued to him, no assessment could be made to him because he was not a person "receiving or entitled" to that income within section 114(1) ICTA 1970[8] and that income did not arise or accrue to him within section 108, paragraph 1(a) of the Act.[9]

All three courts held that the assessments were not valid. Where trustees have no beneficial interest in a

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4. [1987] STC 371
5. [1988] STC 684
6. [1989] STC 473
7. Now section 686 ICTA 1988
8. Now section 59(1) ibid
9. Now section 18(1) ibid

trust fund, and no beneficiary has an absolute vested interest in its income, trust income is income "accruing to" them within paragraph 1 (a) of section 108 ICTA 1970 which they "receive" or to which they are "entitled to" within section 114(1) jointly, not severally. Therefore, where one or more of such trustees reside outside the UK, the other trustee or trustees cannot be assessed to income tax under Case V by virtue of paragraph 1(a)(i) of section 108.

It should be noted that the two parties in this case were arguing for one extreme or the other. As far as the Inland Revenue were concerned, the charging provision applied if <u>any</u> of the trustees was resident in the UK; whereas the taxpayer argued that the charging provision applied only if <u>all</u> of the trustees were UK resident. Both parties agreed that the CGT test was inappropriate.

Each of these extremes gives rise to anomalies. Taking the Inland Revenue's construction, a trustee who becomes UK resident would therefore become chargeable to tax on all of the trust income regardless of the residence of the other trustees, the settlor and the beneficiaries. But, taking the taxpayer's view, if there is a UK resident settlor of a settlement, the income of which is being accumulated, but all of the beneficiaires are UK residents, all that has to happen is that an additional non-resident trustee is appointed for the overseas income of the settlement to escape UK tax completely until it is remitted to a UK resident beneficiary.[10] It can therefore be seen that the decision in the Dawson case opened up an obvious loophole. So, just as the Inland Revenue were unhappy about the chaotic and easy to manipulate state of the law on the residence of companies and individuals, they were concerned about the rules on residence of trusts, a concern that must have been greatly increased by the Dawson decision which meant that

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10. When a charge would arise under section 740 ICTA 1988, infra

their established practice regarding residence of trusts for income tax purposes was wrong.

In fact, the loophole exposed by the Dawson case was very short-lived. Section 110 FA 1989 enacted that, for 1989/90 onwards, if a settlor is resident, ordinarily resident or domiciled in the UK when he provides funds for the settlement, the trust will be resident in the UK if at least one of the trustees is resident in the UK.

Emigration of Trusts

In the same way that there were tax incentives to move companies abroad and for individuals to emigrate to break the nexus between themselves and the UK, so the incentives were there for trusts. There were, however, certain constraints. With companies it was the statutory constraint imposed by tax law[11] until those constraints were removed in 1988 and replaced by a tax charge on capital assets on emigration.[12]

With individuals it was the practical one that relatively few individuals have been prepared to move abroad purely to save tax. With trusts there is the question of whether trusts actually can be exported under the general law of trusts. Of course, if a trust is set up as non-resident from the start, no such problem arises.

However, as regards trusts which were originally set up in the UK, the Dawson case shows how easy it is to move a trust outside the income tax rules, and even after section 110 FA 1989 it is still relatively easy to export a trust for income tax purposes. For CGT, a majority of overseas trustees must be appointed and the administration must be abroad.

This presupposes that there is a power to appoint non-resident trustees. It is common these days for such power to be expressly stated in the trustees, but even in the absence of such a power, it appears that a bona fide appointment of non-resident trustees could only be challenged by a beneficiary, not by the Inland Revenue if they suspected that it had been done to avoid tax.

There are four cases which establish this, with varying emphasis on the tax motives for going offshore.

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11. Section 765 ICTA 1988
12. See Part 5

In Re Seale's Marriage Settlement,[13] Buckley J held that, in the circumstances, it was advantageous for the trust to be exported irrespective of the tax advantages. Considering the facts, this is not really surprising. The two parties to a marriage settlement and their children emigrated to Canada and each of them was likely to remain living there. It was only sensible for the settlement, in effect, to follow them.

Much more instructive from a tax point of view is Re Weston's Settlement[14] A settlor made two settlements in 1964 in England with UK resident trustees. One settlement was in favour of his younger son, and the other was on the marriage of his elder son. The settled assets were mostly shares in an English company of which the settlor was Chairman.

Until January 1967, the settlor and his family lived in England. In December 1966, he purchased a house in Jersey and, between January and May 1967, he made four short visits to Jersey. From August 1967 onwards, he and his wife and sons lived in Jersey. The settlor claimed to be domiciled in Jersey.

A summons under Section 41 of the Trustee Act 1925 and Section 1 of the Variation of Trusts Act 1958 was taken out on behalf of the settlor for the appointment of two persons resident in Jersey as trustees in place of the existing UK trustees, and the insertion in the settlements of a power for the new trustees to transfer the trust assets to new trusts made in Jersey. This would have avoided capital gains tax by virtue of section 25(1) FA 1965 and estate duty by virtue of section 28 FA 1949.

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13. [1961] 3 All ER 136
14. [1968] 1 All ER 720

At first instance the case was heard by Stamp J. He held that the application should be refused because no member of the family had become domiciled in Jersey, and he was not satisfied that any of the beneficiaries intended to continue living there so that the only benefits to be achieved were entirely of a fiscal character.

The judge said that the immediate purpose of the application was to remove the assets of the settlements from the jurisdiction of the English Courts and from the clutches of the Inland Revenue. The immediate result of this would be to avoid a potential liability for a very large sum of CGT. The judge accepted that the court was not the watch dog of the Inland Revenue and that regularly variations of trusts were sanctioned which would, on the one hand, provide a tenant for life with capital instead of income and, on the other hand, mitigate the burden of estate duty that would otherwise be payable on his death. However, he said that there must be some limit to the devices which the court ought to countenance in order to defeat the fiscal intentions of the Legislature. The proposals in this case, in his view, overstepped that limit. The family had only just moved to Jersey and the inference from the facts was that the principal purpose of the move abroad was the avoidance of tax. If the family had settled in Jersey, the judge might well have thought it right to accede to the application, but the family had not been in Jersey for more than a few months and he did not accept, on the evidence, that any member of the family could possibly establish that he was domiciled in Jersey. He said:

> "I am not persuaded that this application represents more than a cheap exercise in tax avoidance which I ought not to sanction, as distinct from a legitimate avoidance of liability to taxation."[15]

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15. p725

It can be seen that Stamp J effectively drew a line between "legitimate avoidance" and what he considered here to be unacceptable avoidance. It is not clear, however, quite how he drew the distinction. He did not explain; he merely said that the taxpayers had overstepped the limit.

Given that he might well have granted the application if the family had settled in Jersey, but that he refused it because they had not been there for more than a few months, it is apparent that he was relying on the inference that the family's move to Jersey was a tax motivated decision. This would be a logical progression from Re Seale which had established that a real emigration of the family was justification for the trust being allowed to emigrate also.

The difficulty in establishing clearly where the line should be drawn can be seen from a note in "Taxation" magazine of 10th February 1968.[16] It disclosed that, on the same day that Stamp J gave his judgement in the Chancery Division, in the Divorce Court, Faulks J exercised his discretion to make absolute a decree nisi within a fortnight - an unusually brief period - because he had been told that, if the decree were granted, the wife would be able to remarry before 5th April 1968, and her new husband would be entitled to the married man's personal allowance for 1967/68. Faulks J considered this "a very sensible reason" and granted the decree. It is likely that Stamp J would have found that this fell the right side of the line as well.

The taxpayer in Re Weston appealed to the Court of Appeal where his decision was again refused.[17] Lord Denning MR considered that two propositions were clear:

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16. p325
17. [1969] Ch 223

(1) In exercising its discretion, the function of the court was to protect those who could not protect themselves. It had to do what was for their benefit.

(2) It could give its consent to a scheme to avoid death duties or other taxes. Nearly every variation that had come before the court had had tax avoidance for its principle object, and no one had ever suggested that this was undesirable or contrary to public policy. It was, however, necessary to add a third proposition, namely:

(3) The court should not consider merely the financial benefit of the infants or unborn children, but also their educational and social benefit. There were many things in life more worthwhile than money.

Lord Denning MR said:

> "I do not believe that it is for the benefit of children to be uprooted from England and transported to another country simply to avoid tax. It was very different with the children of the Seale family, which Mr. Justic Buckley considered. That family had emigrated to Canada many years before, with no thought of tax avoidance, and had brought up the children there as Canadians. It was very proper that the trust should be transferred to Canada. But here the family had only been in Jersey three months when they presented this scheme to the court. The inference is irresistible: the underlying purpose was to go there in order to avoid tax. I do not think that this will be all to the good for the children."[18]

Having built up their wealth in this country, they wanted to leave without paying the taxes and duties which were imposed on those who stayed. If this was genuinely for the benefit of the children, the court would allow it to be done but, if it is not truly for the benefit of the children, the court would not countenance it.

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18. p244

Lord Denning MR, of course, was never fond of tax avoidance. As he said in this case, "avoidance of tax may be lawful but it is not yet a virtue". Harman LJ agreed with the Master of the Rolls. In his view this was "an essay in tax avoidance, naked and unashamed".

The distinction drawn by Stamp J and the Court of Appeal was confirmed in a similar case: Re Windeatt's Will Trusts,[19] in which the family had lived in Jersey for many years and it was clear that they had established a real connection with Jersey. The Chancery Division allowed the application because, although the emigration of the trust was fiscally beneficial, it was not the only reason for the application.

A proposed emigration of a UK trust to Jersey was also sanctioned in Re Whiteheads Will Trusts.[20] In the High Court, Pennycuick V-C said that it was not "proper" for non-residents to be appointed as trustees except in "exceptional circumstances" (and, of course, in the absence of express powers in the trust deed) and that the court would interfere if asked to do so by a beneficiary. The judge did, however, think there were "exceptional circumstances" here justifying the appointment in that the beneficiaries had genuinely settled outside the UK. In view of these circumstances, the judge was clearly not bothered by the fact that the appointment of overseas trustees was to avoid tax. He said:

> "I should, perhaps, add that one of the purposes of this appointment is unquestionably to escape the burden of certain United Kingdom fiscal liabilities. It has, however, long been established that there is no reason why the court should not lend its assistance in connection with a particular transaction, and so far as the appointment of new trustees out of court is concerned, it is, I think,

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19. [1969] 2 All ER 324
20. [1971] 2 All ER 1334

an absolutely irrelevant consideration. Those possessing the power are clearly entitled to exercise it as they think best in the interest of the trust's estate."[21]

I can therefore be seen that, even in the absence of the express power in the settlement deed to export the trust, it is only in extreme cases that a trust can be prevented from being exported.

21. p1339

Counteracting Measures

Reference should be made to Part 2 of this Chapter for an analysis of how taxpayers have sought to use trusts to break the nexus with the UK for income tax purposes by moving assets out of the UK, and how those schemes have been combatted. Here attention is turned to trusts and CGT and on taxpayers' efforts to exploit the basic rule that non-resident trusts are not liable to UK CGT on assets situated in the UK,[22] except where the trust carries on business in the UK through a branch or agency.[23] Without anti-avoidance legislation, it would be a very simple matter to arrange for chargeable assets to be chanelled through a non-resident trust which could dispose of them free of CGT.

The original section dealing with gains of non-resident trusts was very unsatisfactory and was replaced in 1981 with a much fairer section.

When CGT was introduced in 1965, the FA of that year contained a section dealing with gains accruing to non-resident trusts: Section 42 FA 1965.[24]. The section applied to gains accruing to trustees who were neither resident nor ordinarily resident in the UK, where the settlor was domiciled and either resident or ordinarily resident in the UK when a settlement was set up or when the gain was made.[25] Although the overseas trustees could not be made liable to tax, the gain could be apportioned to any beneficiary who was domiciled and either resident or ordinarily resident in the UK in the year the gain was made. The apportionment could be in "such manner as is just and reasonable".[26]

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22. Section 2(1) CGTA 1979
23. Section 12 ibid
24. Later section 17 CGTA, now repealed
25. Section 42(1) FA 1965
26. Section 42(2) ibid

Section 42 FA 1965 was discussed, and its limitations exposed, in Leedale v Lewis.[27] The facts were that, in 1968 a UK resident created a settlement under which non-resident trustees had powers, which had not been exercised, to appoint the capital and income of the settlement for the benefit of members of the specified class, namely, any grandchild or remoter issue of the settlor born before "the Perpetuity Day" (which was defined by a "royal lives" clause) or their wives, husbands etc. and, subject thereto, there was a discretion to pay or apply the income for the benefit of such members, any income not so applied to be accumulated. Under a letter of wishes, the settlor stated: (i) that the trustees "should regard the settlement as existing primarily for the grandchildren in equal shares and.... should accumulate income for the time being"; (ii) that when a granchild attained 21 the income of his or her prospective share should be paid out "until such time as circumstances make it necessary or desirable to pay out the capital as well"; (iii) in the absence of special circumstances, the grandchildren should not receive any large sums of capital bvefore reaching 30. At the Perpetuity Date, the funds were to be held "in trust absolutely for such of the grandchildren and remoter issue of the settlor" as should then be living "and if more than one in equal shares per stirpes".

In 1968/69 and 1969/79, no distributions of income were made but the gains which accrued to the trustees were apportioned by the Inland Revenue equally by assessing the five grandchildren under section 42(2) FA 1965.

At the hearing of the appeals, it was common ground between the actuaries that the current market values of each grandchild's "fixed interest" (which would not vest until the Perpetuity Date) was very small. Even the Revenue's actuaries valued the interests at only ½p each!

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27. (1982) 56 TC 501

Section 42(2) was given a wide interpretation, particularly in the Court of Appeal and the House of Lords. The Court of Appeal held that the object of a discretionary trust qualified both as a "beneficiary under the settlement" and as a "person having an interest in the settled property" for the purposes of an apportionement under section 42(2). That subsection therefore required the whole of the amount to which the trustees would have been chargeable, to be apportioned between the five grandchildren as having such interests; the words "in such manner as is just and reasonable" related solely to the mode of apportionment bewteen them. On the facts, the apportionment equally between the beneficiaries was correct, there being no reason for distinguishing between them. Fox LJ said:

> "In general it seems to us that the construction which we have adopted imposes no strain upon the language of the section and is likely to secure, so far as possible, that the tax burden falls upon the persons who, in truth, are likely to be the main beneficiaries of the settlement. We see no reason to put a restrictive construction upon section 42. Settlements created by persons domiciled and resident in the United Kingdom but with trustees abroad are potential instruments of tax avoidance. Section 42 is the recognition of that. It is contended on behalf of the Appellants in the Lewis cases that the section has simply failed in its purpose. The discretionary objects, it is said, do not have 'interests' and are therefore outside section 42(2). So far as persons having fixed interests are concerned, it is said that the effects of the section may be so burdensome that Parliament cannot have intended them. We do not accept that. As we have indicated, we think that the language of the section is sufficiently clear and so far as burdens are concerned, they will result from the

deliberate choice of the settlor or of the trustees or both."[28]

It is noticeable that Fox LJ accepts that the tax burden falls on person's who "are likely to be the main beneficiaries". However, there is a real danger that they might not be the main beneficiaries. They might have imposed upon them a large tax liability with no money from the trust to pay it. It is also noticeable that the Court of Appeal held that the whole of the amount for which the trustees would have been chargeable should be apportioned between the beneficiaries. No account was taken of the actuarial value of the beneficiaries' interests in determining what was just and reasonable; the whole amount was split between them, in this case, equally.

The decision of the Court of Appeal was upheld in the House of Lords, which agreed with the reasons given by the Court of Appeal. In addition, the Law Lords said that another reason for construing "interest" widely was that section 42 had also to apply to settlements covered by other systems of law and, by virtue of subsection (7) to "arrangements". The words "in such manner as is just and reasonable" and "as near as may be, according to the respective values of those interest" suggested a broad, rather than an actuarial approach, in which all relevant considerations might be taken into account: the relative property of one discretionary beneficiary would only be relevant in a case where he was likely to have the trustee's discretion exercised more generously in his favour.

Lord Wilberforce had no sympathy with arguments based on hardship. He said:

> "I would only refer to one other argument, that based on the alleged 'hardship' of accepting the Crown's contention. I do not think that this is a relevant

28. p530

consideration at all. If there were two equally possible constructions of this subsection, it might be correct to choose that which is the more favourable to the taxpayer, on the basis that subjects can only be taxed by clear words. This principle cannot apply where there are decisive legal reasons for preferring one construction rather than another. Once this step has been taken considerations of 'hardship' do not enter into the discussion. The 'hardship' (if any) consists in imposing a tax on discretionary beneficiaries at a time when they may have received no benefit from the trust out of which the tax can be paid. But if that is the effect of the section, it respresents the Parliamentary intention. We cannot characterise it as in itself a hardship. Settlors, after 1965, make their settlements with knowledge of the legislation and of its consequences. They can avoid the use of discretionary trusts, or, if they decide to use them, make provision to meet hard cases. The section itself (subsection(5)) recognises that trustees may take remedial action".[29]

Two points made by Lord Wilberforce call for particular comment. The first is that he says that the House of Lords' interpretation "represents the Parliamentary intention". This is not so.[30] Secondly, he claims that settlors (after 1965) make their settlements with knowledge of the legislation. But the point is that the law was not clear and, in fact, before Leedale, many people clearly though the law was as contended by the taxpayers here. A view with which the Special Commissioners agreed. The decision in Leedale surprised most people, particularly those who were aware of what Parliament actually had intended!

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29. p540
30. Infra

Lord Scarman was equally unimpressed by the hardship argument. He too gave two reasons why it did not worry him. One was similar to Lord Wilberforce's point about the settlor creating the settlement knowing what she was doing. The second was that, if the beneficiaries are liable, the trustees can pay the tax for them.[31]

Throughout the passage of this case through the courts, particularly in the House of Lords, the judges referred to the use of discretionary trusts as tools for tax avoidance. This appears to have persuaded them that this harsh interpretation of the section was required to curb the perceived abuses.

Parliament, on the other hand, recognised that the section worked in an unjust way and replaced it in 1981. The section was far from satisfactory and there were large areas of doubtful interpretation. It really was only satisfactory where the beneficiaries interests were fixed.

The section was also unfair in its treatment of losses. Losses of previous years could not be brought forward to determine the apportionable amount. As a result, the CGT on a non-resident trust could be even greater than if the trust had been resident in the UK. This harsh rule was changed in 1981.

The Judiciary's efforts to cure the defects of the section had proved a disaster. Not only was the section replaced (before the Court of Appeal and House of Lords deciaions in Leedale), but legislation was specifically brought in in the FA 1984 to alleviate some of the harsh effects of the Leedale decision.

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31. pp544-5

A Parliamentary Question was raised in the House of Commons in 1983[32], namely:

> "To ask Mr. Chancellor of the Exchequer whether he will introduce legislation to reverse with retrospective effect the decision of the House of Lords in the case of Leedale v Lewis."

In a Written Answer, the Financial Secretary to the Treasury, Nicholas Ridley, said:

> "No. FA 1965 Section 42 (later CGTA 1979, Section 17) suffered from a number of major weaknesses. The decision of the House of Lords in the case of Leedale v Lewis established that, in relation to discretionary beneficiaries who had received no benefit from the trust, the section did not in certain respects give effect to the intention of the then Government at the time when it was introduced. But the experience in the operation of the section, and its examination by the courts in the course of the Leedale v Lewis case, made it clear that it also had certain fundamentally unsatisfactory features whether or not it was construed as decided by the House of Lords.
>
> In many cases the main effect of reversing the decision of the House of Lords would not be to reduce the overall tax burden, but to shift it from discretionary beneficiaries to beneficiaries with fixed interests in a way which would be neither fair nor reasonable. Accordingly it would not be practicable to introduce retrospective legislation of the kind suggested. The Inland Revenue are therefore issuing assessments on beneficiaries under foreign discretionary trusts in accordance with the decision of the House of Lords.

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32. See [1983] STI 163

The judgements in the House of Lords showed that in the generality of cases there should not be hardship in assessing a beneficiary who has received nothing from a trust since the section expressly provides that the tax bill can be met by the trustees without giving rise to any further charges.

Nevertheless there may still be potential hardship if the trustees refuse to take advantage of this facility. But this applies not only to discretionary beneficiaries, whose position was discussed in 1965, but also, with a greater force, to beneficiaries with fixed interests since they are less likely to be able to be reimbursed by the trustees if they are not also discretionary beneficiaries.

Prior to the decision of the Court of Appeal in Leedale v Lewis it was not the practice of the Inland Revenue to assess mere discretionary beneficiaries who have not received any payment from a foreign trust; while FA 1981 provides that for the future gains will not be charged until a benefit has been obtained. Accordingly I consider that it would be right to allow analogous treatment for the intervening years.

The Government will therefore be proposing at the Committee stage of the Finance Bill the introduction of a Clause to allow any beneficiary of a foreign trust, whether his interest is fixed or discretionary, who has not received any benefit from the trust, to defer, without interest, payment of the relevant capital gains tax assessed on him for the year 1980/81 or any earlier year until such time as he, or any person connected with him, obtains either directly or indirectly a corresponding benefit from the trust. This will apply to any tax on assessments made under Section 42 which has not been paid before today.

> The proposal is designed to meet genuine cases of hardship without undermining the fundamental purpose of Section 42 that gains made by foreign trusts set up by UK settlors for the benefit of UK beneficiaries should not escape taxation."

It is noticeable that the Financial Secretary accepted that the section, as interpreted by the House of Lords, did not give effect to the intention of the Government.

The resulting provisions referred to were contained in section 70 and Schedule 14 FA 1984.

The Leedale case was followed in two High Court decisions. The first was Bayley v Garrod[33], a decision of Mervyn Davies J.

This case involved a highly artificial avoidance scheme. Under a settlement non-resident trustees in 1967 acquired two worthless debts owed by "International" and "Status", two subsidiaries of Garrod and Lofthouse Limited, a company controlled by the settlor. The settlor's two children, Christopher Garrod and Sally Forbes, were among the discretionary beneficiaries. In 1976 a scheme was implemented with the object of avoiding CGT on the distribution of the trust assets to the two above-named beneficiaries. The scheme involved the following steps: The reversionary interest in the trust fund was appointed to the two beneficiaries in equal shares, and it was assigned by them on the next day to a Jersey company for £1 each. The two beneficiaries, plus the three companies, each opened accounts with Rothschilds Bank (which was aware of the scheme). On the following day Rothschilds made an offer to the trustees of credit facilities of £800,000, which

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33. (1983) 56 TC 695

the trustees accepted. The trustees exercised their discretion to appoint £600,000 to Christopher and £200,000 to Sally. On the next day, the trustees borrowed the £800,000 from Rothschilds and directed it to be paid to Christopher and Sally who in turn lent that sum to Garrod and Lofthouse Limited, which issued to them loan notes of equivalent face value bearing interest at 5%. A few days later, International and Status (having borrowed £800,000 from Garrod and Lofthouse Limited) repaid debts totalling over £800,000 to the trustees, who thus made a gain of that amount. The trustees then repaid the loan from Rothschilds.

An assessment of £600,000 was made on Christopher and £200,000 on Sally under Section 42 FA 1965. The court held that the assessments must stand based on Leedale v Lewis. The decision was undeiably correct on the authority of the Leedale case.

The second case was a decision of Vinelott J: Ewart v Taylor.[34] The Leedale decision caught out the taxpayer here and wrecked the scheme. The facts of this case need not be set out in detail, but the arrangement in question was basically that assets held by non resident trustees were appointed to beneficiaries and then sold back to the trustees in such a way, it was hoped, as not to generate a charge to CGT.

This case is also interesting in that the taxpayer was reduced to putting forward "reverse-Ramsay" arguments to the effect that, by virtue of the Ramsay decision, the intermediate steps, including those that gave rise to a liability under Leedale should be ignored. As will be seen in Chapter 11, this argument failed.

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34. [1983] STC 721

As mentioned above Lord Wilberforce in Leedale referred to the inention of Parliament. In fact, it has been shown that Parliament did not intend what the House of Lords decided.[35]

It is, of course, a traditional rule of statutory construction that judges cannot refer to Hansard, so Lord Wilberforce cannot be criticised on that score. But the Inland Revenue knew perfectly well what the intention of Parliament was and, indeed, would originally have advised Government Ministers on the legislation. For them then to turn round and instruct counsel to advance arguments completely at variance to what the Inland Revenue had advised Ministers, and what Parliament clearly intended, raises questions as to the fairness of the Revenue's attitude. The Inland Revenue would have known that the provision in the Finance Bill originally read "whether the interest be a life interest, or an interest in reversion, <u>or an interest under a discretionary trust</u>." The words underlined were specifically deleted from the provision following objections in Parliament.

The worst characteristics of section 17 CGTA 1979, as exposed in the Leedale case, were swept away when Parliament replaced that section with a new regime in 1981: <u>sections 80-84 FA 1981</u>.

<u>Section 80</u> applies to gains made by trustees who are neither resident nor ordinarily resident in the United Kingdom if the settlor is domiciled and either resident or ordinarily resident in the UK in the year the gain was made or in the year he made the settlement.

This link with the settlor was a carry over from Section 17. It is not easy to see why this link with the settlor should be retained. The section imposes liability on the beneficiary but someone who has lived here all his life

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35. See HW Wiggin, Law Society Gazette, 23 February 1983, p461

can receive a large capital sum completely tax free just because, many years before, a settlement was set up by someone who was neither domiciled nor resident/ordinarily resident in the UK. On the other hand, a beneficiary who has little contact with the UK, but who happens to be resident here in the year he receives the capital sum can find himself landed with a liability because of the status of the settlor. Such a provision is probably attributable to the Legislature's preoccupation with tax avoidance in this field.

Under section 80 beneficiaries cannot be subject to CGT in respect of the gains of non-resident trustees until they receive capital sums from the settlement and the charge is in proportion to the size of the capital sum received. The way the section works is that the capital gains of the trustees are worked out on the assumption that they are resident in the UK. The total gains since 6 April 1981, less any amounts already charged on the beneficiaries under section 80 or secton 81,[36] are the "trust gains for the year" and these gains are attributed to the beneficiaries in proportion to capital sums they have received from the trust since 10 March 1981, unless and to the extent that those sums have already been taxed under these provisions. A beneficiary cannot be taxed on a gain in excess of the capital sum he has actually received.

This is, of course, a much fairer system and, in fact, it provides valuable tax planning opportunities based on the fact that tax on capital gains can be deferred (and even avoided completely if a beneficiary becomes non resident before receiving a capital sum).

The fact that the worst defects of section 17 have been removed is not to say that the section works fairly in every case. The way the liabilities are calculated can give rise to some surprising results. Whether a

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36. Infra

beneficiary incurs a large or a small CGT liability could be a matter of pure chance. This is because capital payments are attributed to trust gains in an arbitrary arithmetical way. For example, there may be trust assets of £500,000 in the hands of non-resident trustees and they may have made gains of £250,000. Assume that one beneficiary is resident in the UK and the other is not, and the trustees want to distribute all of the trust assets to them equally. If they pay £250,000 to the non-resident beneficiary first, this distribution will be set against the trust gains cancelling them out and giving rise to no CGT liability because the beneficiary is non-resident. They can then pay the remaining £250,000 to the resident beneficiary in the following year. He will not suffer a CGT charge because all of the trust gains would have been effectively used up. On the other hand, if the trustees reversed the order of the gifts, the whole of the trust gains would be attributed to the resident beneficiary and he would have to pay CGT on the lot.

This is just one of a number of arithmetic anomalies that can arise in the operation of the section. In practice, non-resident trustees are usually professionally advised and can use the rules to their best advantage which, at best, means they can make real savings and, at worst, that they fall into no traps. Nevertheless, the potential difficulties remain to catch the unwary.

It would not be difficult to remove these difficulties from the section without opening up loopholes but, on the whole, the section is seen as working fairly, and there is little call from taxpayers for its amendment.

<u>Section 81</u> concerns migrant trusts. It produces a measure of relief from section 80. Under the normal provisions of section 80 a capital sum received by a beneficiary will still be caught even if it precedes the realisation of the gain by the trustees. What section 81

says is that, if a capital payment is received by a beneficiary when the trust is resident in the UK, that payment will not give rise to a charge under section 80 if the trust is subsequently exported and the trustees make a gain, but this relief only applies if the payment was not made in anticipation of a disposal by the trustees once they have become non-resident.

Section 15 CGTA 1979 was a sister section to Section 17 in that it apportions to shareholders gains made by a non-resident company which, if it were resident in the UK, would be a close company. The section itself did not suffer from the same defects as section 17, chiefly because the interests of shareholders are fixed and ascertainable and the section survives today.

However, there was originally a loophole available by combining sections 15 and 17. If a non-resident trust owned a non-resident company, the gains made by the non-resident company could not be apportioned through the non-resident trust to the UK beneficiaries because it was only resident or ordinarily resident persons who could be treated as if a part of the chargeable gain had accrued to them.[37] This, of course, excluded the non-resident trustees. This glaring loophole was stopped by section 85 FA 1981. For gains made after 10th March 1981 by a non-resident company, the gains are treated as having accrued to the trustees of the non-resident trust, enabling the gains to be apportioned to the beneficiaries in accordance with the procedure noted above.

One obvious tax avoidance device was prevented when the general CGT hold-over for gifts in section 79 FA 1980 was extended to cover transfers to trustees by section 78(1) FA 1981. The general hold over relief did not apply to gifts to non-residents and, if a UK donee trustees went

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37. Section 15(2) CGTA 1979

abroad, the held-over gain crystallised.[38] This prevented an asset being put into a UK trust, and the trust then being exported.

Nevertheless, the fact that only the held-over gain crystallises left plenty of scope for tax planning. For example, assume that an individual had an asset with a fairly low value but which was likely to increase substantially in the future (it may, for example, be land on which planning permission was expected, or shares in a private company which was due to be floated on the stock exchange). The asset could be transferred into a UK resident trust when its value was low, any gain at that stage being held over. Later, before disposal, the trust could be exported. Even if the value had increased substantially after the asset was placed in the trust only the held-over gain would crystallise, the great increase in value would not fall into charge. In a later tax year, the non resident trustees could sell the asset free of CGT, and it would only be when capital payments were made to UK beneficiaries that any further CGT liability would arise.[39]

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38. See Chapter 8
39. Under section 80 FA 1981, supra

Disposals of Interests in a Trust

The general rule is that a dipsosal by a beneficiary of an interest in a settelement which he has not acquired for money or money's worth will not give rise to a CGT charge.[40] Section 58 (1) CGTA 1979.

A number of tax avoidance schemes were built around this rule, all similar to what was sometimes known as the "Sale into Settlement Scheme". The basic steps of this scheme were that the beneficiary sold his interest in the trust to a non-resident, following which the trust became non-resident. Subsequently, and in a separate year of assessment, the non-resident purchaser became absolutely entitled to the settled property as against the trustees. No chargeable gain arose on the trustees because they would previously have become non-resident and, on the beneficiary becoming absolutely entitled as against the trustees, no part of the gain on the deemed disposal[41] under could be apportioned under section 17, as the purchaser was also non-resident.

This scheme formed the basis for the avoidance arrangements in Berry v Warnett[42] and Chinn v Collins.[43] The latter case had the additional element of the trust property being sold back to the original beneficiaries.

The facts of Berry v Warnett were as follows. The taxpayer executed transfers of shares in favour of a Guernsey company, "Investors Trustees Limited". A few days later, on 4th April 1972, a settlement was executed by the taxpayer, a Jersey company called "First Investors and Savers (Jersey) Limited", and Investors Trustees Limited, by which the taxpayer assigned the reversionary

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40. Section 58(1) CGTA 1979
41. Under section 54 ibid
42. (1982) 55 TC 92
43. (1980) 54 TC 311

interest in the trust fund to the Jersey company for £14,500, retaining for himself a life interest. By a deed dated 6th April 1972, he assigned his life interest to a Bahamas company, "First Investors International Holdings Limited", for £130,000.

He was assessed to CGT for 1971/72, which assessment was upheld by the Special Commissioners on the basis that, on 4th April 1972, he had made a disposal of the trust fund, and not merely a part disposal.

Goulding J, in the High Court, and the majority of the Court of Appeal found for the taxpayer, although not without reluctance. For example, Goulding J, referring to the consequences of the taxpayer's argument said:

> "These are strange and unsatisfactory results. They cannot, in my judgement, have been intended by Parliament. It may be that they will not matter in the artificially contrived circumstances of the present case, where, after the second sale neither the trustees nor any cestui que trust under the settlement remained resident in the United Kingdom. They are nonetheless so anomalous, and potentially unfair, that the court should seek a construction of the Finance Act 1965 that will avoid them, even if it has to strain the particular words that Parliament has used."[44]

Having said that, he turned "hopefully and willingly" to the arguments for the Crown but, ultimately, he felt he had to find for the taxpayer, on the basis that there was only a part disposal of the trust fund within the relevant year because, even if there was a gift in settlement within the meaning of section 25(2) FA 1965,[45] section 22(4)[46] of that Act was not applicable because,

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44. p104
45. Now section 53 CGTA 1979
46. Later section 19(3) ibid, now repealed, see Chapter 8.

on the evidence, there was one agreement between all three parties to the settlement and the taxpayer was at arm's length with both of the other parties, and that paragraphs 17 and 21 of Schedule 7 of the Act[47] were not applicable, since there was no element of bounaty on the taxpayer's part.

The Court of Appeal dismissed the Crown's appeal on substantially the same grounds and they too considered that there was only a part disposal (i.e., of the reversion), the life interest in income remaining undisposed of.

The majority of the judges of the Court of Appeal who found for the taxpayer felt dissatisfied with the decision they felt they had to make but they did not consider that this gave them any license to stretch the language of the statute. Oliver LJ, for example, said:

> "The judicial conscience may sometimes be required to display a certain flexibility in questions of construction where the context is clear, but I do not think that it should be, or can be stretched beyond the point of credibility simply because of an uneasy suspicion that the Legislature, if it had given more thought to the matter, would have done more effectively what it seems to have set out to do."[48]

The House of Lords with, in some instances, perhaps not the best arguments they have ever advanced in giving judgement, reversed the decisions of the lower courts. They restored the decision of the Special Commissioners, holding that the disposal of the legal title to the trust fund (the first step mentioned above) became an effective disposal for CGT purposes when, on 4th April 1972, trusts were declared other than in favour of the settlor, thus making the fund settled property.

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47. Now sections 62 and 63 ibid
48. p113

By virtue of section 22(4)(a) FA 1965[49] that disposal was deemed to be for a consideration equal to the market value of the fund because it was acquired by the trustees otherwise than by way of a bargain made at arm's length, the bargain between the taxpayer and the Jersey company being irrelevant; and the disposal was not a part disposal under section 22(2)(b)[50] because nothing remained undisposed of.

In any case, by the time the House of Lords came to hear the case, section 25(2) FA 1965[51] had been amended by the substitution of "transfers into" for "gift in".[52] Any shortcoming in the judgements of the House of Lords did not, therefore, adversely affect later settlements, but a lot of schemes implemented before 1981 fell by the wayside on the strength of the Berry v Warnett decision; the Special Investigations Section of the Inland Revenue had kept all such schemes in abeyance until the decision in Berry v Warnett was given by the House of Lords.

As mentioned above, the scheme in Chinn v Collins was based on the same basic steps although it had a few additional elements. This plan was commonly known as the "contingent interest scheme" or "contingent apportionment scheme".

The basic idea was that the trustees appointed an interest to a beneficiary contingently on the beneficiary surviving for a few days.[53] The trustees would then become non-resident. The beneficiary would sell his interest to a non-resident and this would be exempt under section 58 CGTA 1979. As neither the purchaser nor the trustees were resident in the UK, the vesting in the purchaser was exempt.

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49. Later section 19(3)(a) CGTA 1979
50. Now section 19(2)(b) ibid
51. Which was by then section 53 ibid
52. Section 86 FA 1981
53. In this case it was three days.

The actual facts in Chinn v Collins have already been considered.[54]

This case was, of course, in the run up to the Ramsay line of cases[55] and the judges who were to develop the "new approach" were beginning to finalise their views on to pre-packaged schemes and schemes implemented in furtherance of an undertaking. The judges of the House of Lords here, Lords Wilberforce, Fraser, Russell and Roskill and Viscount Dilhorne, plus Templeman J in the Chancery Division, were therefore prepared to be rather looser with their interpretation of the actual legislation in question than might otherwise have been expected.

The taxpayer had really tried to be too clever, the basic scheme would probably have worked. But the combination of the assignment to the Jersey company and the contract to purchase from the Jersey company, as part of a composite scheme, was too much for Templeman J and the Law Lords to swallow.

Templeman J, for example, said:

> "Mr. Potter, on behalf of Anthony [one of the taxpayers], argued that Rozel became the beneficiary and the person absolutely entitled as against the trustees by reason of the assignement, but that Anthony did not become the beneficiary by reason of the contract; the assignment and the contract were independent transactions. In my judgement, they were inter-dependent and conditional one upon the other. Although the assignment was executed before the contract was signed, no party was free in law to enter into the one and reject the other. Anthony would not have entered into the assignment, save in escrow, assigning his contingent equitable interest in the 184,500 settlement shares for £352,705 unless

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54. See Chapter 2
55. See Chapter 11

he was sure that if he survived until 1st November 1969 he would obtain the shares for £355,162.10s. Rozel would not have executed the assignment, save in escrow, thus purchasing the contingent interest of Anthony in the 184,500 settlement shares for £352,705, unless Rozel was sure that if Anthony survived until 1st November 1969 he would take the shares for £355,162.10s."[56]

The Court of Appeal, on the other hand, insisted that the legal effect of the transactions had to be considered separately and then the relevant statutory provisions had to be applied to the situation as so found.[57]

The House of Lords reasoning was similar to Templeman J's. Lord Russell, for eaxmple, said:

"There were in this case... as it seems to me two matters of crucial importance. The first is that on 20th November the record on the turntable which was switched on contained the whole story from beginning to end and there was no provision for switching it off half way. The second is that having regard to the scheme as a whole I find it quite unreal to construe the agreement by Anthony to purchase from Rozel and Rozel to sell (in which agreement time was of the essence) 184,500 shares in Lex as anything other than to repurchase the aliquot interest in the settled funds which had been the subject of the contingent appointment on its expected maturing to an absolute interest."[58]

Despite the failures of the schemes in Berry v Warnett and Chinn v Collins, the simple plan whereby the trust property could not return to the beneficiaries would probably still have worked. Consequently, the

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56. (1980) 54 TC 311 at p 326
57. See Buckley LJ at p332 and Goff LJ at pp340-1
58. p352, see also Lord Wilberforce at p350

legislature stepped in to make such arrangements ineffective from 10th March 1981 by virtue of section 88 FA 1981. Subsection (1) stated that section 58(1) CGTA 1979 cannot apply if the trustees are neither resident nor ordinarily resident in the United Kingdom.

That provision on its own would have been susceptible to considerable exploitation because a beneficiary could have disposed of his beneficial interest when the trust was still UK resident and the trust could then have been exported, as in Chinn v Collins. Subsection (2) prevented this arrangement from succeeding by levying a CGT charge when the trust is emigrated.

It is not clear why the provision has been drafted as it has been because it is the beneficiary who makes the gain but the trustees who pay the tax, tax which is not allowed as a credit on any subsequent charge under sections 80 or 81 FA 1981.[59] The Legislature have gone further than just prevent the schemes that existed before 1981 from succeeding. Perhaps they were influenced into introducing a harsh provision by the highly artificial schemes which used the basic steps outlined above.

As well as these statutory counteracting measures, trusts have also, of course, been subject to the main judicial anti-avoidance initiative, the "new approach".[60] Indeed, one of the pair of cases that launched the new approach, Eilbeck v Rawling,[61] concerned a scheme involving overseas trusts. The scheme failed mainly on technical grounds, although the Law Lords made it clear that it would also have failed under the new approach.

The facts have been set out in Chapter 8,[62] from which it can be seen that the object of the scheme was to create a capital loss of about £350,000 to offset a capital gain

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59. Supra
60. See Chapter 11
61. (1981) 54 TC 101
62. See also Chapter 11

the taxpayer had already made on the sale of some shares. To this end, the taxpayer set up a Jersey settlement in which he had a reversionary interest. The scheme also involved a settlement being set up in Gibraltar with a trust fund of £600,000. The taxpayer purchased a reversionary interest in the Gibraltar settlement for £543,000. The trustees of the Gibraltar settlement then advanced to the trustees of the Jersey settlement £315,000 out of the Gibraltar trust fund, thus depreciating the value of the reversionary interest that the taxpayer had purchased. So, when the taxpayer sold his reversionary interest in the Gibraltar settlement for £231,130, he had made, so he claimed, a loss of £312,470. As he had acquired his reversionary interest for consideration in money or money's worth, the disposal of his reversionary interest was not exempt, whereas, when he sold his reversionary interest in the Jersey settlement for £312,100 (representing the advance from the Gibraltar settlement), that was exempt because he had not acquired that for a consideration in money or money's worth.

At first instance, Slade J rejected the taxpayer's claim for a loss because the £543,600 paid for the reversionary interest in the Gibraltar settlement included a fee for the scheme organisers, so it was not a payment made wholly and exclusively for the asset within what is now section 32(1)(a) CGTA 1979.[63]

The Court of Appeal took a different route to the same conclusion. According to Buckley and Donaldson LJJ, the £315,000 appointed by the Gibraltar trustees to the Jersey settlement was not taken entirely out of the Gibraltar settlement because it remained settled on trusts originating in that settlement. The reason for this was that the donee of a special power of appointment under a settlement charged with the exercise of a

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63. pp153-4

discretion acts as a delegate of the settlor when he exercises that discretion. Accordingly, when the Gibraltar trustees appointed £315,000 out of the capital of the Gibraltar settlement, to be held on the trusts of the Jersey settlement, the Gibraltar trustees were acting as the delegates of the Gibraltar settlor, so that the £315,000 remained settled upon trusts which derived from the Gibraltar settlement. The reversionary interest in that fund was therefore an interest under the Gibraltar settlement. Because of this, the sale of the reversionary interest in the appointed fund was, in fact, a sale of the reversionary interest in the Gibraltar settlement, so that the proceeds had to be taken into account in computing the allowable loss accruing to him from the sale of the reversionary interest in the Gibraltar settlement.[64]

Not surprisingly, Templeman LJ[65] took a different line, treating the whole scheme as a singular contract, or a series of interdependent contracts, which had to be looked at as a whole. In other words, he was foreshadowing the new approach of the House of Lords.[66]

In the House of Lords, on the technical mechanics of the scheme, the Law Lords did not take much time considering this area. Lord Wilberforce was very general in his analysis, merely saying, after dealing with the new approach:

> "Although this disposes of the appeal I think it right to deal with the particular point which, apart from the judgement of Templeman LJ, forms the basis of the decisions below. This is whether the sale of the reversion under the Gibraltar settlement on 3rd April 1975 gave rise to an allowable loss if regarded in isolation. I regard this, with all deference, as a simple matter. What was sold on 3rd

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64. See pp161-2 and p168
65. See Chapter 11
66. See pp164-5

April 1975 was Mr. Rawling's reversionary interest in £255,390; for this Mr. Rawling received £231,130 certified by Solandra to be the market price. Not only was this the fact (the trust fund at that time was of that amount), but the agreement for sale specifically so stated. It recited that the vendor, Mr. Rawling, was beneficially entitled to the sole interest in reversion under the Gibraltar settlement, 'being a settlement whereof the trust fund presently consist of £255,390'. What he had bought, on the other hand, for £543,600 was a reversionary interest in £600,000, subject to the trustees power to advance any part to him or to a settlement to which he had an equivalent reversionary interest. After the advance of £315,000 (effectively to Mr. Rawling so that to this extent he had got back part of his money), all he had to sell was the reversionary interest in the remainder; this he sold for its market price. Alternatively, if the £315,000 is to be considered as in some sense still held under the Gibraltar settlement, the sale on 3rd April 1975 to Goldiwill for £231,130 did not include it. On no view can he say that he sold what he had bought: on no view can he demonstrate any loss. I think that substantially this view of the matter was taken by Buckley and Donaldson LJJ, and I agree with their judgement."[67]

Lord Wilberforce was not being strictly accurate when he said that his view was "substantially" that taken by Buckley and Donaldson LJJ; only when Lord Wilberforce commented: "Alternatively, if the £315,000 is to be considered as in some sense still held under the Gibraltar settlement, the sale on 3rd April 975 to Goldiwill for £231,130 did not include it", did he come near to the reasoning of Buckley and Donaldson LJJ.

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67. pp192-3

As is noted in Chapter 11, precision was not one of the more noteable features of the House of Lords judgement in Ramsay[68] and Eilbeck v Rawling.

Lord Fraser addressed himself more clearly to the issue and specifically followed the line taken by Buckley and Donaldson LJJ.[69] Lord Russell, however, was nearer to Lord Wilberforce in his brief comment on the scheme.[70]

So the taxpayer here failed, not only because it was just the sort of circular, self counselling scheme that was the main (and, indeed, only) target of the Crown[71] in the Ramsay/Rawling cases, but also on the technical merits: the taxpayer fell down on the application of basic trust law to his complicated scheme. However, on the latter point, what emerged from the various judgements was that there was no consistent judicial view on why the taxpayer failed. There were three views, in fact; Slade J's at first instance; that of Buckley and Donaldson LJJ and Lord Fraser; and Lords Wilberforce and Russell's. This divergence of judicial opinion did not matter to Mr. Rawling, but it did not give an unequivocal guide to the nature and effect of a special power of appointment. However, in so far as a clear line can be drawn from the case, it seems that income tax law follows the basic principles of equity.

A similar issue, the effect of special powers of appointment, and whether their exercise took funds out of the original settlement arose in connection with another tax avoidance scheme in Roome and Denne v Edwards.[72]

A comparison of the judgements in this case with Eilbeck v Rawling would suggest that a different test is appropriate for CGT and in deciding whether the second

68. W.T Ramsay Ltd v IRC (1981) 54 TC 101
69. p196
70. p199
71. See Chapter 11
72. (1981) 54 TC 359

set of trustees has to come absolutely entitled as against the first set.[73] The problem became not nearly so important as it was in 1981 with the extension by section 82 FA 1982 of hold-over relief under section 79 FA 1980 to disposals by trustees. With the restriction on the availability of hold-over relief under the FA 1989, this point again becomes important.

The different treatment in the two cases to the issue was particularly noteable when it is considered that five of the nine judges were the same in both cases: Buckley and Templeman LJJ in the Court of Appeal and Lords Wilberforce, Russell and Roskill in the House of Lords.

The scheme in this case, an artificial avoidance scheme, involved the exportation of trust with a view to breaking the nexus between the actor (in this case, those who were to make the CGT disposal) and the taxing jurisdiction (the UK).

The details were as follows. Under a marriage settlement of 1944, a wife had a life interest, her husband, had after her death, a protected life interest, and they together had a special power of appointment. In 1955 the wife and husband appointed by deed, under their special power of appointment, a fund ("the appointed fund") in favour of one of their daughters; and thereafter the appointed fund and the residue of the 1944 fund ("the main fund") were separately administered (although until February 1972 the trustees of both funds were identical). On 7th February 1972, Denne replaced one of the original trustees as co-trustee with Roome of the appointed fund: at no time was Denne ever a trustee of the main fund. As part of a tax avoidance scheme, Roome had valuations made of both funds and on 28th February 1972 an order was made under the Variation of Trusts Act 1958 approving an arrangement altering the trusts on which the main fund was held.

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73. For the purposes of section 54 CGTA 1979

On 15th March 1972 that arrangement was brought into effect. On 20th March 1972 all of the beneficiaries having interests in the main fund assigned those interests to two Cayman Island companies, Cayman Reversionary Interest Co Limited ("CRI") and Royal Oak Investments Limited ("Royal Oak") for cash. On 21st March 1972 the original trustees of the main fund (Roome and also Denne's predecessor) were replaced by two non-UK residents. On 13th April 1972 CRI assigned its interest in the main fund to Royal Oak so that the latter became absolutely entitled to it as against the non-resident trustees.

Assessments were issued to CGT on Roome and Denne in respect of the occasion of charge arising on 13th April 1972 on the basis that both the appointed fund and the main fund were "property comprised in a settlement" within the meaning of section 25 (11) FA 1965;[74] and that paragraph 12 (1) Schedule 10 FA 1965[75] enabled the assessments to be raised against Roome and Denne.

The Special Commissioners upheld these assessments but the Chancery Division (Brightman J) allowed the appeal holding that, although both the appointed fund and the main fund were on 13th April 1972 "property comprised in a single settlement", namely in the marriage settlement of 1944, the trustees to whom, for the purposes of paragraph 12 (1) Schedule 10 FA 1965 the chargeable gain then accrued, were the two individual non-resident trustees, so that the wrong pair of trustees had been assessed.

The Court of Appeal dismissed the Crown's appeal but disagreed with Brightman J's reasoning. The Court of Appeal held that the 1955 appointment resulted in the appointed fund ceasing to be comprised in the same

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74. Now section 52(3) CGTA 1979
75. Now section 48(1) ibid

settlement as the main fund: it then became subject, for CGT purposes, to a separate settlement consisting of two documents, the 1944 marriage settlement and the 1955 appointment. Accordingly, section 25(11) did not thereafter apply in relation to the two funds. In a case to which section 25(11) applied, chargeable gains would accrue, under paragraph 12(1) Schedule 12 FA 1965, not to the persons in whom the property in question had been vested, but to the "single and continuing body of person" mentioned in section 25(1) FA 1965.[76]

The House of Lords unanimously allowed the Crown's appeal. They affirmed the Court of Appeal's reasoning about the situation where section 25(11) applied, but reversed their decision on the first ground, holding that the 1955 appointment did not bring into existence a separate settlement. Therefore, on 13th April 1972, the appointed fund and the main fund were parts of "property comprised in a [single] settlement... vested in [different] sets of trustees" within section 25(11) FA 1965 and Roome and Denne were thus correctly assessed in respect of the chargeable gain then accruing to the trustees of that single settlement.

So the scheme failed because the House of Lords considered that the scheme was not successful in breaking the nexus. Once again, the fact that this area of the law is not entirely clear is shown by the fact that all three courts analysed the law differently: even the High Court and the Court of Appeal (which both found for the taxpayers), did so for entirely different reasons.

An earlier attempt to use non-resident trusts to break the nexus between the UK and the actor can be seen in the case of <u>IRC v Countess of Kenmare</u>.[77] This case is

76. Now section 52(1) ibid
77. (1957) 37 TC 383

examined in Chapter 2. Basically, the taxpayer in this case failed because on the facts, she had failed to place the trust fund and the income from it outside the reach of the relevant UK Act.[78]

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78. Section 38 FA 1938

Dual Resident Trusts and CGT

The exploitation of dual resident companies to avoid CGT has been considered in Part 5 of this Chapter. There is a similar scheme for individuals using dual resident trusts. The favourite countries used are Belgium or, (except in the case of land) the Republic of Ireland.

The steps of a typical scheme would be:

1. A UK resident individual who owns, say, land situated within the UK on which there is a substantial unrealised capital gain, sets up a trust with one UK resident corporate trustee.
2. He settles the land on the UK corporate trustee reserving a life interest in income to himself and, subject to that interest, as the individual appoints.
3. A Belgian company is incorporated with an authorised share capital of an amount equal to the market value of the land. This company is appointed an additional trustee of the settlement jointly with the UK company. The administration of the trust is carried on in Belgium.
4. Shares in the Belgian company are issued to the UK company to the value of the land.
5. The legal title to the land is transferred to the Belgian company to be held as nominee for the UK company and the Belgian company jointly for the purposes of English law.
6. The Belgian company executes a declaration of trust, binding under both English and Belgian law, acknowledging that it holds the property on the trusts of the settlement.
7. For Belgian tax purposes, the shares in the Belgian company are issued for a consideration equal to the market value of the land. Therefore, on a liquidation of the Belgian company there is no Belgian tax liability on a notional difference between the amount of the company's share capital and the amount of the proceeds of liquidation.

8. The trust will be resident in both the UK and Belgium under the domestic law of those countries but, because it is administered in Belgium, it would be subject only to Belgian CGT by virtue of the terms of the UK/Belgium double tax agreement.

9. When the land is sold the trustees will be subject to Belgian CGT but not to UK CGT. Belgian tax will only be payable on any surplus of the sale proceeds of the land over its market value at the date of the transfer to the Belgian company.

This scheme, like the company one, exploits the residence rules in UK domestic law and the residence provisions of the appropriate double tax agreements. By using this concept, taxpayers are able to break the nexus with the UK and thereby avoid UK tax. It is true that a nexus is made with another country but, because of the domestic law of that country, the tax to which the taxpayer is thereby exposed is limited.

This is a good example of a taxpayer exploiting the rules enacted to prevent double taxation to avoid tax. It also demonstrates the problems in integrating the domestic rules of countries with the double tax agreements which exist between most major countries throughout the world. Although the drafting of double tax agreements (mainly through the work done by the OECD), and the methods of using them, are becoming more sophisticated, it is almost inevitable that loopholes will be left because of the diversity and complexity of tax systems throughout the world.

PART 9

OTHER INTERNATIONAL TAX ISSUES

Artificial Transactions in Land

Several schemes aimed at breaking the nexus with the UK have been foiled by the anti-avoidance provisions in section 776 ICTA 1988 which were not specifically aimed at international tax avoidance.

Section 776 is considered in Chapter 3 but, for present purposes, it is sufficient to consider subsection (8), which states:

> "If all or any part of the gain accruing to any person is derived from value, or an opportunity of realising a gain, provided directly or indirectly by some other person, whether or not put at the disposal of the first-mentioned person, subsection (3)(b) above this section shall apply to the gain, or that part of it, with the substitution of that other person for the person by whom the gain was realised."

Subsection(3)(b) treats the gain as income of the person by whom the gain is realised.

Schemes whereby the opportunity of making a gain are transmitted to an overseas entity have been caught by this subsection. This subsection, as with the rest of the section, is worded in wide and sweeping terms.

Two linked cases concerned with one such attempt to break the nexus with the UK in respect of the sale of land were <u>Yuill v Wilson</u>[1] and <u>Yuill v Fletcher</u>[2]. These cases concerned the same set of facts.[3]

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1. (1980) 52 TC 674
2. [1984] STC 401
3. These cases are also dealt with in Chapter 3

Mr. Yuill was the Chairman of Cecil M Yuill Limited, a building company which he, together with trustees of certain family settlements, controlled. This company sold two parcels of land to two separate companies in which the shares were held by the taxpayer or trustees of family settlements. The taxpayer set up a Guernsey trust which, in turn, set up two Guernsey companies, Ceville Limited and Mayville Limited. The two English companies sold their respective pieces of land to the two Guernsey companies for a price reflecting the value of the land without planning permission. In the following year the trustees of the Guernsey sold the two Guernsey companies to Valnord Limited which was another Guernsey company but which was owned by an unconnected overseas trust which was not set up by the taxpayer or his family, and in which the taxpayer and his family were not included in the class of beneficiaries. Shortly afterwards, planning permission to develop the land was obtained and Cecil M Yuill Limited purchased both parcels of land from Ceville Limited and Mayville Limited on terms that the purchase price was partly repayable in the event of nationalisation or compulsory acquisition of the land within five years.

The taxpayer was assessed under what was then section 488 ICTA 1970 on the gains made by Ceville Limited and Mayville Limited and it was held that, by virtue of the taxpayer's powers over the companies and the family trusts, the taxpayer had provided the two Guernsey companies with the opportunity of making the gains within subsection (8).

For technical reasons which are not of relevance here,[4] the bulk of the assessment was discharged in Yuill v Wilson, but the Inland Revenue successfully remedied the situation in the later case of Yuill v Fletcher.

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4. See Chapter 3

The Crown's argument was that, by virtue of subsection (8), the taxpayer could be substituted for the two Guernsey companies, a view that was upheld by the courts. Without the subsection, the Inland Revenue would have gone away empty handed because, as the two Guernsey companies were outside the jurisdiction of the UK courts, no tax could be obtained from them (even though they would technically have been liable)[5], the nexus between the entities that made the relevant disposal and the UK had been broken but subsection (8) formed an artificial link between those entities and a person still in the UK.

In the High Court in Yuill v Wilson, Templeman J, as is his wont,[6] analysed the avoidance scheme in a wider context by virtue of the fact, that was undeniable, that this was a composite scheme and, even in those pre-Ramsay days, Templeman J, was not well disposed towards artificial tax avoidance schemes. For example, he said:

> "In my judgement, the Stated Case also reveals that the Commissioners received ample and cogent evidence pointing inexorably to the conclusion that it was the taxpayer who provided Ceville and Mayville with the opportunity of making gains of a capital nature from the disposal of [the two parcels of land]. The lands were sold to Mayville and Ceville by the Yuill Company, [and the two UK companies], but section 488(8) would be useless if it were pulled up short by an incorporated company. The persons principally concerned and interested to see that the Yuill company, [and the two UK companies] sold [the two parcels of land] to Ceville and Mayville respectively were not the taxpayer's solicitor or his accountant acting as trustees, or his fellow directors on the boards of the Yuill Company, [and the two UK companies].... The person principally concerned and interested to deprive the Yuill Company [and the two UK companies] of the

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5. Section 776(14) ICTA 1988
6. See Chapter 11

opportunity of making a future gain, and to provide that opportunity for Mayville and Ceville instead, was the taxpayer acting in the interests of his family. I have no doubt that under expert advice the taxpayer so provided and that the directors, trustees and any other persons concerned were happy to acquiesce in proposals which did nobody any harm and which, if it was or became possible to avoid tax, would do some good."[7]

Templeman J's judgement also made it clear that section 776 could be applied even if all of the transactions were at market value, if there was a motive to avoid tax on the part of the person providing the gain. On this point the Court of Appeal and the House of Lords agreed. The Court of Appeal and the House of Lords also agreed that the taxpayer had de facto power to transfer the opportunity of making the two Guernsey companies within subsection (8).

Section 776 was also used to prevent the nexus being broken in respect of other arrangements in <u>Sugarwhite v Budd</u>[8]. The facts were that, in September 1971, the taxpayer purchased a property ("the Hoop Lane" property) for £16,000. The property had a sitting tenant and, after failing to persuade the tenant to move, the taxpayer decided to sell the property as quickly as possible. In 1972 a sale of the property was arranged through a solicitor. Under the sale agreement the taxpayer contracted to sell the property to Madeira Investments Properties Limited, a Bahamian company. The contract provided that Madeira was entitled to sub-sell or nominate another sub-purchaser in consideration of the payment by him of £26,500, of which £16,750 was paid to the taxpayer, £500 to Madeira, and the balance to two Bahamian companies.

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7. pp691-2
8. [1988] STC 533. This case is also dealt with in Chapter 3.

In April 1973 the taxpayer purchased another property ("the Fountayne Road" property) for £20,000. The following month the taxpayer entered into a contract for the sale of the property to Madeira for £25,000. As with the earlier contract, there was a special provision declaring that the purchaser was entitled to sub-sell or to nominate another purchaser. The property was transferred to the ultimate purchaser (an English company) for £35,500 of which the purchaser was directed to pay £25,000 to the taxpayer, £1,000 to Madeira and the remaining £7,500 to the other two Bahamian companies.

The taxpayer was assessed to income tax under Schedule D for the years 1972/73 and 1973/74 on the basis that the gains from the disposals of both properties fell to be treated as income of the taxpayer under what was then section 488(2)(a),[9] and that he was a party to an arrangement to enable the overseas companies to realise a profit by way of a capital gain within section 488 (2)(ii).[10]

At first instance,[11] Vinelott J found that the Fountayne Road property had clearly been acquired with the sole or main object of realising a gain from its disposal. Such a gain was made through an arrangement or scheme which enabled the Bahamian companies, who were parties to the scheme, to realise a gain by an indirect method. Accordingly, the provisions of section 488(2)(a) and (ii) were satisfied.

As regards the Hoop Lane property, the Special Commissioners held that the section 488 assessment could not stand because, on the facts as found, the taxpayer had transferred it in good faith. The Revenue did not appeal against this finding. One aspect of the Revenue's

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9. Now section 776(2)(a) ICTA 1988
10. Now section 776(2)(ii) ibid
11. [1987] STC 491

attitude to this first transaction is not explained, namely, why did the Revenue not seek to assess the taxpayer's own gain under section 488? It probably comes down to nothing more than that the sum involved (£750) was too small for the Revenue to bother about trying to make a section 488 assessment stick. It is clear from the judgement of Vinelott J[12] that some sort of assessment was raised, but counsel for the Revenue was unable to say whether it was under Schedule D Case I or CGT. Vinelott J did say that the sum could not have been assessed under section 488,[13] but this is clearly wrong: if it was a gain of a capital nature, it was within section 488(2)(a) and (i). From Nourse LJ's judgement in the Court of Appeal, however, it is clear that an assessment under Schedule D Case I was raised.[14]

The position regarding the Fountayne Road property was different. The Special Commissioners found that the taxpayer was an active party to the transactions which resulted in the profit on the property being transferred to the Bahamian companies. Again subsection (8) was used to substitute the taxpayer for the overseas companies.

In the High Court the taxpayer had argued that the transactions really amounted to a joint venture, and therefore the profit earned by the Bahamian companies was income, not capital. As noted in Chapter 3, the taxpayer's main problem in relation to this claim was that he could adduce no evidence to substantiate his claims. In the absence of evidence to the contrary, the Special Commissioners had found that the taxpayer had transmitted to the Bahamian companies the opportunity of making a gain, and that these gains were of a capital nature, a finding upheld by Vinelott J. The assessment stood because the taxpayer had acquired the property with

12. p499
13. Ibid
14. [1988] STC 533 at p535

the sole or main object of realising a gain from the disposal of it; a gain was obtained from the disposal by virtue of an arrangement or scheme indirectly by persons (namely the three Bahamian companies) who were parties to the scheme; and the taxpayer had provided the three Bahamian companies with the opporunity of making the gains.

Again, the profit made by the taxpayer himself (in this case, £5,000, so it was big enough for the Inland Revenue to worry about) was not assessed under section 488. This too was not explained. Perhaps it was assessed under Schedule D Case I.

On appeal, the Court of Appeal dismissed the taxpayer's claims for the same reasons as Vinelott J.

In appropriate cases, the non-resident entity will have protection from a section 776 charge under a double tax agreement. The precise nature of the protection afforded by double tax agreements is, in some respects, not entirely clear and the matter is untested before the courts.

A section 776 charge would probably be excluded under the Article, contained in most OECD-based treaties, exempting tax in the host country in respect of "industrial and commercial" profits unless they arise through a permanent establishment. It is possible that a Court might hold that a section 776 charge does not come within this Article - although this appears unlikely. Even if the Revenue could win this argument, if a double tax agreement has a sweeping up Article, excluding a tax charge in the host country for income from services "not expressly mentioned" in other Articles, the matter is put beyond doubt.

A suitably worded treaty would not, however, protect a UK resident who provides a non-UK entity with the opporunity of making the gain, as in Mr. Yuill's case.

Personal Services

This topic is closely linked with two other areas considered in other chapters:

(1) "one man companies" examined in the context of piercing the corporate veil;[15]

(2) personal service companies and section 775 ICTA 1988.[16]

It is somewhat artificial to divide this subject into three in this way because they are all part of the same problem: how individuals can operate through other entities to shelter some or all of the rewards for their services from tax. Here, the international aspect of the question is considered.

It has already been seen that advantage could be taken of the remittance basis rules, before the law was changed, to keep overseas source income for personal services outside the UK tax net:[17] see, for example, Newstead v Frost.[18]

Another case involving an overseas partnership where the Inland Revenue were caught out was Padmore v IRC.[19]

Whereas, in the case of David Frost, the effect of the decision in the taxpayer's favour was nullified by a general change in the remittance basis rules, Mr. Padmore's victory was met with swift, specific and retrospective legislation just a few months later.

Before setting out the facts of the case, it is necessary to consider the background. The position at the time of the Padmore case was as follows. Under section 153 ICTA

15. See Chapter 12
16. See Chapter 1
17. See Part 4
18. (1980) 53 TC 525
19. [1989] STC 493

1970,[20] where the control and management of a business carried on by a partnership was situated abroad, that business was deemed to be carried on by persons not resident in the UK, and the partnership was deemed to reside outside the UK, even if some of the partners were resident in the UK. The partnership can only be assessed to UK tax under Case I or II of Schedule D on profits arising from trading operations within the UK.[21] Income arising from possessions out of the UK is taxable under Case V.[22] This includes an interest in a foreign partnership. In many UK double tax agreements there is a provision that industrial and commercial profits of an enterprise carried on by a resident of the other country are to be exempted from UK tax, except to the extent that they arise from trading in the UK through a permanent establishment here.

The facts of the Padmore case were these. The taxpayer, a UK resident, was employed by a firm of chartered patent agents in London. In 1976 he became a partner in Computer Patent Annuities (CPA), a firm carrying on business from Jersey furnishing a worldwide renewals service in connection with patents and trademarks. CPA had more than 100 partners, most of whom were resident in the UK. Its day to day business was dealt with by two managing partners who were resident in Jersey. The taxpayer received a share of CPA's profits every year from 1976 to 1982 and claimed relief from UK income tax under Schedule D Case V in respect of that share of profits for the relevant years under section 497 ICTA 1970[23] and paragraph 3(2) of the UK/Jersey double tax agreement. The taxpayer argued that the definition provisions contained in paragraph 2(1) of the agreement included in the term "Jersey enterprise" the business of a partnership carrying on business in Jersey, with the result that his share of the profits of CPA fell within

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20. Now section 112 ICTA 1988
21. Section 153(2) ICTA 1970
22. Section 18(3) ICTA 1988
23. Now section 788 ICTA 1988

the exemption in paragraph 3(2). This paragraph reads as follows:

> "The industrial or commercial profits of a Jersey enterprise shall not be subject to United Kingdom tax unless the enterprise is engaged in a trade or business in the United Kingdom through a permanent establishment situated therein. If it is so engaged, tax may be imposed on those profits by the United Kingdom, but only on so much of them as is attributable to that permanent establishment."

Peter Gibson J held that a partnership as an assessable entity was to be assumed to have a residence for the purpose of the agreement, the determining factor being the place of its control and management. The Special Commissioners had held that CPA had its management and control in Jersey and, therefore, it was resident there and its business in Jersey was a "Jersey enterprise" for the purpose of paragraph 3(2). The effect of paragraph 3(2) was to exempt from UK income tax all the profits of a Jersey enterprise unless attributable to a permanent establishment situated in the UK.

It followed that, as all the profits were thus exempt from UK income tax, a share of those same profits was also exempt from UK income tax, such a share being no different in quality from the totality. Accordingly, the taxpayer's share of CPA's profits was exempt from UK income tax under paragraph 3(2).

Peter Gibson J gave his decision in December 1986[24] and in the following March proposals were announced as part of the budget changes to nullify this decision. The relevant changes were eventually contained in section 62 F(No2)A 1987 which added two new subsections to section 153 ICTA 1970.

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24. [1987] STC 36, affirmed by the Court of Appeal at [1989] STC 493

The new section 153(4)[25] provides that, where a partnership is, or is deemed to be, resident outside the UK, a UK resident partner is not entitled to exemption from UK tax on his share of the income of capital gains of that partnership by virtue of a double tax agreement. Instead, he will be assessable to UK tax on his share of the income and capital gains of the partnership.

The new section 153(5)[26] is concerned with a qualifying distribution paid by a UK company to a non-resident partnership. The partnership is not itself entitled to the tax credit[27], but if a UK resident partner of such a partnership is entitled to a share of the distribution, he is also entitled to the relevant proportion of the tax credit.

In themselves, the changes are not unreasonable. The Padmore decision had been something of a surprise to some, but not all, experts and left a gaping whole through which UK resident partners in non-resident partnerships could escape UK tax in appropriate cases. The manner in which that hole was filled, however, calls for comment.

The Inland Revenue Press Release issued on 17th March 1987 announcing the change stated rather euphemistically:

> "The legislation is intended to do no more than restore the general understanding of the law as it was before the decision in Padmore v CIR".

The relevant clause in the Finance Bill was defended in Standing Committee in the same way.[28]

What the Government were really saying was that the legislation would be completely retrospective.[29] Such drastic measures had only previously been taken where artificial and fairly provocative avoidance had taken

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25. Now section 112(4) ICTA 1988
26. Now section 112(5) ibid
27. Section 231(1) ibid
28. H.C. Deb, 15 July 1987, vol 119, col. 1176
29. See section 62(2) F(No2)A 1987

place, whereas here there was merely a flaw in the legislation not justifying full blooded retrospective legislation.

The reason for this course was, according to the Government, that, to allow the re-opening of settled cases going back six years would have meant the repayment of an enormous amount of tax. It is questionable whether this was so. The Government did not explain how they imagined that settled cases would be re-opened. The only way this can be done is under "error of mistake" relief under section 33 TMA 1970 and the Government must have had this in mind. Section 33 only applies if the error or mistake is in a return. Surely the returns would not have been wrong because they would have shown the UK partners' share of the profit. Those figures would not have been rendered incorrect merely by reason of the error in the Revenue's view of the tax consequences arising from them. It therefore appears that settled assessments for earlier years could not have been re-opened. Therefore, the only tax at stake would have been that under assessments for 1986/87 or earlier years which were not settled. It seems unlikely that the true loss to the exchequer would have been as great as the Standing Committee were lead to believe.

The legislation did generously concede[30] that the change would not effect "the determination of any Commissioners or judgement of any court made or given before 17th March 1987".[31] This is not giving much away. The only court case was Mr. Padmore's. There is no way of knowing whether there were any Commissioners' decisions in the taxpayers favour, but details of no such decisions appear to have been made public.

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30. Section 62(2)(a) F(No2)A 1987
31. The date of the Press Release

The section also states that the changes do not apply to any proceedings in the Court of Appeal or the House of Lords on an appeal from a decision of the High Court of Session given before 17th March 1987.[32] This does not appear to have helped any taxpayer apart from Mr Padmore himself.

It is understood that three other cases were under appeal to be heard before the Commissioners at the time of the change and that, on a concessionary basis, the Inland Revenue decided to look at them in the light of the Padmore case. The Inland Revenue subsequently dragged their heels, however, and it is not known what the result of these appeals will be.[33]

In the November 1988 edition of "Capital Taxes: News and Reports"[34] at p149, Mike Truman argued that the anti-Padmore legislation was, ineffective. His reasoning appears to be correct. His analysis was as follows. The new subsection (4) to section 153 ICTA 1970 became section 112(4) ICTA 1988 which reads:

"In any case where -

(a) a person resident in the United Kingdom (in this subsection and subsection (5) below referred to as 'the resident partner') is a member of a partnership which resides or is deemed to reside outside the United Kingdom; and

(b) by virtue of any arrangements falling within Section 788 any of the income or capital gains partnership is relieved from tax in the United Kingdom,

The arrangements referred to in paragraph (b) above shall not affect any liability to tax in respect of

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32. Section 62(2)(b) F(No2)A 1987
33. This information comes from Mr Alan Stroud, a partner in Milne Ross, chartered accountants, whose appeal was one of the three mentioned.
34. p149

the resident partner's share of any income or capital gains of the partnership."

Section 788[35] gives effect to double taxation agreements. Subsection (3) of this section provides:

> "Subject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax insofar as they provide:
> ...(c) for determining the income or chargeable gains to be attributed ...to persons resident in the United Kingdom who have special relationships with those persons not so resident..."

References to income tax can be applied to capital gains tax.[36]

Section 788 applies to the UK resident partners of a partnership which is controlled overseas. Accordingly it is within the ambit of section 112(4). However, the exemption from tax in section 788(3) operates regardless of anything in any other enactment unless it is contained within Part XVIII ICTA 1988. Section 122(4) is not within this Part and so it would therefore appear to be ineffective.

Truman pointed out[37] that the Inland Revenue do not share the view that the new subsection is ineffective and that they considered this point when the legislation was in draft, and concluded that it was effective, primarily because the intention of the legislation was clear and the courts are, in their view, very slow to construe a section as having no effect. As Truman pointed out, this is true but, he says, it is unusual to construe a charging section other than strictly and, since the

35. Previously section 497 ICTA 1970
36. Section 10 CGTA 1979
37. p150

Inland Revenue could easily have put the section into the Double Taxation Relief Part of ICTA 1988, it might be difficult to defend their interpretation before the courts. It appears, in fact, that Truman did not go far enough because, as will be shown in Chapter 14, the clear words of the statue take a taxpayer in the situation of Mr. Padmore outside the charging provisions. It is only where there are two alternative constructions that a court will normally consider the intention of the legislation and give effect to the principal that a section should not be construed as having no effect: these considerations have always been taken to be secondary to the clear words of the section. Although, as can be seen in Chapter 11, the courts have come a long way from the principle of strict and literal interpretation of taxing statutes, the words here are so plain that it is submitted that most judges would be forced to hold that section 112(4) would not catch someone in Mr. Padmore's position.

No one has yet tested this line of reasoning in the courts but, even if the Revenue are, contrary to the above view, right about the way the courts would construe the legislation, the provisions have been very carelessly drafted, particularly as the Inland Revenue were aware of the point, and particularly as the amendment was aimed at such a narrow and specific mischief. Taxpayers have a right to expect a better service from the Inland Revenue and Parliamentary Draftsmen.

A couple of years before Padmore there was another case in which a person resident in the UK used an overseas entity, this time a Panamanian service company, to escape tax. This case was Cooke v Blacklaws.[38] The facts, show what, on one view, appears to be a pretty blatant avoidance scheme and a contrived situation.

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38. [1985] STC 1

Nevertheless, the Special Commissioners held that the taxpayer was truly employed by the company and the judge, Peter Gibson J again, did not feel able to disturb that finding. This decision can instructively be compared with the US courts' approach to this type of arrangement which is examined in Chapter 10.

The facts in this case were that the taxpayer was a dentist domiciled in New Zealand. From 6th January 1985 he worked in a dental practice in England, providing services for the National Health Service. He assigned his fees for this work to the practice and was paid by the practice 50% of the fees after deduction of dental mechanic's charges. Until 31st March 1975 he was a self-employed practitioner taxable under Schedule D Case II. However, from 1st April 1975 his position changed. He entered into an arrangement with a company, Dental Associates Inc. ("DAI"), which was incorporated in Panama and managed in Switzerland. Under that agreement the taxpayer entered into a contract of employment with DAI and DAI undertook to make the taxpayer's services available to the practice. DAI paid a salary to the taxpayer and invoiced the practice for the agreed proportion of the fees earned by the taxpayer and paid directly by the NHS to the practice under the original assignment, together with a management charge.

The taxpayer was assessed to tax under Schedule D Case II on the payment made to him by DAI, but the taxpayer appealed, contending that he was an employee of DAI and therefore qualified for the foreign emoluments relief in paragraph 3 Schedule 2 FA 1974.[39] The Crown contended that the taxpayer's entitlement to fees under the NHS regulations rendered him liable to tax under Schedule D Case II. The Special Commissioners said that the taxpayer would only be taxable under Schedule D Case II if he performed the services as a person in business on

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39. Section 192(4) ICTA 1988

his own account and that, on the facts, the taxpayer was an employee of DAI and qualified for the relief claimed.

The Crown appealed to the High Court contending:

(1) that the only true and reasonable conclusion on the facts was that there was no contract of employment but only a contract which left the taxpayer practising on his own account; and

(2) that the contract contended for by the taxpayer was illegal because dentists employed by the NHS could not be employed by a body corporate save under certain special provisions which, as the taxpayer agreed, did not apply in the present case.

The Case Stated disclosed that the taxpayer had become discontented and was considering returning to New Zealand. It was therefore decided to set up a non-resident company which would employ the taxpayer and other New Zealand domiciled dentists with the object of securing for them attractive terms of employment, particularly the favourable tax treatment given to "foreign emoluments". The taxpayer was told that it would be advantageous for him to be employed by DAI. The advantages were:

(i) He would have a guaranteed salary for three months, and if he became ill and were unable to work he would still be paid a guaranteed minimum salary for three months; whereas, as a self-employed person his money stopped as soon as he stopped work;

(ii) he would get tax advantages; and

(iii) DAI would pay the costs of repatriating him and his family when he wanted to go back to New Zealand at the end of his term of employment.

These advantages persuaded him to stay. The tax advantage was the prime, although not the sole, inducement.[40]

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40. Paras 16 and 17 of the Case stated.

Peter Gibson J held that the test applied by the Commissioners to determine whether the taxpayer was an employee or self-employed for tax purposes was correct, and the only true and reasonable conclusion on the facts did not contradict their determination. Although tax was levied on the basis of what was done, and not what ought to have been done, where liability to tax depended on a question of law, it could not be said that the illegality or otherwise of the taxpayer's acts was immaterial. It was a factor which the Commissioners could properly take into account. In this case, it was one of a number of factors and it was not conclusive.

The fact that this case must be near the borderline can be seen from the following passage from the judgement:

> "In a forceful and persuasive argument counsel for the Crown persuaded me that had I been the tribunal of fact I might well have reached the conclusion that there was no contract of employment. But that is not a relevant consideration on this appeal unless I can be satisfied that there was no evidence to support the conclusion reached by the Commissioners."[41]

Unlike the Padmore case, this one was not followed by counteracting legislation because the foreign emoluments relief was withdrawn in any case. This withdrawal was not due so much to the perceived abuses such as in this case, but more to the Government's view that they were not required in the prevailing economic climate.

In any case, the Revenue would have appreciated that the taxpayer was rather lucky to have won this case and his victory would not have been likely to have opened the flood gates, even if the relief had remained on the statute books.

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41. p17

A third recent case on the use of an overseas entity for the provision of services was IRC v Brackett.[42] The facts of this case have already been given[43] and the case has been discussed in relation to section 739 ICTA 1988.

However, as well as the section 739 arguments, the Revenue attacked the arrangement on two other fronts:

(1) under Section 79 TMA 1970 and

(2) under Section 487 ICTA 1970.[44]

The Revenue won on the section 79 point so their section 487 assessments were discharged. The fact that the Revenue succeeded on two alternative grounds was a powerful barrier to similar arrangements being effected.

The section 79 point was quite straightforward: an individual such as Mr. Brackett was quite capable of establishing a branch or agency under established law, if the facts justified it, and the judge came to the conclusion that there was sufficient evidence before the Special Commissioners to find as they did. This was on the ground that Mr. Brackett's activities constituted "the essential operations of the company's trade" and he was "the sole United Kingdom resident by whom the company carried on its trade in the United Kingdom". The fact that the various contracts were finalised in Jersey did not matter in the circumstances of the case.[45]

As far as the section 487 assessments were concerned, the judge did not go into the arguments because, in the light of his findings on section 478 and section 79,[46] it was unnecessary to consider them further.[47]

The Special Commissioners findings on the section 487 issue, such as they were, went as follows:

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42. [1986] STC 521
43. See Part 2
44. Now section 775 ICTA 1988, see Chapter 1
45. p540
46. See Part 2
47. p540

"It seems to us clear, and the taxpayer did not seriously dispute, that section 487(1)(a) applies to the facts of this case since Drishane[48] was put in a position to enjoy the receipts derived from the taxpayer's earning capacity in the occupation of business consultant. We find it more difficult to say whether, for the purposes of paragraph (b), a capital amount was 'obtained by [him] for himself or for any other person' as part of, or in connection with, or in consequence of the arrangements and since the question does not arise in the light of our decision on the corporation tax assessments we express no view upon it.

Since it may become relevant at a later stage of the proceedings, and since it is a question of fact, we should, however, state our finding in relation to paragraph (c) [of section 487(1)], the question of motive. On this point we give full weight to the fact, stressed by the taxpayer in his argument, that Drishane was not set up for the specific purpose of the arrangements which we have to consider. It was there already, having been set up for a different purpose which came to nothing as explained in our earlier decision. But the conclusion seems to us inevitable that the decision to use Drishane as the taxpayer's sympathetic employer was prompted in a large part by tax considerations. It is plain, as indeed the taxpayer admitted, that it was recognised as being essential for Drishane to enter into contracts with its customers in Jersey and not in the United Kingdom in order to rebut any suggestion that Drishane was trading in the United Kingdom. We have held that particular ruse to have been unsuccessful, but its object was to enable the fruits of the taxpayer's labours, previously taxed in this country, to be enjoyed by Drishane free of that liability. We find that the avoidance or reduction of tax was one

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48. The employing company.

of the main objects of the arrangements entered into between the taxpayer and Drishane."[49]

The section 487 arguments advanced by the Revenue are noteable in that they showed that the Revenue were prepared to throw off the self-imposed limitations of seeking to apply the section only to entertainers and sportsmen.

So, with victory on two fronts, and a favourable response from the Special Commissioners on the third, this case shows that the Revenue are widening their attack on such arrangements and, despite the Judiciary's reluctance to look through the corporate veil of "one man" companies under general principles,[50] there are other weapons at the Revenue's disposal. It is becoming much more difficult for UK resident taxpayers to use one man companies to avoid UK tax. The Revenue are broadening their area of attack and the opportunities for taxpayers are diminishing all the time.

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49. pp535-6
50. See Chapter 12

Captive Insurance Companies[51]

Captive insurance companies had their origins in the 19th century, but it is really only in the 1950s and subsequent decades that they have come to the forefront of international tax planning as vehicles for saving tax. There are now over 1,500 captive insurance companies and most of them are offshore, i.e., not in the same countries as the main group companies.

They are basically "in-house" insurance companies set up by groups of companies primarily to insure the risks of other group members. Groups naturally looked at offshore locations, not only to avoid higher rates of tax in the countries of residence of the main group companies, but also to avoid the comprehensive insurance legislation in those countries.

The movement towards captive insurance companies began in the USA and, today, the majority of captive insurance companies have been set up by US corporations. The most popular location for captive insurance companies of US corporations is Bermuda. Probably as many as 90% of Bermuda captive insurance companies have been set up by US corporations. Bermuda is, in general, a very popular location for captive insurance companies and there are over 900 established there.

The other main locations are the Cayman Islands and Guernsey and also several states of the USA have become popular locations due to beneficial tax regimes for captive insurance companies. Examples are Colorado, Tennesee and Vermont. These US states, plus Bermuda, the Cayman Islands and Guernsey contain the bulk of the world's captive insurance companies.

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51. See also Part 1 for an introduction to this subject

Besides the USA, the other main country whose companies have set up captive insurance companies is the UK, although the number is much less than by US corporations, with probably under 100 captives so far established, mainly in Bermuda and Guernsey. Guernsey became the favourite location while the UK exchange control regulations were in force.

More than any other entity used in international tax planning, captive insurance companies normally have real substance. It is essential that they are properly set up and administered. In other words, regardless of tax benefits, they must be real and genuine insurance companies running at a profit. It is usually also the case that they are set up by companies or groups who genuinely find the ordinary insurance companies unsuitable, often because they make more claims than the average company, and so find the premiums prohibitively expensive. For example, one of the UK's leading security groups, the Securicor Group, has its own captive insurance company in Gibraltar because it found that the costs of meeting its risks in the normal insurance market extremely high, due to the number of claims it had to make following robberies.

However, given that captive insurance companies are normally genuine insurance companies, the tax advantages they offer are undeniably important. The premiums paid by the group companies in high tax countries are normally deductible and the profits of the captive insurance companies are taxed at a much lower (or nil) rate, enabling the captive insurance companies to build up reserves more rapidly than if the captive insurance companies had been set up in a high tax country. These high reserves in turn enable the captive insurance companies to give greater insurance cover to the group companies. If the surplus funds are subsequently returned to the parent company, the high tax jurisdiction will tax the surplus at that stage,[52] but a valuable deferral of liability would have been achieved at least.

Captive insurance companies vary greatly in size. At the small end of the scale there are the captives established principally to provide in-house cover. They are usually set up in countries with no insurance legislation and little or no tax burden. Often they are managed from another haven and run, not from within the company, but outside by a professional, such as an accountant. This type of captive is the most susceptible to challenge by high tax jurisdictions in which the group companies are situated.

By far the largest category, constituting perhaps 80% of all captives, are the "small-scale" captives. Although some are located in high tax countries, most are set up in tax havens. They are normally run from outside the company by independent managers or management companies in the insurance field; relatively few are run by accountants and lawyers.

The large, full scale captives have their own management and have been set up for many years. They have much less need to re-insure their risks. They can be set up either in tax havens or in the high tax countries in which the group companies are situated.

Captives that are set up in the country of the parent are normally subject to much stricter insurance legislation, reporting requirements, less confidentiality, and high taxation. They are often required to be more highly capitalised.

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52. This may not be the case if the funds are made available by way of a loan.

All in all, up to 15% of industrial premiums worldwide are paid to captive insurance companies. Most captives cover gaps in the availability of the insurance cover from independent sources or are able to provide very much cheaper cover, and most captives are genuine profitable operations.

The deductibility of premiums is one area where high tax jurisdictions have been seeking to challenge captive insurance company structures, particularly in the USA and, to a lesser extent, the UK. In the UK, for instance, changes have been based on the Controlled Foreign Companies legislation[53] but the Inland Revenue have also used section 74(a) ICTA 1988, i.e., claiming that the premiums were not paid "wholly and exclusively" for the purposes of the payor company's trade; and section 770 ibid, the transfer pricing rules.[54] These attacks have lead to an increase of captive insurance companies writing business outside the group.

The attack on the deductibility of premiums has been fiercest in the USA. IRS Revenue Ruling 77 - 316 was to the effect that premium payments by US corporations to wholly owned foreign insurance subsidiaries were not deductible as a business expense on the basis that there was no shifting of economic risk and risk distribution which, in the view of the IRS, were characteristics of insurance. The ruling identified three situations in which premiums paid to a captive insurance company would not be tax deductible under section 162 of the Inland Revenue Code. These were:

(1) A direct transfer of premiums by a US parent company to a newly organised, wholly owned foreign insurance subsidiary of the parent in respect of contracts entered into for fire and other casualty insurance.

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53. See Part 6
54. See Part 3

(2) The payment of insurance premiums by the domestic corporation, but in this case to an independent and unrelated domestic insurance company. However, a contractual arrangement exists under which the independent insurer agrees to transfer immediately 95% of the risks under a re-insurance agreement with the US parent's wholly owned foreign insurance subsidiary.

(3) Insurance premiums paid directly to the foreign captive which in turn, again under a contractual agreement, transfers 90% of the risk through re-insurance plans to an unrelated domestic insurance company.

In the second situation, the deduction is not disallowed to the extent that the unrelated domestic insurance company retains the risk and, similarly in the third situation, a deduction would be allowed to the extent that the captive transfers the risk to an unrelated domestic insurance company.

Another IRS Revenue Ruling, 78-338, concerns group captive insurance companies. A group, or multiple, captive is a captive insurance company jointly owned by a number of corporations. The ruling states that premiums will probably be allowable if they are based on prudent insurance principles. The actual ruling related to 31 unrelated corporations, none of which controlled the captive. The premiums were fixed according to normal insurance criteria and each of the corporations held less than 5% of the total risks incurred by the captive insurance company. It should also be noted that the captive here would be outside the subpart F legislation. Here, there was risk shifting and risk distribution as required by Ruling 77-316 and the premiums were deductible.

It is unclear, however, where the dividing line lies between these two rulings.

As a result of these two rulings US corporations have, in recent years, changed their tactics as regards captive insurance companies. They have tended either to set up group captives or diversified into unrelated business.

Other countries have been slow to follow the USA along these lines, although the UK Inland Revenue have recently been questioning the deductibility of premiums.

In Canada, for example, the courts have refused to go as far as the UK courts. In <u>Consolidated Bathurst Limitedv the Queen</u>,[55] the Federal Court Trial Division adopted the "shifting of risk" and "economic family" doctrine explained in, for example, the US cases of <u>Carnation Company v CIR</u>,[56] and <u>Stearns - Rogers CorpInc v US</u>,[57] and refused deductions for premiums paid by a Canadian company to an offshore captive insurance company. However, the Federal Court of Appeal rejected the "economic family" principle and held that the premiums could be deductible except in those years in which the Canadian company had to indemnify the third party re-insurer against loss in its arrangements with the captive insurance company.[58]

In fact, the "economic family" doctrine has also been doubted in the USA. In <u>Humana Inc and Subsidiaries</u>[59], the Tax Court rejected the claim to deduct the premiums on the basis that the risk had not been shifted, but the majority rejected the economic family approach described in Revenue Ruling 77-316 on the basis of <u>Crawford Fitting Co v US</u>.[60] Certain judges were,

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55. 85 DTC 5120
56. 640 F.2d 1010 (9th Cir 1981)
57. 577 F. Supp. 833 (D. Colo 1984)
58. 87 DTC 5001, see Chapter 10
59. 88 TC No13 (1987)
60. No.C82-3008 (E.D Ohio 1985)

however, of the opinion that the majority decision was actually an application of the economic family theory.

Despite the reluctance in many countries to interfere, the situation would be different and an attack would be likely if it is not being run on a proper commercial basis, and if the premiums paid to it are unrelated to the risks involved.

In addition, the various Controlled Foreign Companies provisions throughout the world[61] will have an impact on insubstantial captive insurance companies. The Canadian FAPI Rules, for example, will hit captive insurance companies which are "controlled foreign affiliates".

The overall position in the UK, as in other major jurisdictions, is that the authorities acknowledge that there is genuine need for captive insurance companies, but they are very aware that they can be used as tax avoidance vehicles.

The attention paid by the IRS in the USA and the Inland Revenue in the UK to the deductibility of premiums and the application of the various Controlled Foreign Companies divisions to prevent the undue accumulation of profits, tend to ensure that insubstantial captive insurance companies cananot be used primarily as tax avoidance vehicles. In any case, it is almost universally recognised in the commercial world that it would be foolhardy to set up a captive insurance company purely for tax reasons. The costs of setting it up and running it, plus the increasing likelihood of a challenge, either on the premiums, or under Controlled Foreign Companies provisions, render such a course very unattractive. However, given that in many cases there is genuine need for an in-house insurance company, the question of location is an important consideration and

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61. See Part 6

groups will usually choose a low tax area and/or a country with less restrictive laws on insurance for their captive.

At the moment, the balance appears to be right in most cases. Genuine commercial captive insurance companies are flourishing; insubstantial tax motivated vehicles can rarely survive.

Other Uses of Non-Resident Companies

Non-resident companies have been used in tax avoidance structures in other ways to break the relevant nexus with the UK.

One scheme that has been in the forefront of the attention of the courts, the Revenue and professional advisers in recent years is the scheme used in Floor v Davis, Furniss v Dawson, Craven v White and Bayliss v Gregory.[62] Although, in most cases, it was not necessary for capital gains tax purposes that the intermediate company should be resident overseas, at the time, having the intermediate company resident offshore saved capital duty so, in each of the cases mentioned above, the intermediary was established offshore.

No more need be said about this aspect of these four decisions because the fact that the intermediate company was non-resident had no bearing on the outcome of the cases and it was not disputed that they did achieve their limited objective of saving duty.

A different situation arose in connection with another tax avoidance scheme in Young v Phillips.[63] The facts of this case have already been given.[64] This scheme sought to rely on the exemption from UK CGT for UK residents domiciled abroad in respect of assets situated outside the UK. The way the taxpayers sought to break the nexus was to convert chargeable UK situs assets to non-UK situs assets. It can be seen in Chapter 8 that the taxpayers attempted to do this by the following arrangements. The taxpayers, who were resident and ordinarily resident in the UK but domiciled in South Africa, held the issued shares in three English companies. Each of these

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62. See Chapters 8 and 11
63. [1984] STC 520
64. See Chapter 8

companies had substantial amounts standing to the credit of its profit and loss account. With a view to mitigating their potential liability to tax, the taxpayers entered into a pre-ordained series of transactions designed to transfer the value of their interests in the companies to two newly formed Jersey companies. They attempted to do this by increasing the capital of the three English companies by the creation of preferred ordinary shares ranking pari passu with the existing ordinary shares, save for priority in repayment of capital on a winding up. It was then resolved that sums standing to the profit and loss accounts of the English companies be capitalised and appropriated to the taxpayers, and applied in paying up in full the new preferred ordinary shares to be allotted to the taxpayers. On the following day, the preferred ordinary shares were allotted to the taxpayers on renounceable letters of allotment. The taxpayers were appointed directors of the Jersey companies and it was resolved that shares in those two companies be issued to the taxpayers at a specified premium. The consideration received by the Jersey companies from the taxpayers for the issue of the shares was over £1.3 million. The taxpayers went to Sark, taking with them the letters of allotment, and disposed of their rights under them to the Jersey companies by completing the form of renunciation in each of the letters. The Jersey companies paid the taxpayers an identical sum to that received in consideration for the shares.

The main ground on which the taxpayers failed was that the court held that they had not succeeded in breaking the nexus. They had disposed of UK assets, namely choses in action situated in the UK. The letters of allotment were documents evidencing rights against private UK companies enforceable in the UK.

Nicholls J also held that the scheme would also have failed under the Ramsay principle.[65]

Collco Dealings Limited v IRC[66] was a dividend stripping case considered in Chapter 1. As with the Young v Phillips case, the taxpayer attempted to use its status to avoid UK tax. Here, the taxpayer company was resident in the Republic of Ireland and not resident in the UK, but it failed on the construction of the UK statute as it applied to the taxpayer and its actions.

The company claimed repayment in respect of dividends, but the Inland Revenue refused on the footing that there had been a process of dividend stripping and that the company was "a person entitled under any enactment to an exemption from income tax which extends to dividends on shares", so that section 4(2) F(No.2)A 1955[67] applied, and the claim was therefore refused. The taxpayer company contended that the above words did not apply to residents of the Republic of Ireland. However, the House of Lords decided that the words covered persons in the position of the taxpayer company. Lord Simonds said that it had been argued on behalf of the taxpayer company that to apply section 4(2) to the taxpayer company would create a breach of the relevant double taxation agreement and would be inconsistent with the comity of nations and the established rules of international law; the subsection must, therefore, be so construed as to avoid this result. This argument was dismissed by Viscount Simonds as follows:

> "What, afterall, is involved? It is nothing else than that, when Parliament said 'under any enactment', it meant 'any enactment except...'. But it was not found easy to state precisely the terms of the exception. The best that I could get was 'except an enactment which is part of a reciprocal

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65. See Chapter 11
66. (1961) 39 TC 509
67. See Chapter 1

arrangement with a sovereign foreign state'. It is said that the plain words of the statute are to be disregarded, and these words arbitrarily inserted in order to observe the comity of nations and the established rules of international law... but I would answer that neither comity nor rule of international law can be invoked to prevent a sovereign state from taking what steps it thinks fit to protect its own Revenue laws from gross abuse or to save its own citizens from unjust discrimination in favour of foreigners."[68]

The other Law Lords agreed. Basically, what this amounts to is that a clear enactment of the UK legislature cannot be controlled by any rule of international law not also an enactment of that legislature.

Sometimes overseas companies are utilised specifically to exploit particular shortcomings in taxing legislation. One such shortcoming concerned the 'apportionment' legislation. The history of this legislation is examined in detail in Chapter 1. For present purposes, it is sufficient to note that, beginning in 1922, the Legislature attempted to prevent the avoidance of surtax by the retention of profits in a company. Successive enactments were countered by new types of scheme which, in turn, prompted new legislation.

At one stage in the development of the apportionment legislation, section 41 FA 1938 was introduced to stop a scheme which had been developed to exploit the position as it then stood. Prior to section 41, a taxpayer could not have profits of a foreign company apportioned to him. Section 41 was therefore introduced to close up this gap with reference to settlors. Effectively, section 41 extended the apportionment provisions to a trustee or beneficiary who was a member of a foreign company. The

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68. p528

section did not prevent the use of a string of foreign companies, and so section 13(3) FA 1939 was introduced to prevent this variation. The question of whether this subsection was successful was the point at issue in Lord Howard De Walden v IRC.[69] It will be seen that the scheme used by the taxpayer in that case was not caught by the apportionment legislation as it then stood. The tiers of foreign companies effectively broke the necessary chain. The legislation was subsequently amended to stop the loophole identified in this case.

It can be seen that overseas companies, like others entities examined in this Chapter, have been used in many ways in an attempt to break the nexus between the UK and the taxpayer and his activities. Where these attempts have been successful, the result has normally been an appropriate change in the legislation to prevent further exploitation of the same loophole.

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69. (1948) 30 TC 345. See Chapter 1

CHAPTER 10

THE APPROACH TO TAX AVOIDANCE IN OTHER COUNTRIES

INTRODUCTION

Tax avoidance is something all countries, other than tax havens, have to face up to, to a greater or lesser extent. The major industrial countries of the world have for many years been faced with a wide range of avoidance devices, sometimes of a complex and sophisticated nature. The responses, however, have varied greatly. This divergence in approach is particularly marked in those countries with common law jurisdictions, the civil law approach often being based on the doctrine of "abuse of rights".

In this Chapter the different way the major developed countries have tackled the avoidance problem are examined. The first three Parts deal with three common law countries, namely:

Part 1	-	United States of America,
Part 2	-	Canada,
Part 3	-	Australia.

The approaches taken in these countries are particularly interesting because, although they all have similar legal systems to the UK, and they have been very active in the anti-avoidance field, their approaches to the problem have been very different, both from the UK, and from each other. Comparing the experiences of these countries to the UK's is therefore instructive. These three countries will accordingly be examined in detail.

In Part 4, there is a brief review of the situation in certain other major countries. Here, the aim is not to give a complete picture of the principles adopted in any country, but to highlight specific points of interest in the light of the UK system.

PART 1

UNITED STATES OF AMERICA

Introduction

It is particularly enlightening to examine how tax avoidance has been countered in the USA when compared with the position in the UK. Both countries, of course, are common law jurisdictions with a highly developed economy, and in both countries taxpayers have been particularly ingenious in their attempts to thwart the Revenue authorities. The approaches to tax avoidance in the two countries has been very different, particularly the approaches of the courts. The analysis in this Part concentrates on the way the US judges have dealt with tax avoidance and the principles they have adopted.

The first step is to define the concept of "tax avoidance" as understood in the USA. In fact, it is basically the same as in the UK. Tax evasion is a serious crime punishable by a fine and imprisonment. Tax avoidance is not a crime, but it is disliked by the authorities who try to put a stop to it. Tax planning is merely the normal running of a business so as to pay as little tax as possible. The distinction is in essence that used by Lord Templeman in the Challenge Corporation case.[1]

As mentioned above, tax evasion is a crime and the government have to prove their case beyond a reasonable doubt. Because of this heavy burden of proof, the government normally only claim tax evasion where they are fairly confident of being able to discharge this heavy burden.

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1. [1986] STC 548, see Chapter 11

There is no general provision denying the availability of a tax benefit if tax saving is the sole or main motive. However, various other doctrines have been evolved, such as substance over form, the sham doctrine and the doctrine of recharacterisation. In addition, the courts have sometimes refused to grant a tax allowance if tax avoidance was the only reason for the transaction. The various methods used by the courts and the legislature to combat avoidance are examined in this Part, with particular attention being given to the judicial responses, but it is here that the most instructive comparisons with the UK arise. Accordingly, it is helpful to start with a brief note on the structure of the courts in the USA insofar as tax cases are concerned.

The Courts in the USA

If a taxpayer wishes to challenge the IRS there are two main routes he can go. There is a specialist tax court, the United States Tax Court. He would appeal to this court before he makes any payment to the IRS. On the other hand, he can actually pay the tax and then sue the authorities for a refund of it. If he takes this course, he has another choice. He can go to the Federal Court of Civil Jurisdiction, the United States District Court, or he can go to a court of special jurisdiction hearing claims of all kinds, the United States Claims Court.

There are a number of factors which could influence a taxpayer's decision in this respect. One is, of course, whether he wishes to pay the tax before taking action in court. Another factor is that the judges of the District Court are often considered to take, in general, a wider view of transactions than judges of the Tax Court because their experience has not been restricted to tax cases.

A third important factor arises from the system of appeals. The court in which the case is heard in the first instance will determine what avenues of appeal are open. A taxpayer may find that the precedents of one appeal court are more favourable to him than the precedents of the others, and this may determine in which court he takes his case.

The United States Court of Appeal is the appropriate appeal court for the Tax Court and the District Courts. There are eleven of these appeal courts, of which ten are district appeal courts and the other is the Court of Appeals for the Federal circuit. These eleven courts of appeal can decide cases independently of the others, and the differences that arise are not often resolved by the Supreme Court because that court rarely hears tax cases.

Because of this, the scope for the growth of different tax avoidance principles is much greater than it is in a country such as the UK. From the United States Claims Court, the appeal lies to the Court of Appeals for the Federal circuit.

These courts do not like to interpret a provision differently from an interpretation given to it by that court or a superior court.

When interpreting the legislation the courts look to the purpose of the legislation, and they have regard to the legislative history of the provisions. This practice is recognised by the various committees responsible for producing the legislation and those committees therefore produce reports which are intended to be used as an aide to interpretation.

The legislation the US courts have to interpret is often of a different nature to UK legislation in that the US legislation is less precise being concerned more with concepts than detail. Compare the definition of "distribution" in the UK law[2] with section 316 of the Inland Revenue Code ("IRC") which defines dividend for US tax purposes as any distribution of property by a corporation to a shareholder.

The judgements in US courts tend to be shorter and less detailed than those handed down by UK courts. This has the disadvantage that a US court might purport to apply a principle but not explain fully (or at all) how or why it is being applied. This, plus the apparent liking of US judges for the application of general doctrines, has lead to a proliferation of different anti-avoidance principles, often inadequately analysed in relation to the case at hand, and sometimes inconsistent with principles applied in other cases. Accordingly, it is difficult, if not impossible, to define the limits of any

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2. Section 209 ICTA 1988

of the anti-avoidance principles and they often merge into one another or more than one might be applied in a particular case.

Regulations, Interpretations and Rulings

Another important area in which the US and UK systems differ is that there is an extensive system of regulations, interpretations and rulings in the United States. The four categories are:

1. Legislative Regulations.
2. Interpretative Regulations.
3. Administrative Interpretations.
4. Private Rulings.

Each of these is considered in turn below.

1. Legislative Regulations.

These regulations are, in effect, delegated legislation. They are issued following a directive from Congress.

2. Interpretative Regulations.

Unlike legislative regulations, interpretative regulations do not have the standing of legislation. The IRS issues these regulations, which give their interpretation of the provisions in question.

In practice, the view of the IRS as represented in the regulations is only changed prospectively.

The courts are not, of course, bound by the interpretation of the IRS as shown in these regulations but, nevertheless, they do have quite a lot of weight and they do influence the courts in determining the underlying purpose of the legislation.

The reason these regulations are so useful in this respect is that they often follow the explanations issued by the Joint Committee on Taxation. This is a committee containing members of the House of Representatives and Senate whose job it is to oversee the administration of the tax system. Furthermore, normally the regulations also follow the view of the legislative committee which drafted the legislation in question. In addition, usually the public are given the opportunity to comment on proposed regulations before they come into force. The courts also recognise that regulations can be implicitly approved by Congress if legislation is enacted dealing with the same subject matter as the regulation without calling the interpretation of the IRS into question.

This is not to say, of course, that the courts always follow the interpretation contained in these regulations. If the court considers that a particular regulation does not comply with the language and the purpose of the legislation they will over rule the interpretation contained in the regulation.

There is a practical problem facing taxpayers which is similar to that faced in the UK. If a taxpayer wishes to challenge the interpretation of the IRS as contained in one of these regulations then, in the same way as a UK taxpayer who wishes to challenge the view of the Inland Revenue, he has to take into account the potential cost of taking the matter through the courts, which is normally the only way in which these regulations can be challenged.

3. Administrative Interpretations.

These are the views of the IRS which are published covering various matters. For example, the IRS may publish certain technical information and guidelines on certain topics and also generalised rulings. The IRS abides by these rulings unless its previous view is found to have been wrong.

4. Private Rulings.

   These are rulings which are requested by the taxpayer relating to specific transactions. These rulings do not bind the IRS in other transactions.

   If a private ruling is requested, the taxpayer must set out the business reason for the transaction in question. Rulings are not, therefore, available in respect of arrangements which have no business purpose.

All of the above regulations, interpretations and rulings are published and available to taxpayers in deciding how to plan their affairs. Furthermore, once a ruling has been requested, the taxpayer can discuss the case wth the IRS so as to amend his transaction as appropriate.

Because of the system of regulations, interpretations and rulings, the Executive, in the person of the IRS, has a great deal of power and the Executive has a great deal of effective control over the development of tax law, even though their interpretation and control is subject to review by the courts.

The detailed and helpful regulations in the US contrasts with the reluctance, and somtimes refusal of the UK Inland Revenue to release material (such as instructions to Inspectors) and the refusal of specialist departments to offer advice except on "recent" legislation.

The Development of Anti-Avoidance Principles: The Early Years

In the early part of this century, the courts in the USA adopted a literal approach to the interpretation of tax statutes. For example, in Gould v Gould,[3] the following passage appeared in the court's decision:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt, they are construed most strongly against the Government, and in favour of the citizen."[4]

In US v Merriam[5], the Supreme Court applied the well-known dictum by Lord Cairns in Partington v A-G.[6]

However, now, with the business purpose test so widespread, this is not the present position. The US courts moved away from this strict interpretation. For example, in White v US[7], Stone J said:

> "We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be

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3. 245 US 151 (1917)
4. p153
5. 263 US 179 (1923)
6. (1869) LR 4 HL 100 at p122, see Chapter 11
7. 305 US 281 (1938)
8. p292

abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be."[8]

It is interesting to trace the development of the form and substance and other anti-avoidance doctrines in the USA, not only as a comparison with its development in the UK, but also because US authorities were relied on by the House of Lords in the Ramsay case.[9] Set out below is an analysis of how the various anti-avoidance doctrines developed along entirely different lines in the USA from the UK. The US courts have been more flexible and pragmatic in the development of certain judicial principles to combat avoidance than have their UK counterparts.

Originally, the US Courts looked more to the form rather than the substance of a transaction. An example of this is the Supreme Court case of US v Isham[10] where the court said:

> "To illustrate. The Stamp Act of 1862 imposed a duty of two cents upon a bank check, when drawn for an amount not less than twenty dollars. A careful individual, having the amount of twenty dollars to pay, pays the same by handing to his creditor two checks of ten dollars each. He thus draws checks in payment of his debt to the amount of twenty dollars, and yet pays no stamp duty. This practice and this system he pursues habitually and persistently. While his operations deprive the Government of the duties it might reasonably expect to receive, it is not perceived that the practice is open to the charge of fraud. He resorts to devices to avoid the payment of duties, but they are not illegal. He has the legal right to split up his evidences of payment, and thus to avoid the tax. The device we are considering is of the same nature."[11]

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9. W.T Ramsay Ltd v IRC (1981) 54 TC 101
10. (1873) 17 Wall 496
11. p506

In fact, just as the Duke of Westminster case[12] laid the foundation for the development of anti-avoidance principles in the UK for over forty years, there was just such a fundamental case in the USA within four months of the Westminster case: Gregory v Helvering.[13] The case introduced the business purpose test into US tax law.

What was in question in this case was a reorganisation which fell within the literal wording of the statute. Nevertheless, the anticipated tax consequences did not arise because the transaction was outside the "plain intent" of the legislation; it was "an elaborate and devious form of conveyance masquerading as a corporate reorganisation". The court considered that to adhere to the strict words of the statute "would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose".

In other words, the tax consequences were determined by the end result rather than the intermediate steps, even though those steps were real. Accordingly, this case can be seen as an example of the "step transactions" doctrine[14] which later found a counterpart in the UK (although in a narrower form) in the "Ramsay" principle, as refined by Furniss v Dawson.[15]

Basically, the situation was that the taxpayer owned a corporation, the United Mortgage Corporation ("UMC"). UMC transferred shares in a second company, Monitor Securities Corporation ("MSC") to a third, Averill (a new corporation), which issued all of its shares to the taxpayer. A few days later, Averill was liquidated and the MSC shares were distributed to the taxpayer, who sold

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12. (1935) 19 TC 490, see Chapter 11
13. 293 US 495 (1935)
14. Infra
15. (1984) 55 TC 324, see Chapter 11

them on at a profit. The only purpose of Averill was to take part in this arrangement.

It is clear that the taxpayer wanted to sell the MSC shares and obtain in her hands the proceeds. She could have had the MSC shares distributed to her as a dividend which she could then have sold but this would have resulted in the value of the shares being taxed as ordinary income. She wished to avoid this, although she was prepared to suffer some capital gains tax. She therefore attempted to use the provisions relating to reorganisations in the US tax code.

The section in question[16] said that no gain arose to the shareholder on distribution by a corporation in a reorganisation of stock or securities of another corporation which was also a part to the reorganisation.

The Commissioner argued that the creation of Averill was without substance, and therefore should be disregarded. As a result, the entire transaction should be considered as a distribution of the MSC shares and a dividend, producing ordinary income equal to the value of the shares. The sale of the MSC shares had no tax effect, since, once taxed as a dividend, they had a basis equal to their value.

The Board of Tax Appeals[17] held in favour of the taxpayer. They said:

> "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration. The general legislative plan apparently was to recognise the corporate entity and, in view of such recognition, to specify when the gains or losses would be recognised and upon what basis they should be measured. We may not destroy

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16. Section 112(g) of the 1928 Act
17. 27 BTA 223 (1932)

the effectiveness of this statutory plan by denying recognition to the corporation and thus preventing consideration of its transactions."[18]

A great deal of the development of the business purpose test in the US can be traced back to a passage from the Circuit Court[19], judgement of Learned Hand J when he spoke of the business purpose test in the following terms:

> "But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganisations'."

Judge Learned Hand, in finding for the Commissioner, said, in a passage from which the above quotation was taken:

> "We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its unity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Anyone may so arrange his affairs that this taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury: there is not even a patriotic duty to increase one's taxes. [He here cited the Isham case[20]]. Therefore, if what was done here, was what was intended by [the section], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was.

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18. pp225-6
19. 69 F.2d 809 (2d Cir 1934)
20. Supra

Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definition of each term used in the statutory definition. It is quite true, as the board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises - industrial, commercial, financial, or any other - might wish to consolidate, or divide, or add to, or subtract from, their holdings. Such transactions were not to be considered as 'realising' any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate 'reorganisations'.

We do not indeed agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by winding up that company. The Averill Corporation had a juristic personality, whatever the purpose of its organisation; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that they were not what the state meant by a 'reorganisation' because the transactions were not part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect. But the result is the same whether the tax be calculated as the Commissioner calculated it, or upon the value of the Averill shares as a dividend."[21]

It is clear that, when the judge used the description "sham" he was not using that term as it is understood in the UK.[22]

He had said that tax is levied in the world of real commercial and financial transactions and exemptions from tax operate in the same context. Therefore real commercial and financial transactions form the context in which tax legislation must be read. The judge found that there was no reorganisation here because the transaction was not part of the conduct of the business of either company. The judge is here introducing a motive test in that, if there was no business purpose, there was no reorganisation, and the exemption from tax could not apply, regardless of whether the requirements of the provision could be satisfied on a literal reading.

The business purpose test, as thus set out by Learned Hand was not a substance over form concept (although the business purpose test tended to merge with that doctrine as it was developed[23]). In fact, Learned Hand was retaining the form adopted by the taxpayer, but applying to it the underlying purpose of the legislation.

In this respect, it is interesting to consider the reasoning of the Commissioner which Learned Hand rejected. The Commissioner had said that the setting-up

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21. pp810-1
22. See Chapter 11
23. See the Supreme Court decision in this case, infra

of the new corporation, and the acquisition by it of the property, were steps designed solely to avoid tax. They should therefore be disregarded as fiscal nullities. The Commissioner ran the transactions together and treated Mrs. Gregory as receiving the MSC shares from UMV in the form of a dividend.

Judge Learned Hand rejected this analysis and accepted the reality of each step, even though they were inserted purely for tax avoidance purposes. In the light of the facts in Furniss v Dawson itself it is interesting to consider that the judge said that tthe court could not treat as inoperative the transfer of the MSC shares by UMC or the issue of shares by Averill to Mrs Gregory.

The judgment of Learned Hand was upheld by the Supreme Court, which agreed that there must be a business purpose if a transaction is to comply with the legislation. However, the pure business purpose test, uncomplicated by notions of substance over form, step transactions or shams, which was the basis of Learned Hand's judgment, was, it seems, widened by the Supreme Court.[24]

It can therefore be seen that Judge Learned Hand's original business purpose test was rather limited. This could well have been because:

> "The problem of permissible tax avoidance was presented to him .... as if it involved the question of regard or disregard of the corporate entity. As a consequence, the business purpose requirement was apparently intended to do no more than establish a modest threshold of legitimacy, one which would exclude transitory legal arrangements in some instances and little else. In Hand's conception of it, the business purpose doctrine was thus in a sense

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24. See the judgment of Mr Justice Sutherland, infra

> an affirmation that form controls substance, but with the qualification that the form adopted must be functional in some respect."[25]

The Supreme Court[26] accepted the right of the taxpayer to reduce his taxes:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

Nevertheless, the reorganisation was disregarded because it had no substance: it was:

> "Simply an operation having no business or corporate purpose - a mere device which put on the form of a corporate reorganisation as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a pre-conceived plan, not to reorganise a business or a part of a business, but to transfer a parcel of corporate shares to the petitioner."[27]

Thus the court, like many after it, both in the UK and the USA, had to grapple with the two concepts, pulling in opposite directions, that taxpayers can seek to reduce their tax liabilities; but a motive to avoid tax, if not coupled with a business purpose, may render the transactions fiscal nullities.

The court held that the rule which excludes from consideration the motive of tax avoidance was not relevant because the transaction upon its face was outside the plain intent of the statute.

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25. Yale Law Journal, 1968 (77) p440 per Prof Chirelstein
26. 293 US 465 (1935)
27. p469 per Mr Justice Sutherland

The two passages above highlight a distinction which is often not fully appreciated and which is particularly relevant in the UK now in the light of the "new approach"[28] (although the distinction is drawn from, and immediately relevant, to US principles).

We have in issue here two mental states: one dealing with fiscal motives; the other with commercial motive.

The fiscal motive can be expressed in a number of ways but can perhaps fairly be put as follows:

> The intention to save tax will not alter the normal result of the statute. If, ignoring the tax motive, the result of the transaction is what the statute allows, ulterior tax motives will be ignored.

The commercial motive can be expressed as follows:

> If the sole object of the taxpayer is the implementation of a preconceived plan, the effect of which is not that contemplated by the statute, the individual steps will be disregarded.

In the present case, for instance, Mrs Gregory intended to form a corporation, and she did so. However, the transaction was held to fail by the courts because the taxpayer lacked the intention to reorganise a corporation (i.e. she lacked a business purpose).

In the Supreme Court, the judgment of Mr. Justice Sutherland contained the following passage, (two extracts from which have already been quoted):

> "It is earnestly contended on behalf of the taxpayer that since every element required by [the section] is to be found in what was done, a statutory

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28. See Chapter 11

reorganisation was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganisation in reality was effected within the meaning of [the section], the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v Isham, 17 Wall. 496, 506; Superior Oil Co. v Mississippi, 280 US 390; 395, 396, 50 S. Ct. 169; Jones v Helvering, 63 App. D.C. 204, 71 F.2d 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When [the legislation] speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganisation' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually appeared; what do we find? Simply an operation having no business or corporate purpose - a mere device which put on the form of a corporate reorganisation as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganise a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But the corporation was nothing more than a contrivance to the end described.

> It was brought into existence for no other purpose; it performed, and it was intended from the beginning it should perform, no other function. When that limited function has been exercised, it immediately was put to death.
>
> In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the legislation] was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganisation, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exhort artifice above reality and to deprive the statutory provision in question of all serious purpose."[29]

The limits of the business purpose test as first set out by Judge Learned Hand in Gregory can be seen from a case decided a year later, Chisolm v Commissioner,[30] which was decided in 1935. In this case a partnership acquired, and then disposed of, certain property. The reason for the disposal through the partnership was a deferral of tax. However, Learned Hand in this case applied the business purpose test to the partnership itself rather than the transaction. The partnership was carrying out genuine business activities and was not just a conduit for getting rid of the property. Furthermore, the sale by it was a real sale not a sham. The case was distinguished from Gregory and the tax liability was incurred by the partnership not the individuals.

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29. p469
30. 79 F.2d 14 (2d Cir 1935)

Referring to the Gregory case, Hand said:

> "It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose that counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realise. In Gregory v Helvering...., the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draft the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganised companies, they would have escaped, whatever other aim they might have had."[31]

Chisolm showed that the early business purpose test was rather limited, in that there was no general motive test. Judge Learned Hand confirmed this in a number of cases. For example, there is the case of <u>Commissioner v National Carbide Corporation</u>.[32] In this case, Learned Hand said:

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31 p15
32 167 F.2d 304 (2d. Cir 1948) affirmed 336 US 422 (1949)

"In Gregory v. Helvering the taxpayer had organised a corporation only to serve as a means of transfer; it was used once and only for that purpose, and was dissolved as soon as it had done so. The Court held that it was not a 'corporation' within the meaning of that term, as Congress must be understood to have used it, because in common speech, it means a jural person created to conduct industry, commerce, charity or some other commonly practiced activity, and not to serve merely as an escape from taxation. Such a corporation might be in some context a 'corporation'; but words are chameleons, which reflect the colour of their environment, and in a tax statute 'corporation' could not have been so intended.

This decision has at times been thought to trench upon the doctrine - which courts are never tired of repeating - that the rights resulting from a legal transaction otherwise valid, are not different, vis-a-vis taxation, because it has been undertaken to escape taxation. That is a doctrine essential to industry and commerce in a society like our own, in which, so far as possible, business is always shaped to the form best suited to keep down taxes. Gregory v Helvering, supra, was no exception. In spite of the fact that it was the purpose for which the taxpayer created the corporation that determined the event; for it is not the presence of an accompanying motive to escape taxation that is ever decisive, but the absence of any motive which brings the corporation within the group of those enterprises which the word ordinarily includes. Indeed, a corporation may be a 'sham' and 'unreal', when the only reason for its creation was 'to deter the creditors of one of the partners' who organised it, for that is not an activity commonly understood to be corporate."[33]

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33. pp306-7

But the judge never lost sight of the fact that a taxpayer is entitled to reduce his taxes by legitimate means. In a case called Commissioner v Newman[34], in a passage perhaps as famous as Lord Tomlin's in the Duke of Westminster case,[35] he stated:

> "Over and over again the courts have said that there is nothing sinister in so arranging one's affairs so as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right; for nobody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

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34. 159 F 2d 848 (2d Cir 1947)
35. See Chapter 11

Development of Anti-Avoidance Principles after Gregory

After the Gregory case the courts were not consistent in the extent to which they would go to apply the spirit and intent of the legislation. Some cases combined the business purpose test with the more general doctrines of substance over form and the sham doctrine, which enabled the form of a transaction to be ignored.

For example, this is what happened in the Supreme Court case of Higgins v Smith.[36] Here the Supreme Court went further than they did in the Gregory case. Whereas the business purpose test was originally an instrument of statutory interpretation, Higgins v Smith extended it so that transactions could be treated as fiscal nullities. In effect, the business purpose test was treated as part of the wider substance v form principle, the Supreme Court saying that the Commissioner is not bound by the form chosen by the taxpayer where it is unreal or a sham; the Commissioner, they said, "may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute".

The facts of the Higgins v Smith case were that the taxpayer disposed of securities to a corporation in which he held all of the shares. He claimed a loss arising from this disposal. The Commissioner accepted that ownership had actually passed, and that the transaction was at open market value. Furthermore, the corporation had been in existence for some time. The Commissioner attacked the transaction by saying that no loss occurred from the transaction because there was so great a degree of identity of substance between the taxpayer and the company.

The court, at first instance, found in favour of the Commissioner but, on appeal, the Appeal Court reversed

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36. 308 US 473 (1940)

this decision, holding that it was not open to the court to disregard the separate identity of the corporation because it was not claimed that the corporation was set up solely for tax avoidance. This decision was widely accepted as being correct. However, the Supreme Court cited the Gregory case for finding for the Commissioner. The Supreme Court claimed that Gregory was a "precedent for disregard of a transfer of assets without a business purpose". The Supreme Court further stated that "transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration". The Supreme Court accepted that the corporation was real and that there had been a genuine transfer of assets to it but they considered that the control by the taxpayer of the property that was transferred by "so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity".

This approach is considerably wider than that taken by Judge Learned Hand in the Gregory case.

The effect of Higgins v Smith was, however, limited in 1943 by the case of Moline Properties Inc. v Commissioner[37], in which the court decided that the separate legal existence of a corporation could not be disregarded unless the corporation was "a sham or unreal". In this case, it was the taxpayer who tried to rely on the lack of separate identity between an individual and his wholly owned corporation.

In a later case, Commissioner v Transport Trading & Terminal Corp,[38] Learned Hand confirmed that Gregory was not restricted to corporate reorganisations. He said:

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37. Infra
38. 176 F.2d 570 (2d Cir 1949)

> "It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."[39]

In this case, the court held that a distribution of assets by a subsidiary to a parent, followed by a sale by the parent which had, previously secured a purchaser, was not the kind of 'distribution' which the legislation envisaged, and therefore the subsidiary was liable to tax accordingly.

The same point was confirmed in Weller v Commissioner,[40] where the court said:

> "Thus the principle laid down in the Gregory case is not limited to corporate reorganisations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and 'not to include transactions entered upon for no other motive but to escape taxation'".[41]

In the case of Kocin v U.S.[42] a corporation paid commissions to a partnership the partners in which were the shareholders in the corporation. The Court held that the partnership had not been created for an independent business purpose and would not allow the corporation's claim to a deduction for the commissions paid.

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39. p572
40. 270 F.2d 294 (3d Cir 1959)
41. p297
42. 187 F.2d 707 (2d Cir 1951)

Goldstein v Commissioner[43] signalled an extension of the business purpose test. In this case, the taxpayer borrowed money at 4% to purchase tax exempt U.S. Treasury Notes yielding less than 2%. It was held that the loan was acquired solely for the purpose of obtaining the interest deduction to reduce the taxpayer's marginal tax rates, and she failed in her claim for a deduction for the interest payments.

The previous authorities tended to deny interest deductions on the basis that the transactions were shams. In this case, however, the Court held that the debt was valid, but refused to allow a deduction because of the absence of any purpose in the transactions other than the purpose of saving taxes. The section in question was section 163(a) IRC. The Court said:

> "Section 163(a) does not 'intend' that taxpayer should be permitted deductions for interest paid on debts that were entered into solely in order to obtain a deduction."

The Court also said:

> "In order to fully implement this Congressional policy of encouraging purposive activity to be financed through borrowing, section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it

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43. 364 F.2d 734 (2d Cir 1966)

can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompt the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangements beyond the taxpayer's desire to secure the deduction. After all, we are frequently told that a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them by an means the law permits."

In the case of Lifschultz v Commissioner,[44] the Court followed the Goldstein decision in denying a deduction. Judge Hays said:

"Moreover, even if the various transactions had resulted in a profit, deductibility for interest could still have been denied."[45]

In the case of Rubin v United States,[46] the taxpayer did make a real economic gain but it was held that "this was incidental to the chimerical character of the transaction."

It therefore appears that the fact that the transactions had the effect of producing a profit does not alter the purpose for which they were entered into in the first place.

The Supreme Court case of Commissioner v Court HoldingCo.[47] is interesting in that the question to be decided was similar to that in Furniss v Dawson,[48] in that the taxpayer had commenced negotiations for carrying out an undoubtedly commercial transaction but he sought to alter the tax effects by changing the nature of the transaction

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44. 393 F.2d 232 (2d Cir 1968)
45. p234
46. 304 F.2d 766 (7th Cir 1962)
47. 324 US 331 (1945)
48. (1984) 55 TC see Chapter 11

prior to its implementation. The court in this case, as in the Furniss v Dawson case, held that the attempt failed. This is an example of what is know in the U.S.A. as the doctrine of recharacterisation. This doctrine is well developed in the U.S.A. This case is dealt with below.

This approach was not restricted to arrangements involving liquidations. For example, in Palmer v Commissioner,[49] the taxpayer owned property on which he gave a mortgage to a bank to secure a loan from the bank to the taxpayer's wholly-owned corporation. The taxpayer negotiated a sale of the property to obtain funds to reduce the debt, then transferred the land to the corporation which sold the property and reported the gain. The court held that the taxpayer was taxable on the gain under the Court Holding principle.

The principle was also applied in Hallowell v Commissioner,[50] where the taxpayer transferred appreciated stock from his personal brokerage account to the account of his 96% owned corporation, which then sold the shares. The taxpayer was held to be taxable on the disposal.

The same result has been reached where an individual negotiates a sale of property and then transfers the property to a trust which completes the sale: see Malkin v Commissioners.[51]

In the Court Holding Co. case itself, a corporation had negotiated the sale of a building to the stage where an oral agreement for sale had been made. However, before the transaction could be completed, following the receipt of professional advice, the negotiations were broken off and the building was conveyed by the corporation to the individual who held all of its shares, in the form of a tax-free liquidating dividend. The individual then

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49. 354 F.2d 974 (1st Cir 1965)
50. 56 TC 600 (1971)
51. 54 TC 1305 (1965)

agreed to a sale to the original purchaser. The Supreme Court said:

> "The Tax Court concluded from these facts that, despite the declaration of a 'liquidating dividend' followed by the transfers of legal title, the corporation had not abandoned the sale negotiations; that these were mere formalities designed to 'make the transaction appear to be other than what it was', in order to avoid tax liability. There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. ..... On the basis of these findings the Tax Court was justified in attributing the gain from the sale to the respondent corporation, the incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be reviewed as a whole, and each step from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass the title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[52]

This decision was distinguished by the Supreme Court in U.S. v Cumberland Public Service Corporation.[53]

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52. Per Mr Justice Black, giving the opinion of the Court
53. 338 US 451 (1950)

This was another case involving the purported sale of assets by an individual, which assets had been passed up to the individual from a wholly owned corporation in the form of a liquidating dividend.

The Supreme Court referred to what had been said in the Court Holdings case relating to substance and form, but distinguished the present case from Court Holdings saying:

> "Our Court Holding Co decision rested on findings of fact by the Tax Court that a sale had been made and gains realised by the taxpayer corporation.... The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidations was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability."

The Court went on to mention what it had said in Court Holdings about the incidence of taxation depends upon the substance of a transaction regardless of "mere formalisms" and that taxes on a corporate sale cannot be avoided by using the shareholders as conduits through which to pass title. The Court then continued:

> "This language does not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution. While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognise such a distinction for tax purposes."

The Court continued:

> "Here, on the basis of adequate subsidiary findings,

> the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."[54]

From this case it can be seen that the principle of the sham and the step transaction doctrine are merely means of deciding what the substance of a transaction is.

The distinction between the two cases, on the analysis of the Supreme Court in the Cumberland case, comes down to a question of fact and evidence. In Court Holdings it was held on the facts that the sale was really made by the corporation, the individual shareholder being merely a "conduit". In the Cumberland case, on the other hand, the "conduit" argument was rejected and it was held that the shareholders genuinely made the sale.

The decisions after the Cumberland case tended to favour the taxpayer. The courts often did not ascribe the sale to the corporation even though negotiations occurred prior to liquidation and were conducted by the stockholder, as long as the contract to sell was entered

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54. pp454-5, per Mr Justice Black, the same judge who had given the Court's opinion in the Court Holdings case.

into by the stockholders and not the corporation.[55]

The situation was not a satisfactory one because cases with substantially similar facts led to completely different tax results. A revision in the statute was therefore necessary.

In 1954, legislation was introduced which would make the tax results of the facts in the Court Holdings case and the Cumberland case the same. The provision then introduced was section 337 IRC which abolished the tax charge on a liquidation where the assets are distributed within twelve months. The section was repealed in 1986, with the result that a corporation would pay tax whether the asset is sold or distributed to the shareholders. At the same time legislation was introduced regarding corporate reorganisations which was aimed at stopping various avoidance techniques. Treasury Regulation 1.368-1(b) shows how doctrines such as the business purpose test, the step transaction principle, the sham doctrine and substance over form underlie these provisions. The Regulation states:

> "The purpose of the reorganisation provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures.... In order to exclude transactions not intended to be included, the specifications of the reorganisation provisions of the law are precise.

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55. See for example, St. Louis Union Trust Co. v Finnegan, 197 F.2d 565 (8th Cir 1952) Gensinger v Commissioner, 208 F.2d 576 (9th Cir 1953) Doyle Hosiery Corp. v Commissioner, 17 TC 641 (1951) Oahu Beach & Country Homes, Ltd v Commissioner, 17 TC 1472 (1952) Merkra Holding Co. v Commissioner, 27 TC 82 (1956) cf:Burley Tobacco Warehouse, Inc. v Glenn, 207 F.2d 779 (6th Cir 1953) and Donner v Commissioner, 227 F.2d 381 (2d Cir 1955) (the court held that a liquidation following contracts of sale but before conveyance of title is governed by Court Holdings).

Both terms of the specification and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule."

In an article entitled "Furniss v Dawson: The US Experience",[56] M.B. Aidinoff commented:

"Incorporation of a motive test in legislation or of a business purpose test into statutory definitions removed some of the uncertainty which was an inevitable concomitant of the rejection by the courts of the literal construction of taxing statutes as an added implementation of Congress' intent in the face of fluid and developing commercial situations. However, whereas a literal construction ran the risk of ossifying legislation and leaving it powerless to meet the constantly changing ingenuity of the taxpayer, it has rightly been said that 'the trouble with dependence upon free or liberal statutory interpretation of a taxing statute, is that no one can be sure when it will be employed'. This uncertainty persists."

There is some debate as to the extent to which a business purpose must be present to prevent the transaction being ignored. Until fairly recently it was generally though that there had to be either no business purpose, or a business purpose which was merely negligible or remote.

However, recently some Courts have appeared to demand "a primary profit motive". This can be seen, for example, in the case of Fox v Commissioner[57] which concerned an

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56. Fiscal Studies, Nov 1985, p73
57. 82 TC 1001 (1984)

options spread (similar in effect to a commodities straddle) which the Court held was not deductible, as there was not a primary profit motive apart from the saving of tax.[58]

On the other hand, in the case of Estate of Baron v Commissioner[59] the Court did not look for a primary profit motive, but considered factors such as the substantial lack of proportion between the amount of tax benefit sought and the anticipated pre-tax profit ($365,000 net tax benefits, compared with $70,000 pre-tax profit), in determining whether the taxpayer had a profit motive separate from the savings tax.

In the U.K., a similar result was reached in Thomson v Gurneville Securities Limited[60]. There the Court considered a potential repayment of tax of £413,000 against a commercial profit of £91,000. Lord Simon said:

> "Looking at the transaction as a whole, was it, on the one hand, one whereby a true commercial profit was taken in a fiscally advantageous way or, on the other, one in which a 'commercial profit' was merely a by-product, or a disguise for what was really a tax recovery device? Whichever way the question is put, I have no doubt that, judged both qualitatively and quantitively, the transaction falls into the latter category in each case."[61]

Although it was about 1981 when the Court appeared to look for a primary profit motive in some cases, in the

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58. In this respect see also: Brannen v Commissioner 78 TC 471 at p. 505 (1982), Lemmen v Commissioner 77 TC 1326 (1981), Hager v Commissioner 76 TC 759 (1981).
59. 83 TC 28 (1984)
60. (1971) 47 TC 633, see Chapter 1
61. p679
62. See for example Faulconer v Commissioner 84-2 USTC, paragraph 9955, at p 85, 918, note 10 (4th Cir. 1984).

area of what are known as "hobby losses", some Courts appeared to look for a primary investment motive earlier than this.

In connection with the application of the business purpose test to situations involving double taxation agreements, the position can be seen from the case of <u>Aiken Industries v Commissioner</u>,[63] and subsequent Rulings 84-1152 and 84-153.

The Aiken case involved back to back loans which were only effected to obtain an advantage under a treaty. The Court held that the treaty corporation to which the interest payments were purported to be made did not have sufficient control over the interest to be treated under the treaty as the actual recipient.

In the Letter Rulings, which involved the U.S./Netherlands Antilles treaty, this approach was expanded to cases where the interest rate on the receivable was 1% higher than the interest rate on the loan payable. The Revenue in the Aiken case assumed that the treaty corporation was not a "sham", but they still ruled that it could be ignored because it "was merely a conduit for the passage of ..... interest payments". The "primary purpose" of the corporation was stated to be the obtaining of exemption under the treaty and it was stated that the arrangement lacked sufficient business purpose to overcome the "conduit nature" of the transaction, even though it could be demonstrated that the transaction might have served some economic purpose. The relative importance of the profit motive compared with the tax motive was taken into account by the Revenue as it was by the Court in the Fox case.[64]

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63. 56 TC 925 (1971)
64. Supra

The line between recognising and ignoring, for tax purposes, the mechanics of a transaction is a constant source of case law. For example, in the field of transactions involving wholly-owned corporations, compare the approach of the courts in the Northern Pacific Railway case and the Sun Properties case.

In Nothern Pacific Railway Co. v United States,[65] the court denied a capital loss in a transaction involving a parent and two wholly-owned subsidiaries, the court saying that there was no real alteration in the corporations' economic status. The court continued:

> "On the contrary, the design was to have everything remain as before. Despite the form of the loss-sale, that is the actuality and the substance. For this specific situation, therefore, there can be no loss, under the terms of the internal revenue statute and the Treasury regulation."[66]

This approach contrasts with that of the court in Sun Properties Inc. v United States[67], which refused to apply the business purpose doctrine where a "sale" to a wholly-owned corporation was involved.

Here there was a "sale" of a warehouse by a sole shareholder to a newly formed corporation for $125,000, its fair market value, to be paid by the corporation at the rate of $4,000 every six months. This was treated as a contribution to capital by the lower court,[68] so that the corporation, as regards depreciation, was restricted to the shareholder's basis, because the court found that there was only a purpose to reduce taxes.

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65. 378 F.2d 686 (Ct Cl 1967)
66. pp692-3
67. 220 F.2d (5th Cir, 1955)
68. 54-2 USTC 9528 (S.D Fla, 1953)

The decision was reversed on appeal, the higher court allowing the step-up in depreciation. The higher court appeared to discard the "business purpose" and other tax avoidance tests. The court said, in effect, that a sale is a sale for tax purposes even though it may have no separate business significance. The court said:

> "Nor does the fact that this transaction may not have had any business purpose other than saving taxes, rationally imply that it was not a sale. No cases require that a sale have any business purpose beyond that of realising a capital gain.... On the other hand, where the issue is the recognition of a corporate reorganisation, Gregory v Helvering, supra, or of a one-man corporation as a separate entity, Higgins v Smith, 308 U.S. 473, 60 S. Ct. 355, 84 L. Ed 406, or of a sale and leaseback arrangement, Shaffer Terminals, Inc v Commissioner, 9 Cir., 194 F. 2d 539, the existence of an independent business purpose may be very important. However, we would be most reluctant to impose a court-made requirement of a business purpose independent from taking a gain or loss, in determining the genuineness of sales in general, since it is common knowledge that vast numbers of sales have been made and are still being made for the purpose of taking gains and losses at times which provide the optimum tax benefits."[69]

It can therefore be seen that there is a very wide range of views on the extent to which a business purpose test applies in the USA and no precise guidelines can be drawn from the many cases heard since Gregory v Helvering. The position has been well summed up by J.R. Hellerstein in "Judicial Approaches to Tax Avoidance",[70] who has said:

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69. 174-5
70. 1964 Tax Conference Report 55 at pp65-6

"Where do we draw the line in defining the areas to which the business purpose doctrine applies? This is not an easy question to answer, and it is complicated by the fact that among the judges of the many courts over our country before whom tax cases are tried or heard on appeal, there are wide divergencies in attitudes towards the doctrine, ranging from empathy to outright hostility.... I would venture the following as a capsulized statement of the contours of the test. The business purpose doctrine is an appropriate tool for testing the tax effectiveness of a transaction, where the language, nature and purposes of the provision of the tax law under construction indicate a function, pattern and design characteristic solely of business transaction. While the courts have not articulated the doctrine in precisely these terms, most of the cases decided by the courts that are not hostile to it will pretty well fit into this formulation. And as thus formulated it appears to me to be a wholesome and useful technique for preventing distortion and misuse of the statute."

The Form and Substance Doctrine

The substance over form doctrine is used in an even wider an vaguer sense than in the UK.[71]

Professor Tiley in "Judicial Anti-Avoidance Doctrines: The US Alternatives - Part II"[72] comments:

> "Among the doctrines invoked in this area few are more insidiously attractive and yet at the same time more elusive than the doctrine that one should tax by reference to substance rather than form."[73]

That this is the case in the UK is evident from Chapter 11. It is even more so in the US. Tiley cites an American commentator, Isenbergh[74] who wrote:

> ".... [J]udges have aspirations. Little attention is drawn to those who hew narrowly technical rules. The painstaking process of examining transactions and statutes to determine whether they concord promises little glory in a society that has always looked to courts for strokes of statesmanship, it is easy enough to understand a judge's temptation to cut through rather than unravel the Gordian knot. A simpler variant of this attitude is the desire not to look naive, to understand what is 'really going on'. Many of the judges who have written opinions in this area display the tone of one who wants very much not to be taken in."[75]

Tiley also cites Judge Learned Hand in Commissioner v Sansome,[76] who described the doctrine as an anodyne for the pains of reasoning.

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71. The UK position is examined in Chapter 11
72. [1987] BTR 220
73. p226
74. 49 Univ of Chi LR 859
75. p882
76. 60 F.2d 931 at 933 (2d Cir 1932)

This has been true in the UK,[77] in the US where the lack of detailed reasoning and analysis in some judgments has lead to a position in which the boundaries and applications of the doctrine are vague and difficult to define.

The basic rule is that the substance of the transaction is the important element rather than the form in the United States. A tax avoidance motive may give rise to the application of the substance rule, although motive alone does not establish liability.

There are certain transactions which often give rise to the application of the substance principle. These include:

(i) transactions not at arms length;
(ii) sales which establish losses;
(iii) transactions between controlling stockholders and corporations;
(iv) corporation reorganisation;
(v) transactions involving several steps;
(vi) rents as distinguished from sales;
(vii) constructive income; and
(viii) payment of another person's obligations to a third party.

Regarding (v) above, if a step is taken for tax avoidance reasons, it is not ignored if there is a business purpose. This is the step-transaction principle whereby a series of steps may be amalgamated and treated as a single transaction if the steps are interdependent and directed at a particular end result. This is similar but not identical to the "Ramsay" principle in the UK.[78]

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77. See Chapter 11
78. See Chapter 11

One aspect of the form and substance doctrine is the economic approach to the consequences of transactions. Hellerstein[79] discussed this doctrine. He said that it has probably had its most important impact on the taxation of family income, especially the taxation of family trusts. The doctrine has been used, for example, to defeat avoidance through the use of a short-term trust; the income from which was taxed on the grantor who retained powers of administration over the trust, rather than on the beneficiary. The court refused to recognize that the grantor ceased to be the owner of the property after the trust was created. Hellerstein said:

> "Reliance on economic factors to strike down tax avoidance is the broadest and the most elusive of the judicial barriers to tax avoidance that we have considered; and inevitably it has produced the widest variations in acceptance and application among the judges."[80]

It can be seen that the "substance" doctrine is a well established principle in the USA. A typical example of the application of this doctrine was <u>Bayley v Commissioner</u>.[81] In this case the taxpayer and his wife owned nearly all of the shares in a corporation which they exchanged for new shares and debenture bonds payable in ten years but callable at will. It was held by the Appeal Court that this was not a reorganisation that escaped tax because Congress had only meant to exempt real reorganisations.

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79. Op Cit
80. p73
81. 331 US 739 (1947)

Recognition of Corporate Entities

It will be seen in Chapter 12 that UK courts are generally reluctant to pierce the corporate veil and ignore the existence of companies. US courts are much less reticent in this respect.

In the US, as in the UK, there are statutory provisions that allow a corporate entity to be ignored for tax purposes in particular situations, but here the discussion will be centred on the general judicial principle, so far as it exists, of piercing the corporate veil.

In general, US courts will ignore corporations for tax purposes if they have no "substance" in that they have no commercial purpose and do not carry out real commercial operations. Nevertheless, there is a principle in the USA that the corporate veil cannot be pierced, but the boundaries of this principle are different from those in the UK.

Moline Properties Inc. v Commissioner[82] is the leading case on the principle that you cannot look through the corporate veil. The facts were that an individual transferred his property to the company in return for shares. The reason was to enable him to use the shares as security for a debt. Once the debt was paid off, control reverted to him and the company commenced trading.

This case established that, for the purpose of federal income tax, gains from sales by a corporation of its property, although the corporation was wholly owned by an individual, could not be treated as income taxable on the individual rather than on the corporation. Business factors had led to the setting up of the corporation and it actually carried on a real trade.

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82. 319 US 436

Mr. Justice Reed said:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the State of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal and undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."[83]

However, as mentioned above, the corporate identity will be ignored if it is a mere sham:

> "In general, in matters relating to the Revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction."[84]

A number of cases have discussed this point in connection with personal service corporations.[85]

For example, the case of the Estate of Nathaniel Cole[86] concerned a corporation set up by the singer Nat King Cole. The profits of the corporation could not be imputed to the singer because the corporation was not a sham. The singer was paid a fixed salary for his service regardless of whether the corporation earned profits. The profits depended on the corporation's own efforts to sell tickets to shows and expenses in running shows rather than on the singer's services.

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83. pp438-9
84. p436. See also National Carbide Corporation v Commissioner 366 US 422 (1949)
85. The position in the UK is discussed in Chapters 1, 9 and 12.
86. 73,074 P-H Memo TC (1973)

A similar case concerned the comedian Jack Benny. In Jack Benny and Mary Benny v Commissioner of Internal Revenue,[87] a corporation was created with Jack Benny having a majority interest, for the exploitation of his services. The corporation's stock was sold to CBS and the IRS claimed that the purchase price received by Jack Benny was, in reality, a reward for his services. However, the Court held that the proceeds were solely in payment for stock, and no part of it was paid as compensation for Jack Benny's services.

There are some interesting observations on this doctrine by the Court, US Court of Appeals, 7th Cir., in the case of Foglesong v Commissioner of Internal Revenue[88]. This case concerned commissions received through a salesman's personal service corporation. The Court considered that tax avoidance was not the sole purpose of the transaction and the organisation and operation of the corporation did not constitute a sham. Circuit Judge Cudahy quoted Mr. Justice Holmes in Klein v Board of Supervisors,[89] where he said:

> "But it leads nowhere to call a corporation a fiction, if it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a non-conductor that makes it impossible to attribute an interest in its property with its members."

To this, the Circuit Judge Cudahy commented:

> "In the instant case, the following circumstances, among others, are present:

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87. 25 TC 197 (1955)
88. (1980) 45 AFTR 2d 80-1581
89. 2H2 US 19 at p24

(i) the corporation and not the taxpayer is the party to the contracts under which services are performed,

(ii) the corporation is recognised to be a viable, taxable entity and not a mere sham,

(iii) non-tax business purposes are present even though tax avoidance is apparently a major concern..... (9) as will appear, other and more appropriate legal bases exist for attacking apparent tax avoidance than broadscale disregard of the corporate form through application of assignment of income theory. We note especially that the Tax Court did not find the corporation to be a pure tax avoidance vehicle."[90]

The judge referred to the Moline case[91] and said that:

"The Court perceived the problem as determining whether the corporate form might be disregarded for tax purposes as a sham or unreal. The Court said that the corporation was a viable taxable entity so long as the purpose of its creation is the equivalent of business activity or its creation is followed by the carrying on of business by the corporation".

He also referred to the Roubik case[92] where the decision went the other way. The reason was that the corporate form was repeatedly flouted and the corporation was not an operating enterprise; it was a sham. In the present case, the Tax Court specifically found that the corporation was not a sham and was a viable taxable entity.

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90. pp1584-5
91. Supra
92. Infra

The judge had some interesting comments on documentation as it relates to the form and substance doctrine in cases such as this. He said:

> "The Tax Court here also places much emphasis on the absence of a written employment contract and/or a covenant not to compete between taxpayer and the corporation. The elevation of form over substance in this analysis is manifest. If there were an employment contract and/or a covenant not to compete (in a single employee situation) and the employee-shareholder wished to withdraw his services for the corporate engagement, he could simply (as corporate officer) rescind the contract or covenant or decline to enforce it. There is no way of establishing an enforceable legal obligation which would require the sole shareholder-employee in a personal service corporation to work exclusively for the corporation. In the instant case, the employee-shareholder has in fact so worked exclusively. This fact is more significant than any paper obligation which might have been created. We note also that in the essentially meaningless corporate arrangements of Roubik, there was a covenant not to compete, which apparently had no realistic impact."[93]

Finally, the judge stated:

> "In the instant case, the Tax Court did not find that the corporation was organised as a pure tax avoidance vehicle. Nor has the Tax Court perceived any flouting of the corporate form in the way business has been conducted. Pittsburgh Tube & Plymouth Tube entered into contracts requiring the corporation to provide them services, for which they paid the corporation. Taxpayer then worked exclusively for

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93. p1587

the corporation in enabling it to carry out its responsibilities as a sales representative. The corporate tree seems sturdy enough to become fruit-bearing subject, of course, to whatever pruning (radical or otherwise) by the Tax Collector appears appropriate."[94]

Circuit Judge Wood, however, delivered a short but strongly worded dissenting judgment. He said, "This corporation is nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due.... his (i.e. that taxpayer's) make-believe corporation is too transparent for me to accept for tax purposes."[95]

The case of Sam Siefel v Commissioner[96] considered this principle in connection with arrangements with a foreign element. Here, the taxpayer formed a Panamanian corporation for the purpose of investing in a joint venture in Cuba. The Court held that there were bona fide business reasons for forming the corporation, so that its corporate entity could not be disregarded so as to attribute its income to the taxpayer, who held all of the stock. The Court accepted that the corporation was properly organised and that it existed as a legal entity. Nevertheless, the Court said, if in fact it was organised or utilised solely as a device for defeating taxes and carried on no business of consequence, there was ample authority to justify ignoring the corporate form. On the other hand, the Court accepted that tax considerations were taken into account when the corporation was established. Judge Raum said that "the only apparent purpose for the formation of a Panamanian corporation rather than a US corporation was to avoid payment of any tax on the income from the joint venture as it was

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94. p1588
95. Ibid
96. 45 TC 566 (1966)

earned. But, prior to the Revenue Act of 1962, adding Section 951 to the 1954 Code, there was a loophole in the Code which permitted that result, and petitioner was free to take advantage of it."[97]

As in the UK, the Court will invariably ignore sham companies. Subject to this, the corporate entity will not be ignored as long as it is set up for a proper business activity. A number of cases in which this has been in issue are discussed below.

The tax authorities have expressed their views on tax haven subsidiaries in a memorandum in 1961[98] as follows:

> "If we determine that the foreign subsidiary has no substance, but is merely a shell, we attempt to disregard its existence and to tax its purported earnings to the parent corporation. However, courts have disregarded the corporate entity only in unusual cases. For example, they have done so where it was shown that the corporation was a mere agent for its owners or where the businesses of the separate entities were so commingled as to constitute a single business enterprise. It is the position of the Service that in order for a foreign subsidiary to be recognised as a separate entity from its parent for tax purposes, it must be engaged in some industrial, commercial, or other business activity. Escaping taxation is not such a business activity."

In the case of Hospital Corporation of America v Commissioner[99], HCA formed a Cayman Islands corporation to negotiate and perform a contract to manage a hospital in Saudi Arabia, and it made available to its Cayman

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97. p576. See also Carnation Company v Commissioner 71 TC 400 (1978)
98. (Hearings of the President's 1961 Tax Recommendations before the House Committee on Ways and Means, 8th Cong. 1st sess. Vol 4 at 3546 (1961)).
99. 81 TC 520 (1983)

Islands subsidiary its hospital management expertise and experience. The Court held that the subsidiary was not a sham corporation and recognised it as a separate legal entity for Federal Tax purposes.

Judge Parker said:

> "Generally, the corporate entity will be respected except in 'exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights' New Colonial Ice Co v Helvering 292 U.S. 435, 442 (1934)"[100]

The judge cited Aldous Homes Inc. v Commissioner.[101] He said:

> "In Aldous Homes, 16 'alphabet corporations' were organised to develop a tract of land for residential purposes. The corporations operated in all respects in unison. None of the corporations had employees of its own. The houses were built on a mass production basis as the construction workers moved from house to house when their particular trade was needed. We held that the alphabet corporation were not organised for any purpose other than the obtaining of tax benefits; that they did not carry on the business activities which resulted in the profits from the development of Tract 17169 nor any substantial business activities, and consequently did not earn the income in question".[102]

The Court considered that there were genuine business reasons for establishing a corporation. The taxpayer admitted that one of the reasons the corporation was set

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100. p579
101. 33 TC 582 (1959)
102. p580

up in the Cayman Islands was that there was no income tax there. This in itself was not sufficient reason to disregard the corporation. The Court recognised the rule stated in cases such as Gregory v Helvering that taxpayers have the right to plan and carry out transactions in such a manner as to minimise the incidence of taxation.

The judge said:

> [The Commissioner's] contention that LTD [the Cayman Islands corporation] is a sham is based primarily on his assertion that petitioner could have negotiated and performed the contract itself. The question is not whether petitioners could have, but whether it in fact did.... Since LTD was organised for a business purpose and actually carried on some business activities in 1973, we hold that LTD was not a sham corporation and that it is to be recognised for tax purposes."[103]

This approach has also been adopted in connection with double taxation agreements. For example, in <u>Perry R. Bass v Commissioner</u>,[104] the taxpayer established a Swiss corporation and transferred to it undivided interests in oil-producing properties. The corporation then carried out business activities in respect of those interests. The Court held that the corporation was a separate entity for tax purposes and its undistributed income could not be taxed in the hands of the taxpayer.

The corporation itself was exempt from US tax under the US/Swiss DTA.

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103. pp585-6
104. 50 TC 595 (1968)

The Court considered that the Swiss corporation carried out actual business activities even though the taxpayer made business decisions and directed the company's affairs. Furthermore, the Court accepted that the corporation was established to avoid tax.

The Perry Bass cases should be compared with Johansson v USA[105] where a corporate entity was ignored by the Court because the taxpayer acted as though no corporation existed.

The case concerned Ingemar Johansson, the professional boxer. He claimed exemption from tax under the US/Swiss DTA on the basis that he received employment income from a Swiss company under the 183-day rule.[106] However, the court decided that the Swiss company had no legitimate business purpose, but was merely a device used by Johansson to avoid tax. The fact that he was motivated by a desire to minimise tax was not, by itself, enough to defeat him (Gregory v Helvering) but the way he chose to put his desire into effect was by means of the company which carried out no real business functions.

A very similar case was Patterson v Commissioner,[107] which, like the Johansson case, concerned a boxer, in this case Floyd Patterson, the erstwhile world heavy-weight champion. In the Patterson case a corporation was ignored because it was "nothing more than a passive and temporary depositee of monies". It was merely used by Patterson and his manager as an instrument of tax avoidance, in that the income arising was, in substance, Patterson's, not the corporation's.

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105 336 F.2d 809 (1964). See also Aiken Industries v Commissioner, supra

106 Under this rule, which is contained in many treaties, a resident of one country is not taxable in the other country in respect of duties of an employment exercised in the other country, if he is there for 183 days or less in a tax year, and certain other conditions are fulfilled.

107 25 Tax Ct Memo 1230 (1966)

Another case along the same lines was Kimbrel v Commissioner.[108] Here, the Commissioner claimed that the corporations involved were "mere depositories" for the individual shareholder's income since the corporations were not engaged in any business activity, but merely received income for services performed solely by the individual taxpayer. The court held the taxpayers directly taxable on income received by the corporation, and emphasised that in those situations in which the separate corporate existence was upheld, "the dominated companies, acting through their officers or stockholders, performed some activity which resulted in the involved income."

Consideration should also be given to Tomlinson v Miles[109] because the taxpayers were arguing for the corporate entity to be set aside and the Government was seeking to establish that the corporation was a taxable entity. The taxpayers, four individuals, desired to purchase some land. To avoid any legal complexities which might arise from the eventual sale of the property due to the number of owners involved, they formed Milspinmar Corporation to hold title. At the first and only formal meeting of the board of directors, it was resolved that title would be held "for use and benefit of the ..... beneficial owners according to the interest set forth, for the purpose of facilitating the payment of taxes and to expedite the conveyance of any or all of said property." The land was subsequently sold in several transactions. The District Court, holding for the taxpayer, found that the corporation was not a separate entity subject to tax on the gains received from the sales.

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108 371 F.2d 897 (5th Cir 1976), see also Jackson v Commissioner, 233 F.2d 289 (2d Cur 1956) where a corproation was disregarded because its sole function was to expedite the individual taxpayer's transfer of stock.

109 366 F.2d 710 (5th Cir, 1963)

Chief Justice Tuttle said:

> "We think it clear that without dispute these individuals elected for purposes of their own to cause title of this property to be placed in the corporate name, and for it to be dealt with for their benefit in such manner as it would have to be dealt with so long as the corporation appeared to be the record title holder of the property. The benefits of such an arrangement are obvious. In the first place, no dower rights would attach to the wives of the three married parties to the transaction. In the second place, in the event of the death of any member of the group no administration would be necessary in order to clear the title to the real estate. In the third place, sales could be made by an execution of an instrument signed by officers of the corporation rather than requiring [the signatures of all the individuals]. Also, any other documents necessary in completing transactions dealing with the sale of property, such as the releasing of mortgages on the property, the cancellation of security instruments when full payment was completed, the execution of contracts for sale all would be facilitated. Finally, by the maintenance of a corporate bank account in which all funds were initially deposited, current payments of taxes, fees and the like could be made and all the excess could be immediately paid out to the individuals."

The taxpayers contended that the effect of this arrangement was to create the corporation as a bare trustee for the taxpayers, who were the beneficial owners of the property. The Government, on the contrary, contended that, having elected to have the transaction handled in corporate form, the corporation could not be excused from reporting the transactions resulting in a profit as its own profit, and paying taxes on this income entirely separately from the tax obligations of the individual taxpayers who were really stockholders of the corporation. The court said that the answer to this question was to be found by applying the Moline Properties case,[110] namely, that a corporate entity must be recognised if it is set up for a purpose equivalent to a business activity.

The taxpayers argued that the mere carrying on of business by the corporation, to satisfy this requirement of the Moline Properties case, must be business relating to property to which it has title, either legal or equitable. They contended that this corporation was the holder of a mere nominee title, with neither legal nor equitable ownership of the property, and that, therefore, such business as was carried on by the corporation did not fall within the Moline formula. The Court could find no such limitation in the formula adopted by the Supreme Court in the Moline Properties case. That no such limitation is intended was made clear by the Supreme Court's subsequent opinion in National Carbide Corporation v Commissioner of Internal Revenue.[111] The Court there expressly called attention to its holding in the Moline Properties case, notwithstanding the finding of the Tax Court that full beneficial ownership of the property there involved was in the sole stockholder.

Here the Court said that it could not be gainsaid that what was done by Milspinmar Corporation was the "equivalent of business activity," and amounted to "the carrying on of business by the corporation." There was no doubt but that the parties, when they initiated the corporate set-up, had the purpose that these activities would be carried on, and it was equally certain that they were actually carried on, thus meeting both of the alternative requirements arising from the Moline Properties.

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110. Supra
111. Supra

Accordingly, the judgment of the trial court, finding that the corporation owed no obligation for its own income taxes, was wrong.

A similar case, where the individual taxpayer unsuccessfully attempted to have a corporation ignored was Carver v US.[112] The taxpayer contended that, although the corporation had a charter, the fact that it issued no stock, filed no returns, had no directors or officers, and kept no books should preclude its recognition as a separate entity. The court, however, held that the corporation was a taxable entity, finding the requisite "business activity in certain real estate financing and sales operations."

In Taylor v Commissioner,[113] the taxpayer argued that a corporation holding title to land should not be taxed on the revenue received from a gravel pit. The court ruled that the opening of a checking account and the execution of deeds and a mortgage constituated "business activity": "If [the corporation] were to serve only as a straw, it should have only performed those transactions essential to the holding and transferring of title."[114] Similarly, in Commissioner v State-Adams Corp.,[115] the court rejected the taxpayer's argument that the holding of title did not warrant recognition of the corporate entity, since the corporate functions of collecting money with respect to the land constituted "business activity".

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112 412 F.2d 233 (Ct Cl 1969)
113 445 F.2d 455 (1st Cir 1971)
114 p457
115 See also Britt v US, 431 F.2d 227 (5th Circ. 1970) (where the court held, for the taxpayer, that the corporation was a separate entity since the corporate activity in signing notes and collecting dividends constituted "business activity"); and Tomlinson Fleet Corp. v Commissioner, 25 T.C.M. 59 (1966) (corporation organized to effectuate an isolated sale was engaged in business).

It can be seen that, based on the Moline Properties test, a corporation will not be disregarded if it carries on a business activity. The question then arose as to whether investment activity can satisfy the test. In Noonan v Commissioner,[116] a corporation received income as a limited partner from a business enterprise in which the sole shareholder was a general partner. The Tax Court acknowledge that the corporation had been properly organized, but it refused to recognize the separate corporate entity where the record was devoid of evidence showing any active business purpose. See also Lowndes v US,[117] where the taxpayer acquired, in a bargain purchase, four corporations whose sole assets consisted of cash. The corporations invested the funds in interest-bearing time deposits for a period of 6 months to enable the taxpayer to obtain capital gain treatment on the liquidation of the corporations. The court held that the corporate entity should be disregarded, the transaction treated as the purchase of cash at a discount, and upheld the Commissioner's determination that the taxpayer realized ordinary income at the time of acquisition of the stock to the extent of the difference between the fair market value of the stock and the purchase price.

However, taxpayers have sometimes been successful in having their corporations recognized as separate entities under the Moline Properties concept of "business activity", even though the corporate function consisted only of investment activity rather than active business operations. In Sam Siefel v Commissioner,[118] as noted above, the taxpayer, wishing to limit his potential liability, established a Panamanian corporation to invest in a farm joint venture in Cuba. The taxpayer had no immediate need for the profits and his plan at the time

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116. 52 TC 907 (1969)
117. 384 F.2d 635 (4th Cir, 1967)
118. Supra

of the incorporation was ultimately "to obtain the fruits of the venture through liquidation of the corporation". Although the other members of the joint venture actively participated in the farming operation, the corporation's only activity was to receive money from the venture, deposit it in its account, and periodically invest and reinvest the funds in the Cuban farming venture. The Tax Court concluded that there was a sufficient amount of business activity: "Nor may it be said that [the corporation's] minimal activity did not constitute the conduct of business. The point is that [the corporation] was formed for only a limited purpose, namely, to invest in the joint venture".[119] Section 951 of the IRC, added in 1962, would now deal with the situation in Siefel to the extent that a foreign, rather than than a domestic corporation was involved.

The taxpayer or the Commissioner may attempt to achieve the same result as is produced by the disregard of corporate entity theory on the ground that a principal-agent relation exists between the shareholder and the corporation, and therefore the income involved is the shareholder's rather than the corporation's.[120] Language in National Carbide Corp. v Commissioner[121] lends support to this approach, and it has been applied in some lower court decisions. For example, in Worth Steamship Corp. v Commissioner,[122] a corporation holding title to a ship was held to be acting as agent of the beneficial owners, and was therefore not taxable on the income earned from the operation of the ship. Also in Carver v US,[123] the proceeds from the sale of real estate

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119 45 TC at p577. See also Cukor v Commissioner 27 TCM 89 (1968) where it was said that "even the minimal activity of investing in a joint venture and receiving the profits therefrom may be sufficient to warrant recognition of a corporation as a separate taxable entity" (p93).

120 Similar arguments have been advanced in the UK, see Chapter 12.

121 Supra

122 7 TC 654 (1946)

123 Supra

effected by a shell corporation holding title thereto were paid directly to the sole shareholder of the corporation. The proceeds were taxable on the shareholder and not on the corporation; the corporation was merely the agent of the shareholder.

In cases where the agency theory is invoked, the issue is who in fact earned the income, since the corporate entity as such is not disregarded.

The question of recognising or ignoring a corporate entity crops up in a different context in connection with the US "transfer pricing" legislation, section 482. For example, in Hamburgers York Road, Inc. v Commissioner,[124] a corporation operating a retail men's store in Baltimore set up a subsidiary to operate a new store in the suburbs. The advertising for the two stores was handled together, a single customers list was used for charge accounts, alterations on clothes sold at the branch were done at the original store, and there was no accurate system for allocation of overhead expenses. The Tax Court upheld the Commissioner's allocation of all of the income and deductions of the subsidiary to the parent under section 482: The Court stated:

> "We are confident that the [parent] would not have permitted such an arrangement if it had dealt with [the subsidiary] at arm's length. For such use of its business organization and assets, [the parent] would, we believe, have claimed for itself the profits in their entirety of [the subsidiary's] segment of the integrated business."[125]

A similar result was reached in Wisconsin Big Boy Corp. v

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124. 41 TC 821 (1964)
125. p837

Commissioner,[126] where all the income and deductions of a chain of restaurant subsidiaries were allocated to the parent under section 482. The subsidiaries were operated as a "single, integrated business operation" and the taxpayer failed to offer any proof supporting a lesser allocation.

On the other hand, in Your Host, Inc, v Commissioner,[127] ten restaurant subsidiary corporations were found to be "viable economic activities" since their success did not depend on the goodwill and trademark of the parent corporation and therefore the Commissioner was not justified in allocating all of the income from the subsidiaries to the parent.

On the relevance of control see Hall v Commissioner[128], where the taxpayer, as a sole proprietorship, sold goods manufactured by him to a foreign corporation at a price considerably below his usual list price, the stock of the corporation, according to the taxpayer, being owned by his son and another. The court said that section 482 was applicable regardless of the legal ownership of the stock, since the taxpayer in fact exercised control over the corporation and dominated it. It therefore allocated a part of the corporation's income to the taxpayer by treating sales to it as if made in accordance with list prices.

It can be seen that, apart from special situations, such as where the agency principle prevails or section 482 applies, the recognition or disregard of a corporate entity normally depends on the Moline Properties test of

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126. 452 F.2d 137 (7th Cir 1971). See also Phillip Brothers Chemicals Inc v Commissioner 435 F.2d 53 (2d Cir 1970), where the whole of the income of a foreign sales corporation was allocated to the parent because there was no evidence that the subsidiary carried on any substantial business activity.
127. 58 TC 2 (1972)
128. 2 TC 390 (1959)

"business activity". This is a fairly clear test but it inevitably merges in some cases with other judicial doctrines such as substance over form.

The disregard of corporate entities by virtue of the fact that they are not carrying on sufficient business activities to satisfy the Moline Properties test does mean that US courts are readier to look through such entities than their UK counterparts are.[129]

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129. See Chapter 12

The Sham Doctrine

This terms is used differently in the US than it is in the UK.[130] Its use is very much wider in the US and is normally applied where the form of a transaction is disregarded in favour of its substance; the form is then said to be a "sham".

A good example of this can be seen in Gregory v Helvering[131] where Judge Learned Hand said:

> "All these steps were real, and their only defect was that they were not what the statute meant by a 'reorganization', because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect."[132]

Another example of this doctrine in operation is Barnett v Commissioner.[133] In this case the taxpayer prepaid interest on a loan made at the year-end to finance the purchase US "Treasury Obligations". A month later, in the next tax year, the loan had been fully paid and most of the prepaid interest had been refunded to him. It was held that the "loan" was without substance and was a sham.

A further example is one of the cases cited by Lord Wilberforce in Ramsay[134]: Knetsch v US.[135] In that case the series of steps was held to be a sham; the "facade of loans" having no substance except for the intended tax deduction. Although the words of the statute were complied with, the transaction was held to have no effect.

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130. For the UK position, see Chapter 11
131. Supra
132. 69 F.2d 809 at p811
133. 385 US 1005 (1967)
134. W.T Ramsay Ltd v IRC (1981) 54 TC 101, see Chapter 11
135. 364 US 361 (1960)

It can be seen that, unlike in the UK, where the term "sham" has a specific and narrow meaning, in the USA it is really no more than a designation used where the insubstantial form of a transaction is ignored in favour of the underlying substance. This should be kept in mind when judgments in US tax avoidance taxes are being read.

The Step Transaction Doctrine

This doctrine takes a number of forms but they are all based on the rule that the court will look at the end result of a connected series, and not apply fiscal consequences to any intermediate step which has no business purpose. Lord Brightman's well-known formulation of the Ramsay principle in Furniss v Dawson[136] is a UK equivalent; as opposed to Lord Bridge's which is an example of the more amorphous substance over form doctrine.[137]

The step transaction has been established in the US for many years, and is less precise than Lord Brightman's version which, despite the efforts of the Inland Revenue and some judges, noteably Lord Templeman,[138] the UK courts have refused to expand.[139]

In any case, it is suggested that Lord Brightman's analysis can only strictly be seen as a step transaction argument on the basis, as found by Lord Brightman, that the proceeds paid to Greenjacket had to be treated as received by the Dawsons. This is probably the least satisfactory aspect of Lord Brightman's analysis. In some respects, Lord Brightman's criteria are nearer the US business purpose test than many of the forms of the step transaction test.

The various US cases have suggested three tests:

1. The End Result Test. This is the widest and probably the main test. Under this test, separate transactions are viewed as a single one where it appears that the separate transactions were integral parts of a single

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136. (1984) 55 TC 324, see Chapter 11
137. Ibid
138. See Chapter 11
139. See the judgments of the majority of the House of Lords in Craven v White [1988] STC 476, see Chapter 11.

transaction intended from the outset to be taken for the purpose of reaching the end result. In the case of Security Industrial Insurance Co v US,[140] the court held that the end result of a complex series of transactions was the taxable purchase of one corporation's assets by another. The court stated that the central purpose of the step transaction doctrine was to ensure that the tax consequences of a particular transaction turned on its substance rather than its form. The court also applied the next test, the "interdependence test".

2. The Interdependence Test. This test applies where the steps are so interdependent that it would be pointless carrying out one without completing the series. Therefore, the various steps must be viewed as a single transaction. In the Security Industrial case the court said that:

> "Each step was dependent for its success upon each of the others; in isolation the steps were meaningless".[141]

This widest formulation is really an extention of the substance doctrine in that the form of the various transactions is subservient to the substance of the end result sought by the parties.

3. The Binding Commitment Test. This test says that the separate transactions will be viewed as a single one only where there is a binding commitment to implement the later steps. This

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140. 702 F.2d 1234 (5th Cir 1983)
141. p1247

test has been held to apply where an agreement made it extremely likely that the later steps would take place.

In the case of Commissioner v Gordon,[142] the Supreme Court said of the test:

> "It does, however, mean that if one transaction is to be characterised as a 'first step' there must be a binding commitment to take the later steps."[143]

In the case itself there was, in fact, no binding commitment to implement the second transaction, so the tax consequences were determined by the first step alone viewed in isolation. This worked against the taxpayer company in this particular case because it disposed of over 80% of its holding in another company in two transactions. However, it could not take advantage of the US demerger provisions which required a disposal of 80% because, when the first disposal took place, there was no binding commitment to make the second.

Step transaction cases can also be split into those where the intermediate steps are ignored because they lacked business purpose and those where the intermediate steps are transitory. Compare, for example, the Hunter Manufacturing Corp and Weyl-Zuckerman cases, on the one hand; and the De Treville and Waterman Steamship Corp. cases on the other hand.

In Hunter Manufacturing Corporation v Commissioners,[144] a corporation owned 76% of the stock of a worthless

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142. 391 US 83 (1968)
143. p96
144. 21 TC 424 (1953)

subsidiary. It acquired the other 24% so that it could claim an ordinary loss on the worthlessness of a 95% owned subsidiary. The Tax Court denied the deduction because there was no business purpose in the acquisition of the minority interest.

The situation in Wyel-Zuckerman & Co v Commissioner,[145] was that a corporation planning to sell property showing a gain, transferred it to its subsidiary and then received it back as a dividend, paying an inter-corporate dividends tax, but it was hoped that the base cost would be increased to market value (under the law then in existence) so that the parent would not make a taxable gain on the sale. The court held that the intermediate steps must be ignored because they lacked a business purpose.

A similar result in the other class of case was reached in De Treville v Commissioner.[146] Here the court refused to give independent significance to the distribution of cash to a shareholder, immediately followed by the shareholder purchase of property from the corporation; the end result of the transaction was a distribution of the property by the corporation to the shareholder. The taxpayer had hoped to take advantage of the fact that only distributions of money could qualify as tax-free distribution of previously taxed income.

In Waterman Steamship Corp v Commissioner,[147] the company was negotiating the sale of stock in a wholly-owned subsidiary. The agreed price was $3,500,000 but the company's base cost was only $700,000. So the subsidiary paid a dividend of $2,800,000 in the form of a note. The stock was sold to the purchaser for $700,000 and the

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145. 232 F.2d 214 (9th Cir, 1956)
146. 445 F.2d 1306 (4th Cir, 1971)
147. 430 F.2d 1185 (5th Cir, 1970)

purchaser provided funds to the subsidiary to pay off the $2,800,000 dividend note. Because of the consolidated return provisions, it was hoped that the dividend would have been tax-free. However, the court refused to view the transaction as a dividend distribution and treated the dividend "note" as part of the purchase price. The court said:

> "The so-called dividend and sale were one transaction. The note was but one transitory step in a total, pre-arranged plan to sell the stock.... Gregory[148] does not per se preclude a taxpayer from decreasing his taxes or avoiding them with methods permitted by law. The application of that principle does not mean, however, that a person may reduce his tax liability by transferring his money from one pocket to another even though he uses different pairs of trousers."[149]

An important characteristic of the business purpose/transitory transaction categorisation has been pointed out by Professor Tiley,[150] namely, that the taxpayer is more able to invoke the step transaction doctrine in the first situation than the second because, in the first, the reason for fusing the intermediate steps was to get at the real nature of the transaction. He cited the following from Commissioner v Ashland Oil and Refinery Co:[151]

> "For this reason and because the steps themselves are not ordinarily intended to obscure the transaction's substance, the taxpayer is usually as free as the Commissioner to insist that it be viewed as a whole. When unnecessary or transitory steps are deliberately

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148. Gregory v Helvering, supra
149. pp1192-3
150. Op Cit pp236-7
151. 99 F.2d 588 (1938). This was, incidentally, one of the three US cases cited by Counsel for the Crown in Furniss v Dawson, see Chapter 11.

employed by the taxpayer however, the courts are less disposed to permit the taxpayer to retrace his steps in order to leave the devious path and get back on the straight and narrow; in these circumstances the privilege of disregarding the unnecessary steps is sometimes reserved for the IRS."[152]

The Ashland Oil and Refinery Co is interesting because the taxpayer did successfully invoke the step transaction doctrine. The court stated that it was not going to recognise the intermediate transactions. It said:

"without regard to whether the result is imposition or relief from taxation, the courts [recognise] that where the essential nature of a transaction is the acquisition, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority."[153]

With the three separate tests, and the business purpose/transitory step distinction, it can be seen that the step transaction doctrine is a wide, diverse, and sometimes vague and uncertain principle. It sometimes appears that US judges tend to apply the step transaction doctrine in an effort to get to what they perceive to be the "substance" of the arrangements without full regard for the details of the arrangements themselves and their taxation implications.

Whereas, in the UK, the courts, after Lord Brightman's formulation in Furniss v Dawson,[154] were generally very suspicious of any attempt to extend the step transaction

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152 p591
153 Ibid. For a case in which the taxing authorities successfully, invoked the step transaction rules see Kimbell-Diamond Milling Co. v Commissioner 187 F.2d 718 (5th Cir 1950)
154 See Chapter 11

doctrine, or to apply it in a vague way to situations not precisely covered by Lord Brightman's words; in the US, the courts, over the years, have freely used the doctrine, in one or other of its forms, almost willy nilly so that it is not possible to extract any precise guidelines as to its exact application to proposed transactions.

It is submitted that it is much better to have a relatively precise test based on Lord Brightman's criteria, as interpreted by the House of Lords in Craven v White et al,[154] than to be confronted with the US mish-mash of vague and overlapping doctrines. The UK situation certain gives greater certainty than the US one, but it is undeniable that it leaves a very much wider gap for tax avoiders. This is the age-old problem: the more precise and certain the anti-avoidance measures become, the easier it is to circumvent them.

The width of the US step transaction doctrine can be seen, for example, in the field of corporate reorganisations. The step transaction doctrine was used to defeat a claimed reorganisation in Helvering v Elkhorn Coal Co.[155] In this case a corporation, Mill Creek Company, wanted to acquire the operating assets of another corporation, the Elkhorn Coal and Coke Co., but did not want its investments. Elkhorn formed another corporation and it transferred to it its investments. The new company issued all of its stock to Elkhorn, which distributed it to its shareholders. Elkhorn then transferred its remaining assets to Mill Creek for stock of Mill Creek. Elkhorn was then dissolved and the Mill Creek stock was distributed to Elkhorn's shareholders. It was claimed that each step in the

154. See Chapter 11
155. 95 F.2d 732 (4th Cir, 1938)

transaction was tax free, but the court held that the transaction must be viewed as a whole, and that the transfer of Elkhorn's operating properties to Mill Creek was not tax free because it did not constitute the transfer of substantially all of Elkhorn's properties, as the statute required. The court was of the opinion that the statutory exemption could not be broadened by "such an artifice."

On the other hand, the doctrine can be used to produce a reorgnisation and tax free exchange when the taxpayer was trying to produce a taxable transaction in order to crystallise a tax loss: see Heller v Commissioner[156]. The facts were that Heller, Bruce & Company, a Delaware corporation engaged in the investment banking business desired to become a California corporation, as it preferred to operate under the California laws. On 6th December 1937, Heller, Bruce & Co. was organized under the law of California to acquire and carry on the business of the Delaware corporation. The taxpayer and the other two officers and stockholders of the Delaware corporation paid cash for stock of the California corporation. The taxpayer had borrowed the cash from a bank in the same amount, and its collateral was applied by the bank against the new California corporation loan. The Delaware corporation, on 16th December 1937 then used the cash to pay its prior bank loan, so that the bank ended up with the same amount outstanding as a loan as respects the corporations. The Delaware corporation dissolved on 20th December 1937 and distributed the balance of the cash in liquidation. After these various steps the directors, officers and shareholders of the California corporation were the same as those of the Delaware corporation, and the business was continued as before. The taxpayer claimed a loss on the liquidation of the Delaware corporation.

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156. 2 TC (1943), affirmed 147 F.2d 376 (9th Cir 1945)

The Commissioner contended that the taxpayer did not sustain a deductible loss in 1937 by reason of the series of steps; that they were part of one transaction, the substance of which was an exchange of stock in the Delaware corporation for stock in the California corporation pursuant to a plan of reorganization; and that no gain or loss is recognizable because of the provisions of the section.

The court said that, in determining the substance of a transaction it is proper to consider the situation as it existed at the beginning and end of the series of steps as well as the object sought to be accomplished the means employed, and the relation between the various steps. The taxpayer and the other two stockholders and directors of the Delaware corporation, decided to have the business, assets, and liabilities of that company taken over by a new California corporation. The desired end was accomplished by a series of steps, all of which were planned in advance. When the plan was completed the former stockholders and directors of the Delaware corporation were in control of the new California corporation, and it had acquired the assets, business, and liabilities of its predecessor. The net result was that the taxpayer and the other two stockholders had substituted their interest in the Delaware corporation for substantially the same interest in the California corporation. The non-recognition of gain or loss provisions of the statute are "intended to apply to cases where a corporation in form transfers it property, but in substance it or its stockholders retain the same or practically the same interest after the transfer."

The court pointed out that the result achieved under the plan could have been accomplished by having the California corporation acquire the assets of the Delaware corporation for its stock, and by having the latter distribute the stock to its stockholders in complete liquidation. The taxpayer and his associates apparently chose the longer route, hoping that they might thereby become entitled to a loss deduction. However, the effect of all the steps taken was that the taxpayer made an exchange of stock of one corporation for stock of another pursuant to a plan of reorganization. No gain or loss could be recognized for tax purposes on such a transaction.

However, it has been held possible for taxpayers to invoke the step transaction doctrine to produce a reorganisation. This occurred in King Enterprises v US,[157] an example of the end result test.

The taxpayer was a stockholder in Tenco which was acquired by Minute Maid in return for the issue of stock, cash and promissory notes. Minute Maid then merged with Tenco and three of its other subsidiaries. The taxpayer claimed that the acquisition and merger were one transaction. The court agreed on the basis that, on the evidence, the merger was intended right from the beginning. Because of this finding, the taxpayer was able to obtain a deduction in respect of the cash and promissory note element of the consideration for the acquisition.

See also Chapman v Commissioner,[158] in which the step transaction was used to defeat a reorganisation claimed by the taxpayer by linking two separate acquisitions made 14 months apart. For technical reasons, the first, relatively minor acquisition did not qualify for reorganisation relief and, by linking it with the second, major, acquisition, the second, which by itself would have qualified, was tainted as well.

The interaction of the step transaction doctrine with specific statutory provisions was considered in Granite

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157. 418 F.2d 511 (Ct Cl 1969)
158. 68 F.2d 856 (1st Cir 1980)

Trust Co. v US.[159] The Commissioner tried to use the step transaction doctrine to bring a liquidation under a section under which, after a plan of liquidation is adopted, certain sales and gifts are made so as to come within the provision disqualifying liquidation if the amount of stock ownership dropped during liquidation. The court, however, gave effect to the sales and gifts, saying:

> "As for the Commissioner's 'end-result' argument, the very terms of [the section] make it evident that it is not an 'end-result' provision, but rather one which prescribes specific conditions for the non-recognition of realised gains or losses, conditions which, if not strictly met, make the section inapplicable.....In the present case the question is whether or not there actually were sales. Why the parties may wish to enter into a sale is one thing, but that is irrelevant under the Gregory case[160] so long as the consummated agreement was no different from what it purported to be.....We find no basis on which to vitiate the purported sales, for the record is absolutely devoid of any evidence indicating an understanding by the parties to the transfers that any interest in the stock transferred was to be retained by the taxpayer.... In addition to what we have said, there are persuasive reasons of a general nature which lend weight to the taxpayer's position. To strike down these sales on the alleged defect that they took place between friends and for tax motives would only tend to promote duplicity and result in extensive litigation as taxpayer led courts into hair splitting investigations to decide when a sale was not a sale. It is no answer to argue that, under Gregory v Helvering, there is an inescapable judicial duty to examine into the actuality of

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159. 238 F.2d 670 (1st Cir 1956)
160. Gregory v Helvering, supra

purported corporate reorganizations, for that was a special sort of transaction, whose bona fides could readily be ascertained by inquiring whether the ephemeral new corporation was in fact transacting business, or whether there was in fact a continuance of the proprietory interests under an altered corporate form..... In short, though the facts in this case show a tax avoidance, they also show legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be, and we believe they must be given effect in the administration of [the section] as well as for all other purposes."[161]

The line taken in Granite Trust shows how unpredictable the step transaction principle can be. The principle failed in the Granite Trust case because the court was considering a detailed statutory provision with which the taxpayer had complied. It is evident that, in the US, there are some provisions which the courts may decide override the end-result principle.

On the other hand, the approach of the court in the Granite Trust case appears to be more akin to the minority, rather than the majority of the Supreme Court in Knetsch.[162] The majority in Knetsch looked to the underlying economic substance of the transaction in question in that case.

Nevertheless, it appears still to be the case that the end-result principle cannot be invoked merely because the taxpayer took one of two ways of achieving the same result which gave him the bigger tax advantage: see Magneson v Commissioner.[163] Obviously, however, this

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161. pp675-8, see also Auco Manufacturing Co v Commissioner 25 TC 975 (1956)
162. Knetsch v US, infra
163. 753 F.2d 1490 (9th Cir 1985)

will only be the case where the method chosen does not involve "sham" transactions within the Knetsch formulation.[164]

164. Infra

The Knetsch and Gilbert Cases

Lord Wilberforce in the Ramsay case[165] quoted from two American decisions "as examples, expressed in vigorous and apt language, of a process of thought which seems to me not inappropriate for the Courts in this country to follow." He said that the decisions "do at least confirm me in the belief that it would be an excess of judicial abstinence to withdraw from the field now before us."[166] The decisions in question are Knetsch v US[167] (a majority decision of the Supreme Court) and Gilbert v Commissioner.[168] As these two decisions were specifically raised by Lord Wilberforce they are now considered in more detail.

Knetsch v United States

In this case, the Supreme Court held that the taxpayer could not deduct interest paid on the purchase price of 30 year deferred annuity savings bonds and on borrowings on the bonds, where his annual borrowings kept the cash value of the bonds, on which the annuity or life insurance payments depended, at nominal amounts. There was nothing of substance to be realised by the taxpayer beyond a tax deduction. Congress, by disallowing, in 1954, deductions for single premium annuity contracts, did not show an intent to allow deduction if interest on pre-1954 transactions without regard to whether the transactions created a true obligation to pay interest.

The majority judgement was delivered by Mr. Justice Brennan. The following passages are extracts from his judgement and are interesting in the light of the citation of the case in Ramsay.[165]

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165. W.T Ramsay Ltd v IRC (1981) 54 TC 101
166. See Chapter 11
167. 364 US 361 (1960)
168. 248 F.2d 399 (2d Cir 1957)

(1) "The trial judge made findings that 'there was no commercial economic substance to the ..... transaction,' that the parties did not intend that Knetsch 'become indebted to Sam Houston'[169] that 'no indebtedness of [Knetsch] was created by any of the ..... transactions,' and that 'no economic gain could be achieved from the purchase of these bonds without regard to the tax consequences.....'. This conclusion of law based on this Court's decision in Deputy v du Pont, 308 US 488, was that 'while in form the payments to Sam Houston were compensation for the use of forebearance or money, they were not in substance. As a payment of interest, the transaction was a sham.'"

It is noticeable here that the Court is talking in terms of sham transactions in the US sense, not in the narrower UK sense.[170]

(2) "We put aside a finding by the District Court the Knetsch's 'only motive in purchasing the ten bonds was to atempt to secure an interest deduction.' As we said in Gregory v Helvering, 293 US 465: 'The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted..... But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.'"

In other words, this is an application of the second Gregory principle (namely, that concerning commercial motive).

(3) "In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000,

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169. This refers to the Sam Houston Life Insurance Co.
170. See Chapter 11

which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000. Plainly, therefore, Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax'. Gilbert v Commissioner, 248 F.2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realised by Knetsch from this transaction beyond a tax deduction."

(4) "We, therefore, look to the statute and materials relevant to its construction for evidence that Congress meant..... to authorise the deduction of payments made under sham transactions entered into before 1954. We look in vain."

The dissenting opinion was delivered by Mr. Justice Douglas, with whom two other judges agreed. He said that:

> "As long as the transaction itself is not hocus pocus, the interest charges incident to completing it would seem to be deductible under the Internal Revenue Code as respect annuity contracts made prior to March 1, 1954, the date Congress selected for terminating this class of deduction.... The insurance company existed; it operated under Texas law; it was authorised to issue these policies and to make these annuity loans."

The final passage in the short dissenting judgement is reminiscent of English Courts in the years following the

Duke of Westminster[171] case. This passage runs as follows:

> "Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. Will the Service that calls this transaction a 'sham' today not press for collection of taxes arising out of the surrender of the annuity contract? I think it should, for I do not believe any part of the transaction was a 'sham'. To disallow the 'interest' deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative, evils or abuses can be particularised by Congress. We deal only with 'interest' as commonly understood and as used across the board in myriad transactions. Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognise them tax-wise."

It is understandable that Lord Wilberforce should cite this case as supporting his new approach because Knetsch was probably the nearest the US courts have come to saying that a tax advantage can be withheld solely on the basis that there is no business purpose. There is also a parallel in that the Supreme Court paid lip service to the traditional authority, Gregory v Helvering (decided within five months of the Duke of Westminster case), but then proceeded to give a judgment which, in certain respects, appears to undermine it.

It is also perhaps fitting that Lord Wilberforce, when embarking on a course that would throw UK tax law into

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171. IRC v Duke of Westminster (1935) 19 TC 490, see Chapters 11 and 14.

years of uncertainty, should draw comfort from an American case which itself did not appear to have a precisley defined direction.

The Supreme Court purported to respect Gregory v Helvering but said that the transactions were a "sham". However, it is difficult to see how they can be viewed as "shams" except by virtue of the tax motive, which the Gregory case decided was not relevant.

Gilbert v Commissioner of Internal Revenue

This case concerned advances made by a stockholder and his wife to a corporation to finance its operations, which advances were evidenced by promissory notes from the corporation. The taxpayer was one of two principal stockholders, and the advances were made pursuant to an understanding of the two stockholders that the operations of the corporation would be financed by each of them in this manner on an equal basis.

Circuit Judge Media gave the main judgement of the Court. The judge said that the taxpayer was claiming that the transactions were loans because interest paid on such loans would be deductible for tax purposes and, when the debt becomes worthless, the lender is entitled to a full deduction for tax purposes, not subject to a limitation imposed by US law on capital losses. The judge continued:

> "By way of preliminary, it is trite to say that the mere empty form of the transaction does not preclude further enquiry. It is alway open to the Commissioner to prove that the transaction is not what it appears, that the parties truly intended to and actually did enter into another and hidden agreement by which their rights are to be governed. It is also clear that, for purposes of the Federal

tax statute, even though the parties have intended to create a debt, the Courts will not recognise it as such as against the taxing power if they have failed to create a binding obligation.... Assuming then that the true nature of the obligation has been established, and that it is not so unlike a classic debt as to preclude treatment as such, the enquiry is not yet ended, for 'the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of the taxing statute; it does not close them.' Bazley v Commissioner, 331 US 731, 741. This principle is generally said to derive from Gregory v Helvering, 293 US 465."

The judge then dealt with Gregory v Helvering, Higgins v Smith and Bazley and commmented:

"The principle that emerges from these cases is that statutory terms are not to be interpreted independent of their context and underlying policy."

He further said that it was too well settled to require discussion that legal transactions cannot be upset merely because the parties have entered into them for the purpose of minimising or avoiding taxes which might otherwise accrue. Despite such purpose, the question is always whether the transaction under scrutiny is in reality what it appears to be in form. He said that the controlling factor is <u>result</u>, not <u>motive</u>.

He continued:

"In many cases in which the Gregory principle is called into play the question is whether a tax-significant transaction has occurred. But this is not to say that Gregory has application only where the question is whether a transaction is to be completely ignored for tax purposes. The principle is fully as applicable where there is no doubt that a very real transaction has taken place and the question is whether the characterisation urged by the taxpayer accords with substantial economic reality. In either case the taxpayer must show that his treatment of the transaction does not conflict with the meaning the Congress had in mind when it formulated the section sub judice."

The judge then considered the technical facts relating to the case in question as regards US law. He then concluded:

"Where the Courts have spoken of tax avoidance motives, they have as a rule had reference to their conclusions rather than to the evidence. The statement that the taxpayer was seeking to avoid taxes has been used as the equivalent of the statement that the taxpayer has tried to base a deduction on an advance which was in fact too risky to qualify as a loan for tax purposes. As we have shown, the motives and expectations of the taxpayer are relevant only insofar as they contribute to an understanding of the external facts of the situation."

Circuit Judge Hand delivered a dissenting opinion on the facts and the test to be applied. He also approached the principle in a slightly different way. He referred to the doctrine which stems from Gregory v Helvering that, although the rights of a taxpayer may be absolute as between himself and his corporation, the law at times refuses to regard those rights in assessing his income tax. He continued:

"It is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their 'interpretation' demands the projection of their expressed purpose, upon occasions, not present in the minds of those who elected them. The Income Tax Act imposes liabilities on taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; or we cannot suppose that it was part of the purpose of the Act to provide an escape from the liability that it sought to impose."

In other words, a business purpose test was being applied.

The judge then cited the cases of Gregory v Helvering, Griffiths v Comssioner, Higgins v Smith and Bazley v Commissioner. He then continued:

When a taxpayer supposes that the transaction, in addition to its effect upon his tax, will promote his beneficial interest in the venture, he will of course secure the desired reduction for it would be absurd to hold that he must deny himself an economic advantage unless he pay the tax based upon the facts that have ceased to exist. Moreover, he will also be relieved, if he supposes that the trasnaction will, or may cause him a loss, although in that event it is true that his only motive will be to avoid tax. For instance, if a very rich man sells shares of stock and invests the proceeds in municipal bonds, he will not be taxed on the dividends of the shares, although his only motive was to avoid the tax upon his dividends."

He then said that he could not quite understand the test adopted by his two fellow judges. He said:

> "To say that it is whether the transaction has 'substantial economic reality', or 'is in reality what it appears to be in form', or is a 'sham' or a 'masquerade', or 'depends upon the substance of the transaction': all of these appear to me to leave the test undefined, because they do not state the facts that are to be determinative.
>
> I would therefore substitute this which seems to me to avoid that defect and at the same time state the doctrine adequately:
>
> > 'When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?'
>
> The burden will then be on them to prove that they did so suppose".

The House of Lords took a similar line in the Burmah Oil case.[172]

Gilbert is not a particularly good case for Lord Wilberforce to cite in support of his approach in Ramsay, given the strong dissenting judgment, and even Circuit Judge Hand's alternative test is uncertain in its scope beyond questions of interest. In fact, Gilbert is a good example of the imprecise application of the judicial anti-avoidance principles in the USA, an imprecision that should have no part in UK tax law.

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172. IRC v Burmah Oil Co Ltd (1981) 54 TC 200, see Chapter 11

General Comments on the Various Doctrines

It can be seen that there are various doctrines the US courts can call upon to defeat avoidance schemes, each with different elements.

Sometimes the courts decide what the substance of the transaction is and then choose which doctrine to apply to it to defeat it. This may happen in borderline cases between one or more of the doctrines. In other cases the facts may justify the application of more than one doctrine and the court will have a choice as to which one to apply. One of the American correspondents of the Revenue Law Committee of the Law Society, Professor Nelson Moore gave an example of this in "Tax Law in the Melting Pot."[173]

> "Our Internal Revenue Code Section 163 allows a deduction for interest paid or accrued within the taxable year on indebtedness, whether the debt is undertaken for personal or business reasons. There must, however, be a debt. In evaluating whether a taxpayer has engaged in a transaction warranting an interest deduction, the federal courts have variously relied upon the sham transaction doctrine (Barnett v Commissioner, 364 F.2d 742 (2d Cir 1966), cert denied, 385 US 1005 (1967)), the substance v form doctrine (Battlestein v IRS, 631 F.2d 1182 (5th Cir 1980) and Rubin v United States, 304 F.2d 766 (7th Cir 1962)), the step transaction doctrine (Rubin v United States and Lynch v Commissioner, 273 F.2d 867 (2d Cir 1959)) and a variation of the business purpose doctrine (Goldstein v Commissioner, 364 F.2d 734 (2d Cir 1966), cert denied 385 United States 1005 (1967) [an "economic purpose" doctrine]). To a large degree of course the selection of which doctrine to utilise was dependent on the peculiar facts of the

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173. A study by the Revenue Law Committee of the Law Society (1985)

> transaction involved. Nonetheless, I believe that in many of these cases the facts could have accommodated the use of several of the anti-avoidance doctrines."[174]

The US courts are free to recharacterise a transaction in accordance with its substance. This is different from the situation in the UK.[175]

Considering the various anti-avoidance doctrines, the multiplicity of courts and the lack of review by the Supreme Court, it is perhaps surprising that there is not greater uncertainty in the law. This is due to the wide body of judicial precedent and administrative rulings. Tax planners in the USA seek to mould a transaction as closely as possible to an existing precedent. Furthermore, tax planners know the purpose of legislation and know that the courts will follow this purpose. During the legislative process a great deal of explanation is given of the aims of legislation a long time before the bill is drafted. Congress is given an explanation of the purpose of the legislation, an explanation available to the public. The committees of both the House of Representatives and the Senate often produce their own paperwork on the proposed legislation and once the bill has been drafted, a report is published explaining it. Planners may structure transactions to come within a ruling, regulation or interpretation. These administrative outpourings therefore have a much more important role to play in this respect than Inland Revenue press releases or Statements of Practice. In the US, the regulations etc do provide a great deal of certainty for taxpayers. In fact, a taxpayer, if he wishes to challenge a regulation etc is likely to have to go through the courts and so, in practice a taxpayer should not undertake a transaction which runs counter to a regulation etc unless he is prepared to defend his transaction in the courts.

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174. p98
175. See Chapter 11

A taxpayer can, of course, obtain a ruling of his own (if a regulation is pending, however, no ruling will be given in advance of the publication of the regulation). If he goes ahead without a ruling or regulation, there will be a large measure of uncertainty in the light of the fact that there is no consistent approach in the various anti-avoidance doctrines. The opportunities for innovative tax planning are therefore restricted by this uncertainty which lies outside the limits of the various lines of precedent and administrative pronouncement.

The IRS have a great deal of power, but US practitioners do not necessarily see this as undesirable. This may be due to the fact that the IRS are very helpful in dealing with taxpayers and in giving rulings. Furthermore, the IRS are normally found to be consistent in their approach, due to the small number of specialists who deal with particular aspects of the law. It is normally considered that the system is quite cost effective, as lengthy and costly litigation is avoided and the IRS can concentrate resources in specialised areas by being able to make savings in the compliance areas.

This is not to say that the IRS do not find that they are sometimes understaffed and that it cannot deal with all of the requests for rulings, which may be delayed or not available at all. In these cases uncertainty may exist for taxpayers and it is here that the lack of any consistent judicial approach to the anti- avoidance doctrines may put the taxpayer at a disadvantage unless he can bring himself within an existing precedent.

Of the various doctrines, different ones appear to have predominated at different times.

The general direction of the decisions has been towards a substance over form doctrine supported by the step transaction doctrine which may be coupled with the business purpose test and the "sham" doctrine.

It is apparent that judges such as Lord Wilberforce have cast their eyes across the Atlantic for inspiration or comfort when seeking to break new ground in UK tax law. This is dangerous given the enormous differences in the structure and workings of the legislatures, judiciaries and administrations in the two countries.

Furthermore, even in the US, the application of the various anti-avoidance doctrines is characterised by inconsistency and uncertainty. Over 50 years after the Gregory v Helvering case, US courts and commentators cannot be certain as to the extent and working of the various principles and the extent and nature of their overlap. This uncertainty is evident in the very cases cited by Lord Wilberforce in Ramsay, namely, Knetsch and Gilbert. The incorporation of US doctrines into UK tax law would be a recipe for confusion and disruption.

Lord Bridge in Furniss v Dawson[176] too drew inspiration and justification from US principles. He noted that in the USA, the Gregory v Helvering case had decided that a taxpayer may so arrange his affairs that has taxes will be as low as possible but that the US courts had then developed different techniques from UK courts for combatting tax avoidance. This, of course, is quite correct. He referred also to the Duke of Westminster case[177] but then said:

> "When one moves, however, from a single transaction to a series of interdependent transactions designed to produce a given result, it is, in my opinion, perfectly legitimate to draw a distinction between the substance and the form of the composite transaction without in any way suggesting that any of the single transactions which make up the whole are other than genuine."

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176. (1984) 55 TC 324
177. Duke of Westminster v IRC (1935) 19 TC 490

He then said that this had been the approach of the US courts, but he did not analyse the US principles in any detail in support of his bald statement.[178]

It is really not good enough that Lord Bridge can purport to apply, or be inspired by, US doctrines when there is no evidence in this judgment, or any of his other judgments, that he fully understood the nature of the US principles, or the implications of their importation into UK tax law. It is suggested that he was wise not to have attempted a review of the US authorities because no consistent and certain principle could be extracted from the diverse and sometimes even contradictory principles. Nevertheless, the fact remains that Lord Bridge seems to be espousing a substance doctrine going beyond the more certain criteria set out by Lord Brightman and taking comfort in undefined US principles.[179]

Certainly, the cases cited to him by Counsel for the Crown[180] would only have given him a very restricted view of US position. The only cases cited were Gregory v Helvering;[181] Commissioner v Ashland Oil Refining Co;[181] and Commissioner v Transport Trading and Terminal Corporation.[181]

As Counsel for the taxpayers pointed out,[182] the influence of American decisions should be regarded with considerable care as there is no unanimity of approach in them. It was also pointed out that the Transport Trading case was criticised and not followed in subsequent cases.

It is submitted that the reservations felt by Counsel for the taxpayers in Furniss v Dawson are well founded. Courts in the UK should think long and hard before seeking to take support from US decisions, and when they

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178. pp391-2
179. See pp 392-3
180. See p386
181. Supra
182. p386

do rely on them, even if only for comfort, they should give taxpayers greater guidance on how these US authorities are being used than did Lord Wilberforce in the Ramsay case or Lord Bridge in Furniss v Dawson.

PART 2

CANADA

Introduction

Canada provides a very interesting contrast to both the UK and the US systems. Like both of those countries, the familiar doctrines are to be found in Canada's case law. The substance doctrine, the notion of the "sham", piercing the corporate veil, the step transactions doctrine, amongst others, have their place in Canadian tax law. Nevertheless, these principles are not applied in precisely the same way as in either the USA or the UK. What is more, unlike both the USA and the UK, but in a similar way to Australia,[1] there are general anti-avoidance provisions in Canada. This general anti-avoidance legislation exists alongside specific provisions, some widely drawn, others more specific, of the kind found in the UK.

In this Part, therefore, consideration is given both to the judicial principles, and to the legislative provisions, to see how the general measures work in conjunction with the specific anti-avoidance section. Some interesting comparisons with the UK system can be drawn.

It will be seen that, whereas US judicial approaches to tax avoidance are beginning to influence the thinking of judges in the UK;[2] in Canada, the movement tends to be the other way, with principles arising out of cases in the UK being considered, and sometimes followed, sometimes rejected, in Canada.

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1. See Part 3
2. See Part 1

In this Part three preliminary matters are dealt with briefly; statutory interpretation; the scope of tax avoidance and tax evasion; and the system of advance clearances. Then particular attention will be given to the business purpose test and the influence of a case called Stubart Investments Ltd v The Queen.[3] This will be followed by a review of the main anti-avoidance doctrines used by the Canadian judges and, finally, the anti-avoidance legislation will be considered.

In this Part all section numbers refer to sections of the Income Tax Act ("ITA") unless otherwise stated.

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3. [1984] CTC 294

Statutory Interpretation

Traditionally, the Canadian courts followed courts in the UK in adopting a narrow literal approach to tax legislation. The well-known dictum from the judgment of Lord Cairns in Partington v A.G[4] has been cited with approval by the Supreme Court of Canada.[5] However, recently the courts have appreciated that tax statutes, like other statutes, should be interpreted in line with the purpose or intention of Parliament.[6]

Nevertheless, the strict approach is still applied in some case, so that, for instance, it was held that tax should not be imposed except in accordance with the clear and unambiguous words of the statute in The Queen v Harman.[7]

Where there is an exemption or reduction claimed by a taxpayer, any ambiguity in the statute will be resolved in favour of the Revenue. On the other hand, if the Act is unclear and the relevant provision cannot be resolved by reading the statute as a whole, the Canadian courts will normally look into the intention of Parliament.[8] This approach has been used with more frequency in recent years in relation to tax avoidance schemes.

It is permissible for the courts to consider the legislative history of an enactment but this does not go as far as allowing the general use of Parliamentary records or statements made by members of the government. In this respect, the practice of the Canadian courts is similar to that adopted by UK courts.

This rule is not so strictly adhered to as it used to be,

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4. (1869) LR 4HL 100
5. See for example Versailles Sweets Ltd v A.G of Canada [1924] SCR 466 at p468: and MNR v Sheldon's Engineering Ltd [1955] SCR 637 at p645
6. See, for example Minister of Revenue for Ontario v McCreath (1976) 67 DLR (3d) 449
7. 79 DTC 5837, affirmed 80 DTC 6052
8. The Queen v Continental Air Photo Ltd 62 DTC 1306

however. For example, in Canterra Energy Ltd v The Queen[9], Mr Justice Reed said:

> "While extrinsic evidence may be admissible to ascertain the object of legislation, and thus indirectly influence the interpretation of statutory provisions, it is not admissible for the purpose of construing statutory provisions directly...."

In the Stubart case,[10] Estey J adopted an approach which was much more liberal than that traditionally adopted by Canadian courts. He indicated that a court should look at the purpose of the legislation:

> "Gradually, the role of the tax statute in the community changed, as we have seen, and the application of strict construction to it receded. Courts today apply to this statute the plain meaning rule, but in a substantive sense so that if a taxpayer is within the spirit of the charge, he may be held liable."

He then quoted with approval the following words from "Construction of Statutes"[11] by E.A Dreidger:

> "Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament."

The Carter Commission[12] noted that the rule of strict construction has been carried to extreme lengths in cases

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9. 85 DTC 5245. See also Lor-Wes Contracting Ltd v The Queen 85 DTC 5310
10. Stubart Investments Ltd v The Queen, supra
11. 2nd ed. (1983) at p87
12. Supra, Vol 3 App A p544

under section 21 ITA,[13] citing as an example MNR v MacInnes.[14] In this case, the taxpayer gave money and bonds to his wife. His wife purchased bonds with the money. The wife then sold all of the bonds and with the proceeds of that sale she purchased still other income-producing property. The income produced by the purchased property was sought to be taxed as income of the husband. The court held that section 21 taxed the transferer only on the income from the property transferred to his wife or from property substituted for it; but not income from property substituted for such substituted property. Not surprisingly, Parliament responded immediately with an appropriate amendment.[15]

The Carter Commission[16] also noted that the courts in Canada sometimes ignore or modify the rule of strict interpretation to reach what appears to be a sensible result. In Settled Estates Ltd v MNR[17], the Supreme Court held that a trust was not an "individual" for the purpose of determining whether a corporation was a personal corporation notwithstanding section 63(2) ITA which provides that "a trust or estate shall, for the purposes of this Act,.... be deemed to be..... an individual".

Similarly, in MNR v Pillsbury Holdings Ltd,[18] the Exchequer Court restricted the meaning of the general words " a benefit or advantage has been conferred on a shareholder by a corporation"[19] to refer only to benefits or advantages conferred on a shareholder qua shareholder.

If the wording of the statute is ambiguous, the ambiguity

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13. This provision is similar to section 663 ICTA 1988 in the UK except that the UK provision relates to transfers etc to children.
14. [1954] Ex.C.R. 151
15. Section 22(3) ITA
16. Vol 3 App A p554
17. [1960] SCR 606
18. [1965] E.X.C.R. 676
19. Section 8(1) ITA

is normally resolved by reference to the context and in such a way as to give a reasonable meaning to the provision: Hargal Oils Ltd v MNR.[20]

Furthermore, the Supreme Court indicated that it may be willing to extend the traditional rules of statutory interpretation to comply with the spirit of a provision in Jodrey Estate v Min. of Finance, (Nova Scotia).[21] Dickson J said:

> "Fiscal legislation does not stand in a category by itself. Persons whose conduct a statute seeks to regulate should know in advance what it is that the statute proscribes. A court should ask - what would the words of the statute be reasonably understood to mean by those governed by the statute? Unnatural or artificial constructions are to be avoided.... Although a court is entitled in the case of fiscal legislation as with other enactments, to look to the purpose of the Act as a whole, as well as the particular purpose of a given section, it must still respect the actual words which express the legislative intention."

As regards the approach to tax avoidance, as in the UK, the Canadian courts' attitude has altered over the years.

Traditionally, the Canadian courts have respected the reasoning in the Duke of Westminster case.[22] Normally the legal result or effect applied, as opposed to the financial or economic effect.[23]

The courts did appear, however, to have been moving away from the Duke of Westminster until the three or four

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20. [1965] SCR 291
21. [1980] 2 SCR 744
22. Duke of Westminster v IRC (1935) 19 TC 490
23. See, for example: Seven Up of Montreal Ltd v MNR [1952] EX.C.R. 288; Canadian Safeway Ltd v MNR [1957] SCR 717; and Bell v MNR 62 DTC 1155

years before the Stubart case when it appeared that they were moving back to the approach shown in the Stubart case itself.[24]

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24. Infra

Tax Avoidance/Tax Evasion

As in the UK, there is a distinction between tax avoidance and tax evasion. J.R Robertson, the Director General, Corporate Rulings Directorate, Legislation Branch, Revenue Canada, Taxation said in an article:

> "For our purposes, the line between tax avoidance and fraud is very narrow. In Canada, where a corporate set up is such that the documentation says one thing but the actual facts are something else, if proof can be obtained, a case of fraud would exist....."[25]

The distinction, although perhaps narrow, is clear.

Evasion has been defined by the tax authorities as:

> ".....the commission or omission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law, or a conspiracy to commit such an offence. This may be accomplished by the deliberate omission of revenue, the fraudulent claiming of expenses or allowances, and the deliberate misrepresentation, concealment or withholding of material facts."[26]

Prosecutions of multinationals for evasion have not, however, been very numerous, although in R v Myers[27] an individual was prosecuted for siphoning income offshore through two tax haven entities. He was found guilty of tax evasion. Merely using tax havens would not have been enough by itself to substantiate a charge of evasion but here there was an element of deceptions as well.

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25. "The Use of Tax Evasion and Tax Avoidance by Multinational Companies: a Canadian View", CTJ, Volume XXV, No 5, p513
26. Information Circular 73-IOR2, 24 April 1978 para 8
27. (1977) CTC 507

The tax authorities' view of tax avoidance is as follows:

> "The type of cases intended to be referred to the Tax Avoidance Division are restricted to those where the taxpayer has apparently circumvented the law, without giving rise to a criminal offence, by the use of a scheme, arrangement, or device, often of a complex nature, whose main or sole purpose is to defer, reduce or completely avoid the tax payable under the law. Usually a series of transactions is involved which do not truly reflect what is actually happening, and sometimes the avoidance is accomplished by shifting the liability for tax to other taxpayers not at arm's-length in whose hands the tax payable is reduced or eliminated."[28]

Tax planning, on the other hand is considered to include circumstances:

> ".....in which a taxpayer is seeking a beneficial result, [and] has merely selected a certain course of action that is either clearly provided for or not specifically prohibited in the law and has implemented that decision is a real way. Indeed, the Department does not view itself as having any special responsibility in respect of any form of tax planning that consists of a genuine arrangement of one's affairs openly and within the framework of the law so as to keep one's taxes to a minimum."[29]

It can therefore be seen that the tax authorities differentiate between evasion, artificial tax avoidance and tax planning. Although this distinction is relatively clear in theory, in practice the line between avoidance and planning can become blurred. There is perhaps a clearer

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28. Information Circular 73-IOR2, para 50
29. Ibid, para 49

division between evasion and avoidance but, even here, it is sometimes not black and white. Compare, for example, the Myers case with R v Redpath Industries Ltd.[30] The tax authorities had for a number of years been turning their attention to offshore transshipment companies exploited by Canadians. It can be seen from the Dominion Bridge[31] and Spur Oil[31] cases that one line of attack had been based on civil tax remedies. On the other hand, they raised a claim of tax evasion in the Redpath case.

In Redpath it was claimed that the transshipment company activities constituted evasion under section 239(1)(d) of the Income Tax Act which states that:

> "Every person who has.... (d) wilfully, in any manner, evaded or attempted to evade, compliance with this Act or payment of taxes imposed by this Act, is guilty of an offence."

The taxpayer was acquitted in the Quebec Court of Sessions of the Peace because the Crown had not proven that the transshipment company amounted to a "criminal sham". The taxpayer had sought proper legal and accountancy advice before it set up the offshore structure and it had operated that structure in accordance with that advice; there was, therefore, no deceit or misrepresentation. It was found that the taxpayer at no time attempted to hide the facts from the tax authorities and, in fact, it was expressly disclosed to the authorities that it was connected with the offshore company. It was also found that the contracts with the offshore company were real and binding. The Minister's appeal was dismissed.[32]

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30. [1983] CTC 133
31. Infra
32. [1984] CTC 483

Revenue Clearances and Other Published Information

Revenue Canada give advance clearances setting out how they will interpret particular provisions in the light of particular facts. This practice of giving rulings started in 1970 and there is no legislation compelling Revenue Canada to give clearances. Clearances are given only if the parties to the proposed transactions are actually named and a fee is paid.

Rulings used not be given in cases where the transactions did not have a bona fide business purpose or where they are designed for improper tax avoidance, but this restriction has now been dropped. An advance ruling is regarded as binding on Revenue Canada.

Some people think that Revenue Canada sometimes use the rulings system to stop schemes it does not like by refusing to give rulings, rather than by actually bothering to change the law but, on the whole the availability of advance rulings works well and makes a big difference from the position in the UK. Furthermore, the structure of society is different than in the UK. In the words of the Law Society booklet "Tax Law in the Melting Pot":[33]

> "Canada is an open, mobile society where a comparatively small population is still endeavouring to exploit the full potential of the second largest land area in the world. In the light of that background and the fact that the number of capital taxes is fewer than in Britain, the number of complicated tax schemes is notably less in comparative terms."[34]

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33. Supra
34. p72

The point is also made:

> "The existence of the rulings system in Canada does, however, reduce the number of cases where a scheme may have been entered into with a tax avoidance motive and the question of whether the scheme has been successful is only finally decided by litigation many years later, with unforeseen effects on many other transactions."[35]

As well as the Rulings there are various other forms of published information to help taxpayers plan their affairs with a great amount of certainty. These are:

1. Regulations (which are binding)
2. Interpretation notes (published with technical Bills in advance of the main Finance Bill)
3. Interpretation bulletins (their purpose is to give the Revenue Department's interpretation of the law - they are not binding)
4. Technical interpretation letters (written interpretations on hypnothetical transactions).

As in the US, the tax authorities in Canada have a wish to help both taxpayers, by ensuring that taxpayers are more certain as the likely tax consequences of proposed actions, and themselves by cutting down on compliance work and generally ensure the more efficient conduct of commercial transactions.[36]

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35. Ibid
36. See "Tax Law in the Melting Pot" pp38-40

The Stubart Case and the Business Purpose Test

It is interesting to compare the judicial attitudes towards tax planning and tax avoidance in the UK, the USA and Canada. The UK situation is examined in Chapter 11. It has been seen in Part 1 of this Chapter that the USA has, for many years, looked to the substance of a transaction, rather than the form, and there is a highly developed business purpose test. In Canada, on the other hand, the business purpose test was strongly rejected by the Supreme Court in Stubart Investments Ltd v The Queen.[37] It is instructive to consider the effect that this decision had on tax planning in Canada, as compared to the long established situation in the USA and the "new approach"[38] adopted by the courts in the UK.

The facts were that Stubart was a profitable company and it have a sister company, Grover Cast Stone Company, which had made substantial losses in the past. In the United States, groups can submit consolidated returns and in the UK, trading group losses may be transferred within a group. Neither of these facilities was available to Stubart under Canadian law.[39] Therefore, to avoid the wastage of the losses in Grover, Stubart sold its business assets to Grover which, in turn, appointed Stubart as its agent to carry on business on behalf of Grover. It was intended that Grover would reconvey the business to Stubart once the accumulated losses had been used up. In fact, Grover's business was later sold to a third party.

The Department of National Revenue assessed the profit from the business which Stubart had transferred to Grover on Stubart, which appealed.

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37. [1984] CTC 294
38. See Chapter 11
39. Losses can now be utilised by merger; sections 87 and 88 ITA

The Attorney General of Canada, on behalf of the Revenue, argued on two fronts:

1. The transaction was not complete and, therefore, ineffectual.[40]
2. No transaction is acceptable for tax purposes unless it is implemented for a bona fide business purpose.

The findings of the Supreme Court, in finding for the taxpayer, may be summarised as follows:

(a) the transaction was not a sham;
(b) section 137[41] had not been argued and, therefore, was not directly relevant;
(c) the transaction was not incomplete;
(d) there was no extra-statutory business purpose test;
(e) the transaction was not artificial or offensive to the "object and spirit" of the legislation.

The Supreme Court concluded that Canadian tax law did not constain a general business purpose test or a civil law "abuse of rights" principle. As will be seen below, however, the redrafting of section 245 in 1988 incorporated such concepts into Canadian law. In fact, even the original section 245(1) might have made some impact if it had been advanced by the Revenue. This section is examined below.

Mr Justice Estey considered various decisions of lower Canadian Courts on the business purpose test principle. In particular, he referred to the decision of the Exchequer Court in Foreign Power Securities Ltd v MNR[42],

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40. This was the basis for the Revenue's success in the Federal Court of Appeal, infra, but it was rejected by the Supreme Court on the facts.
41. Later replaced by section 245, infra
42. 66 DTC 5012

where the court said that:

> "there is indeed no provision in the Income Tax Act which provides that, where it appears that the main purpose or one of the main purposes for which any transaction or transactions was or were effected was the avoidance or reduction of liability to income tax, the Court may, if it thinks fit, direct that such adjustments shall be made as respects liability to income tax as it considers appropriate so as to counteract the avoidance or reduction of liability to income tax which would otherwise be effected by the transaction or transactions."[43]

Estey J gave what was the unanimous view of the Supreme Court when he stated:

> "The courts may, of course, develop, in their interpretation of section 137, doctrines such as the bona fide business purpose test; or a step-by-step transaction rule for the classification of taxpayers' activities which fall within the ban of such a general tax avoidance provision...... I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose. A strict business purpose test in certain circumstances would run counter to the apparent legislative intent, which, in the modern taxing statutes, may have a dual aspect."[44]

The Supreme Court in the Stubart case reaffirmed the Duke of Westminster doctrine which had been limited in effect in the UK by the adoption of the new approach by the

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43. p 5027
44. (1984) CTC 294 at p314

House of Lords.[45] Wilson J said: "I think Lord Tomlin's principle is far too deeply entrenched in our law for the courts to reject it in the absence of clear statutory authority. No such authority has been put to us in this case."[46]

The Supreme Court had some interesting things to say about the philosophy of tax planning. They observed that Canadian tax law has many provisions that provide tax incentives to undertake certain transactions where "motive would nowhere appear to be a precondition of eligibility" and that this also "applies to the decision of the taxpayer in incorporate or to carry on business in partnership with a corporation.... Whether or not these choices are made solely on the basis of tax advantage, whenever the Income Tax Act prescribes different tax rates for different forms of business, the taxpayer must surely be free to choose whatever mode fits his plans".

The Supreme Court appeared to go even further than this and inclined to the view that the mitigation of tax is itself a business purpose. They cited Ward and Cullity, "Abuse of Rights and the Business Purpose Test"[47] who said:

> "if taxes are minimised or postponed, more capital will be available to run the business and more profit will result. Surely, in the penultimate decade of the 20th century it would be naive to suggest that businessmen can, or should, conduct and manage their business affairs without regard to the incidence of taxation or that they are not, or should not, be attracted to transactions or investments or forms of doing business that provide reduced burdens of taxation."[48]

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45. See Chapter 11
46. p318
47. 29 Canadian Tax Journal 351(1981)
48. pp473-4

The Tax Review Board had dismissed the taxpayer's appeal on the ground that the transaction was a sham, because it was reversible once the tax benefit had been obtained, by reason of the common control over Stubart and Grover. The taxpayer failed on the same grounds before the Trial Division of the Federal Court.

The Federal Court of Appeal also found against the taxpayer but on different grounds. The Court did not feel obliged to consider whether the transaction was a sham.

The Federal Court of Appeal[49] held that the transactions in dispute were not completely carried out. They said:

> "While the elements for a successful transfer of the undertaking of Stubart to Grover were present, the failure to do those things necessary to effectuate the complete transaction deprives it of the reality necessary to conclude that the Minister erred in reassessing the appellant as he did for the taxation years in issue. Support for this conclusion is, of course, derived from the admitted purpose for entering the transaction and the projected resale back to Stubart after utilisation of Grover's tax losses as well as the fact that such resale could readily be accomplished because the directors and, to a large extent I think, the shareholders of each company were the same."

The Supreme Court in Stubart mentioned the UK cases of Ramsay[50] and Furniss v Dawson.[51] Estey J was of the opinion that Ramsay reflects "the role of the Court in a regime where the legislature has annunciated taxing edicts in a detailed manner but has not superimposed

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49. 80 DTC 5020
50. W.T Ramsay Ltd v IRC (1981) 54 TC 101
51. (1984) 55 TC 324

thereon a general guideline for the elimination of mechanisms designed and established only to deflect the plain purpose of he taxing provision."

Estey J noted that the Canadian system differed from the UK system in that, in the former, there is a general anti-avoidance provision aimed at artificial deductions: section 137(1)[52]. In fact, section 137 was not argued by the Government in the Stubart case, presumably because the agency between Stubart and Grover meant that the profits earned from the business transferred to Grover were included in the income of Stubart, but were offset by a deduction when the income was accounted for by Stubart to Grover under the agency agreement.

In trying to avoid the problems of using section 137(1), the Revenue did not rely on the section but argued that a transaction effected only for tax reasons and no business purpose must be a sham. This argument failed in Stubart but this does not mean that section 137(1) will never be applicable; in fact, Estey J's remarks, considered later, would have allowed a more widespread use of the original section 245(1). He said that his guidelines for statutory interpretation were limited to "circumstances where the Crown relies on the general pattern of the Act and not on any specific taxing provisions."

There are a large number of specific anti-avoidance provisions, some of which are dealt with below. Some are charging sections in that they impose tax, whereas others do not impose tax but permit the Minister to determine whether a transaction is taxable or not. When Estey J referred to "specific taxing provisions", he may have meant to exclude the guidelines he set out if an assessment is based on a provision of the Act designed to

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52. Now section 245(1) ITA, infra

deal with a specific course of conduct (for example sections 55, 56(2), 69, 74, 245, 247).[53] If so, the Revenue may argue the relevant specific statutory provision as well as the more general principle.

Estey discussed the anti-avoidance provision in section 137(2)[54] in connection with the case of The Queen v Esskay Farms Limited[55] in which the facts were similar to those in Furniss v Dawson.[56] In Esskay Farms Limited, a trust company was interposed in a sale of land in order to obtain instalment sale treatment. The Government claimed that it could ignore the trust company, but this was rejected by the Court. The Court said that the taxpayer had ordered its affairs "so as to attract a lesser tax at a subsequent time as it is entitled to do." Furthermore, the taxpayer "effected a tax advantage to itself as is its right and accordingly it is incongruous that the advantage should be construed as a 'benefit' to the Defendant within the meaning of section 137(2)"[57] In Stubart, Estey J accepted that the only reason for the interposition of the trust company in the Esskay Farms Limited case was the reduction of tax. Following the reasoning of Estey J through, it seems that the Supreme Court rejected the rules laid down in Furniss v Dawson. Afterall, the transactions in Esskay Farms Limited were as preordained as those in Furniss v Dawson.

Estey J also considered the US case of Gregory v Helvering.[58] He considered that the US and UK tax system were different from the Canadian system because they contained no general anti-avoidance provision similar to s137 and, as a result, the judicial doctrines have been expanded to include a business purpose test which is not

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53. Infra
54. Now section 245(2) infra
55. 76 DTC 6010
56. (1984) 55 TC 324, see Chapter 11
57. p6018
58. 293 US 465 (1935), see Part 1

required in the Canadian tax system due to its general anti-avoidance rules.

Lord Wilberforce in Ramsay indicated that it had been argued that the absence of any general anti-avoidance provision in the UK capital gains tax legislation indicated a Parliamentary intention that only Parliament, and not the courts, should develop rules to cover loopholes in the legislation. Lord Wilberforce rejected this argument.[59] By way of contrast, in Australia, the presence of a general anti-avoidance provision has also been held to be evidence that Parliament did not intend the courts to develop any separate anti-avoidance doctrines of their own.[60]

Estey J asked "What then is the law in Canada as regards the right of a taxpayer to order his affairs so as to reduce his tax liability without breaching any express term in the statute?"[61] His answer was:

> "The presence of a provision of general application to control avoidance schemes looms large in the judicial approach to the taxpayer's right to adjust his sails to the winds of taxation unless he thereby navigates into legislatively forbidden waters. The legislature has provided the standards of unacceptable avoidance procedures, and there being no other limit imposed by the Act, the Court found itself under no duty, nor indeed possessed of any authority, to legislate new limits. Where, as in this appeal, the Act expressly permits the application of accumulated losses to reduce taxes on current and future earnings, the tax collector must

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59. (1981) 54 TC 101 at pp186-7
60. Federal Commissioner of Taxation v Patcorp Investments Ltd 76 ATC 4225 at p4232 per Gibbs J, see Part 3
61. [1984] CTC at p302

demonstrate a statutory bar to succeed."[62]

He therefore rejected the business purpose test. He concluded: "I would, therefore, reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent bona fide business purpose."[63]

The judge further said that a business purpose test was inappropriate partly because of the practice of having annual amendments to the ITA so that the law could easily be amended by the legislature. This practice does not invite the courts to interfere. He also thought a business purpose test to be inappropriate, because:

> "At minimum, a business purpose requirement might inhibit the taxpayer from undertaking the specified activity which Parliament has invited in order to attain economic and perhaps social policy goals...
>
> Indeed, where Parliament is successful and a taxpayer is induced to act in a certain manner by virtue of incentives prescribed in the legislation, it is at least arguable that the taxpayer was attracted to these incentives for the valid business purpose of reducing his cash outlay for taxes to conserve his resources for other business activities. It seems more appropriate to turn to an interpretation test which would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. In short, the tax statute, by this interpretative technique, is extended to reach conduct of the

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62. p305
63. p314

taxpayer which clearly falls within 'the object and spirit' of the taxing provisions. Such an approach would promote rather than interfere with the administration of the Income Tax Act, supra, in both its aspects without interference with the granting and withdrawal, according to the economic climate, of tax incentives. The desired objective is a simple rule which will provide uniformity of application of the Act across the community, and at the same time, reduce the attraction of elaborate and intricate tax avoidance plans, and reduce the rewards to those best able to afford the services of the tax technicians.

In all this, one must keep in mind the rules of statutory interpretation, for many years called a strict interpretation, whereby any ambiguities in the charging provisions of a tax statute were to be resolved in favour of the taxpayer; the taxing statute was classified as a penal statute."[64]

Estey J set out[65] some guidelines for Canadian courts to follow when faced with the question of business purpose in the future:

"1. Where the facts reveal no bona fide business purpose for the transaction, section 137[66] may be found to be applicable depending upon all the circumstances of the case......

2. In those circumstances where section 137 does not apply, the older rule of strict construction of a taxing statute, as modified by the courts in recent years..... prevails but will not assist the taxpayer where:

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64. p315
65. At p316
66. Infra

(a) the transaction is legally ineffective or incomplete: or

(b) the transaction is a sham within the classical definition.

3. Moreover, the formal validity of the transaction may also be insufficient where:

   (a) the setting in the Act of the allowance, deduction or benefit sought to be gained clearly indicates a legislative intent to restrict such benefits to rights accrued prior to the establishment of the arrangement adopted by the taxpayer purely for tax purposes;[67]

   (b) the provisions of the Act necessarily relate to an indentified business function. The idea has been expressed in articles on the subject in the United States:

   > 'The business purpose doctrine is an appropriate tool for testing the tax effectiveness of a transaction where the language, nature and purpose of the provision of the tax law under construction indicate a function, pattern and design characteristic solely of business transactions.'[68]

   (c) 'the object and spirit' of the allowance or benefit provision is defeated by procedure blatantly adopted by the taxpayers to synthesize a loss, delay or other tax saving device, although these actions may not attain the heights of

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67. What the judge means is that the court would not consider necessarily effective attempts made by a taxpayer retroactively to revise or alter the characterisation of income or of other rights and obligations after they have already been created.
68. citing Hellerstein op cit p66

'artificiality' in section 137. This may be illustrated where the taxpayer, in order to qualify for an 'allowance' or a 'benefit', takes steps which the terms of the allowance provisions of the Act may, when taken in isolation and read narrowly, be stretched to support. However, when the allowance provision is read in the context of the whole statute, and with the 'object and spirit' and purpose of the allowance provision in mind, the accounting result produced by the taxpayer's actions would not, by itself, avail him of the benefit of the allowance."

In this last category Estey J appears to be referring to arrangements such as those where the taxpayer attempts to generate a tax loss without a "real" loss as in, for example Ramsay and Eilbeck v Rawling.[69]

After setting out the above guidelines, Estey J said:

> "These interpretive guidelines, modest though they may be, and which fall well short of the bona fide business purpose test advanced by the respondent, are in may view appropriate to reduce the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally guided and equally specialised taxpayer reaction. Otherwise, where the substance of the Act, when the clause in question is contextually construed, is clear and unambiguous and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question."

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69. (1981) 54 TC 101, see Chapter 11

Estey J considered there to be a better alternative to a business purpose test. He said:

> "It seems more appropriate to turn to an interpretation test which would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. In short, the tax statute, by this interpretive technique, is extended to reach conduct of the taxpayer which clearly falls within the object and spirit of the taxing provisions. Such an approach would promote rather than interfere with the administration of the Income Tax Act, in both its aspects without interference with the granting and withdrawal, according to the economic climate, of tax incentives."

Case Law After Stubart

The Stubart decision was not concerned with section245(1)[70] and it did not deal with its scope and applicability. The court rejected the business purpose test as an independent anti-avoidance principle. However, the existence or otherwise of a bone fide business purpose may determine whether an expensive is "artificial" in the context of section245(1).

After the Stubart case the first case in which section245(1) was argued was Edmonton Liquid Gas Ltd v The Queen.[71] Here the taxpayer, in 1974, prepaid the anticipated costs of drilling oil wells which were substantially drilled in a later year. By a change of the law proposed in the November 1974 Budget, the drilling expenses were 100% deductible and the agreements to prepay the drilling costs was made shortly afterwards.

It was argued by the Crown that the prepaid costs amounted to an artificial reduction of income within section245(1) and should be disallowed. It was held by the Federal Court of Appeal that section245(1) did not apply because all that the taxpayer had done was to take advantage of a new government policy and the deductions claimed were fully in accordance with the object and spirit of the provisions.

The Edmonton Liquid Gas case reaffirmed the principle in The Queen v Alberta Southern Gas Co Ltd,[72] in which it was held that , where provisions have the clear purpose of encouraging taxpayers to enter into particular types of expenditure, a taxpayer who comes within the object and spirit of the provisions cannot be said to reduce his

70. Infra
71. 84 DTC 6526
72. 78 DTC 6566. See also The Queen v Parsons and Vivian [1984] CTC 354, infra

income unduly or artificially just because he was induced to incur the expenditure by tax considerations.

The Stubart and Edmonton cases showed a trend in the taxpayer's favour. A change of direction was suggested in the case of Consolidated-Bathurst Ltd v The Queen. This was a decision of the Federal Court of Canada,[73] which was partially reversed by the Federal Court of Appeal.[74]

The taxpayer company manufactured pulp, paper and packaging. It had incorporated, through a Canadian subsidiary, a Bermuda resident insurance company. Overseas Insurance Company ("OI"). This was in the early 1970's. The taxpayer company then reinsured various risks with OI, either directly or through the purchase of insurance policies with Canadian insurers, who then reinsured such policies with OI. Between 1971-1974, the Canadian insurers insisted that the taxpayer company indemnify them should OI not meet any claim pursuant to the reinsurance policies. OI also arranged bank letters of credit in favour of the Canadian insurers which were secured by deposits of OI with a Canadian bank. The letters of credit were also guaranteed by the taxpayer company to the bank. In 1975, although OI provided a letter of credit to the Canadian insurer, there was neither an indemnity not a guarantee supporting it.

The Revenue attacked this arrangement in two ways. The first was that it disallowed such of the taxpayer company's premiums as were retained by OI in excess of

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73. 85 DTC 5120
74. 87 DTC 5001

the claims paid by OI. It claimed that the company had created a reserve in the hands of OI contrary to section 18(1)(e) which read:

> "In computing the income of a taxpayer from a business or property no deduction shall be made in respect of...... an amount transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by this Part."

The Revenue also sought to disallow the deduction under section 245(1),[75] which, as mentioned above, was not argued by the Revenue in Stubart.

The second line of attack was to assess the taxpayer company to tax on the income earned by OI on the basis that the services it provided were not insurance services but were part of a scheme of self-insurance "whereby the [taxpayer company] established a fund to bear its own risks to the extent that these risks were not allocated to non-related insurers and reinsurers."

It was accepted that the transactions were not shams and that the documentation was effective.

The Court found for the Revenue on the deductibility of premiums question; but for the taxpayer company on the taxability of the interest question.

The judge, Strayer J, considered the Stubart case. He said:

> "I am now bound by the decision of the Supreme Court of Canada in Stubart Investments Limited v HM The Queen [1984] 84 DTC 6305, since followed by the Federal Court of Appeal in HM The Queen v Parsons & Vivian [1984] CTC 354. In the Stubart case the

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75. Infra

Supreme Court held that a transaction may not be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose. While the Court recognised that the lack of such purpose might bring a taxpayer within what is now subsection 245(1), that provision was not relied on in the Stubart case. This means, apparently, that not only is a taxpayer not precluded from arranging his affairs to minimise his tax, i.e no bona fide business purpose. But I take a corollary of this to be that the presence of a bona fide business purpose does not immunise the taxpayer from tax liability, if the transaction otherwise attracts tax. So I think this issue need not be considered further."

The judge's view was, then, that a bona fide business purpose did not prevent section245 applying. He said "the absence of a bona fide business purpose is not a condition precedent to the application of section245(1) if artificiality is otherwise established." On the deductibility of the insurance premiums under section245(1), the judge said that he had to consider whether the insurance arrangements made by the Canadian corporation accord with normal concepts of insurance, or whether the premiums paid to the Bermudian subsidiary should be non-deductible as artificially reducing the income of the Canadian corporation.

He continued:

"One can only infer that OI 'had to do whatever its parent said', as the Supreme Court put it in the Covert case, and that that parent (St. Maurice) had to do what its parent (Consolidated-Bathurst) said. There was certainly nothing in the evidence to suggest that OI had ever diverged from the implementation of the Plaintiff's plan for risk management..... Therefore the 'insurance program' must be seen as a device for channelling funds from the Plaintiff to one of its own instrumentalities over which it had complete control, and to which it would have to look to pay losses retained by OI. Any funds available in OI would be funds having their origin with the Plaintiff. Any surplus OI might enjoy would ultimately be under the control of the Plaintiff as the sole shareholder of the sole shareholder of OI. Any losses which OI did not have assets to cover would have to be borne by the Plaintiff. The net result is similar to the establishment of a reserve fund by any institution or corporation from which it would plan to pay for uninsured losses to its property...... Therefore I conclude that the so-called 'premiums' paid by the Plaintiff in respect of risks for which its instrumentality, OI assumed the responsibility, were disbursements which would artificially reduce the income of the Plaintiff and are, therefore, not deductible from its income, pursuant to subsection 245(1). In fact such disbursements were in effect amounts transferred to a reserve fund and are, therefore, not deductible by virtue of paragraph 18(1)(e) of the Income Tax Act."

This approach is similar to that taken in the UK and the USA in connection with premiums paid to captive insurance companies.[76]

Therefore, on the insurance arrangements, the court, in determining whether they were normal or artificial, considered itself free to pierce the corporate veil to examine the true economic relationship between Consolidated-Bathurst and its subsidiaries. The court held that the arrangements did not constitute true

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76. See Chapter 9

insurance contracts, relying on three US cases: Helvering v Le Gierse,[77] Carnation Corp v Commissioner,[78] and Stearns-Roger Corp Inc v US.[79]

The judge referred to the words of Estey J in Stubart on the object and spirit of the provisions.[80] The judge then said:

> "Parliament having specifically precluded in paragraph 18(1)(e) of the Income Tax Act the deduction from income of the amounts transferred to a reserve fund, I cannot think it was Parliament's intention that such a proscription should be capable of avoidance if the taxpayer can assemble a sufficient array - one not normally available to individuals or small businessmen - of advisers and offshore management firms to create what, if in legal form is an insurance scheme, is in reality a reserve fund for repair or replacement of uninsured property."[81]

The decision of Strayer J was partially reversed in the Federal Court of Appeal.[82]

The Federal Court of Appeal rejected the "economic family" principle emanating from the US cases of Carnation and Stearns-Roger Corp on which Strayer J had relied. They held that, by virtue of the indemnities and guarantees in the years 1971-1974, there was no shifting of risk, with the result that no insurance protection was purchased and the deduction of the premiums paid resulted in an artificial reduction in the taxpayer company's income.

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77. 312 US 531 (1941)
78. 640 F.2d 1010 (1981)
79. 577 F.Supp 833 (1984)
80. Infra
81. 85 DTC 5120 at p5126
82. 87 DTC 5001

Stone J, giving the judgment of the court said:

> "The [Revenue] urges that these payments constitute a 'reserve' within paragraph 18(1)(e) of the Act and the learned trial judge agreed. There seems to me, however, no necessity of characterising the payments in that or any other particular way. It is sufficient to say that they cannot be regarded as insurance premiums deductible against income. This follows because in the circumstances they were abnormal payments whose deduction would 'artificially', reduce income within the test of artificiality set forth in the Shulman case.[83] A contract of insurance is a contract to indemnify an insured for losses incurred to the full extent provided in the contract according to its terms and conditions. In my view, an arrangement or condition whereby an insured may be required to absorb any portion of the loss for which indemnify is so provided does not result in bona fide insurance protection. Monies paid as premiums therefor may not be deducted from income as business expenses."[84]

However, the premiums paid by the taxpayer company in 1975 were held to be deductible because OI had by then built up substantial assets and so the taxpayer company did not have to give either an indemnity or a guarantee.

The lower court had not considered that the absence of an indemnity and guarantee was sufficient to shift the risk from the taxpayer company to OI. However, as mentioned above, the Federal Court of Appeal rejected the "economic family" principle and, at the same time, strongly repudiated the view that a court could pierce the corporate veil. Stone J stated that:

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83. Shulman v MNR [1961] CTC 385, infra
84. pp5005-6. The definition of "artificial" in section 245(1) is dealt with, infra

"..... the concept of 'economic family' has been neither authoritatively established nor universally accepted. In this Court for the first time the [taxpayer company] relies on a decision of the High Court of the Netherlands rendered August 21, 1985 (Court Roll No 22929). The parties are not identified by name. As I understand, a domestic business concern placed its insurance requirements and those of its other companies with an offshore subsidiary incorporated under the laws of the Netherlands Antilles. It was assessed to tax liability on the basis that risks were not covered by insurance and that no business relationship existed between the parent and the offshore subsidiary. The Court disagreed, saying at page 26 of the certified translation handed to this Court:

> 'For the rest, the argument is based on the view that with companies belonging to one group for the purpose of corporation tax, no attention should be paid to the transfer of risks to a company belonging to the group by means of premium payment, since in this case, these risks remain inside the concern.
>
> This view is not correct. If and in so far as in a group relationship a premium is charged for the transferred risk, based on normal business practice - and therefore is not influenced by the relationship itself within that concern - allowance should be made for the premium payment when corporation tax is levied.'

While care must be taken in the treatment to be given this case decided under foreign laws with which we are not familiar, it may be seen as rejecting the 'economic family' concept. As I see it, adoption of that concept would amount to a wholesale disregard of separate corporate existence regardless of the circumstances in a particular case. I find that to be unacceptable."[85]

The Federal Court of Appeals, therefore, took little notice of the US cases relied on by Stayer J. This is not surprising given the fact that there is no statutory provision similar to section 245(1) in the US Internal Revenue Code. In any case, in Clougherty Packing Co v Commissioner,[86] the US court denied deductions for premiums to captive insurance companies on the basis that there was no shifting of risk, rather than on the "economic family" principle.

The actual decision in Consolidated-Bathurst is no longer of practical relevance because, since 1976, the foreign accrual property income ("FAPI") rules have provided that premiums received in respect of a Canadian risk by a controlled foreign captive insurance company fall within the FAPI rules if they are paid directly to the controlled insurer[87] and, since 1981 amounts paid indirectly through another insurer have also been caught. As has been seen in Chapter 9, income caught by the FAPI rules is attributed to the Canadian shareholders.[88]

Despite the FAPI rules. Consolidated-Bathurst is still important for its rejection of the "economic family" principle and of the Spur Oil definition of "artificial" in section 245(1).[89]

In their study "Tax Law in the Melting Pot", the Revenue Law Committee of the Law Society commented on this case that:

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85. p5007
86. 87-1 USTC 9204 (9th Cir 1987)
87. Section 95(2)(b) and (3)
88. Section 91(1)
89. Infra

"Canadian practitioners therefore doubt whether Stubart has effectively killed the business purpose test, as Consolidated Bathurst has shown that, it has relevance in connection with the artificiality provisions of section245(1)."[90]

The study also commented that Revenue Canada, in fact, do appear to take the view that there is no business purpose test in Canadian tax law. On 26 November 1984 the Minister of National Revenue, Hon Perrin Beatty stated to the 37th Tax Conference of the Canadian Tax Foundation:

"Over the years this position was reinforced by the Courts which seemed to support the concept that there was in income tax law a business purpose test. This controversy has now been put to rest by the Supreme Court of Canada in the recent case of Stubart Investments Limited which clearly found that there is no such test in Canadian income tax law unless it is specifically required in a statutory provision."

The study booklet noted that the Minister went on to say that the rulings service should now encompass the business view that taxes are costs to be reckoned with, "in recognition of the frustration being experienced by the private sector who are unable to obtain certainty with respect to legal tax planning."[91]

The study concluded by saying:

"It should, however, be noted that, specific statutory provision and arguments apart, Estey J still required that the taxability of transactions should be decided in the light of the object and spirit of the statute. This is therefore a broad

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90. p71
91. Taxpayers in the UK would no doubt echo this sentiment

view of the statutory interpretation of the case. The judiciary appears able to strike down transactions they feel socially undesireable and some Canadian commentators feel that there may still be scope for a business purpose doctrine in transactions which involve complex steps. As our Canadian correspondent commented when dealing with artificiality: 'Such tests when applied by the judiciary often produce results less than satisfactory in terms of certainty due in part to the reality of the continuing evolution in judicial approach'."[92]

The next important case to consider on this subject is Indalex Ltd v The Queen,[93] which was a decision of the Federal Court Trial Division which concerned the Canadian transfer pricing rules.[94] Revenue Canada alleged that Indalex Limited, a Canadian company, paid excess prices to a related company established outside Canada which acted as an intermediary between Indalex and an independent Canadian vendor.

The overseas company, Pillar International Services Limited, was no more than a middleman between two unrelated Canadian companies, Indalex and Alcan Ingot. For this reason, the transaction was not simply attacked under the transfer pricing rules of section 69(2) of the Income Tax Act, but also on wider grounds. Revenue Canada used the following arguments:

1. The interposition of Pillar could be ignored as a sham so that its profits could be added to the profits of Indalex. This argument was based on the Dominion Bridge case.[95]

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92. pp71-2
93. 86 DTC 6040
94. See Chapter 9
95. Dominion Bridge Co Ltd v The Queen 77 DTC 5367, infra

2. It was argued that the purchases were made pursuant to an incomplete contract, in other words, the doctrine of ineffective transactions was sought to be applied with the result that payments made by Indalex to Pillar could be ignored and added back to the income of Indalex.

3. The payments by Indalex to Pillar should be disallowed under section 245(1).

4. The inter-company pricing rule of section 69(2), coupled with section 67, was argued.

The Court rejected the sham doctrine and the argument that the transactions were legally ineffective (distinguishing the Dominion Bridge case). The Court further found that section 245(1) did not apply to inter-company pricing cases such as the one in question except to the extent that the price paid exceeds an arm's length price, based on the Spur Oil case.[96] Therefore, despite the arguments of Revenue Canada, the case was decided on the inter-company pricing rules of section 69(2) and here the Court found that the price paid was excessive.

The way the Court dealt with the various arguments of the Revenue deserves fuller comment.

1. Sham/Business Purpose Test.

The Revenue claimed that the transactions should be ignored as a sham because they lacked business purpose. This was rejected by the Court, citing the Stubart case. Madame Justice Reed said:

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96. Spur Oil Co Ltd v The Queen 81 DTC 5168, infra

> "Thus the sham test when applied as a general principle of statutory interpretation requires that for a transaction to be disregarded by the Court it must exhibit an element of deception, not merely to be found to have no business purpose other than tax avoidance."[97]

On the facts, it was held that no such deception took place in this case.

The Dominion Bridge case,[98] which also involved the purchase by a Canadian company of raw materials supplied through an offshore intermediary, was, as mentioned above, distinguished. In the Dominion Bridge case the operations of the intermediary were held to constitute a sham. In that case the offshore company was controlled in virtually every respect by the Canadian company, but great care was taken to give the pretence that the intermediary was an independent company. The intermediary was not manned by any staff with any expertise in steel purchasing (it was managed by officers of a trust company) and its staff always acted under instructions from the Canadian company. Decary J said:

> "The fact that the Appellant always controlled every step of the operations of Span [the offshore intermediary] from the purchase price to the selling price of offshore steel, that the Appellant paid Span the price of domestic steel for offshore steel, the latter steel having a lower fair market value, and the power the Appellant had to control the Board by virtue of Article 74 of the Articles of Association of Span show that the purpose of the incorporation of Span was a sham and that its

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97. p6045
98. Infra

operations were also a sham because, in point of fact, these operations were those of the Appellant and consequently the expenses and disbursements of the Appellant pertaining to the creation and the operations of Span and the income of Span from interest and dividends are as feigned as the creation and operations of Span."[99]

However, there was no finding of a sham in the Spur Oil case even though the Court of Appeal said:

"It was never intended that the officers and directors of Tewpin [the offshore intermediary] in Bermuda would exercise management and control of Tepwin's business in any aspect.... instead they were to carry out the instructions given by the officers and directors of the US parent and, to a lesser degree in certain matters, the instructions given by the officers and directors of the Canadian parent and the Appellant."[100]

2. Incomplete Transaction Doctrine

The Revenue argued that the purchases by Indalex from Pillar were ineffective and that the underlying contract was incomplete. However, on the facts, it was found that the contract was enforceable despite the somewhat informal nature of some of the arrangements.

3. Section 245(1)

On the Revenue's arguments based on section 245(1), the Court followed the Spur Oil case. In that case the Federal Court of Appeal said that:

"...... the finding of artificiality in the transaction being examined, does not, per se, attract the prohibitions set out in

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99. 75 DTC 5150 at p5154
100. 81 DTC 5168 at p5169

subsection 137(1) of the Income Tax Act[101]... To be caught by that subsection, the expense or disbursement being impeached must be in an artificial or undue reduction of income, 'undue' when used in this context should be given its dictionary meaning of 'excessive'. In the light of the Crown's concession referred to supra, that under the Tewpin contract, the Appellant would be paying slightly less than fair market value, it cannot be said that the Tewpin contract and the Tewpin charge result in an excessive reduction of income."[102]

On this interpretation., "undue", in cases such as Indalex and Spur Oil, where there is a transshipment arrangement, comes down to an issue of arm's length prices under section 69(2). Madame Justice Reed in Indalex found that section 245(1) required not only a finding of artificiality but also a reduction of income. This interpretation also found favour with the Federal Court Trial Division in the Consolidated Bathurst case (which, as has been seen, involved a captive insurance company rather than a transshipment company).

Madame Justice Reed therefore held that the issues in the Indalex case were reduced to a consideration of sections 67 and 69. She said:

> "Thus, subsection 245(1) will only be applicable if the price paid by the plaintiff to Pillar International resulted in a reduction of income otherwise payable. The sole issue becomes a determination as to the reasonableness of the price paid or fair market value under sections 67 and 69."[103]

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101. The predecessor to section 245(1), infra
102. 81 DTC 5168 at p5173
103. p6046

4. Section 69(2)

Once the issue had been reduced to a question of whether the price paid by Indalex was excessive, the Court found, on the facts, that the price was excessive and reallocated 80% of the profit to Indalex.

The Federal Court of Appeal[104] not only rejected the taxpayer's appeal but upheld the cross-appeal by the Crown on the allowance of 20% of the markup. Therefore, all of the profit was reallocated to Indalex.

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104. 88 DTC 6053. On the transfer pricing question, see also Irving Oil Ltd v The Queen 88 DTC 6138, which is dealt with in Chapter 9.

Anti-Avoidance Doctrines

As in the USA and UK there are various judicial anti-avoidance principles used, to a greater or lesser extent, by the courts. The rules used by the Canadian judges are now briefly considered.

The Substance Doctrine

This is recognised in Canada but, as in the USA and the UK, it is a nebulous concept which can be difficult to pin down. What is clear is that nomenclature cannot prevail over the underlying realities. The same is true in the UK.[105] Beyond that it can be said that the form of the transactions can be set aside in favour of the substance if the parties do not intend that the rights and obligations suggested by that form will apply to them. In those circumstances, the rights and obligations will correspond with what the parties intended. For example, in Dominion Taxicab Association v MNR,[106] the Supreme Court said that "in considering whether a particular transaction brings the parties within the terms of the Income Tax Act its substance rather than its form is to be regarded."

In the Stubart case,[107] the Supreme Court found that the substance and the form of the transaction were the same (the transfer of the profitable business to Grover).

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105. See Chapter 11
106. 54 DTC 1020
107. Supra, see also Siebens v MNR, 71 DTC 5310; Gibson v MNR, 57 DTC 1119; West Hill Redevelopment Co v MNR, 69 DTC 5385; and Front & Simcoe Ltd v MNR (1960) Ex CR 350, in which the Exchequer Court refused to recognise the form of a transaction as it was only a mask to hide another transaction. The form of the transaction was, it was claimed, damages for the cancellation of a lease, but the Court held that the sums were in fact prepaid rent under a lease.

The Sham Doctrine

The Canadian courts have adopted the UK concept of the sham and have tended to follow the definition in Snook v London and West Riding Investments Limited.[108]

Accordingly, unlike the US concept, a "sham" in Canada is where the parties are seeking to deceive others, normally the tax authorities, that transactions are something different from what they really are. As a result, the doctrine is not often applied in cases of tax avoidance where the legal rights and obligations, whether they are held to work or not, are not normally hidden behind a facade.

In the Stubart case, Estey J, in the Supreme Court, said, in relation to the sham argument, "there is, in short, a total absence of the element of deceit, which is the heart and core of a sham".

It has been seen that, in that case, the Tax Review Board dismissed the taxpayer's appeal on the ground that the transaction in question was a sham because it was reversible. The Supreme Court, however, disagreed. They held that the question as to whether a particular transaction was complete was separate from the question of whether it was a sham, because a sham transaction was either one conducted with an element of deceit so as to create an illusion calculated to lead the tax authorities away from the taxpayer or the true nature of the transaction, or, alternatively, it involved simple deception whereby the taxpayer created a facade of reality quite different from the disguised reality.

Not surprisingly, there is some overlap between the sham doctrine and other principles. For example the

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108. [1967] 1 All ER 518, see Chapter 11

"ineffective and incomplete transaction doctrine" (MNR v Shields,[109] and Ablan Leon v MNR)[110], agency (Dominion Bridge Co Ltd v The Queen)[111]; the "step transaction" doctrine (Susan Hosiery No 2 v MNR).[112]

Piercing the Corporate Veil

The related doctrine of "piercing the corporate veil" is also recognised in Canada in certain circumstances, as is demonstrated by the case of Dominion Bridge Company Limited v The Queen[113] in which an offshore company was ignored because it lacked viability.

This case perhaps marks the point furthest away from the Duke of Westminster principle.[114] In that case, a Canadian resident corporation whose business consisted of the purchase and fabrication of steel, incorporated a wholly-owned subsidiary in the Bahamas. The subsidiary was to take over the steel purchases from foreign suppliers formerly done from Canada. The Bahamian company would then resell the steel to its Canadian parent at a substantial mark-up.

The Crown attacked this arrangement under section 137 on the basis that the payment to the Bahamian company by the Canadian parent was a disbursement which artificially reduced the Canadian company's income, because the Bahamian company was a sham vis-a-vis the Revenue. The Trial Division and the Federal Court of Appeal held that the subsidiary was indeed a sham. The Trial Judge, Decary J stressed the tax avoidance motive. He said: "If the Appellant had been content with paying fair market value for offshore steel plus a customary commission..... the result might have been different." This is similar

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109. 62 DTC 1343, infra
110. 76 DTC 6280, infra
111. 77 DTC 5367, infra
112. 69 DTC 5347, infra
113. Supra
114. Duke of Westminster v IRC (1935) 19 TC 490, see chapter 11.

to a business purpose test. The two courts did not consider any provisions of the Income Tax Act because they held that, on the facts, the Bahamian company had no legal existence.

In Spur Oil Co Ltd v The Queen,[115] the facts were that a Canadian company, which had previously purchased oil from an associated company, started to buy it at a higher price from a Bermudian company which was wholly-owned by the parent (resident in Canada) of the Canadian company. The Trial Division[116] held that the additional cost was not deductible as the new arrangements were artificial transactions within section 137(1), and that the management and control of the Burmud company was not in Bermuda but was really divided between the US and Canada, and that the oil was still being sold under the original agreement.

The Federal Court of Appeal reversed the finding of the lower court on the basis that the new price was below the then market price and that, therefore, it could not be said to be excessive. Furthermore, the transactions had been properly effected and so the reduction in income was neither fictitious nor simulated.

The court held that section 137 did not prevent a taxpayer from generating the same profit from a transaction with an affiliate as it would from a similar transaction with a third part at arm's length. The section would only have applied if the cost of the oil "by reason of an act of the Appellant or those controlling it, increased above the cost prevailing in the industry at the same time and under the same circumstances."

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115. 81 DTC 5168
116. [1980] CTC 170

H. Stikeman in "Furniss v Dawson : The Canadian Approach"[117] commented that this was "a business test" not "a business purpose test". On the Spur Oil case he said:

> "With Spur it looked as if the millennium had been reached in terms of transfer pricing cases at least, and it seemed that the market-place was to be the measure of the propriety of the amount sought to be deducted in a non-arm's length transaction. Nevertheless, the Crown continued to persist in its attempts to impose tax on profits from situations which it considered to be, if not illegal, at least objectionable. In doing so it abandoned, for a time, reliance on subsection 245(1), ie. the disallowance of deduction in respect of disbursements or expenses relating to transactions or operations that 'if allowed would unduly or artificially reduce the income.' Instead the Revenue turned to an extra-statutory doctrine: 'the business purpose test'."

For a detailed history of the business purpose test see Estey J in Stubart [1984] CTC 294 at pp308-311.

It has been seen above that, the Federal Court of Appeal strongly rejected the "economic family" principle and its inherent piercing of the corporate veil on purely substance grounds and the importation of US doctrines in <u>Consolidated-Bathurst v The Queen</u>.[118]

Nevertheless, it remains possible to pierce the corporate veil on other bases such where the corporation in question lacks viability or under related concepts such as agency. Similarly, other entities may be disregarded

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117. "Fiscal Studies" February 1986 p82 at p85
118. Supra

because they have not be validly set up in the circumstances. For example, purported partnerships were set aside in MNR v Shields[119]; and Ablan Leon v MNR.[120]

Agency

As in the UK and the USA, transactions in Canada can be attacked on the basis of agency or nomineeship. A typical example of this is where the courts have held that a tax haven subsidiary has acted as the agent of its Canadian parent as in the Dominion Bridge case.[121]

Another aspect of the same concept is the "puppet" corporation where a subsidiary merely acts on the instructions and under the influence of the parent. Here, the separate existence of the "puppet" subsidiary might be ignored.

Cases in which the "agency" principle have been discussed include Pigott Investments Ltd v The Queen;[122] Natural Retreats of Nova Scotia Ltd v MNR;[123] L. Berman & Co v MNR;[124] and Heap and Partners (Nfld) Ltd v MNR.[125]

Incomplete Transaction Doctrine

The doctrine of ineffective or incomplete transactions is also recognised by the Canadian Courts. It has been expressed in the Federal Court of Appeal in connection with tax avoidance transactions in the following way:

> "...... it is the duty of a court to carefully scrutinise everything that a taxpayer has done to ensure that everything which appears to have been done, in fact has been done in accordance with

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119. 62 DTC 1343
120. 76 DTC 6280
121. Supra
122. [1973] CTC 693
123. 79 DTC 391
124. 66 DTC 772
125. 61 DTC 1150

applicable law. It is not sufficient to employ devices to achieve the desired result without ensuring that those devices are not simply cosmetically correct in form, but in fact, are in all respects legally correct, real transactions."[126]

A taxpayer must, therefore, fully document the transactions he implements and carry out all steps necessary to implement them (for example, transfer title properly and obtain any appropriate government licences), otherwise the courts will disregard the transaction.

There is a clear distinction between ineffective transactions and shams. With the former concept, what was intended by the parties was never actually achieved; whereas, with a sham, a transaction would be completed but it would be a facade to hide a different transaction.

On the doctrine of ineffective or incomplete transactions, particularly in an international context, see, for example, Richardson Terminals Ltd v MNR[127]

Here, a corporation purported to be acting as agent for an associated company in the business of dealing in grain. The associated company had brought-forward losses. The business was carried on in the name of the first company and all contracts were in its name. Although there was an agency agreement, the associated company did not change its constitution to allow it to carry on the grain business and it did not have the appropriate licence to do so. The court held that the profits generated by the business belonged to the first company, not the associated company.

Whatever the parties' intention may have been, they had not carried that intention through by means of complete

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126. Atinco Paper Products v The Queen 78 DTC 6387 at p6395 per Urie J
127. 72 DTC 6431

transactions.[128]

The Step Doctrine

Canadian courts have not generally adopted the doctrine of "step transactions" which is used in the USA and now, to a certain extent, in the UK, under which tax consequences are determined by the end result of a series of transactions, ignoring intermediate steps. However, the Canadian courts have used it in cases involving pre-ordained and dependent steps in blatant tax avoidance schemes, and have examined the entire series of transactions to discover the true tax consequences, rather than the tax effects of each transaction.

For example, in Susan Hosiery No 2 v MNR,[129] the taxpayer corporation set up a pension plan for four senior executives. The corporation borrowed $200,000 from a bank and paid it to the pension fund trustees. The pension plan was immediately wound up and the trustee made single lump sum payments to the executives who were entitled to certain tax advantages in respect of those payments. The executives then loaned the lump sum payments back to the corporation which, in turn, repaid its bank loan.

The court held that the transactions were a sham and that no bona fide pension plan was ever established; it was held that the parties did not intend to set up any legal rights or obligations under the plan.

In the case of Smythe and Day v MNR[130], a complex series of transactions was undertaken with the purpose of converting a taxable distribution into a tax free capital

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128. See also Kingsdale Securities Co Ltd v MNR 74 DTC 6674; Gait Paper Products Ltd v MNR [1975] CTC 10; The Deltona Corporation v MNR 73 DTC 5180; and Stubart Investments Ltd v The Queen, supra
129. 69 DTC 5346, see also West Hill Redevelopment Co Ltd v MNR, supra
130. 69 DTC 5361

gain. The Supreme Court found that, in substance, there had been a distribution of undistributed income and that there had not been a sale of the shares which the taxpayer had asserted was a capital transaction.

Abuse of Rights

This doctrine originally found no place in Canadian Law, being essentially a civil law doctrine. Quebec does have a civil law system but that had not caused the abuse of rights doctrine to be developed in Canada.

However, when section 245 was recast in 1988,[131] an abuse of rights doctrine was effectively incorporated into Canadian tax law for the very first time. It remains to be seen what the Canadian courts will make of this alien concept.

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131. Infra

Anti-Avoidance Provisions

Compared with the UK, there are few provisions in the Canadian tax code which grant relief only where tax avoidance is not the only or main purpose. In fact the only ones are sections 103, 245, 246 and 247.[132]

Set out below is a description of the main anti-avoidance provisions in Canada. It will be seen that, with one major exception, they are specific. the exception is section 245 which was redrafted in 1988 to become a general anti-avoidance provision.

The main anti-avoidance sections in Canada can be divided in certain categories depending on their subject-matter.

It will be seen that many of the sections are similar to UK provisions, but there is a major difference; as well as the specific legislation, whether drafted in narrow or wide terms, there is the general anti-avoidance provision unlike anything in UK tax law.

The Fair Market Rule

The ITA contains a fair market rule which applies to transactions not at arm's length. If a taxpayer acquires an asset from a person in a non-arm's length transaction, and he pays an amount in excess of market value, he is deemed to have acquired it at fair market value. On the other hand, if he disposes of an asset in a non-arm's length transaction for less than market value, he is deemed to have received market value for tax purposes: section 69.

This section also covers the situation where a taxpayer transfers property at an undervalue to an unrelated

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132. Infra

corporation or partnership as part of a series of transactions intended to use deductions or losses of the transferee to shelter accumulated gains on the property in question. In these circumstances, the taxpayer is deemed to have disposed of the property at market value.[133]

Non-arm's length persons are defined by section 251(1) as persons who are either "related" within the meaning of section 251(2), or unrelated parties who in fact do not deal at arm's length, a condition which the courts consider to arise where the parties do not have separate economic interests or where one imposes its will upon and dominates the actions of the other. Under section 251(2), "related" persons include a corporation which controls another or two corporations controlled by the same third party.

There are similar provisions to this in the UK, of course. For example, see section 29A and 62 CGTA 1979[134] and, in an international context, section 770 ICTA 1988.[135]

Capital Gains

In addition, however, there is a more general provision aimed at defeating tax avoidance where the result of one or more sales, exchanges, declarations of trust or other transactions is that a taxpayer has disposed of property under circumstances such that he may reasonably be considered to have artificially or unduly reduced the gain, created a loss, or increased the loss from a disposition. In these circumstances, the taxpayer's gain or loss shall be computed as if the reduction, creation, or increase had not occurred: section 55(1).

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133. For a more detailed examination of this section see Part 3 of Chapter 9
134. See Chapter 8
135. See Chapter 9

Section 55(1) is one of a number of provisions[136] which are widely drafted but which deal with a specific type of scheme which the legislature wishes to stop. Because of the general nature of these provisions, the Revenue have the means to put a stop to the scheme, but the legislation does not spell out the means to establish the substituted transaction upon which the taxpayer will have to pay tax; thus the use of the word "reasonably", which gives the courts plenty of scope in interpreting the section.

Another provision, which is more specific, is aimed at preventing taxpayers from converting taxable capital gains on the disposal of shares into tax-free intercompany dividends: <u>section 55(2)-(4)</u>.

Where a Canadian company receives a taxable dividend in respect of which it is entitled to a tax deduction, as part of transaction or a series of transactions, one of the purposes of which is to effect a significant reduction in the capital gain which, but for the dividend, would have been realised on a disposal at market value, the recipient is normally deemed not to have received the dividend, but is instead deemed to have realised a capital gain equal to the amount of the dividend.

There are other provisions which deem a capital loss from particular transactions to be nil. For example, there is a "superficial loss" rule which deems a loss to be nil where a taxpayer, his spouse or a controlled corporation acquires identical property to that disposal of, or the disposed-of property itself, within 30 days of disposal. This is to prevent disposals and reacquisitions to realise accrued losses (namely, "bed and breakfast" transactions). The loss is not lost altogether, but

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136. Section 247(2), infra, is another.

merely deferred because an amount equal to the loss is added to the base cost of the property.[137] Also, where a corporation disposes of property to a person who controls it, or to another corporation controlled by him, the loss is again rolled-over.[138] Losses are disallowed on the disposition of debts that did not arise solely for the purpose of producing income,[139] and there are provisions preventing a taxpayer from transferring capital gains or losses to a spouse. The subsequent gains or losses made by the spouse are deemed to be realised by the taxpayer.[140]

Expenses

Section 67 states:

> "In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.

This provision is not, in fact, widely used and it restricted to provocative cases.

Another section which originally related to expenses has, in effect, been turned into a general anti-avoidance provisions: section 245(1).[141]

Section 78 contains two anti-avoidance provisions concerning expenses. The first applies where an amount in respect of a deductible expense is owing by the taxpayer to a person with whom he is not at arm's length and it is still unpaid two years after the end of the tax year in which the expense was incurred. The other

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137. Sections 40(2)(g)(i), 53(1)(f) and 54(i)
138. Sections 40(2)(e), 53(1)(f.1)(f.2) and 85(4)
139. Section 40(2)(g)(ii)
140. Section 74
141. Infra

provision applies where such an amount is owing by the taxpayer to a person as remuneration and remains unpaid one year after the end of the tax year in which it was incurred. In each case the amount in question is either included in the debtor's income or the debtor and creditor may elect for the amount to be deemed to be received by the creditor.

An expense can also be disallowed if it is not incurred in a profit making operation,[142] and section 18(1)(e) is often used to attack arrangements involving captive insurance companies. It denies a deduction of any contingent reserve or fund.

Section 245(1) has regularly been used to combat tax avoidance schemes.

During the Second World War Canada imposed an excess profits tax of 100%. As a result, tax avoidance increased greatly and became very organised. After the end of the war, three very broad anti-avoidance provisions were enacted: sections 137, 138 and 138A, two of which, in an amended form, are still part of the Canadian tax code as section 245 and 246.

The provision in point here began life as section 6(2) of the Income War Tax Act and then became section 137(1), which read:

> "In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce income."

No clue was given as to what was meant by "unduly" or

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142. Section 18(1)(a). See also section 15(1) which deems a benefit conferred on a shareholder to be income.

"artificially". This later became section 245(1).

A very large number of avoidance schemes sought to generate a tax advantage by way of a deduction, so this subsection has been the subject of numerous tax cases.

For a long time section 245, and before it section 137, was considered to be dead, but it is now a very important factor in tax planning. The authorities invoked the section in its arguments before the courts as an all-embrasing long-stop. In fact, the section has now been restructured to do just that.[143]

In connection with section137, Philip F Vineberg QC has said:

> "In some cases there appears to be very little disposition to analyse the precise phraseology of section 137. Followed literally the first part of the section purports to attack any deduction in respect of a disbursement or expense that would unduly or artificially reduce the income. Occasionally this has been expanded as though it was directed against any transaction that would unduly or artificially reduce income - a much broader concept."[144]

As an example, he cited the case of Shulman v MNR.[145] In this case, a solicitor established a corporation to conduct his internal office management. The court considered that the primary object of interposing the corporation "was to reduce the income tax payable by the Appellant on his professional income." The combined income of the individual and the corporation was no less than it would have been if there had been no

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143. Infra
144. "The Ethics of Tax Planning" [1969] BTR 31 at p39
145. [1961] CTC 385

incorporation. It was, however, noted that the individual refrained from drawing any salary for his work for the corporation and so diminished his own income, although there was a corresponding increase in the income of the corporation which was taxable (albeit at different rates). Comment was also made on the way funds were withdrawn from the corporation:

> "The manner is which the management agreement was implemented cannot be regarded as natural. Shultup [the company] was used as a two way conduit pipe through which to draw $9,500 from the operating revenue of the law office and then return $9,000 of that withdrawal to the law office treasury as a loan for use as urgently need working capital. That is clearly an artificial transactions. Mr Shulman cannot loan money to himself."

Vineberg commented:

> "If the first part of the judgment were taken literally it would follow that no one whose income attained a level of taxation exceeding the corporate rate would be entitled to incorporate - a conclusion as novel as it is unjustified by the precise wording of section 137(1)."[146]

What Vineberg described as an "even more astonishing" judgment was Dr Edward Murphy v MNR,[147] A doctor was assisted by his wife who looked after the administration of his practice. She formed a company for this purpose. The wife received a sum which was less than independent office help would have cost and there was no denying the quality and worth of the services provided. These services probably augmented the doctor's income rather

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146. Op cit p40
147. 68 DTC 5178

than diminished it. Under what was then section 21(2), where a spouse was an employee, remuneration was not deductible (presumably due to the fear that such remuneration would not be bona fide). The services here were genuine and the fee for them modest but the court concluded that, as a result of the "roundabout workings of the little play", the income if the doctor had been reduced and section 137(1) fitted the facts "to a nicety".

The section seems to have a rather harsh application here, given than the doctor's income was probably increased as a result of the services supplied to him, not decreased. In any case, unreasonable expenses would have been disallowed under what was then section 12.

Before the Consolidated-Bathurst case, the leading case on section 245(1) was Spur Oil Ltd v The Queen[148] the facts of which have already been given.

The Federal Court of Appeal found that the price paid by the taxpayer company for the crude oil from the Bermuda company was, in fact, slightly less than the fair market value for crude oil at the relevant time. Accordingly, there was no undue or artificial reduction of income from the purchasing transaction.

The Federal Court of Appeal set out certain principles concerning section 137(1). They said:

> "To be caught by that subsection, the expense or disbursement being impeached must result in an artificial or undue reduction of income. 'Undue' when used in this context should be given its dictionary meaning of 'excessive'."[149]

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148. Supra
149. 81 DTC 5168 at p5173

Regarding the meaning of "artificial", the court differed from earlier cases. In Shulman v MNR,[150] it was said that the word meant "not in accordance with normality", "unnatural" or "as opposed to natural". This was quoted with approval in later cases such as Don Fell Ltd v The Queen,[151] and Sigma Explorations Ltd v The Queen.[152] These cases were not cited in Spur Oil and the court there adopted a more restrictive meaning of "simulated" or "fictitious". On the basis of this narrower meaning, the court concluded that, as long as a transaction is not a "sham", and as long as the expenditure in question was equal to fair market value, section 245(1) would not apply.

The next case to consider is Consolidated-Bathurst Ltd v The Queen[153]. Here, Strayer J in the Federal Court of Canada[154] differed from the Spur Oil case (which was not cited) and adopted the Shulman definition of "artificial". So did the Federal Court of Appeal.[155] Stone J, in giving the judgment of the appeal court, in referring to the Spur Oil definition, said:

> "That case did not involve an insurance scheme. Additionally, while binding and enforceable legal obligations were incurred, the transaction did not, as here, relieve the performance of a fundamental obligation, had the need to do so arisen."[156]

So, the appeal court did not expressly reject the Spur Oil definition in all contexts (such as in transfer pricing; the context of the Spur Oil case itself). It seems to be accepted, however, that the Spur Oil definition is no longer appropriate in cases of transfer

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150. Supra
151. 81 DTC 5282
152. 75 DTC 5121
153. Supra
154. 85 DTC 5120
155. 87 DTC 5001
156. p5006

pricing: see Indalex Ltd v The Queen[157], a transfer pricing case in which the "not in accordance with normality" definition was used.[158]

Estey J dealt with section 245 in Stubart[159] although it had not been argued and so was not directly relevant. He said that the amounts paid by Stubart to Grover were disbursements to which section 245(1) could have applied. However, this seems a strange finding in the light of the fact that Stubart was acting as Grover's agent and the sums paid out by Stubart did not belong to it, and so it did not incur any disbursements which reduced its income within section 245(1). Estey J must have been giving a wide definition to the term "disbursements" that did not rely on legal ownership of the funds, but which included a mere flow of funds.

It appears that the Crown adopted this wide approach. Before the Canadian Tax Foundation Conference in November 1984, WJA Hobson QC, who was a senior officer of the Federal Department of Justice, said:

> "Tax administrators and planners are forewarned that the concept of disbursement may be exceptionally broad. If such be the case, it is likely that the words '*deduction*' and '*expense*'...... will also be given such fair, large and liberal interpretation as best ensures the attainment of the object of subsection 245(1) of the Act."

Such a wide view was given legislative force with the remodelling of the section in 1988. The redrafting in 1988 turned section 245 into a full-blown general anti-avoidance provision.[160]

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157. Supra
158. 86 DTC 6039 at p6046
159. Stubart Investments Ltd v The Queen, supra
160. Infra

Benefits

Section 137(2)(3) (later to become section 245(2)(3)) was a general provision aimed at tax benefits beings conferred on taxpayers. The subsections read:

> "(2) Indirect payments or transfers. Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatsoever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transactions or that one or more other persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending upon the circumstances, be
>
> (a) included in computing the taxpayer's income......,
>
> (b) deemed to be a payment to a non-resident person......, or
>
> (c) deemed to be a disposition by way of gift....
>
> (3) Arm's length. Where it is established that a sale, exchange or other transaction was entered into by persons dealing at arm's length, bona fide and not pursuant to, or as part of, any other transaction and not to effect payment as a whole or in part, of an existing or future obligation, no party thereto shall be regarded, for the purpose of this section, as having conferred a benefit on a party with whom he was so dealing."

The point of deeming a payment to be a payment to a non-resident under (b) is that withholding tax would then be payable.

Even before the section was redrafted in 1988, section 245(2) was considered to be the widest tax avoidance section in the ITA. It is noticeable that it did not depend on the intention of the parties. It was, however, rarely applied on its own in a judicial decision against a taxpayer. It was not used in the Stubart case,[161] but in Indalex Ltd v The Queen[161] the court applied section 245(2) and held that the transactions resulted in a benefit being conferred by the taxpayer which was subject to withholding tax.

Philip F. Vineberg[162] discussed what was then section 137(2) in connection with a case called Smythe v MNR.[163] He said:

> "A benefit is said to have been conferred upon the taxpayers. In fact, they wound up with no more aggregate wealth than they had before, even apart from the judgment, albeit in somewhat different form. The combined assets of the taxpayers involved and their corporations remaining under their control were no more than they had been before the operation started - indeed a little less. There was never any legal compulsion to declare dividends. It was always fairly open to the corporation to plough back profits year after year without deduction of any personal income taxes that would have been imposed by distribution of dividends. Moreover, everyone acknowledges that the shareholders, by 'going public', or selling out their shares to persons interested in conducting the corporate business operations in the future could have realised an entirely tax-free capital gain. If section 137(2) is given as broad an interpretation as it was in the judgment it would be possible to argue that any time a corporation sells any of its products at a profit

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161. Supra
162. Op cit at p42
163. [1967] CTC 498

it confers a benefit on its shareholders by augmenting the value of their securities to the extent of the addition to undistributed income remaining after corporate tax. In the prevalent atmosphere of today, section 137 appears to be applied more on the basis of its heading, 'artificial transactions', notwithstanding the rules of construction to the contrary, than by any precise analysis of its phraseology."

The imprecision identified here in relation to the original wording can only be exacerbated by the wide and general form in which the section has been recast. As part of Canada's tax reform programme in 1988, section 245 was repealed and replaced by a new section 245. The new section constitutes a general anti-avoidance provision based around a statutory business purpose test. In view of the importance of this section, its provisions are set out here at length.

"245(1) Definitions - In this section......
'tax benefit' - 'tax benefit' means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;
'tax consequences' - 'tax consequences' to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount:
'transaction' - 'transaction' includes an arrangement or event.

(2) General anti-avoidance provision - Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would

result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) Avoidance transaction - An avoidance transaction means any transaction
(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or
(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

(4) Provision not applicable - For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

(5) Determination of tax consequences - Without restricting the generality of subsection (2),
(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
(b) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,
(c) the nature of any payment or other amount may be recharacterised, and
(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction."

It can be seen that the new provisions allow Revenue Canada to alter the tax effects of a transaction which is not entered into primarily for bona fide business reasons other than to produce a tax saving.

When the proposals for the new section were first published in a White Paper on 18 June 1987 there was a great deal of opposition. Nathan Boidman in Tax Management International Journal[164] explained that many representations were made opposing the change, and both the House of Commons and Senate Committees advised against the proposal, recommending instead an extension of the old section 245(1) to all transactions (ie, to enable Revenue Canada to redetermine the tax effects of a transaction which artificially reduced income subject to taxation).

It was also noted that the Department of Finance made a proposal to drop the reference to "business purpose" and to adopt a test of whether a transaction has been "arranged primarily for bona fide purposes other than to obtain" a tax benefit. The government, however, ignored these proposals and the many protests and stuck with the business purpose test.

Boidman pointed out that the new section uses the European civil law notion of abuse of rights.[165] He is no doubt right in fearing that this "will most probably create much uncertainty until the courts have worked out the

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164. Vol 17 No 2 (12 February 1988) p94
165. See subsection (4)

meaning of such radical concepts." He could also have pointed out that the relevant subsection commences "For greater certainty....". It is barely credible that those preparing this legislation can have failed to see what a ridiculous thing this was to say. Anyone with even a cursory understanding of the potential operation of such a provision in a common law jurisdiction such as Canada's would appreciate that certainty is one of the last things such a section will produce.

Incorporating such a civil law concept into a common law jurisdiction is an unfortunate development. Canada's courts are used to dealing with more specific concepts and it is too early to gauge whether the judges will resist such sweeping legislation as they did for so long in Australia.[166]

Until the courts have had this provision before them for a number of years, there is likely to be a climate of great uncertainty in tax planning in Canada.

It can be seen from the wording in the new section set out above that where a transaction is an "avoidance transaction", the tax consequences shall be determined as is reasonable in the circumstances in order to deny the "tax benefit" that would otherwise result, directly or indirectly, from that transaction.

Such legislation as this is little short of a disgrace. Where is the certainty that a taxpayer is entitled to expect? How can taxpayers and their advisers legitimately and properly plan genuine business transactions not knowing how such wooly and imprecise legislation will be construed by judges brought up on common law concepts, rather than the alien principles imported into this section? It is likely to take years before the courts can bring some semblance of order to the chaos wrought by the legislators who clearly have,

166. See Part 3

either little regard for the legitimate expectation of taxpayers in ordering their affairs, or little understanding of how anti-avoidance provisions work.

Transferring Income

In Canada, as in other countries with an income tax regime incorporating a progressive rate structure, there is an incentive for high-income taxpayers to seek to divert some of their income to lower-income members of their families and other connected or associated persons. As would be expected, the Canadian tax code contains a number of provisions aimed at stopping what are perceived to be the worst abuses.

Section 56(2) is aimed at transactions whereby payments are made to a person whom the taxpayer wishes to benefit or who will hold the payment for the benefit of the taxpayer. The income is deemed to have been received by the taxpayer. This section is used, for instance, to prevent individuals such as athletes and professionals who provide services, from avoiding tax by setting up companies for the provision of their services.

A later subsection is aimed at the transfer of a right to income to a person with whom the taxpayer is not at arm's length. Unless the income arises from property which the taxpayer has also transferred, the income is deemed to have been received by the taxpayer: section 56(4).[167]

In the case of inter-spouse transfers, income from the transferred property is imputed back to the transferor spouse. Similar inputation rules apply to transfers to persons under 18 and to loans to such persons.[168]

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167. See for example, The Queen v Canadian American Loan Corpn [1974] CTC 101
168. Sections 74 and 75(1)

Where a taxpayer transfers property but retains a right to determine the person to whom it is ultimately transferred, the income from the property is attributed to the taxpayer.[169]

There is a general rule relating to profit sharing in partnerships Section 103 states that the profit shares agreed by the partners can be altered if the principle reason for the agreement may reasonably be considered to be the reduction or postponement of tax.[170]

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169. Section 75(2)
170. See Tenenbaum v MNR [1977] CTC 2534

Dividend Stripping and Associated Corporations

In 1963 section 138A was introduced and later became section 247.[171] The section contained two major discretionary powers involving a direction by the Minister of National Revenue. Subsection (1) concerned dividend stripping; and subsection (2), associated corporations.

Subsection (1) originally read as follows:

> "(1) Dividend Stripping. Where a taxpayer has received an amount in a taxation year,
>
> (a) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,
>
> (b) in consequence of a corporation having
>
> (i) redeemed or acquired any of its shares or reduced its capital stock, or
>
> (ii) converted any of its shares into shares of any other class or into an obligation of the corporation, or
>
> (c) otherwise, as a payment that would, but for this section, be exempt income,
>
> which amount was received by the taxpayer as part of transaction effected or to be effected after June 13 1963, or as part of a series of the purposes of which, in the opinion of the Minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution or income of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified by the Minister shall, if the Minister so directs,

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171. Now repealed

(d) be included in computing the income of the taxpayer for that taxation year, and

(e) in the case of a taxpayer who is an individual, be deemed to have been received by him...."

In 1985 the subsection was modified to include transactions designed to convert dividends into exempt capital gains in certain circumstances and, in 1986 it was redrafted in different terms.

It can be seen that the subsection contained the test "one of the purposes of which" is tax avoidance. This test, plus the discretion given to the Minister, meant that the potential to catch "innocent" taxpayers was not insignificant.

Despite this legislation, the major judicial decisions on dividend stripping have been reached without the use of this provision because the Supreme Court has held that the extracted surplus was taxable as a deemed dividend under normal rules.[172] It was, however, successfully applied in one case: Giguere v MNR.[173] This case involved the redemption of preferred shares which had been acquired as consideration for the sale of common shares of another company.

Despite the fact that section 247(1) was not used extensively by the court, it had a major effect on tax planning due to the width of its language and potentially wide area of operations, the frequency with which it was threatened by the authorities, and the uncertainty surrounding its application.

As with section 703 ICTA 1988[174], the wording of section

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172. See for example, Smythe v MNR, supra; and Craddock and Atkinson v MNR [1969] CTC 566
173. [1972] CTC 2466
174. See Chapter 1

247(1) was wider than was required to counter the schemes it was aimed at. In particular, the mental element test was framed so that the provision could apply if "one of the purposes" of the transaction was the avoidance of tax, and the wording was such that innocent transactions could be caught.

The result of s successful application of the subsection was that, at the direction of the Minister, the amount in question was included in the taxable income of the taxpayer.

There was the ability to obtain clearance in advance from the Minister in the case of company reorganisations being undertaken for bona fide commercial reasons.

Vineberg[175] asked why dividend stripping was so popular with "authoritative professional men" in Canada in the light of judicial attacks elsewhere.[176] He said:

> "The short answer is that they were induced to consider it legally permissible under the Canadian statute by departmental action or, to be more precise, inaction.... If you examine the evolution of the Act there appeared to be no general overall prohibition against dividend stripping. If there had been, why was it necessary at different consecutive stages to introduce the provisions of section 28 and section 105B on designated surplus, section 105C and the amendments thereto on undistributed income after amalgamation, and section 138A. If the reasoning in the Smythe case[177] turns out to be a correct statement of the law, all of

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175. Op cit at pp41-2
176. For example, Newton v Federal Commissioner of Taxation [1958] AC 450, a Privy Council case originating in Australia, see Part 3; and Johnson v Jewitt (1961) 40 TC 231, in the UK, see Chapter 1
177. Smythe v MNR, supra

these are superfluous. It took even the officials of the income tax department almost twenty years to discover the prohibitions inherent from the outset in section 137. On the other hand, if the Act must be gauged by the way in which it is administered in practice how can one explain the silence, the tolerance and, indeed, even the encouragement imparted by the Ministry of National Revenue? Belatedly finding a new meaning to the old law belies the principle that amendments of the tax law should emanate only from Parliament."

Section 247(2) stated that where, in the case of two or more corporations, the Minister was satisfied:

(a) that the separate existence of those corporations was not solely for the purpose of carrying out the business of those corporations in the most effective manner; and

(b) that one of the main reasons for such separate existence was to reduce the amount of taxes that would otherwise have been payable under the Income Tax Act

the Minister could direct that the corporations should be deemed to be associated with each other so that the advantage of the small business deduction, giving rise to the lower tax rate, was restricted.

Unlike subsection (1), this provision was extensively used and applied by the courts in appropriate cases.

Section 247 was repealed in its entirety in 1988. It was presumably felt that with the very wide general anti-avoidance provisions in section 245, there was no need for the more specific, although still wide, provisions in section 247.

"Tax Avoidance"

What was originally section 138(1) (which later became section 246(1)) purported to deal with tax avoidance. It stated that, where the Treasury Board had decided that one of the main purposes for a transaction or transactions in question was "improper" avoidance or reduction of tax, the Board could give "such directions as it considers appropriate to counteract the avoidance or reduction."

It appears that this provision was never used, on the basis that avoidance of tax can never be "improper".[178] The section, in this form was repealed in 1984.

Anti-Avoidance Provisions - Conclusion

It can be seen that Canadian tax legislation contains anti-avoidance provisions similar to those used in the UK. Canada has for a long time had, as well as the more specific provisions, certain widely drafted anti-avoidance provisions which the courts have not been too eager to apply. Now, however, even these wide provisions pale into insignificance in the face of the new section 245, a section of astonishing width and uncertainty. The next few years should be very interesting as taxpayers and their advisers seek to come to terms with this legislation and the courts begin to indicate the extent to which they allow the Revenue to apply the section.

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178. See Carter Commission, op cit Vol 3 App A p568

PART 3

AUSTRALIA

Introduction

One specific and important aspect of tax avoidance in Australia is dealt with in this Part: the general anti-avoidance provisions that have been part of Australian law for over 100 years. This is of particular interest at the moment because the judges of the House of Lords in the UK have been toying with general anti-avoidance concepts for a number of years[1] and some commentators have asked[2] whether general anti-avoidance legislation might be appropriate for the UK. Furthermore, as have been seen in Part 2 of this Chapter, Canada has recently introduced very wide and general anti-avoidance legislation.

As Australia, a country with a similar judicial system to both the UK and Canada, has had such general legislation for so long, it is instructive to see how the courts have dealt with it. This is particularly interesting in the light of the fact that judges in the UK, when sitting as members of the Privy Council, have had the opportunity to consider this legislation.

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1. See Chapter 11
2. And almost invariably rejected

The History of General Anti-Avoidance Provisions

Victoria had a provision as early as 1877, Section 55 of the Land Tax Act 1877 provided:

> "Every covenant or agreement between landlord and tenant contrary to the true effect and intent of this Act shall be void and of no effect as between the parties thereto."

More elaborate provisions, inspired by similar attempts by the New Zealand authorities, soon followed. For example, it was enacted, again in Victoria, in section 44(1) of the Income Tax Act 1895:

> "Every contract covenant agreement or undertaking made or entered into whether by deed, or in writing, or verbally either before or after the commencement of this Act between or by any person or persons or companies whatsoever which but for the provisions of this section would altogether or partially relieve any person or company from the burden or the incidence of the tax of from liability to pay any tax shall so far as such contract covenant agreement or undertaking related to or covers the tax be wholly and absolutely null and void."

Subsection (2) provided:

> "Every person or company who is a party to any such contract covenant agreement or undertaking made after the commencement of this Act shall be guilty of an offence and shall on conviction be liable to a penalty not exceeding one hundred pounds."

In the same year, section 63 of the New South Wales Land and Income Tax Assessment Act 1895 contained a general anti-avoidance provision, but it differed from the

Victoria provision in that it did not provide for a penalty and did not expressly render the transaction void, except for tax purposes.

In 1910, federal tax legislation first contained a general anti-avoidance provision relating to land: section 63 of the Land Tax Assessment Act 1910. A very similar provision was applied to income tax in section 53, Income Tax Assessment Act 1915 which stated:

> "Every contract, agreement, or arrangement made or entered into, in writing or verbal, whether before or after the commencement of this Act, shall, so far as it has or purports to have the purpose or effect of in any way, directly or indirectly,
>
> (a) altering the incidence of any income tax; or
>
> (b) relieving any person from liability to pay any income tax or make any return; or
>
> (c) defeating, evading or avoiding any duty or liability imposed on any person by this Act; or
>
> (d) preventing the operation of this Act in any respect;
>
> be absolutely void, but without prejudice to its validity in any other respect or for any other purpose."

This is very similar to section 260 of the Income Tax Assessment Act 1936, the wording of which dated from 1936 and lasted until 1981 when it was repealed and replaced with the present provisions in Part IV of the Income Tax Assessment Act.

Section 260, differed from the 1915 provision in that section 260 applied only "as against the Commissioner, or in regard to any proceeding under this Act." Accordingly, the wording of section 260 was as follows:

> "Every contract, agreement, or arrangement made or entered into orally, or in writing, whether before or after the commencement of this Act, shall, so far as it has or purports to have the purpose or effect of any way directly or indirectly,
>
> (a) altering the incidence of any income tax;
>
> (b) relieving any person from liability to pay any income tax or make any return;
>
> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
>
> (d) preventing the operation of this Act in any respect,
>
> be absolutely void, as against the Commissioner or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

As will be seen below, section 260 was considered by the Privy Council in Newton v Federal Commissioner of Taxation[3] in which it was said that "purpose" meant, not motive, but the effect which it is sought to achieve. In applying the section, the Privy Council said that one must look at the arrangement itself and see what is its effect, irrespective of the motives of the persons who implemented the arrangement.

In the High Court of Australia Williams J said:

> "The purpose of a contract, agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms."[4]

This was approved by the Privy Council, which also said:

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3. [1958] AC 450
4. (1957) 96 CLR 577

> "In order to bring the arrangement within the section, you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax."[5]

Section 260, thus interpreted, operates in a similar fashion to a business purpose test.

It can be seen, then, that the wording of section 260 is very wide and the courts have long recognised that they had to give the section a fairly narrow construction to fit in with the overall intention of the legislation of which it forms part.

The problem was clearly stated by Fullagar J who said, in the Newton case:

> "..... the 'purposes' or 'effects' which will attract its [ie, section 260's] operation are stated very vaguely. If we interpret it very literally, it will seem to apply to cases which it is hardly conceivable that the legislature should have had in mind. On the other hand, any limitation which we may seek to imply may appear to deprive the section of all practical effect."[6]

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5. Infra
6. (1957) 96 CLR 577 at p646

Construction of the Provisions

The approach of the courts to section 260 was examined in the decision of the Privy Council in Federal Commissioner of Taxation v Newton[7]. Before Newton, the courts had taken the view that taxing Acts should be construed as a whole and that section 260 did not apply where more specific provisions had overriding force, or where the incidence of taxation was the incidence which was contemplated or intended by the Act in question.

The pre-1958 position was set in 1921 in Deputy Federal Commissioner of Taxation v Purcell[8], which concerned the similar provisions of section 53, Income Tax Assessment Act 1915. This case was followed in Molloy v Federal Commissioner of Taxation.[9]

In Purcell, the taxpayer declared himself trustee of certain land for himself, his wife and daughter equally. The declaration contained very wide powers of management, control and investment. This declaration was held not to infringe section 53.

Gavan Duffy and Starke JJ, giving a joint judgment, said:

> "The section, as the Chief Justice says, does not prohibit the disposition of property. Its office is to avoid contracts, etc., which place the incidence of the tax or burden of tax upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income-producing property to another so as to reduce the burden of taxation, the Act contemplates that the new owner should pay the tax.

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7. Supra
8. (1921) 29 CLR 464
9. (1925) R & McG 113

The incidence of he tax and the burden of the tax fall precisely as the Act intends, namely, upon the new owner. But any agreement which directly or indirectly throws the burden of the tax upon a person who is not liable to pay it, is within the ambit of section 53."[10]

The Chief Justice (Knox CJ) had said:

> "The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer. It does not extend to the case of a bona fide disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person. The section is intended to protect the revenue against any attempted evasions of the liability to income tax imposed by the Act - that liability is imposed on the taxpayer in respect of his income (section 10(1)); and the bona fide gift or sale by a taxpayer of assets producing income is therefore in no sense an attempt to evade his liability to income tax."[11]

What the court was saying was that section 53 (and the same would apply to section 260) was part of an Act which contained provisions which were intended to apply or be available to taxpayers even if they intended to reduce their taxes. In these situations, section 53 (or section 260) could not apply since there would have been no attempt to avoid the tax as intended by the Act.

This approach was later adopted and developed by the court in <u>Clarke v Federal Commissioner of Taxation</u>.[12] The court said:

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10. p475
11. p466
12. (1932) 48 CLR 56

> "In its application perhaps it can do no more than destroy a contract, agreement, or arrangement in the absence of which a duty or liability would subsist. Where circumstances are such that a choice is presented to a prospective taxpayer between two courses of which one will, and the other will not, expose him to liability to taxation, his deliberate choice of the second course cannot readily be made a ground of the application of the provision. In such a case it cannot be said that, but for the contract, agreement or arrangement impeached, a liability under the Act would exist. To invalidate the transaction into which the prospective taxpayer in fact entered is not enough to impose upon him a liability which could only arise out of another transaction into which he might have entered but in fact did not enter,"[13]

In other words, sections such as section 260 have an annihilating effect; they do not allow the tax authorities to recharacterise the transactions or to assume alternative transactions. This was applied to section 260 itself in War Assets Pty Ltd v Federal Commissioner of Taxation.[14]

This approach was reaffirmed just before the Newton case in W.P Keighery Pty Ltd v Federal Commissioner of Taxation.[15] In this case, the taxpayer company implemented a complicated scheme to make it a public company which would not be liable to pay "Div 7" or undistributed profits tax, while, at the same time, enabling its two controlling shareholders to retain that control. It was held that section 260 did not apply. The very purpose of Div 7, said the court, was to give a

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13. p77
14. (1954) 91 CLR 53 at pp96-7
15. (1957) 100 CLR 66

choice to a company between incurring the liability attaching to it or becoming a public company. The court stated:

> "Whatever difficulties there may be in interpreting section 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them. It is therefore important to consider whether the result of treating the section as applying in a case such as the present would be to render ineffectual an attempt to defeat etc. a liability imposed by the Act or to render ineffectual an attempt to give a company an advantage which the Act intended that it might be given."[16]

The Keighery case was approved and applied in Federal Commissioner of Taxation v Casuarina Pty Ltd.[17]

However, in Newton v Federal Commissioner of Taxation,[18] the Privy Council appeared to take a different view.

In its accounting period ended 31st December 1949, a private company, which dealt in motor-cars, made a large profit. The shareholders were wealthy and would have been heavily taxed in respect of dividends from the company; and if the profit was not distributed, the company would have had to pay tax at the same high rate. In December 1949, the company amended its articles of association so as to give special dividend rights to the holders of its 80,000 ordinary shares, and those shareholders became entitled between them to nearly £460,000 as a special dividend. After the payment of

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16. pp92-3
17. (1971) 45 ALJR 213
18. Supra

that dividend the shares would carry a fixed dividend of 5 per cent.

The shareholders sold their shares to another private company, Pactolus Limited, at a price of about £460,000, and Pactolus Limited received the amount of the special dividend from the motor company. Pactolus Limited took up 400,000 preference shares in the motor company, and paid that company £400,000. Pactolus Limited sold those 400,000 shares to the shareholders in the motor company, from whom Pactolus Limited had bought the 80,000 ordinary shares, for £400,000. The cheques involved in these transactions were banked simultaneously. Pactolus Limited sold the 80,000 shares, now worth £80,000, to a subsidiary company for that sum. Pactolus Limited was a stock and share dealing company, and it was entitled to set the loss it made on the 80,000 shares, a loss of £380,000, against the special dividend, so that its taxable profit as a result of the transactions was £80,000.

The same kind of transaction was entered into by two other motor companies also controlled by the appellants. Between them the motor companies distributed £1,764,136 as special dividends. The appellants received £1,661,772 for their shares in the three companies, and they paid Pactolus Limited £1,185,631 for the new shares in the three companies; and they kept £476,091. Pactolus Limited retained 161,213 shares in the three companies on which it was entitled to the fixed dividend of 5 per cent, and it also retained £102,404. It was not disputed that all the transactions were genuine and were intended to have the effect they purported to have.

The Commissioner contended that the transactions were caught by section 260. The question was whether the assessable income of the companies included sums declared by them as special dividend totalling £1,764,136.

In the High Court of Australia, Kitto J decided that these sums did not form part of the assessable income of the companies. On the other hand, the Full Court, by a majority, held that they did form part of the assessable income of the companies.

The Privy Council dismissed the taxpayer's appeal. Lord Denning, in giving the judgment of the court, said that the answer to the problem seemed to lie in the opening words of the section. They showed that the section was not concerned with the motives of individuals. It was not concerned with their desire to avoid tax, but only with the means which they employed to do it. It affected every "contract, agreement or arrangement" which had the purpose or effect of avoiding tax. In applying the section, it was necessary to look at the arrangement <u>itself</u> and see which was its effect - which <u>it</u> did - irrespective of the motives of the persons who made it.

He continued, in a passage which contains what may be called the "Newton principle":

> "In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business of family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares cum dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div 7 tax, see W.P Keighery Pty Ltd v Federal Commissioner of Taxation. Nor could anyone, on seeing a declaration of trust made by a father in

favour of his wife and daughter, predicate that it was done to avoid tax, see Deputy Federal Commissioner of Taxation v Purcell."[19]

The reference to the Keighey case is somewhat confusing in that the transactions in that case had as their purpose the avoidance of tax and the arrangements had no substantial practical significance apart from their effect on the taxation of the parties.

On the facts of the Newton case, the avoidance of tax was not the sole purpose or effect of the arrangement. The raising of new capital was an associated purpose. But nevertheless the section could still work if one of the purposes or effects was to avoid liability for tax. The section distinctly said "so far as it has" the purpose or effect. This seemed to import that it need not be the sole purpose.

Looking at the whole of the arrangement, the Privy Council had no doubt that it was an arrangement caught by section 260. The whole of the transactions showed that there was concerted action to an end, and that one of the ends sought to be achieved was the avoidance of liability for tax.

Nothing was avoided as between the parties but only as against the Commissioner. As against him, the arrangement was "absolutely void" so far as it had the purpose or effect of avoiding tax.

This case is instructive in drawing the distinction between motive to avoid tax, and tax avoiding consequences whatever the motives. The motive test is actually difficult to apply except where an exceptional section like section 35 FA 1941 is enacted.[20]

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19. p466
20. See Chapter 1

The reference by the Privy Council to Keighley[21] might have raised doubts about its continued authority but, as it turned out, it was subsequently applied in the Australian courts, as in the Casuarina Pty case,[21] a decision of the Full Court.

The Casurina Pty case was another case in which the purpose of the material transactions was the avoidance of undistributed profits tax payable by private companies. The facts were that the taxpayer company was formed to become a subsidiary of F Ltd, which was in turn the subsidiary of a number of public companies . Of the hundred shares that were issued in the taxpayer company, forty-nine were held by S and his wife, and fifty-one were held by F Ltd. The shares that were held by F Ltd, were, however, redeemable preference shares which could be redeemed by S and his wife, the directors of the taxpayer company, in such a manner as to ensure that effective control of the company remained in their hands. Certain private companies that had substantial accumulated profits declared dividends to the taxpayer company, and it was claimed on its behalf that the taxpayer company was a subsidiary of a public company and hence not a private company for the purposes of Div 7 of the Act and that it was accordingly entitled to retain the dividends that it received without incurring a liability to pay undistributed profits tax.

The Commissioner of Taxation both denied that it was a subsidiary of a public company within the terms of Div. 7, and also maintained that, since a purpose of avoiding taxation was perfectly clear, the issue of the redeemable preference shares should be treated as a private company.

As to the first contention, it was held by the court that the taxpayer company was a subsidiary of a public company within the meaning of the material provisions in Div 7.

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21. Federal Commissioner of Taxation v Casuarina Pty Ltd, supra.

As to the second contention it was held that section.260 did not apply. Walsh J., who delivered the leading judgment of the court, referred with approval to the decision in the Keighery case, which he treated as a case where section 260 had been held inapplicable even though a purpose of avoiding tax had appeared from the terms of the arrangements that was there in question. He went on to express the view that the authority of that decision had been affected neither by the judgment of the Privy Council in Newton's case not by any subsequent decisions. Gibbs J added that even where:

> "one can predicate that the conversion of a private into a public company was done to escape Div 7 tax, this does not mean that the purpose or effect of the arrangement was to avoid a liability imposed on the company by the Act, since the Act itself imposes the additional tax payable under Div 7 only on private companies, and contemplates that companies will, and lawfully may, choose to become public companies within the description of section 103A and so escape liability to pay the tax."[22]

From the Purcell, Keighery and Casuarina cases it appears that section 260 did not apply so as to render invalid a transaction which had a purpose or effect of diminishing tax liabilities, if it appeared from the other provisions of the Act that such transactions were intended to be allowable methods of altering the incidence of taxation. In these circumstances, it cannot properly be said that any tax had been avoided under the Act. Accordingly, if, for example, a taxpayer was given a choice of action, he was allowed to take the one which reduced his liability to tax.

It also appears that, if a taxpayer implements a complicated arrangement, as opposed to a simple one. that fact will not normally have caused section 260 to operate

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22. p224

if the result achieved was one which was intended by the Act to be open to taxpayers to affect their liability to tax.

The "Purpose or Effect" of an Arrangement

It was noted above that, by virtue of section 260, every contract, agreement etc was void "so far as it has or purports to have the purpose or effect" of achieving specified ends.

In the Newton case in the High Court,[23] Williams J said of the words "purpose or effect":

> "These words are in the alternative but they do not appear to me to have any real difference in meaning. The purpose of a contract, agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms. These terms may be oral or written or may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect."[24]

In other words, it is not the "purpose" (ie motive) of the parties that is important, but the effect of the arrangement in question.

The Privy Council agreed with this view, stating, in a passage part of which has already been noted, that:

> "The answer to the problem seems to their Lordships to lie in the opening words of the section. They show that the section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. It affects every contract, agreement or arrangement (which their Lordships will henceforward refer to compendiously

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23. (1957) 96 CLR 577
24. p630

as 'arrangement') which has the purpose or effect of avoiding tax. In applying the section you must, by the very words of it, look at the arrangement itself and see which is its effect - which it does - irrespective of the motives of the persons who made it. Williams J put it well when he said [the words cited above were then set out]. In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section."[25]

Regarding the Privy Council's reference to "ordinary business or family dealing", Lord Wilberforce in Mangin v IRC[26] approved a modification of the Privy Council's test by Kitto J in Hancock v Federal Commissioner of Taxation.[27] Kitto J, in referring to the acts comprising the arrangement, said:

"If those acts are capable of explanation by reference to ordinary dealings, such as business or family dealing, without necessarily being labelled as a means to avoid tax, the arrangement does not come within the section. An example would be a simple sale or gift of shares, even though the motive of the seller or donor may have been to avoid receiving future dividends and incurring the liability to income tax which the receipt of them would have entailed."[28]

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25. [1958] AC 450 at pp465-6
26. (1971) AC 739, infra
27. (1961) 108 CLR 258
28. p283

In Newton, the Privy Council, referring to the transactions under consideration in that case, said that:

> "the avoidance of tax was not the sole purpose or effect of the arrangement. The raising of new capital was an associated purpose. But nevertheless the section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says 'so far as it has' the purpose or effect, This seems to their Lordships to import that it need not be the sole purpose."[29]

It must be assumed that, when the Privy Council used the words "altering the incidence of any income tax" in the earlier citation, their words must be construed so as to refer, not to all alterations of the incidence of tax, but only to alterations not contemplated or intended to be available by other provisions of the Act.[30]

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29. p467
30. See, for example, the Purcell and Keighery cases, supra

Specific Transactions

It is instructive to consider some of the transactions that have been considered by the courts in relation to the section.

1. The Exploitation of Companies

A common arrangement is the incorporation of a business. Given the test laid down by the Privy Council in Newton's case[31], it was normally impossible, in the absence of special circumstances, to conclude that the acts of the parties could be given a reasonable explanation only on the basis that one of their purposes was the avoidance of tax. Furthermore, often the incidence of taxation arising was precisely the incidence of taxation contemplated or intended by the provisions of the Act, such as when a business was incorporated and the company's income was distributed amongst the shareholders. In such circumstances, section 260 could have had no application.

However, there have been cases in which the formation of a company has been part of a larger arrangement which was caught by section 260. An example of this was Peate v Federal Commissioner of Taxation.[32]

The facts were that from 1954 to the middle of 1956, a medical practitioner was in partnership with other doctors and was entitled to 14% of the profits. On 29th June 1956, the partners formed a company, Westbank Ltd, and each partner became a director of that company. The partnership, then consisted of eight doctors, was dissolved on 31st August 1956, and on the same day, eight other companies were formed, one for each of the eight doctors, who each became the governing director of his

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31. Supra
32. [1967] 1 AC 308

company. The shares in the taxpayer's company, Raleigh Ltd, were allotted to trustees for his infant children. One of the objects of Raleigh was to provide medical services.

On 1st September 1956, the taxpayer sold his practice to Raleigh, and entered into a service agreement with that company at a salary. The taxpayer's wife became the secretary of Raleigh, also at a salary. On the same day there was an agreement between the taxpayer, Westbank and Raleigh, whereby the taxpayer's services were made available by Raleigh to Westbank, and whereby a fee equal to 14% per cent of the income of Westbank (after deducting certain expenses) became payable by that company to Raleigh. Similar agreements were made in the other seven cases.

In 1959 one of the doctors withdrew from the scheme, and consequently the fee payable by Westbank to Raleigh (and to each of the other six companies) increased, and there was another increase in 1960. In his return for the year of assessment ended 30th June 1957, the taxpayer included his share of the partnership profits up to 31st August, and for the rest of that year the salary he had received from Raleigh. The assessment for that year was computed accordingly. The return for the next year of assessment showed a salary of £1,560 as the only professional income. The Commissioner assessed the taxpayer, however, on the footing that the arrangements with Westbank and Raleigh had been made void by section 260, and that he was still a member of the partnership, and was entitled to £4,298 as his share of the partnership income for that year. The assessments for the two following fiscal years were made on the same basis. The taxpayer appealed against the three assessments.

In the Australian High Court,[33] Kitto J observed:

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33. (1964) 111 CLR 433

"The arrangement bears ex facie the stamp of tax avoidance. An understandable purpose of providing for the doctors' families, and in doing so quite honestly, is perfectly evident; but what is equally evident is a purpose of doing so by a method which will divert income away from the participating doctors to or for the benefit of their families, to the end that a substantial part of the tax might be avoided which would have been incurred if the income had first been derived by the doctors and then applied by them for the benefit of their families."[34]

Both the High Court and the Privy Council held that the arrangement was void by virtue of section 260.

Raleigh, in addition to paying the taxpayer his salary under the agreement between that company and him, had also paid his wife a salary of £1,200, later increased to

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34. p469

£1,300 per annum, for her services as secretary of the company. Dividends declared by Raleigh had gone to the trustees of two settlements for the benefit of the children.

The tax authorities had assessed the taxpayer's taxable income for 1958 at £4,298. That sum had been arrived at in the following way. The net income of Westbank in that year as returned by that company was £5,013. To that the Commissioner had added the services fees paid by the company of £41,574 and superannuation payments of £1,200, making a total of £47,787. He had then treated 14 % of this sum, namely £6,690, as the taxpayer's income, and had treated some of the expenses claimed as deductions by Westbank Ltd and Raleigh Ltd as allowable deductions from the taxpayer's income. He had disregarded the salary paid to the taxpayer by Raleigh Ltd entirely. Similar returns had been made by the taxpayer for the years 1959 and 1960, and similar assessments by the Commissioner for those years.

Viscount Dilhorne, giving the judgment of the majority, said the first question to be determined was whether the arrangements made in 1956 or any part of them had one of the purposes or effects stated in the section. The Privy Council though that they did. Before the arrangements, the taxpayer received 14% of the net profits of the partnership; afterwards, the doctors who had been partners treated patients in the same way as they had done before but, as a result of these arrangements, their incomes from their practice were reduced to the salaries they received from their companies, which received, either by way of service fees or dividends, the same percentage of the net profits as the doctors had been entitled to under the partnership agreement. Accordingly, the Privy Council considered that the arrangements had the purpose and effect of avoiding a liability imposed on each doctor by the Act.[35]

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35. p330

Viscount Dilhorne then asked what the taxable income of the taxpayer was in the three years in question. He said that the arrangements in 1956 divested the taxpayer of income which he would have received if they had not been made. Tax was avoided on the difference between the salary the taxpayer received and the amount received each year by Raleigh from Westbank in service fees and dividends.[36]

As Kitto J had said, the section "operates only to destroy: it supplies nothing." Viscount Dilhorne pointed out that it only operated notionally to destroy, because the validity of the transaction was only affected so far as the tax authorities and proceedings under the Act were concerned.[37]

He then said that the difficulty lay in determining the income derived by the taxpayer, or deemed to have been derived by him by the arrangements which were treated as void by section 260. He pointed out that the difficulty would not have arisen if the Act allowed the tax authorities to make an assessment to counteract the tax advantage sought to be obtained, as under section 28(3) FA 1960 in the UK.[38]

He continued:

> "Section 260 has to be construed with section 17 and 19 [of the Act]. It can only have practical effect in preventing tax avoidance if the Commissioner is entitled to make an assessment on the basis that the contract, agreements and arrangements rendered void by it had never been made. This necessarily involves treating the taxpayer as having derived

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36. p331
37. Ibid
38. Now section 703(3) ICTA 1988, see Chapter 1

income in excess of that derived by him pursuant to the arrangements. In their Lordships' opinion, reading these three sections together, the Commissioner was entitled to assess the appellant on the income he would have received in each of the three years, if the arrangements coming within section 260 had not been made in 1956."[39]

The agreement to dissolve the partnership, its dissolution, the formation of Westbank and Raleigh and the agreements between the taxpayer and Raleigh, and between the taxpayer, Raleigh and Westbank were all part of the scheme and, in the opinion of the Privy Council, had the purpose and effect of avoiding liability to tax and so were caught by section 260. Accordingly, the tax authorities were entitled to treat the partnership as continuing until, if in fact if had been in existence, it would have been dissolved by operation of law (ie, until one of the doctors withdrew from the scheme in 1959).

Lord Donovan, in a typically detailed and incisive analysis of the position, dissented in a number of important respects. He said that there was no doubt that the conditions precedent prescribed in section 260 were present because the whole arrangement was designed to relieve the taxpayer of some liability to tax.[40] The difficulty lay in the consequences of the "annihilating" effect of the section. The tax authorities had to proceed as though the tainted arrangements etc did not exist; the section did not authorise something new and fictitious to be put in their place.

Lord Donovan noted the way the relevant assessments had been calculated. He said:

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39. p331
40. p339

"Dr Peate had returned as his taxable income the sum of £1,232. The Commissioner added to this the above sum of £6,690, plus a £2 subscription regarded by him as an inadmissible deduction. This gave a total of £7,924. The Commissioner then deducted the foregoing £3,626, leaving a net income for Dr Peate on this basis of £4,298.

The calculation is perfectly intelligible on the hypothesis, for which the Commissioner was contending at the time, that Westbank and Raleigh were simply Dr Peate's agents. The calculation remained unchanged when the prime contention was altered to reliance on section 260. How it squares with that contention, which requires the Commissioner to proceed on the basis that Westbank and Raleigh are to be disregarded, is one of the serious difficulties of the case.

For the succeeding two fiscal years Dr Peate's income was computed on similar lines."[41]

If the purpose of each of the contracts etc was to secure relief from income tax, they were wholly void as against the tax authorities. On a proper application of the section it appears that Lord Donovan was correct in his analysis[42] when he said that disregarding the various arrangements (including the existence of Raleigh, the formation of which was part of the tax avoidance plan), the situation left as regards the taxpayer was as follows:

1. He is found giving medical services to patients.
2. In return the patients pay him money.

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41. p338
42. At pp340-1

3. He cannot, for present purposes, be treated as accountable to Westbank for this money. Thus he is accountable to no one for it, and it may, again for present purposes, be treated as his own.

4. This money therefore represents the gross or "assessable" income which he derives from treating patients. But the Act did not tax gross income but "taxable income", which meant that all allowable deductions must be made.

5. The allowable deductions were defined or "all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income....."

6. The Act did not in terms require that it must be the taxpayer himself who disbursed the outgoings, though ordinarily, of course, this will be the fact. The deductions which have been allowed to Dr Peate were made by Westbank and Raleigh and the amounts extracted by the Commissioner from their accounts. How, asked Lord Donovan, did this square with section 260, which requires the Commissioner to ignore the existence of those companies? Once section 260 invoked he was not entitled to recognise these companies for some purposes and disregard them for others. In so far as the formation of these companies was part of the arrangement which had the purpose of relieving Dr Peate and others from liability to pay income tax, that formation was absolutely void as against the Commissioner "or in regard to any proceeding under this Act." How, in the face of this, the companies were nevertheless brought to life again for the purposes of seeing what expenses they incurred, and then allowing those expenses to the taxpayer, Lord Donovan could not see.

Faced with the difficulties exposed by this analysis, Lord Donovan reached the following conclusions:

"(1) The purpose of the whole arrange was relief in some measure from income tax.

(2) The application of section 260 would involve treating the fees paid to Dr Peate for the services he rendered to patients as his gross or 'assessable' income.

(3) The deduction of expenses to arrive at his net or 'taxable' income involves looking at the account of Westbank and Raleigh; and inasmuch as the formation of these two companies is, under section 260, to be regarded as absolutely void 'in regard to any proceedings under this Act' this procedure is not permissible. The result is not to make Dr Peate taxable on his gross or 'assessable' income, for this would be contrary to the Act. It is, on the contrary, to raise serious doubt as to the applicability of section 2 60 to such as case as the present.

(4) This doubt is increased when the amount of net income to be attributed to Dr Peate can be determined only by attributing to him and his colleagues a decision which they never took except as directors of Westbank.

(5) Section 260 does not, in truth, meet such as case as the present with which its terms are inadequate tocope. It is a section which dates back, it is said, to 1915 when tax-avoidance schemes were less sophisticated and complex. If a charge is created on income so as to lessen the tax, or property is transferred for that purpose, then section 260 will work. The charge and the transfer can be ignored as void, leaving the income as it was. But when a taxpayer puts an end to one source of income and creates another in its stead, the section does no more than destroy the new arrangements so far as the Commissioner and the Act are concerned. This is not enough.

> The old order is not revived by thus annihilating the new. What is needed is authority for the Commissioner to make such assessments to tax as in his view are required to prevent the avoidance of tax which would otherwise occur. Section 260 contains no such authority; and without it, the attempt to impose liability in accordance with 'the facts that remain' leads to difficulty and frustration. The section is obeyed at one time and disobeyed at another.
>
> The Commissioner was quite right in my opinion in his initial disregard of the section and on better ground in his attempt to establish liability by contending that Westbank and Raleigh were mere agents of the doctors, and that the doctors themselves owned the income that their efforts procured. This does not mean that I think the contention right, for it involves treating the agreement between the doctors and Westbank, and between themselves and their family companies, as shams. On the evidence I do not at present see how this contention can be sustained. But if it fails, then, unless and until the legislature adds further and suitable provisions to section 260, the Commissioner must take the facts as he finds them, and assess Dr Peate on the basis of the doctor's own return."[43]

It is submitted that Lord Donovan's analysis is much sounder than that of the majority and that his conclusions were correct, given the "annihilating" effect of the section. The majority appear to have approached the section in a more flexible and looser way and stopped

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43. pp 346-7

short of taking the annihilating effect of the section to its logical conclusions, in a similar way to the analysis of the House of Lords of the "new approach" in the UK in Furniss v Dawson.[44]

However, it seems that even the decision of the majority did not mean that all incorporations by, say, doctors or other professionals would have been caught by section 260. As Windeyer J had said, the facts were very special. The structure and operation of the various companies, including the hiring of the services of the doctors from one company to another, were "out of the ordinary" and there was only a remote resemblance with "the mere carrying on by a company of a trading business formerly carried on in partnership" or with "the management and investment of capital assets by a private company and the distribution among shareholders of the income periodically arising."[45]

A more straightforward arrangement would presumably have been saved from the operation of the section by the principles established in Newton or in Keighery and Purcell.[46]

Another kind of exploitation has already been seen in relation to section 260, the convertion of a company to a public company in <u>WP Keighery Pty Ltd v Federal Commissioner of Taxation</u>.[47] As has been seen, this case arose because private companies paid undistributed profits tax unless they distributed a specified proportion of their taxable income. There was, therefore, often an incentive for a private company to become a public company while, at the same time, remaining under the control of a relatively small number

44. (1984) 55 TC 324, see Chapter 11
45. (1964) 111 CLR 443 at p478
46. Supra
47. Supra

of persons. However, it proved difficult for the authorities to attack such schemes under section 260. The relevant legislation, Division 7 of Part III of the Income Tax Assessment Act, gave each company a choice whether it had to bear undistributed profits tax as a private company, or satisfy the conditions to become a public company. This choice was intended to be available even where it was exercised wholly or mainly with a view to reducing tax.

In the Keighery case, the taxpayer company's shares were spread among enough people to give the company public status. However, many of these shares were redeemable preference shares so that effective control remained in the hands of the directors.

As has already been stated, the Full Court held that section 260 did not apply. The court said that, if those who controlled the company brought about a state of affairs such that, when the last day of the year arrived, the company was not a private company, their action could not be seen as defeating a liability imposed by the Act; on the contrary, it was one which the Act contemplated and allowed. The court said:

> "Because this is so, an attempt by the Commissioner to rely upon section 260 in the present case in order to avoid only the applications for and allotments of the redeemable preference shares would be an attempt to deny to the appellant company the benefit arising from an exercise which was made of a choice offered by the Act itself. The very purpose or policy of Div 7 is to present the choice to a company between incurring the liability it provides and taking measures to enlarge the number capable of controlling its affairs. To choose the latter course cannot be to defeat evade or avoid a

> liability imposed on any person by the Act or to prevent the operation of the Act."[48]

There was a point, however, where an arrangement would go beyond what was contemplated by the Act, because it was part of some wider scheme, that the protection of the principle established in Keighery would not have been available. For example, in Federal Commissioner of Taxation v Casuarina Pty. Ltd.[49] Gibbs J said:

> "No doubt the formation of a public company may form part of an arrangement which has the purpose or effect of avoiding a liability imposed by the Act on some other person but the application of section 260 does not result from the mere fact that the company has become a public instead of a private company."

The Keighery principle also applied to prevent section 260 applying where a non-resident company was formed by resident shareholders and which derived income from sources outside Australia, even if the relevant steps that were taken indicated a purpose of avoiding tax. The same rule applied: the Act intended or contemplated that persons should have a choice of whether to remain or become a resident or to remain or become a non-resident, even if the choice was exercised so as to avoid tax.

Again, however, complex arrangements involving setting up overseas might be caught: compare War Assets Pty Ltd v Federal Commissioner of Taxation,[50] in which the section was not applied, with Bell v Federal Commissioner of Taxation,[51] in which the section was applied.

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48. pp93-4
49. Supra
50. (1954) 91 CLR 53
51. (1953) 87 CLR 548

2. Dividend Stripping

As far as a company with accumulated profits is concerned, the avoidance of undistributed profits tax was often one of the purposes of the parties in implementing the relevant arrangements. However, in simple cases at least, it was not possible to maintain that the only reasonable explanation of the arrangements was that one of the purposes of the arrangements was the avoidance of tax. Even in the case of more complex arrangements, where there was a purpose to avoid both undistributed profits tax and income tax on the shareholders in the event of a distribution, the tax authorities tended to assess the shareholders under section 260 rather than the company: Hancock v Federal Commissioner of Taxation.[52] An attempt to assess the company might well have foundered on the rules adopted in the Casuarina Pty Ltd case.

As regards the shareholders in a company with accumulated profits, section 260 could not be applied to them in a straightforward case because it was not possible to predicate that the only reasonable explanation of the acts of the parties was that tax avoidance was one of the purpose of the relevant arrangements. However, as the Newton case showed, the section could be applied if there had been implemented a complex arrangement, and from the acts of the parties it was reasonably clear that one of its purposes had been the avoidance of a liability to tax intended by the Act to be borne by the taxpayer.

An instructive case in this respect in the Hancock case. It was held, in that case, that section 260 applied to some of the shareholders but not to others. It applied to avoid the relevant arrangement in respect of the shareholders who, after the material dividend payments

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52. Supra

had been made to a share dealing company, re-acquired their original shares; but not to those who merely sold their shares but did not re-acquire them later.

It was, however, often difficult to decide which dividend stripping operations fell within section 260 and which did not. For complex schemes involving dividend stripping, where the section was held to apply even though there was no repurchase of shares, see Bell v Federal Commissioner of Taxation[53], and Mayfield v Federal Commissioner of Taxation [No 1].[54]

Looking at dividend stripping operations from the point of view of the company acquiring the shares and receiving the dividends, the section did not often apply to such a company. It was normally no part of a dividend stripping operation to avoid tax for which such a company would normally be liable: it was only by reason of the dividend stripping operation that the company received any dividends, and so it was not normally possible to point to an attempt to avoid a tax liability of its own: see for example, Rowdell Pty Ltd v Federal Commissioner of Taxation[55], which dealt with the same facts as the Hancock case. Similarly, shareholders of such a company would usually have been outside the reach of the section.

3. Tax Deductions

The right to tax deductions in Australia is granted by statute, subject to the appropriate conditions being fulfilled of course. Here again the Purcell/Keighery principle applies, as can be seen from the case of Cecil Bros Pty Ltd v Federal Commissioner of Taxation.[56]

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53. Supra
54. (1961) 108 CLR 323
55. (1963) 111 CLR 106
56. (1964) 111 CLR 430

The relevant provision governing deductions was section 51:

> "All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

In the Cecil Bros Pty case the taxpayer company carried on a shoe retailing business. It purchased some of its stock from another company, the shareholders of which were the relatives of the shareholders in the taxpayer company. The amount paid for this stock was £19,777 more than the amount the taxpayer company would have paid to an arm's length supplier.

The Commissioner disallowed the £19,777, but the Full Court allowed the taxpayer company's appeal. Dixon C.J. stated:

> "In my opinion, section 260 of the Act can have no application to such a case as the present. Indeed,... I have great difficulty in seeing how it could apply to defeat or reduce any deduction otherwise truly allowable under section 51. Moreover, I do not think that on the facts of this case there was any contract, agreement or arrangement to which the taxpayer was a party, falling within section 260."[57]

Furthermore, the Newton principle would also have defeated the Commissioner because it could not be

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57. p438

established that no other reasonable explanation of the relevant arrangement could be provided than that one of its purposes was the avoidance of taxation. For example, it could be adequately explained on the basis that the shareholders of the taxpayer company wished to confer benefits upon their relatives.

The Newton principle was used by the Privy Council to defeat an attack by the Commissioner on arrangements designed to give rise to deductions under section 51 in Mobil Oil Australia Ltd v Federal Commissioner of Taxation.[58]

With a view to securing exclusive petrol stations, the taxpayer company entered into contracts with retailers. These contracts were of two kinds. The "SSI-B" type of agreement provided for a loan by the company to the retailer and for its repayment by equal monthly instalments of principal and interest. The retailer covenanted, for the duration of the agreement, not to dispose of his interest in the station without first offering it to the company; and that, if the company did not purchase the station, the successor was to be approved by the company and was to continue the retailer's agreement for the rest of its duration. The company obtained the sole and exclusive advertising rights on the station. The company was to pay the retailer a monthly sum calculated so as to coincide with the monthly repayments of principal and interest.

The other agreement, the "SSI-C" agreement, did not provide for a loan nor for monthly payments by the company to the retailer. It provided simply for a specified sum to be paid each year by the company to the retailer.

The total sum paid by the company under the agreements

58. [1966] AC 275

for the period ended 30th June 1953, was £192,701, and this represented about a halfpenny a gallon in relation to the company's total turnover.

It was contended on behalf of the company that the £192,701 was deductible in computing its profits for tax purposes. The Commissioner contended that the £192,701 was not deductible, as it was a capital payment, and also because it was paid pursuant to a tax avoidance arrangement.

Taylor J upheld the decision of the Commissioner, and his judgment was affirmed in the Full Court of the High Court by a majority.

However, the Privy Council held that neither agreement was void under section 260. Lord Pearce, giving the unanimous judgment of the court cited the test propounded by Lord Denning in the Newton case. Lord Pearce then noted[59] that in the present case the trial judge found that:

> "for reasons which no doubt seemed proper to the [taxpayer company] it was not prepared to pay in advance and unconditionally a lump sum for a trade tie extending over a period of years. It was however, prepared to pay that sum by instalments spread over the relevant period and in the meantime to make available to the operator an amount equal to the lump sum involved."

From this Lord Pearce concluded:

> "Under the circumstances existing it is not surprising that Mobil Oil took that line. From a commercial point of view it was a sensible arrangement. And it is not easy to see by what

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59. p292

> other equally convenient method it could have been achieved. In the one case (SSI-C) the retailer received his payments annually so long as he carried out his obligations during periods appropriate to the payments. In the other case (SSI-B), where it was desired that the retailer should have in his hands the whole sum at the beginning of the transaction, the sum was advanced as a loan on which the obligation to repay dwindled at a regular rate while the retailer was earning his reward. Thus the transaction is capable of explanation by reference to an ordinary sensible business arrangement. It does not therefore come within the section."[60]

However, as with other transactions, those aimed at securing tax deductions might be part of a more complex arrangement that could be rendered void under section 260. An example of this was Jacques v Federal Commissioner of Taxation.[61] Here, a company carried on two businesses: coal mining and cement manufacturing. The company was wound-up and it disposed of its business to two new companies. Originally, it had been agreed that, as consideration for the sale of the businesses, the new companies would allot to the liquidator of the old company, or to such persons as he directed, fully paid shares in the new companies. However, when those agreements had been partly performed, a different arrangement was put into effect for the purpose of enabling shareholders in the old company to obtain deductions for calls to be applied by them. Under the new arrangement, the businesses were sold to the new companies for specified amounts, the new companies issued contributing shares to the shareholders of the old company, and calls on those shares were duly paid by the liquidator of the old company, on behalf of the various shareholders, out of the purchase price received from the new companies. This arrangement was held to be void.

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60. pp292-3
61. (1924) 34 CLR 328

Isaacs J said of the arrangement:

> "It is not at all on the same footing as an ordinary purchase of shares in an existing company, even with the accompanying object of satisfying the requirements of the law as to payment of calls. In that case the enterprise exists, and offers the opportunity of investment. There the investor is doing nothing more than the legislature contemplated the taxpayer might legitimately do, or even be induced to do and none the less that besides the risk of capital the advantage of a deduction in relation to income tax was part of the inducement."

But, he said, this arrangement was entered into:

> "simply to manufacture a situation to get the better of the Income Tax Act. It in no way altered the income of the taxpayer or changed its ownership. It was in no true sense a business operation. But, by first deliberately preparing the ground for the misuse of legal expedients recognised as equivalents for payment, and then by such misuse, a factitious liability to pay a call and a factitious payment of the call ensued, but throughout, from the conception to completion, except for a similar object of escaping stamp duty, with the express and sole purpose of lessening the statutory liability of the taxpayers."[62]

Exceptional circumstances such as those in the Jacques case did not often arise so as to justify the application of section 260 to cases involving arrangements designed to generate tax deductions.

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62. pp359-60

4. Non-Corporate Entities

The principles applicable to the formation of companies also applied to the creation of other entities such as partnerships and trusts. For example, the formation of a partnership, and the carrying on of a business by a partnership, were steps contemplated or intended by the Act normally to be open to taxpayers in order to affect their liability to tax. So, for instance, if the owner of income-producing property entered into a partnership agreement with members of his family, pursuant to which the income was divisible amongst the partners, it might have been apparent that the purpose of the agreement was to minimise tax, but it was intended by the Act that this course should normally be open. Section 260 would, therefore, have no application.[63]

Similarly, the formation of trusts to, for example, distribute income amongst family members would normally have been outside the operation of section 260, unless the formation of the trust was part of some wider arrangement.

In Deputy Federal Commissioner of Taxation v Purcell, for instance, an owner of property declared himself trustee of that property in favour of himself, his wife and daughter. Gavan Duffy and Starke JJ said of section 260:

> "Its office is to avoid contracts, etc which place the incidence of the tax or the burden of tax upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income-producing property to another so as to reduce the burden of taxation, the Act contemplates that the new owner should pay the tax. The incidence of the tax and the burden of the tax

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63. See for example, Dobinson v Federal Commissioner of Taxation (1935) 3 ATD 150

fall precisely as the Act intends, namely, upon the new owner."[64]

64. (1921) 29 CLR 464

Comparison with New Zealand Approach

It will be seen in Part 4 that New Zealand has a parallel general anti-avoidance provision, now contained in section 99, Income Tax Act 1976. However, the courts in New Zealand have tended to take a different approach in construing section 99 and its predecessors than the Australian courts have adopted towards section 260.

The Australian courts, as has been seen, always adopted a narrow construction of section 260 and only complex schemes tended to be caught.

The New Zealand courts have gone the other way and given their general anti-avoidance provisions, a broad interpretation to catch tax avoidance schemes. See, for example Wisheart v IRC.[65] The taxpayers were partners carrying on practice as solicitors. Two family trusts were set up. These trusts acquired the shares in a company which, in turn, acquired the lease, furniture, library and equipment of the partnership and agreed to supply them, plus staff to the partnership for £11,120 per annum. The Court of Appeal held that these arrangements were caught by the general anti-avoidance provision then in force: section 108 of the Land and Income Tax Act 1954.

A useful decision to consider here is that of the Privy Council in Mangin v IRC.[66] The taxpayer farmed 385 acres of land in New Zealand. In 1965, with a view to reducing his income tax liabilities, he created a "paddock trust", whereby he leased 25 acres for one year at £3 an acre to trustees, who were to cultivate it. Under a separate deed, the resulting income was to be held on trust for his wife and children. The taxpayer was employed by the

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65. [1971] ATC 6001
66. [1971] AC 739

trustees to sow, harvest and sell the crop and account for the proceeds. The trustees paid him for his labour and expenses incurred and distributed the net income remaining to the beneficiaries. The following year there was a similar transaction in relation to another 24 acres.

By these transactions, part of the taxpayer's income became the income of his wife and children who could claim allowances and reduced rates of tax, which led to less tax being paid on the profits of the whole 385 acres.

Amended assessments were made on the taxpayer to restore the taxpayer's income tax liability to what it would have been but for the "paddock trusts", on the ground that they were absolutely void by section 108.

The taxpayer's appeal was upheld by Wilson J, but his decision was reversed by the Court of Appeal. The taxpayer's appeal to the Privy Council was unsuccessful, the majority holding that, on the true construction of section 108, and on its history and the reasons for its enactment, any contract, agreement or arrangement entered into for the purpose of escaping liability to tax on accrued or future income was void both against the tax authorities and the parties to the contract, agreement or arrangement. Since the taxpayer's principal or sole purpose in creating the "paddock trusts" was not to provide a trust fund for the benefit of members of his family, but to escape liability for tax on part of his income, the "paddock trusts" were void.

The decision of the majority was given by Lord Donovan. He noted that the taxpayer conceded that, if section 108 did apply, the amended assessments would stand because he received the disputed income into his own hands and would not have been able to contend that it belonged to the trustees.[67] The "annihilating" effect of the section did not, therefore, produce the kind of problem Lord Donovan himself identified in the Peate case in relation to section 260.[68]

On the facts of the case, the majority was "in complete agreement" with the observations of Turner J in the Court of Appeal, who had said:

> "The lease of the 24-acre paddock was a lease for one year only. A disposition of an income-earning asset, if the primary reason for it were to provide income for members of the settlor's family, might confidently be expected to be disposition for a longer period than this. It was an essential part of this scheme that while the lease of the wheat paddock was for one year, in the following year another paddock was to be leased - and again another the following year. It was the rotation of crops, of course, which made this kind of thing necessary - but which at the same time made this kind of transaction one particularly unfitted to be the basis of a family trust providing assured regular income for its beneficiaries. I cannot think that successive one-year leases of that particular paddock of the farm which by crop rotation happened to be the wheat paddock can be described as an ordinary family dealing, a typical family trust. I find it difficult, too, to accept Wilson J's conclusion that the rent charged for the paddock was realistic. The profit made undermines such a conclusion. It may well be that the rent, calculated on a basis of arithmetical average with reference to the area involved and the comparative area of the whole farm may appear justifiable; but

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67. p745
68. Supra

it is to be remembered that the paddock leased was always the very paddock which in the particular year under consideration was ready for wheat - a highly profitable crop - and it seems to me that the rent charged for such a paddock in a particular year should have been greatly in excess of a mere arithmetical average. The whole scheme smacks of such business unreality that I cannot accept the conclusion of Wilson J; and for myself I am convinced that the only proper inference to be drawn from the facts of the arrangement, and of the profits resulting therefrom, is that this scheme was devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived."

The majority followed the test propounded by the Privy Council in Newton's case. Referring to the passage cited above in Lord Denning's judgment which set out the test, Lord Donovan said:

"In their Lordships' view this passage, properly interpreted, does not mean that every transaction having as one of its ingredients some tax saving feature thereby becomes caught by a section such as section 108. If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think section 108 can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen, Indeed, in the case of a company, it may be the duty of the directors vis-a-vis their shareholders so to act. Again, trustees may in the interests of their beneficiaries, deliberately choose to invest in government securities issued with some tax-free advantage, and to do so for the express purpose of securing it. They do not thereby fall foul of section 108. The clue to Lord Denning's meaning lies in the words 'without necessarily being labelled as a means to avoid tax.' Neither of the examples above given could justly be so labelled. Their Lordships think that what this phrase refers to is, to adopt the language of Turner J in the present case,

> 'a scheme.... devised for the sole purpose, or at least the principal purpose, of bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived.'

The present case clearly exhibits such a scheme...."[69]

It can be seen that, the majority of the Privy Council relied on the fact that each lease was for only a year and that the actual land leased differed from year to year, and also on the fact that the rent was inadequate. This lead them to conclude that the transaction was unfitted to enable the family trust to provide a regular income for its beneficiaries, and that the whole scheme smacked of business unreality.

However, the decision of the majority can be criticised on a couple of grounds. First, it could be argued that the fact that the rent was less than a market rent is wholly consistent with a purpose of benefiting the taxpayer's family; and that the difference in the leased land is wholly consistent with basic good husbandry in rotating crops and was in no sense extraordinary.

Secondly, the majority of the court, did not consider the Purcell/Keighery principle[70] which had been propounded

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69. p751
70. Supra

for the purposes of section 260. This is unfortunate because it would have been instructive to learn whether the majority thought this principle applied at all and, if so, how they saw it as fitting in with their decision.

Lord Wilberforce gave a dissenting judgment. He noted that section 108 contained only two of the four limbs found in section 260.[70A] Section 108 read:

> "Every contract, agreement or arrangements made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax."

In particular, it did not contain what, to Lord Wilberforce, seemed to be the limb most directly relevant, namely, (c)[71], the limb under which the great majority of decisions had been given. The third and fourth limbs, said Lord Wilberforce, previously appearing in New Zealand legislation in 1900,[72] were dropped in 1916.[73] Lord Wilberforce commented:

> "Now I am prepared to believe that there is some degree of overlapping between the four limbs - although those with the widest spread would seem to be (c) and (d) rather than (a) and (b) which appear to deal with specific limited cases. But it requires a degree of credence, I would, with respect, almost say interpretative astigmatism, to

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70.A p 755
71. The wording of which was "defeating, evading, or avoiding any duty or liability imposed on any person by this Act."
72. Lord Wilberforce was here referring to section 82 of the Land and Income Tax Assessment Act 1900
73. By section 162 of the Land and Income Tax Assessment Act 1916

conclude that the two New Zealand limbs cover effectively the whole of the territory occupied by the Australian section - specifically that they cover the whole field of 'tax avoidance'. Why the New Zealand section was abbreviated in 1916 has not been satisfactorily explained, perhaps for reasons of elegance, perhaps, as the majority judgment suggests, became limbs (c) and (d) were thought to be tautologous. But, like the Venus of Milo, aesthetic improvement by loss of members may be paid for by a loss of potency; and an anonymous draftsman's hypothetical belief as to tautology can hardly make a canon of construction. We have to consider it possible that he may have been wrong".[74]

He was of the opinion that section 108 was not suitable to counter modern tax avoidance. He said:

> "I think that we have here a rusty instrument which breaks in our hands and is no longer capable of repair."[75]

Lord Wilberforce analysed the section as applying to the facts of the case as follows:

> "Briefly to restate the question. Is a transaction, by which the taxpayer has disposed of an income-producing asset, so that in neither of the relevant years does he derive any income, directly or indirectly, fall within the terms of the New Zealand section as either altering the incidence of any tax or relieving him from his liability for income tax?
>
> The case seems, if anything, one of 'avoidance' as 'avoidance' has been interpreted in Australia. But

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75. p757

New Zealand lacks the word - it has 'altering the incidence' and 'relieving'.

As to altering the incidence, I fail to see how this covers the present case. The tax falls on whom it falls according to the Act. Changing - for a period or indefinately - the ownership of land does not alter the incidence of the income tax which is imposed on whoever makes a profit from farming the land. I do not think that this can be got over by calling it 'economic incidence'....

In Deputy Federal Commissioner of Taxation v Purcell (1921) 29 CLR 464, Knox CJ said, at p466:

> 'Its office is to avoid contracts which place the incidence of the tax or the burden of the tax upon some person or body other than the person or body contemplated by the Act. If a person actually disposed of income producing property to another so as to reduce the burden of taxation, the Act contemplates that the new owner should pay the tax. The incidence of the tax and the burden of the tax fall precisely as the Act intends, namely, upon the new owner.'

(ibid. per Gavan Duffy J and Starkey J at p473). This case was approved by this Board in Newton's case.

Then the second limb: 'relieving any person from his liability to pay income tax.' The commissioner's argument placed much emphasis on the contention that 'liability' here may include a future liability. So it may - Elmiger's case[76] so decided - I agree with the decision. But it is one thing to say that an

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76. Elmiger v IRC [1967] NZLR 161

arrangement is caught if and when it applies to income to be received in the future, to which a future liability for tax would attach, and is by the arrangement avoided, and quite another to attack an arrangement under which, in the future, no income is ever derived at all. To describe the latter as one 'relieving' a person 'from his liability' seems to me, with respect, to involve not a flexible use of the word 'relieving' but a simple misuse of language. I cannot forget that 'relief' has a well accepted meaning in fiscal contexts which is a long way from the more general concept of avoidance.

The objection against applying the section (either limb) to dispositions of income-producing property are underlined, I respectfully suggest, by the majority decision. The opinion, by reference to sections 77 and 78 of the Act, as to deriving of income, points out very clearly the difficulties which are likely to arise in the ordinary case, where a disposition within the section has been made, in assessing the disponer to tax. The opinion seeks to overcome this, in the instant case, by reliance on the special circumstance that the income passed through the taxpayer's hands on its way to the trustees. But with respect this ignores the finding of Wilson J not challenged on appeal, that the taxpayer did not derive the income and I fail to see how the physical receipt by him as agent can form the basis of any derivation. As Wilson J said:

> 'The income was not derived by him but by the trustees, and the fact that the merchant who purchased the crops.... paid the proceeds for his own convenience, to the objector does not affect the position.'"[77]

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77. pp757-8

As in the Peate case,[78] the dissenting judgment in the Privy Council, it is submitted, contains the sounder analysis: section 108 was not suitable to strike down the arrangements in question without stretching the language and ironing out the inherent difficulties.

The New Zealand legislation is considered further in Part 4 of this Chapter.

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78. Supra

The Demise and Replacement of Section 260

It has been seen that section 260 had been so interpreted as to have a very restricted operation. In particular, its operation was restricted by the fact that it could not prevent a taxpayer reducing his tax by exercising a choice intended or contemplated by other legislative provisions.

Furthermore, it was strictly an "annihilating" provision, it did not allow the substitution or recharacterisation of transactions.

The traditional unenthusiastic attitude towards the section in the courts can be seen from the case of Cridland v Federal Commissioner of Taxation[79] in which it was said:

> "The taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes specific provision and the validity of the transaction is not affected by section 260 merely because the tax consequences which it attracts are advantageous to the taxpayer and he entered into the transactions deliberately with a view to gaining that advantage."[80]

This case, and others in the 1970's,[80A] by extending the "choice" principle, effectively robbed section 260 of any real use as a powerful tax avoidance tool in the hands of the authorities. It was restricted to the narrow range of cases where taxpayers were prevented from implementing particular transactions by other specific arrangements.

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79. (1978) 52 ALJR 96
80. pp98-9
80A. For example, Mullens v Federal Commissioner of Taxation 76 ATC 4288; and Slutzkin v Federal Commissioner of Taxation 76 ATC 4019.

The attitude of the courts, as then constituted, made it clear that the section had been rendered virtually useless.

Ironically, after the section had been replaced,[81] the High Court, then manned by judges who were less well disposed towards tax avoidance, handed down judgments which demonstrated a much stricter interpretation of the section. This new attitude was demonstrates by a trilogy of cases: Federal Commissioner of Taxation v Gulland; Federal Commissioner of Taxation v Watson; and Pincus v Federal Commissioner of Taxation.[82] All three of these case concerned doctors changing their practices so that they operated through unit trusts. The judgments in these cases showed a marked change of approach. The Court held that the "choice" principle formulated in such cases as Keighery[83] amounted to no more than an example of the rule of statutory construction "generalia specialibus non derogant"[84] so, accordingly, the Keighery principle was only applicable where the transaction was allowed by a specific provision.

This, it is submitted, appears to be an erroneous reading of the earlier Keighery line of cases, which, in effect, said that section 260 could only apply if a specific provision prevented the taxpayer's actions.

In fact, the Court went even further and said that even a specific provision allowing a particular transaction would be of no help to a taxpayer if his transactions were artificial or contrived, so that they could not be predicated as an ordinary business or family dealing. This was, in effect, the approach of the Privy Council in the Newton case.[85]

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81. In connection with schemes entered into after 27 May 1981, infra
82. All 85 ATC 4765
83. Supra
84. "The general cannot derogate from the specific".
85. Supra

However, as noted above, by the time these cases were heard, section 260 had been replaced by much wider provisions. It is clear that, even with the stricter interpretation adopted by the Court in the Gulland, Watson and Pincus cases the original section would still have been ineffective as a general anti-avoidance provision, because the cases dealt with above show that it did not allow the Revenue to reconstruct the transaction; it had merely an "annihilating" effect. What is more, the section only applied to arrangements involving two or more parties.

On a more general note, section 260, as with other general anti-avoidance provisions, lead to considerable uncertainty for taxpayers and their advisers; taxpayers often were not able to establish with reasonable certainty the amount of tax they would have to bear if they took a particular course of action.

A striking example of the problems of uncertainty is provided by the Newton case. As the judges in he various stages of the passage of the case through the courts had not been unanimous as to the application of the section, it could hardly be said that the position was entirely clear, but the taxpayers, having got in wrong, were faced with a penalty of $1,200,000 as well as the tax due.

Another uncertainty surrounding the operation of section 260 was its relationship with judicial anti-avoidance principles. The traditional attitude was that, although the courts had, until the 1980's at least, an unenthusiastic attitude towards section 260, the courts considered that the existence of the section was sufficient reason to prevent the judges from developing any judicial anti-avoidance principles. For example, Gibbs J in the case of Patcorp Investments Ltd v Federal Commissioner of Taxation[86] said:

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86. (1977) 140 CLR 330

"However, the scheme of the English legislation is very different from that of the Australian Act. In particular, the English legislation does not contain a provision like section 260 of the Act which is aimed generally at tax avoidance. The presence of section 260 makes it impossible to place upon other provisions of the Act a qualification which they did not express, for the purpose of inhibiting tax avoidance. In other words, it is not permissible to make an application which does what section 260 fails to do in preventing the avoidance of tax. If it is suggested that a taxpayer had engaged in a device to secure a fiscal advantage, and the relevant provisions of the Act do not expressly deal with the matter, the case depends entirely upon section 260."[87]

This was quoted with approval by Fox, Fisher and Beaumont JJ in Oakey Abattoit Pty v Federal Commissioner of Taxation.[88] This case is interesting in that the judge at first instance had applied the "Ramsay" principle[89] but the Federal Court held that the "Ramsay" principle had no application in Australia due to the presence of section 260. In fact, the Federal Court did not really understand the precise scope of the "Ramsay" principle, as explained in Furniss v Dawson,[90] treating it as a doctrine of economic equivalence, and as being restricted to capital gains tax.[91]

The court therefore rejected the "Ramsay" principle in favour of the application of section 260, and yet, in applying section 260 they came near to the real principle arising out of Ramsay.[92] The court said that the Oakey

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87. pp337-8
88. 84 ATC 4718, see also Lau v Federal Commissioner of Taxation 84 ATC 4929
89. See Chapter 11
90. (1984) 55 TC 324, see Chapter 11
91. Neither being the case, see Chapter 11
92. As opposed to what the Federal Court thought Ramsay said.

Abattoir case should be viewed with the wider perspective that the payment in question was merely one step in a circular series of transactions which bore the stamp of tax avoidance. The taxpayer did not merely create a situation by entering into a transaction to attract particular tax consequences given the complexity, artificiality and circularity of the scheme and its sole purpose of avoiding taxation, the transaction went well beyond merely entering into a transaction.

It is too early yet to tell whether the position will be clearer under the new provisions which came into operation on 27 May 1981: Part IV A of the Income Tax Assessment Act. Under Part IV A, courts must look to the purpose or object of a statute when interpreting it. If a taxpayer enters into a scheme with the object or purpose of obtaining a tax benefit, Part IV A prevents the benefit from arising, and the taxpayer not only has to pay the tax he attempted to avoid, but he may also have to pay a penalty tax of up to twice the amount of the tax he sought to avoid.

It remains to be seen what approach the Australian courts will adopt in cases in which Part IV is raised. Indications, such as they are, indicate that the courts still consider that the presence of a wide statutory anti-avoidance provision prevents them developing a judicial anti-avoidance doctrine based on such things as a business purpose test or the abuse of rights doctrine.

As to the new legislation itself, a number of the limitations of section 260 have been removed; the major one of which it that it now possible to reconstruct a transaction, it is not merely an annihilating provision.

As regards the relationship of Part IV A with other provisions, section 177B(1) states that the operation of Part IV A is not limited by any provision in the Income

Tax Assessment Act apart from Part IV A itself, but other provisions of the Act, such as specific anti-avoidance provisions, are to be applied before Part IV A. A taxpayer can take advantage of specific relieving provisions in the legislation as long as there has been no scheme implemented artificially to come within the relieving provisions.[93]

Before the provisions apply it is necessary to establish the existence of a "scheme" which gives rise to a "tax benefit". A "scheme" is defined as:

> "(a) any agreement, arrangement, understanding, promise or undertaking whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct."[94]

This is a very wide definition indeed, covering virtually any kind of activity, particularly as the person who obtains the tax benefit does not have to be the one who enters into the scheme. However, it is a requirement that the scheme is implemented for the "purpose" of obtaining a tax benefit, and that purpose must be the "dominant purpose".[95]

Section 177D sets out the criteria to which a court must have regard to determine whether the transactions in question constitute a "scheme" to which Part IV A applies. They are:

> (i) the manner in which the scheme was entered into or carried out;

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93. Section 177C(2)
94. Section 177A(1)
95. Section 177A(5)

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result from the scheme;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi).

Part IV A applies where it can be concluded from the above criteria that the scheme was entered into by a person or persons who had the necessary dominant purpose to obtain a tax benefit for themselves or for any other person, whether related or connected, or not.

Dividend stripping is specifically brought within Part IV A[96] in circumstances that would not have been covered by section 260.

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96. Section 177E

Part IV A is, then, a very widely drawn section conferring extensive powers upon the authorities, not only to nullify tax avoidance arrangements, but also to reconstruct transactions in a manner deemed appropriate by the Commissioner. It is too early to say what the courts will make of this provision but what is clear at this stage is that taxpayers and their advisers face a great deal of uncertainty in organising their affairs. As in Canada, Australia is now a very long way indeed from the notion that a taxpayer can only be taxed by clear words and that he is entitled to know with precision what the tax laws are with which he has to deal. It is to be hoped that taxpayers in the UK are never put into such a deplorable position.

PART 4

OTHER COUNTRIES

Introduction

This Part deals with a number of other major industrial countries. The object here is not to give a detailed picture of the anti-avoidance mechanisms of the various countries, but to consider the type of system used, to give an overall picture against which the UK system can be viewed. In addition, a number of points of particular interest are dealt with.

Certain aspects of the anti-avoidance provisions of some of the countries have already been examined in Chapter 9, such as transfer pricing and the "controlled foreign companies" legislation.

The countries dealt with here are:

- New Zealand
- Japan
- France
- Belgium
- The Netherlands
- Finland
- Sweden
- Switzerland
- West Germany
- Italy
- Denmark
- Israel

Although Israel is not normally considered a "major industrial country" it is included because it demonstrates that countries with less dynamic economies face slightly different pressures in the tax avoidance field that the leading commercial countries.

New Zealand

Like Australia, New Zealand has had general anti-avoidance legislation for over 100 years. For example, section 62 of the Land Tax Act 1878 provided:

> "Every covenant or agreement heretofore made or hereafter to be made between landlord and tenant, mortgagor and mortgagee, or between any other persons, altering or attempting to alter the nature of the estate in any land so liable to duty for the purpose of defeating or in any other manner evading the payment of land-tax imposed by this Act, or which shall be in any manner contrary to the true intent of this Act, or calculated to prevent its operation in any respect, shall, so far as regards any such covenant or agreement, be void and of no effect as between the parties thereto."

Such legislation was gradually expanded until, in section 82 of the Land and Income Assessment Act 1900, it was enacted that:

> "Every contract, agreement made or entered into, in writing or verbally, either before or after the commencement of this Act, shall be absolutely void insofar as, directly or indirectly, it has or purports to have the purpose or effect of in any way directly or indirectly altering the incidence of any tax, or relieving any person from liability to pay any tax or make any return, or defeating, evading, or avoiding any duty or liability imposed on any person of this Act, or preventing the operation of this Act in any respect."

This provision established the structure of the New Zealand general avoidance provisions until the present day, although, as has been noted in Part 3 of this

Chapter, the references to "defeating, evading, or avoiding any duty or liability" and to "preventing the operation" of the Act were dropped in 1916.

The present position is section 99, Income Tax Act 1976 which states in subsection (2) that:

> "Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly:
>
> (a) its purpose or effect is tax avoidance; or
>
> (b) where it has two or more purposes or effects, one of its purposes (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to or are referable to ordinary business or family dealings,
>
> whether or not any person affected by that arrangement is a party thereto".

It is further provided that, where a person is affected by any arrangement falling within section 99(2), his assessable income shall be adjusted "in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement."[1]

The predecessor of this provision, section 108 of the Land and Income Tax Act 1954, was a simpler section which stated that a contract, agreement or arrangement was void as against the Commissioner "so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax

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1. Section 99(3)

or relieving any person from his liability to pay income tax."

Accordingly, section 108 was an "annihilating" section because it merely provided for steps to be ignored and applied tax to what was left. Section 99, on the other hand, allows transactions to be reconstructed. The powers of the Commissioner noted above are extremely wide. For example, the Commissioner can adjust income of persons not party to the tainted arrangement.

The Privy Council has had the opportunity to consider section 99 in IRC v Challenge Corporation Ltd[2], a case considered in Chapter 11. The majority of the Privy Council, under the influence of Lord Templeman, gave the section a much wider application than the New Zealand courts, applying questionable notions of economic substance.

The facts, which are set out in Chapter 11, concerned transaction designed to utilise group relief. The transactions in question were not shams but they were inserted solely for tax avoidance purposes. The New Zealand courts held that section 99 did not apply, based on the interaction of section 99 with the rest of the tax code. Their view was that the section does not contain a provision ensuring that section 99 cannot be limited by other sections in the Income Tax Acts.[3] In this case, they said, the taxpayer was within an express relieving provision[4] and so section 99 could not apply even though the taxpayer's motive was tax avoidance. The relieving provisions had its own anti-avoidance measures so the legislature was fully aware of the tax avoidance possibilities. The taxpayer was not caught by the specific anti-avoidance measures, and section 99 could not fill the gap.

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2. (1986) STC 548
3. Compare Part IV A in Australia, see Part 3
4. Section 191, Income Tax Act 1976

As will be seen in Chapter 11, the Privy Council disagreed. In the view of the majority the arrangements in question could be set aside under section 99 on the basis, inter alia, that there had been no "real" expenditure incurred by the taxpayer, It will be seen that the majority gave little importance to the specific provisions of the Act. Whereas the New Zealand courts took the view that the specific provisions effectively precluded the operation of section 99, the majority of the Privy Council were of he opinion that section 99 was of general application and had to be applied in the absence of an express direction excluding section 191 from its ambit.

The approach of the majority can be seen as really an application of the "new approach" of the UK courts to tax avoidance. As will be seen in Chapter 11, the decision of the majority was unsatisfactory and is likely to add to the uncertainty surrounding the application of section 99: doctrines such as "abuse of rights", "fiscal nullity" and the "business purpose test" are alien concepts to the New Zealand tax system. It is not clear how the New Zealand courts will react to the Privy Council decision.

The Challenge case highlights a problem inherent in provisions such as section 99 in that they sometimes, by their very nature, conflict with specific provisions entiteing taxpayers to particular reliefs. It can sometimes be difficult to distinguish between arrangements implemented to take legitimate advantage of statutory reliefs and arrangements implemented solely for tax avoidance purposes. The Privy Council attempted to base a distinction on notions of "artificiality", unreality" and "pretence" as being hallmarks of tax avoidance. The distinction is not, however, clearly, marked notwithstanding Lord Templeman's indications to the contrary.[5]

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5. See Chapter 11

Despite the existence of general, as well as specific anti-avoidance provisions in New Zealand, tax avoidance has increased considerably recently. A study by the International Fiscal Association[6] noted[7] that the Government-appointed Task Force on Tax Reform had stated in its 1982 report:

> "There are indications that avoidance and evasion of income tax and other taxes are becoming increasingly widespread, and that taxpayers and their agents are adopting more sophisticated techniques. The reasons for this lies mainly in the high tax rate now faced by many taxpayers and the availability of a variety of ways to divert income from taxed to untaxed sources."

The rapid increase in avoidance and evasion was due to a substantial extent to the relatively high income tax rates which take effect at fairly low levels. Furthermore, attitudes and techniques of avoidance and evasion filtered into New Zealand from Australia, and to a lesser extent, other countries. As in other countries, not only has the scale of avoidance increased, but there has been a noteable increase in the degree of sophistication being used by tax avoiders.

As well as the general anti-avoidance provisions of section 99, there are numerous specific anti-avoidance sections. It is not necessary to deal with them here, apart from mentioning two points:

1. Section 22 of the Income Tax Act 1976 is aimed at tax avoidance and evasion in an international context. Section 22 allows the Commissioner to make an arbitrary assessment

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6. International Fiscal Association - Studies on International Fiscal Law, Vol LXVIIIa: "Tax Avoidance/Tax Evasion" (1983) (here referred to as the "1983 IFA Report")
7. p533

on a business controlled by non-residents where that business seems to produce insufficient income or an excessive loss. The section has not often been used but, like section 99, it does have persuasive force when the Commissioner calls into question a business' accounts. The section has been used to combat transfer pricing and artificial deduction schemes. It was noted in the 1983 IFA Report[7A] that this section, when coupled with the Commissioner's power to issue an assessment against an agent of a non-resident, and to enforce payment by that agent of any tax so assessed, is a potent potential weapon for the Commissioner. However, because the New Zealand Court favour the legal form of a transaction over the underlying substance, it will still be necessary in many case for the Commissioner to invoke section 99 to support the assessment.

2. There are a large number of deeming and discretionary provisions enabling the Commissioner to attack the substance of a transaction regardless of its form.[8]

The final point to note about tax avoidance in New Zealand relates to tax havens. It was noted in the 1983 IFA Report[9] that New Zealand does not yet have a substantial problem over the abuse of tax havens. Four reasons were put forward for this this:

(i) the small size of New Zealand enterprises compared with the costs involved with using tax havens;

7A. pp537-8
8. See the Law Society booklet "Tax Law in the Melting Pot", pp86-7 for a table of these discretions.
9. pp141-2

(ii) the rigid exchange controls imposed in New Zealand;

(iii) a general lack of sophistication in international tax planning (it was noted in the Report that New Zealand is probably ten years behind countries such as England, Canada and the USA in such matters);

(iv) New Zealand does not generally engage in international transactions of a kind which are conducive to the use of tax havens.

Where tax havens are exploited, the main weapons used against such exploitation are sections 99 and 22.

Japan

The Japanese "controlled foregin companies" and transfer procing provisions are dealt with in Chapter 9.

Generally, although the Japanese Constitution does contain an abuse of rights doctrine[10], this concept is not normally applied in tax cases. This fact was dealt with by David Ward et al in "The Business Purpose Test and Abuse of Rights"[11] who commented:

> "The explanation is perhaps that the doctrine of abuse of rights as applied for tax purposes in civil law countries in Europe connotes the abuse of law or legal forms and it is not exactly the same as the Japanese concept of abuse of rights in the narrow sense. In Japan, the concept of abuse of legal forms, which would be the proper doctrine applied to taxation matters, is not settled in the general law. Also, it should be noted that Japan, unlike Germany[12], does not have a general statutory provision expressly providing an authority to deny efficacy to a transaction where a legal form has been abused."

However, it was pointed out[13] that there is a well established substance over form doctrine which in many ways has similar effects to the abuse of rights principle and the business purpose test used in other jurisdictions, although, as in other countries, the limits of the principle are sometimes unclear. There is also the consideration that there is a constitutional limitation regulating the use of the substance doctrine. Article 84 states that taxes may be imposed only by statute. An unrestricted substance approach would

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10. Article 12
11. [1985] BTR 68 at pp 96-9
12. The Germany legal system has had a strong influence upon that of Japan.
13. [1985] BTR 68 at pp 96-9

violate this Article because principles of interpretation would be used in such a way as to create law. In practice this does place great limitations on the Courts when they seek to set aside the form of a transaction. It appears that the effect of Article 84 is that acts undertaken to avoid taxation may not be ignored unless there is a specific statutory provision allowing it in the particular circumstances in question. So a substance doctrine can be used as an interpretative tool, but it cannot be extended to the complete denial of the legal effect of a transaction, as this would infringe the constitutional principles contained in Article 84.

There are two statutory provisions specifically providing for the substance approach: Article 11 of the the Corporation Tax Law and Article 12 of the Income Tax Law. These Articles are in the same terms, namely:

> "In the event that revenue accruing from an asset or business accrues legally to a merely nominee recipient who does not enjoy the revenue and another person enjoys the revenue, the revenue shall be treated as belonging to the person enjoying it and the provisions of that law shall apply accordingly."

This is known as taxing the "true recipient of income". This is narrower than the substance over form doctrine in that it only determines the real owner of income, whereas the substance over form principle allows the tax authorities to ignore artificial elements of a transaction in favour of the underlying economic substance.

France

The well developed abuse of rights doctrine in France has been applied in tax cases although the extent of its application in fiscal matters has been the subject of some debate.[14]

When this doctrine is applied the created form is disregarded for tax purposes and the true form only is considered. This is embodied in the Book of Fiscal Procedures, Article L64 which reads as follows:

> "Acts which dissimulate the true nature of a contract or of an agreement under the appearance of provisions giving rise to lower registration duties or disguising either a realisation of a transfer of profits or income or permitting the avoidance, either wholly or partly of payment of turnover taxes on the transactions carried out pursuant to the contract or agreement, are not valid against the tax authorities, on whom the burden lies before the tax judge of proving the true nature of the transaction challenged, if the authorities do not take the advice of the consultative committee constituted under Artile 1653C, or if they have raised the assessment of tax contrary to that committee's advice."

The tax authorities therefore have increasing regard to the substance of a transaction rather than its form.

It has been argued by some commentators that Article L64 applies only to simulations or shams and does not constitute a strict substance over form principle. However, the Supreme Court in 1981 gave judgement in a case which would suggest that the concept is not restricted to shams. The Court expressed itself in the following terms:

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14. Ward et at, op.cit. at p86, footnote 93

"Whereas when the tax administration uses the right it is given under this provision [Article L64] in circumstances in which it has the burden of proof, it must, in order to set aside the acts of the taxpayer as being ineffective towards the administration, prove that these acts have a fictitious character or, if not, that they have no other motive than to avoid or alleviate the tax burden which the taxpayer, if he had not carried out these acts, would normally have had to pay having regard to his actual situation and activity."[15]

However, the application of this doctrine is not without limitations in France. This can be seen from a number of cases. For example, in a 1983 case, the Supreme Court refused to apply the abuse of rights doctrine to an arrangement which reduced taxes but which had as its main purpose the circumvention of certain provisions in legislation relating to insurance companies. Under these provisions, stocks which constitute the reserves of an insurance company are valued at cost. In the case in question, the taxpayer sold and immediately repurchased securities which had an increased value, in order to increase its legal reserves. The tax consequence of this was that the company realised a long-term capital gain taxable at only 10%, whereas the tax authorities claimed that the increase in value should have been taxed at 50% because, in their view, the company had revalued its assets although this was contrary to the insurance legislation. Despite the breach of the Insurance Act, the Court held that there was no abuse of rights for tax purposes or fraud on the tax legislation.[16]

The following year the Conseil d'Etat refused to apply the doctrine in a case where a consulting engineer

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15. Conseil d'Etat, 10 juin 1981, no. 19079, and see Ward. p86, footnote 95
16. Conseil d'Etat, 22 juin 1983, no. 32956

entered into a contract to lend his practice without consideration to a company of which he was a director and shareholder in order to take advantage of the corporate rate of tax on his earnings.[17]

The Cour de Cassation has in three cases in 1984[18] rejected claims of the tax authorities that, where there was a transfer of substantially all of the shares of a corporation holding property, which was accompanied by major changes in the corporate structure, the transaction should be considered as a liquidation, and the sale of the underlying assets, with tax being imposed accordingly. The Court ruled that no such liquidation occurred and that the tax consequences must follow the actual legal consequences. In these cases the tax authorities did not specifically seek to apply the abuse of rights doctrine but this may change. It was reported in Tax News Service[19] on 15th January 1985 that, during a tax conference in November 1984, representatves of the French tax authorities confirmed that they had not yet decided whether to argue the abuse of rights doctrine in similar cases in the future in an effort to obtain a different result.

There is a machinery to be complied with whenever the authorities seek to use the abuse of rights doctrine. The burden of proof rests with the tax authorities to prove that there has been an abuse.

Alternatively, they can, before going to Court, seek the advice of the consultative committee which consists of a member of the Conseil d'Etat, a member of the Cour de Cassation, a professor of law and the general manager of

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17. Conseil d'Etat, 11 mar 1984, no.37522
18. Cassation Commerciale, judgement no 246 (Le Jancour), 7 mars 1984; Cassation Commerciale, judgement no 245 (Naturana), 7 mars 1984; Cassation Commerciale, judgement no 365 (Otto Lazar), 26 avril 1984.
19. Issued by the International Bureau of Fiscal Documentation

the Tax Department. The committee would be asked to repress the abuse of rights. Before the committee the tax authorities again bear the burden of proof. If the committee finds for the authorities, the taxpayer must prove the legality of his transactions in Court. If he fails to do so he must pay the tax plus a penalty of 200%.[20]

It can be seen that the tax authorities have encountered difficulties in applying the abuse of rights doctrine to look to substance over form. Furthermore, the 1989 IFA Report[21] disclosed that, following failures of the tax authorities in the courts, the application of the abuse of rights concept to disregard companies is now limited to cases in which companies have been created solely for the purpose of tax avoidance or in which they are mere shells, in that they engage in no business activity and maintain no accounts or general meeting register.

It has been seen in Chapter 9 that France has comprehensive "controlled foreign companies" and transfer pricing provisions. In addition, there are a number of other major anti-avoidance provisions, the most important of which are as follows:

(1) Non-Resident "Services" Companies

As in countries such as the UK and the USA, individuals whose services were particularly valuable, normally in the entertainment and sporting fields, have formed companies to exploit their services. In the case of French individuals, these companies were normally not resident in France. The

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20. CGI Art 1732
21. International Fiscal Association - Studies on International Fiscal Law Vol LXXIV(a), "The Disregard of a Legal Entity for Tax Purpose" (1989; (here referred to as "the 1989 IFA Report"), pp 284-5.

procedure, as have been noted in relation to section 775 ICTA 1988 in the UK[22], was for the company to hire out the services of the individual in return for the appropriate fee, out of which the individual would be paid a modest salary plus "expenses".

In France, this has been tackled by Article 155A CGI. This Article renders certain fees paid to such companies subject to French tax. Sums received by a non-resident company or individual in consideration of services provided by a resident, whether in France or not, are taxable in the hands of the resident individual:

(i) when he controls, directly or indirectly, the non-resident entity; or

(ii) when it cannot be demonstrated that the non-resident entity is principally engaged in industrial or commercial business, other than the rendering of services (this requires more than 50% of the non-resident's entity's turnover to be derived from non-service activities); or

(iii) when the non-resident entity is in a "privileged tax jurisdiction" as defined in Article 238A, CGI.

2. Payments to Privileged Tax Jurisdictions

By virtue of Article 238A, CGI if a French resident individual or entity makes payments such as royalties, fees, management fees, interest payments or salaries to an entity in a tax regime which levies tax at a substantially lower level than France, the payment cannot be deducted in computing

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22. See Chapters 1 and 9

French income tax unless the payer proves that the payments correspond with bona fide commercial transactions and that the payments are neither excessive nor abnormal.

The Article creates a presumption that the payment is unjustified. In fact two separate presumptions are involved, both of which are difficult to rebut. First, the contractual relations between the parties are presumed to be non-existent and the, if that presumption can be rebutted, the payments in question are presumed to be excessive or abnormal.

The burden of proof here is heavy; not only must documents evidencing the obligation to pay be produced, the actual execution of the services in question must be demonstrated. Furthermore, the taxpayer must show that the payment was reasonable, given the value of the services rendered and that it did not constitute an "abnormal management decision."

If the presumptions cannot be rebutted, no deduction will be allowed and, if the French payor is a company and the non-resident recipient is a shareholder, distribution tax is imposed.

If the reality of the transaction is established, but the amount of the payment is excessive, only the excess above the commercial rate is added back under section 238A.

The French authorities have drawn up a non-exclusive list of countries they consider to have a privileged tax system. This includes "high tax" countries which give special concession to certain types of company (such as domiciliary and holding companies in Switzerland, holding companies in Luxembourg and holding and domiciliary companies and Anstalts in Liechtenstein). There are various tests used to establsh whether a country has a privileged tax system but a rule of thumb is that a premumption of privileged tax status will arise if the tax rate is less than two-thirds of that in France.

3. Transfer of Assets Abroad

Under Article 221(2) CGI, if a French company decides to transfer its income-producing assets abroad, or to part with any of its existing business, it will be treated as if it had ceased trading and it will suffer tax as if it had been liquidated. Its assets will be treated as realised at their market value and taxed accordingly. As a result, businesses may not be exported except at a tax cost.

Belgium

Belgium does not have sophisticated or wide-ranging anti-avoidance provisions or principles, and even the abuse of rights doctrine is normally kept out of tax law. As regards the abuse of rights doctrine, it is well develped in other areas of law, but it has traditionally not been used in tax law. Ward et al cites[23] Brepol's Case[24] in which it was said:

> "There is neither a prohibited simulation with regard to the fisc nor fiscal fraud merely because the parties, in order to obtain benefit of a favourable tax provision, have exercised their freedom to contract, without violating any legal obligation, and created relationships all the consequences of which they have accepted, even if the form which they have followed is not the most normal."

In this case, the Court confirmed the taxpayer's right to implement arrangements designed to reduce his tax burden and rejected the Court of Appeal's ruling which had applied the concept of fraud on the law to a transaction designed to reduce taxes through interest deductions.

However, the Belgian Courts appear to be moving away from this traditional approach and now seem more prepared to recharacterise transactions which they do not consider to be genuine even though the parties have accepted all of the legal consequences. In this respect, the Courts have had regard to factors such as the economic purpose of the trasnsction and any tax avoidance motives. The Courts have not referred to the abuse of rights doctrine but the effect of the cases is as if the doctrine had been applied.

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23. Op. cit at p 85
24. Cour de Cassation, 6 juin 1961, Pas. 1961,1,1082

Nevertheless, the 1989 IFA Report[25] discloses that there are no general or specific provisions in Belgian tax law allowing companies to be disregarded for tax purposes where their sole purpose if tax avoidance, and the abuse of rights doctrine cannot be used for this purpose.[26]

Belgian tax avoidance legislation in this area is limited to provisions prohibiting the transfer of the profits between Belgian taxpayers or to foreigners, and a provision concerning the transfer to foreign individuals or legal entitites of assets giving rise to dividends, interest and royalties. It is stated that only the latter provision leads to the disregard of the foreign entity.

Article 187 of the Income Tax Code ("CIR") denies a credit for foreign tax in situations that are deemed to constitute a channelling of loans.

As to "controlled foreign companies" legislation, the Minister of Finance said, in 1986, that such provisions would not be introduced. The 1989 IFA Report stated that such legislation "would not be truly compatible with the Belgian tax systems as a whole."[27] It also noted that substance over form principles are rejected by the Cour de Cassation (the highest court). The court has held that taxpayers have the right to choose the route which gives rise to the least tax, even if the transactions are not commercially the most normal, provided that the taxpyers accept all the legal consequences of their transactions (in other words, as long as the transactions are not shams).

The Report commented that:

> "Since the law of 6 March 1973 amending the company law the existence of Belgian companies that have

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25. pp 210-1
26. Cour de Cassatio', 11 juin 1957, Rep. Fisc. p750
27. p 210

legal personality can however no longer be disregarded without a court order declaring them null. Such orders have effect only with regard to the future. As a result, tax assessments can no longer be based on the sham nature of a company.

Where a company which is originally genuinely formed is later used as a mere tool by its shareholders, the Revenue may rely on the sham nature of the company's activity in order to assess the true beneficiary of the company's profits. The criteria for the existence of a sham activity are however very strict. The sham nature of the company's activity is admitted only when the legal entity has been completely disregarded by the shareholders or directors (no separation of the assets of the company from those belonging to the shareholders or directors, no formal company meetings and no due representation of the company)."[28]

It therefore appears that the sham doctrine is even narrower in Belgium than it is in the UK, and certainly a great deal more restricted than in the USA.

Apart from the transfer pricing legislation described in Chapter 9, there is one other anti-avoidance provision of interest here. Under Article 250 CIR, where a Belgian resident transferor makes a transfer by way of sale or contribution of capital to a foreigner, the transfer can be disregarded for Belgian tax purposes so that any income arising from the transferred assets etc would be taxable on the Belgian resident.

This provision applies if:

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28. p 211

(i) the transferee is a foreign holding company located in a country which is a tax haven or which has a privileged tax regime; or

(ii) the beneficiaries of the income generated by the property in question are subject to significantly lower taxes on the income than they would suffer in Belgium.

The transfer will not, however, be disregarded if either:

(a) the taxpayer proves that the transaction was effected for legitimate financial or economic reasons; or

(b) the taxpayer receives consideration, producing income subject to normal taxation in Belgium, as compared with the tax that the transferor would have paid if the transfer had not ben made.

The Netherlands

Tax avoidance has been defined by the State Secretary of Finance in the Dutch Parliament as follows:-

> "Any action which is essentially of an artificial nature, which has as its purpose the obtaining of a tax benefit, to which a certain tax provision does not apply because of the way the provision has been worded, although it should apply in view of the object of the provision or which does fall within the provision because of the way this has been worded, to which it should not apply in view of this object."[29]

The State Secretary referred to tax evasion as:

> "reprehensible disclosure of incorect information, or non-disclosure of information, to the effect that too low a tax is levied."[30]

The Netherlands provides a number of generous benefits which have given rise to the setting-up of many holding companies and finance companies there with the object of taking advantage of the double tax agreements which the Netherlands have with other countries. The Dutch tax authorities take a fairly lenient view of arrangements which use the Netherlands for tax planning, as long as the transctions are not shams and they do not result in profits, which would otherwise be subject to Dutch tax, being siphoned abroad. As a general rule, the Dutch authorities look more favourably on foreigners using the Netherlands than on Dutch residents using other beneficial tax jurisdictions.

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29. Quoted in "Tax Avoidance, Tax Evasion" by the International Bar Association (London, 1982)", here referred to as "the IBA Report", p 51.
30. Ibid.

The Dutch Courts, when considering tax avoidance, are tending to consider the purpose of the tax provision more than they used to. Nevertheless, the literal approach has been upheld in a number of important cases of both national and international tax avoidance.[31]

The 1983 IFA Report[32] discussed the attitudes to tax schemes in the Netherlands. The freedom of a taxpayer to use "normal" and acceptable" means to reduce tax is a generally accepted tenet of Dutch tax law. However, just because a scheme is commonly used does not mean it can be regarded as "normal" merely because of the frequency with which is is used. In this advise to the Supreme Court before its decision of 22nd July 982, no. 20651, the Attorney General stated:

> "a scheme can become popular very quickly, especially when banks 'sell' tax schemes to their clients in large quantities; in this way a scheme can become very common ('normal' as a quantitive standard), but this does not necessarily deprive such a scheme of its artificial (in essence not 'normal') nature; taxpayers must be in a position to create inventive new solutions (schemes); when a new scheme is used for the first time, it is not common, but it is not abnormal for that reason only."

Whether a scheme is "acceptable" depends on whether its main object is tax saving.

Unacceptable tax avoidance can be attacked in two ways: by the application of the "fraus legis" concept; or under Article 31 of the GAT (the General Law for National Taxes).

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31. See the IBA Report, p 59, footnote 8.
32. pp 559-60

The fraus legis concept is in effect, the abuse of rights doctrine. It can be used by the authorities to disregard artificial and unusual transactions which have been set up exclusively to avoid tax. This has been applied by the courts since 1926.

The first case in which it was applied was in the Supreme Court: HR 26th May 1926, NJ 1926, page 723, PW no 12157. This concerned a scheme aimed at avoiding tax under the Succession Duties Act, which imposed tax on gifts subject to annuities which ended on the death of the donor. Under the scheme, it was arranged that the annuity would end three days before the death of the donor. Nevertheless, the Court held that tax was payable because there was no other reason and no other purpose present than to frustrate the relevant statute, and at the annuity was practically equivalent to one ending on the date of death, and that the purpose and intent of the statute would be contravened if the transactions carried out by the parties were not taxed in the same way as those covered by the statute.

A similar approach was taken by the Supreme Court in 1984,[33] although the concept of fraus legis was not specifically referred to. In this case, the taxpayer was about to emigrate from the Netherlands and, just before he went, he borrowed a sum of money and purchased Government bonds. The interest on the bonds he deducted from his taxable income and, soon after his emigration, he sold the bonds. Apart from the tax saving, the real net economic effect of the transaction was negative. The Supreme Court refused to grant a deduction for the interst on the bonds on the grounds that the transaction did not have a bona fide business purpose and that the tax deduction was the only or main motive for the transaction. The result was that the purpose and intent of the relvant statutory provision[34] would be defeated if

33. HR 21st November 1984, BNB 85/32
34. Art. 35 of the Income Tax Act 1964.

a deduction had been allowed.

The cases have shown that normally four conditions must be satisfied before the fraus legis doctrine can be used. They are:

(1) The legal form of the transaction is unusal or artificial.

(2) The transaction must result in the type of position foreseen by the Legisalture. In other words, the economic effect of the transaction must be the same as that intended to be taxed by the statute.

(3) The arrangement must have been desigend with the sole or main purpose of avoiding taxes, and not to serve a bona fide business purpose.

(4) If the provisions of the tax statute were not applied, the purpose of the law would be thwarted. In other words, the effect of the transactions would frustrate the purpose and intent of the relevant legislation.

What these conditions amount to is that tax is applied according to the true economic circumstances.

Furthermore, the substance over form principle is recognised in the Dutch Courts. For example, in the Sureme Court case, 27th November 1918, B 1202, it was held that money deposited by a corporation with it shareholders in proportion to their holdings, without interest and without terms for the money to be paid back constituted a distribution.

The other way mentioned above that tax avoidance can be attacked is under Article 31, GAT which states:

> "No regard shall be paid, for the levying of direct taxes, to legal acts of which it must be assumed, based on the circumstances, that they would not have been performed had they not had the effect of totally or partially frustrating the levying of tax."

Article 31 can be applied to a single transaction or to a series of transactions which have no real economic effect or which have been implemented solely for the avoidance of tax. If a tax inspector wants to use Article 31, he has to obtain the approval of the Minister of Finance. If this approval is forthcoming, the inspector writes to the taxpayer to tell that he intends to apply Article 31. The taxpayer can then apply to the Court objecting to the Inspector's decision. If the Court turns down the proposal to apply Article 31, the Inspector must settle the assessment without reference to Article 31. On the other hand, if the Court permits the inspector to apply the article, he will settle the assessment on that basis. It can therefore be seen that the Article 31 procedure applies before the assessment is settled whereas other procedures, including fraus legis, are relevant once the assessment has been made on the taxpyer.

There has been a startling change in the attitude of the Courts ot this Article. It has been pointed out[35] that, before 1978 the Supreme Court refused to apply this Article in 39 out of 40 cases brought before them.[36] At this stage, nor surprisingly, the Article was though to be ineffective. However, between 1978 and 1st January 1982, the authorities sought to apply the Article 560 times and in virtually every case they received the

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35. (1983) 23 European Taxation, p27; and Ward et al, op. cit at p 86.
36. The authorities first success in almost 30 years was on 27th December 1967 (HR. BNB 68/80).

support of the Courts. This appear to be a change of attitude hardly less dramatic than the application of the "Ramsay" principle in the U.K.[37]

This increase in the use of Article 31 came about because of the increased practice of attempting to reduce taxable income by creating substantial deductions.

Judgement in some important cases on Article 31 was given by the Supreme Court on 22nd July 1982.[38] In these cases, money was borrowed and invested so that, apart from the expected tax saving, the economic effect was negative in that the return on the investment was less than the cost of the borrowings. For example, one case concerned a Dutch resident who borrowed from a bank at 8½% interest. The taxpayer then used the money to acquire shares in a Netherlands Antilles company, which company deposited the money at 7½% interest with the same bank which provided the money in the first place. The Supreme Court confirmed the application of Article 31 and refused the claim for an interest deduction. The Supreme Court said that, where a transaction would produce a deficit if the anticipated tax savings are ignored, it would be assumed that the predominent motive for entering into the transaction was one of avoiding tax, unless the taxpayer proves that there were other commercial reasons (other than incidental reasons) for the transaction.

These decisions show that certain factors must be present before Article 31 can be applied. These are:

(1) The predominent motive for the transaction must be tax avoidance and, as mentioned above, if the transaction would produce a deficit apart from the proposed tax saving, the Court will infer that the predominent motive was tax avoidance. Even in cases

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37. See Chapter 11
38. HR BNB 82/242

where the deficit was not foreseeable, the Court may still hold in appropriate cases that the predominance motive was tax avoidance.

(2) The taxpayer takes advantage of a method of saving tax which is not intended by the Legislature. The method chosen by the taxpayer does not have to be articial for this purpose.

(3) The way the taxpayer has ordered his transactions conflicts with the purpose of the statute.

When Article 31 is applied, the court ignores actual transactions or structures; whereas, under the fraus legis doctrine, the legal effect of the transaction is recognised but tax is imposed on a structure when an economically identical structure would have attracted tax. In a Supreme Court case [39] it was stated that the courts may apply the fraus legis doctrine even where Article 31 would have been applicable. The procedures to be adopted under Article 31 are more lengthy than those involved in the application of the fraus legis doctrine. However, the powers of the authorities under Article 31 appear to be more extensive than those available under the fraus legis doctrine and this, combined with the change in attitude of the Courts toward the Article, might have meant that the authorities will rely on Article 31 rather than fraus legis.

However, the Ministry of Finance has announced that it will not authorise tax inspectors to use Article 31 from 1st August 1987 to 1st August 1992. Inspectors, for the time being, are therefore restricted to using the fraus legis docrine. Depending on how this works the Government will decide in 1992 whether the use of Article

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39. HR 21st November 1984, VN 1985, p 25

31 is to be allowed in the future. Generally, it was thought to be unsatisfactory to have both fraus legis and Article 31 as different and unconnected principles, leading to a great deal of uncertainty.[40]

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40. Compare, for example, the Supreme Court cases HR 7th February 1979, BNB 79/87 et seq., and HR 4th October 1978, BNB 78/299.

Finland

It is useful to consider Finland here because Finnish tax law contains a general anti-avoidance provision, section 56 of the Taxation Act, which is one of the few general anti-avoidance provisions throughout the world which appears to work well. It has proved to be of great importance in Finland, and a large number of cases have been heard in the Courts on its application.

On the other hand, there are relatively few specific anti-avoidance provisions and such legislation is of minor importance. The National Reporter to the 1983 IFA Report [41] thought that the Legislature have been relatively slow to react to tax avoidance as regards specific anti-avoidance provisions.

Professor Tikka observed[42] that Finnish tax laws are mostly drafted in a hurry and with limited resources. Sufficient attention is not always given to the fact that badly worded legislation can give rise to tax avoidance. He said that the economic substance meant to be subject to tax often has to be defined by means of terms borrowed from private law, and this means that the tax consequences are often associated with the form of a measure or a circumstance under private law. This kind of legislative technique common to many countries, is based on the assumption that a given measure governed by private law, and the economic realities normally connected with it, exist simultaneously. Therefore it is a common tax avoidance technique to give a given measure a form conforming to private law, which form, however, is not adequate with regard to the economic consequences of the measure. This can be called an abuse of private law institutions.

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41. Professor Tikka
42. pp 359-61

Professor Tikka stated:

> "Tax avoidance does not consitute an independent legal problem until an unfounded tax benefit can no longer be refused within the framework of the normal interpretation. The number of tax avoidance cases would probably be much smaller if the tax authorities were relatively free to resort to a narrower or to a wider interpretation or to analogy, and instead of evaluating individual measures it were possible to evaluate a series of measures as a whole. It should also be possible to apply objective criteria to the judgement of the acceptability of, say, pricing or other contract terms from the point of view of taxation. But normally the implementation of tax law in Finalnd is not as relistic as this; on the contrary, there is a strong formalistic tendency. This is partly explained by the views generally held on the division of competence between the legislature and the implementing authorities. A certain degree of formalism is also necessary in order to ensure the predictability of decisions. And, furthermore, not unimportant in this connection is the traditional 'in dubio pro libertate' principle, according to which any regulations affecting citizens' property must be interpreted with caution.
>
> Of course the common occurrence of tax avoidance efforts is partly explained by the heavy tax burden and high tax rates. If the tax benefit sought is considerable, the taxpayer may consider the effort worthwhile even if there is not much chance of succeeding. Tax avoidance which is extensive and assumes sophisticated forms also requires the use of tax advisers with sufficient competence and a certain approach to the matter."

In Finland, the basic rule is that tax law can be amended by the Legislature but, in practice, principles have been developed by the courts, particularly the Supreme Administrative Court.

In relation to the separation of powers and the general anti-avoidance provision, section 56, Professor Tikka observed that, from the nature of section 56, it follows that the area of its implementation is not strictly defined.

From the taxpayer's point of view it is of course important to know beforehand how a given provision will be interpreted, but often it is equally important to be able to rely on the permanence of certain provisions.

Professor Tikka said:

> "A continuous amendment of the law by provisions filling loopholes, tends to reduce the long-range predictability of tax treatment. The granting of tax benefits contrary to the intention and spirit of the law would also conflict with expectations of the economic equality of taxation. If the implementing authorities did not pay any attention to tax avoidance, taxpayers using artifical methods would obtain tax benefits compared with those taxpayers who behave in the normal way intended by the legislator. Of course it must also be remembered that this would cause losses of tax revenue. If the legislator is alert and takes immediate legislative action to prevent tax avoidance, the violation of economic quality and fiscal interest could be stopped short, however. The prevention of tax avoidance by a multitiude of separate provisions might in any case gradually lead to a jungle of

extensive and less controlled legislation.[43] In Finland such a problem has not arisen so far, which is, at least in part, due to the existence of the general clause."

The general anti-avoidance provision, <u>section 56 of the Taxation Act</u>, is expressed in the following terms:

"1. Where a circumstance or a transaction has been given a legal form which is not commensurate with its actual character and meaning, taxation shall take place as if the correct form had been adopted. If it is obvious that a sale price, another consideration or a period of performance in a sale contract or in another agreement has been fixed or other action taken for the purpose of avoiding the payment of tax, the Tax Board shall have the right to assess and estimate the taxable income and property.

2. If it is evident that taxation should be carried out as indicated in subsection 1, the Tax Board shall carefully investigate all circumstances than may be of guidance in reaching a judgement on the matter and offer the taxpayer an opportunity of providing an explanation of the circumstances noted. If the taxpayer then fails to evidence that the legal form given to a circumstance or a transaction conveys its actual character or meaning or that the transaction was not undertaken for the obvious purpose of avoiding a tax, the Tax Board, when

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43. As in the UK.

sessing the tax, shall observe the procedure laid down in subsection 1."

Section 56 has given rise to many decisions of the Supreme Administrative Court.[44] One common category to which it has been applied is where the legal form of a transaction does not convey its real economic effect. An example given in the 1983 IFA Report relates to taxes on certain capital gains. In Finland any profit from the sale of real estate is exempt from tax if the seller has owned it for more than ten years. If, for example, in the ninth year of ownership a prospective vendor leases the real estate to a prostpective purchaser, and the latter grants the former a loan equal to the value of the real estate, it is possible to assess tax on the capital gain even if the sale is not finalised until after ten years of onwership. This particular application of section 56 is, in effect, the substance over form principle.

A second common category of tax avoidance transactions attacked by section 56 consists of step transactions. For example, a capital gain is exempt from tax if the property sold has been received as an inheritance or a gift. There have been arrangements where, say, a father planned to sell real estate or shares, but he has first given the property to his son, who has then sold it on. Where there is reason to suspect that the gift has been made with the purpose of avoiding tax, the father has been taxed on the capital gain even though the validity of the gift under civil law has not been contested, and the sale proceeds have remained in the son's name.

A third common category of situations against which section 56 has been used includes arrangements where the authorities have intervened where a price in a sale deviates from the normal, and no reason other than the

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44. See the 1983 IFA Report, pp362-4.

seeking of a tax benefit can be given for the difference. This is, in many ways, rather like a business purpose test. Often the transactions are between parties not at arms length or where one party is, for example, tax exempt.

There are no strict limits to the application of section 56 but the grounds on which certain standards arrangements have been judged have become fixed enough to ensure a relatively high degree of certainty.

The section does not prevent a taxpayer choosing, from several alternatives, the one he considers most advantageous from a taxation point of view. Also, the most advantageous alternative cannot be determined without taking into account the fact that section 56 may alter the tax consequences which at first sight, and according to a literal interpretation, would seem to accompany an alternative operation.

It is recognised in Finland that a taxpayer is entitled to have certainty in tax law. One of the manifestations of this is the fact that there is provision for obtaining advance rulings: the Central Tax Board can give a taxpayer an advance indication of how a proposed transaction will be treated.

Commenting on the general principle of certainty in relation to tax avoidance, Professor Tikka said that there are diverging opinions on how certainty in tax decisions should be viewed in cases involving tax avoidance transactions. A widely accepted view is that the taxpayer's interest in the certainty of tax decisions is not particulary worth protecting when the taxpyer seeks benefits alien to the intention of the law by means of operations deviating from normal economic procedures. In practice, the conduct of the Central Tax Board has been that, generally, no advance ruling is given if a proposed operation suggests the possibility of tax avoidance.

The case law established by the Supreme Administrative Court has been fairly successful in finding a balance between the requirements of economic equality of taxation and the need for certainty. However, the complaint has sometimes been levelled at the lower tax authorities that they may sometimes be too keen on relying on section 56, thus provoking appeal proceedings.

The element of uncertainty involved in the application of section 56 has a certain preventative effect in practice. Responsible tax planners are cautious and tend to avoid artificial or dubious machinery when trying to cut taxes.

Finish tax law contains few specific provisions designed to prevent international tax avoidance. This is due, partly to the fact that international tax avoidance is not seen as a major social problem, and partly to caution and passivity of the Legislature.

On tax avoidance in general, it has been noted above that Finland has avoided an extensive and complicated legislative framework due mainly to the existence of section 56. Finland appears to have maintained a reasonable balance between the requirements for economic equality of taxation and certainty in tax decisions. Furthermore, section 56 has had a restraining influence in tax planning insofar as a cautious attitude has been adopted towards unusual arrangements aimed at producing tax benefits not intended by the Legislature.

The key to the sucess of the Finnish general anti-avoidance provisions as compared to others mentioned in this Chapter, such as the Australian and New Zealand versions, appears to be the support given to it by the courts. This has been helped by the fact that in Finland there is an absence of detailed legislation which might conflict with, or at least be incompatible with, the general anti-avoidance provision.

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Sweden

Sweden is another country with a general anti-avoidance provision but, unlike Finland, it operates alongside a great deal of complicated specific anti-avoidance legislation.

Before this is considered, however, it should be noted that in Sweden there is a recognised distinction between "tax avoidance" and "tax planning".

"Tax avoidance" refers to a situation in which the taxpayer takes measures which are fully valid in civil law but which take advantage of various tax regulations in such a way as to confer a tax benefit not intended by the Legislature.

If the tax benefit is intended, or at least accepted, by the Legislature, the term "tax planning" is used instead. Taking advantage of the construction of the tax system is also usually referred to as tax planning, and not tax avoidance. An example is that if a taxpayer sells shares and designs the agreement in such a way that tax liability arises and taxation occurs in a tax haven to which he emigrates, then it is a question of tax planning.

The IBA Report gives another example:

> "A seller of land includes his own house in order to get a tax deduction of 3,000 Sek/year for the time he has been living there. Afterwards he buys his house back in a separate deal. The total result is a tax gain compared to an outright sale of the land excluding his own house. Such a combined transaction has not been regarded as tax avoidance to be corrected by the tax courts, as, each part of the transaction, regarded separately, is correct in form and substance."

Taxes are high in Sweden and both tax planning and tax avoidance are widespread. This has given rise to a wide range of complex anti-avoidance provisions which are difficult to interpret. The tax authorities do, however, give advance rulings on proposed transactions.

Swedish courts have not recognised a general abuse of rights doctrine, although it has been specifically inserted in certain statutes; for example, relating to the law of contract.

A general anti-avoidance provision was introduced on a trial basis and was retained at the end of that period as a permanent part of the law. Such a rule was proposed before (in 1931, 1954 and 1963) but was turned down because of the difficulty of combining it with the rule of law and the fair and equal treatment of all taxpayers. This provision was eventually introduced because of the unwillingness of the courts to defeat tax avoidance without the clear support of the law.

The provision in question applies to both national and international tax avoidance. It is Lag 1980:865 ("The Tax Avoidance Act") and came into operation on 1st January 1981. Under this law, transactions are not recognised for tax purposes if they form part of an arrangement to circumvent tax rules.

Originally a transaction was not so recognised if the following conditions were fulfilled:

1. The taxpayer must have performed a legal act which was part of a tax avoidance procedure.

2. The tax avoidance procedure must constitute a roundabout way in relation to a normal and, in economic terms, essentially equivalent alternative course of action.

3. The transaction must result in a substantial tax benefit which can be assumed to have been the decisive reason for the choice of the course of action taken.

4. The procedure must be a clear violation of the purpose of the legislation.

The 1983 IFA Report commented on these conditions.[45] Regarding the first condition, the Tax Avoidance Act can only be applied if the taxpayer has chosen an "artícial" procedure which leads to essentially the same financial result (disregarding the tax benefits) as a <u>normal</u> alternative. However, in tax avoidance transactions, the taxpayer often chooses an altenrative which produces a different financial result.

With respect to the fourth condition, this can be difficult to apply. In some cases, it is not easy to ascertain the aims of the Legislature. Sometimes the reasons for a law may be difficult to ascertain: Swedish tax laws are old and they have often been amended and changed.

The 1983 IFA Report referred to conditions 2 and 4, in particular, as "imperfect preconditions" which "will result in the law's obtaining an exceedingly narrow area of application."

The second condition, which in practice imposed rigid limitations on the application of the general anti-avoidance provision, was removed in 1983.

In a report prepared by the OECD Committee on Fiscal Affairs called "Tax Evasion and Avoidance",[46] it was stated that the record of the Swedish courts was not all

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45. pp 602-3

46. 1980. Here referred to as "the 1980 OECD Report".

one sided and that some transactions, in the absence of an express statutory provision, were invalidated for tax purposes even though they were made in a legally correct form, while other transactions (and sometimes very complicated transactions) were allowed although the only (or almost only) result of the transaction was a reduction in tax. However, Ward et al.[47] noted that, in fact, an invalidation of transactions by the Swedish courts has been very rare and, where it has occured, it normally involved a civil law flaw in the transaction.

When the general anti-avoidance provision applies to a taxpayer, he is taxed as if he had chosen the alternative course nearest to the one he had taken. If this is not possible, tax of a reaonable amount is assessed.

This provision gives rise to much uncertainty as to it applicability. The number of applications for advance rulings has accordingly increased substantially.

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47. Op. Cit. at p 89, footnote 7.

Switzerland

Tax avoidance tends to be rather more difficult in Switzerland than it is in many other countries. In Article 2 of the Civil Code it is stated that:

> "Every person is bound to exercise his rights and fulfill his obligations according to the principles of good faith. The law does not sanction the evident abuse of a man's rights."

The abuse of rights doctrine has long been applied in taxation matters. In addition, the Swiss Courts recognise a principle often termed the "economic approach to the facts" which is a pragmatic rule of interpretation of tax law available to be used by the taxing authorities as a means to counteract tax avoidance. The application of this latter principle is subject to certain conditions in that the tax authorities must prove that the taxpayer has used a "strange and abnormal instrument, which is not justifiable under the circumsntances and which does not correspond to the economic reality."[48] Failure to prove this will mean that the tax authorities cannot go behind the legal forms used by the taxpayer.

The 1980 OECD Report summarised the position [49] as follows:

> "In general, tax is avoided where the taxpayer has chosen for a legal transaction an unusual form of civil law where such unsuaul situation entails a notable savings in tax without it being possible to attribute such as state of affairs to any other motive.
>
> According to the decisions of the Federal Court, a tax is avoided when:

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48. IBA Report p 76
49. p 80

- The form of civil law chosen by the parties appears unusual, inappropriate or strange, and in any case unadapted to the economic circumstances;

- grounds exist for holding that this choice has been improperly made with the sole object of saving taxes which would have been due had the legal relation been arranged in an appropriate manner;

- the procedure chosen would effectively result in a notable savings of tax insofar as it was allowed by the taxation authorities."

If a taxpayer does carry out an unusual transaction, the tax authorities may assume that tax avoidance was intended. The tax authorities may then impose tax as if the transactions had taken place in the normal way, without taking into consideration the unusual means employed for tax avoidance.

The Federal Court found that there was an unusual structure which consituted an abuse in a recent case[50] which involved a complex scheme designed to avoid taxes on dividends which would otherwise have been paid out of substantial surplus profits of a Swiss Corporation owned by Swiss residents. The Court held that the taxpayer was not entitled to a refund of the tax that had been withheld on the dividends.

Similarly, in a case of 11th December 1981,[51] there was a scheme to avoid tax on dividends. The Court looked at the substance of the transaction rather than the form and held that tax was in fact due.

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50. On 3rd October 1980, noted in (1981) 21 European Taxation, p329
51. See (1982) 22 European Taxation p 261

Switzerland has also applied the abuse of rights doctrine to double taxation agreements. On 14th December, 1962 there was passed the Decree of the Federal Council concerning measures against the improper use of conventions concluded by the confederation for the avoidance of double taxation. Under this Decree certain transactions are deemed to constitute an abuse. In Article 1 of the Decree it is stipulated that:

> "The exemption from withholding taxes provided for international agreements negotiated by the Confederation for the purpose of avoiding double taxation (agreement) by the treaty country shall not be applicable to persons who, pursuant to the treaty, are not entitled to such a claim (unentitled persons).
>
> A tax exemption is considered to be abusively (improperly) claimed:
>
> a) if the prerequisites described in the agreement, especially with regard to residence or seat in Switzerland, beneficial interest, taxability are not met;
>
> b) if it is misused."

Article 2 states:

> "A tax exemption is considered to be improperly claimed by a person or corporation or partnership with residence or seat in Switzerland if the claim for tax exemption would have the effect that a considerable portion of the tax exemption would, either directly or indirectly, redound to the benefit of unentitled persons.

A tax exemption is considered to be improperly claimed, _inter alia_, if it concerns revenue

a) of which a considerable portion is used, either directly of indirectly, for the purpose of satisying the claims of unentitled persons; satisfying claims includes, as a rule, utilization of revenue for the purpose of depreciation of assets whose counter-value has been received or is being received, either directly or indireclty, by unentitled persons;

b) which is being received by a corporation with its seat in Switzerland in which a substantial interest is held by unentitled persons, either directly or indirectly in the form of shareholdings, or in some other manner, and which company does not undertake a reasonable distribution of its profits;

c) which, through the intermediary or a trustee, redounds to the benefit of unentitled persons;

d) which redounds to the benefit of a family foundation with its seat in Switzerland, or a partnership with its seat, but without any mercantile establishment in Switzerland, in which unentitled persons have a controlling interest."

This Decree was passed under pressure from Switzerland's treaty partners who complained that the network of Switzerland's double tax agreements was being used by persons who were not strictly entitled to benefit. In other words the Swiss treaties were being used by residents of othe "high tax" countries for the purposes of "treaty shopping".

Most of the recent treaties negotiated by Switzerland contain an Article based on the provisions of the 1962 Decree.

The situation in Switzerland was summed up in the IBA Report as follows:

> "Tax planning as known and practiced in certain countries would often result in situations for which the existence of a tax avoidance scheme would be presumed. As a consequence, planning in the field of taxation remains limited."[52]

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52. p 77

West Germany

The abuse of rights doctrine in tax matters is contained in the General Tax Code.[53] The Code at paragraph 42 states:

> "The tax law cannot be evaded by an abuse of structures offered by law. In the event of an abuse the tax claim arises as if a legal structure had been used which is appropriate to the economic substance of the transaction."

There is also a doctrine of simulation contained in paragraph 41(2) whereby the legal effect of contracts can be ignored where the parties do not really intend the contracts to have legal consequences.

The onus is on the tax administration to prove that the intention to avoid taxes exists. Furthermore, it must be shown that the concept of law used by the taxpayer is inadeuquate for the conomic purposes of the transaction which he seeks to accomplish and that there are not economic or other significant reasons which would justify the use of the concept of law adopted by the taxpayer.

The Courts, through their interpretaion and application of the above conditions, have, it has been claimed, developed the notion of abuse of rights to a point where it is now very difficult to predict the outcome of even modest tax planning efforts for German Tax purposes.[54]

Traditionally, taxpayers were allowed to structure activities so as to pay the least amount of tax. However, the Supreme Tax Court in 1975 and 1976 held that the interposition of foreign corporations by resident

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53. Abgabenordnung 1977
54. See (1983) 23 European Taxation, p 362 ; and (1985) 25 European Taxation, p 21.

taxpayers to hold foreign and domestic assets could consitute an abuse within paragraph 42. In fact, the Courts appear to attack tax saving companies more frequently through the abuse of rights doctrine than through the application of the complex "controlled foreign companies" legislation.[55] In the field of international tax, the German Courts until recently appeared to be reluctant to apply the abuse of rights doctrine to individuals who structure their activities to take advantage of double taxation agreements.[56] However, paragraph 42 has recently been applied by the German Courts to attack the incorporation of a "letter box" company by a nonresident.[57]

It can therefore be seen that the abuse of rights doctrine is used as a general anti-avoidance provision in the German tax system, and it has lead to considerable uncertainty for taxpayers and their advisers.

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55. See Chapter 9
56. See Ward et al, op. cit at p 94.
57. Decision of 10th November, 1983, BStBl. 1984, II p 605

Italy

There is no formal distinction in Italy between "tax avoidance" and "tax evasion", however, the 1983 IFA Report[58] identified four categories, although the boundaries between them are sometimes difficult to draw. The categories were:

(a) "Tax saving", which consists in preventing the actual occurrence of a taxable situation. The example given is of a person who refrains from consuming a certain product solely because it is subject to a consumption tax.

(b) "Tax avoidance", which means exploiting imperfections in the law so that a certain transaction will not give rise to tax, or will give rise to a lower tax burden than would otherwise be the case. The example given in the Report is of one company taking over another for the sole purpose of deducting the latter's past losses.

(c) "Tax evasion", which consists in violating the law in such a way that a fact, constituting a taxable transactions, will not appear as such, or will not become known by the tax authorities. As an example, the Report cites a person altering accounts to conceal profits, failing to submit an income return or submitting an untrue one.

(d) "Tax insolvency", which covers the situation where a taxable transaction has occurred and become known to the tax authorities, but the taxpayer has occurred and become known to the tax authorities, but the taxpayer has avoided

58. p 450

paying the tax. The example given is that of taxpayers who divest themselves of their property in order to escape administrative action.

Regarding the measures employed to combat tax avoidance, the Commission on the Study of Tax Reform was set up by the Government in 1962. The Commission considered whether a general provision should be introduced which would allow the courts to consider whether the sole or main purpose of a transaction is tax avoidance. They decided that the disadvantages of such an approach outweighed the advantages and, accordingly, only specific provisions are used on the legislative front to counter tax avoidance.

Italy also uses a doctrine of "simulation". This can often be very similar to tax avoidance and the "sham" as understood in the UK.[59]

Article 1414 of the Italian Civil Code states that "a simulated contract does not produce effects between the parties. If the parties intend to make a contract different from the simulated contract, the former is binding between them, provided that the requisites for form and substance are present. The preceding provisions also apply to unilateal acts directed toward a specified person, when such acts have been simulated by agreement between the author and the person to whom they are directed."

The doctrine of simulation can itself be divided into two categories; "Absolute" simulation and "Relative" simulation. Absolute simulation occurs where the parties pretend to have entered into an agreement whereas, in fact, no such agreement has been executed. Relative simulation occurs where the parties pretend to have entered into one

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59. See Chapter 11

kind of agreement but they are in fact performing a different one, or, where a person pretends to enter an agreement with one person when in fact he has entered into an agreement with another.

Where an agreement can be shown to be simulated, the authorities can set the agreement aside, and tax the parties according to the real agreement between the parties.

This principle applies to all agreements in Italian Law and is not restircted to tax law.

The IBA Report[60] gives an example which shows the limitations of the doctrine of simulation in the field of taxation. The example refers to a person, S, who, in order to avoid paying tax on a gain from selling property to P for $Y, leases the property to P for 99 years for an annual rent of $X (giving a market value for the lease of $Y) and P lends $Y to S with annual interest of $X. This cannot be attacked as a simulated agreement provided the lease agreement between S and P, and the loan agreement between P and S, are agreements within the law, and are actually executed and performed. However, the scheme could be attacked as simulated if P and S enter into a side agreement whereby S states that he has no right whatsoever to claim that the property at the end of the lease agreement, and he makes a similar statement regarding the loan.

A simulated agreement which is entered into for the purpose of avoiding taxes constitutes tax evasion because the parties either hide information from the authorities, or they represent that their agreements have one form when, in reality, they have another.

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60. pp 46-7

On a wide front, the courts in Italy do not apply the abuse of rights doctrine and Article 23 of the Italian Constitution forbids the courts from creating such a doctrine. Article 23 states that "no personal or patrimonial obligation shall be imposed other than under the law". Furthermore, Article 12 of the "Provisions on the Law in General" relates to statutory interpretation and it says that "in applying statutes no other meaning can be attributed to them than that made clear by the actual meaning of the words, according to the connection between them and by the legislative intent". It then goes on to say that "If a controversy cannot be decided by a precise provision, consideration is given to provisions that regulate similar cases or analgous matters; if the case still remains in doubt, it is decided according to the general principles of the legal order of the State."

By virtue of this provision, in tax cases the spirit of the legislation cnnot be taken into account.

The 1983 IFA Report[61] analysed a recent shift in jurisprudence in considering tax laws. Until a few years ago, the general principle was that one had to look at the legal framework rather than the economic effect, event in relation to Registration Tax which is governed by a provision whereby "taxes are applied according to the intrinsic nature and effects of the acts or transfers, even through the total or apparent forms do not correspond to them." The courts had consistently held that both the intrinsic nature and the effects were to be taken, not in an economic, but in a legal sense.

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61. pp 453-4

Furthermore, the courts had consistently upheld the validity of what was called the "indirect transaction", whereby a legal effect was brought about in an indirect or devious manner. Such a transaction would not be treated as a simulated transaction because the apparent transaction is the one wanted by the parties, it is just that they chose an unusual way of obtaining the same effect.

The position has, however, recently changed in that the courts have held, in certain cases, that situations which previously had been upheld as indirect transactions, were in fact simulated transactions. The courts had regard to the economic reality of the situation as a grounds for taxation. There appears to be no justification for this in Italian law.

Cases which support this change of emphasis include decisions of the Supreme Court of Cassation No. 2115 of 5th May, 1978 and No. 5264 of 7th October, 1981. These cases concerned companies which had made profits and, instead of distributing that profit to the shareholders, which distribution would be subject to the withholding of tax, the companies chose to allocate the profits to a reserve fund and to distribute "stock overprice funds." The Court held that, although this was perfectly legal, it was a device to avoid the burden of the withholding tax and therefore the tax was applied even though from an accounting and a legal standpoint the distribution was indeed of stock overprice fund.

This change in the attitude of the courts can also be seen from the decision of the Court of Cassation No. 2658 of 9th May 1979. By a deed, a father gave to his sons State Bonds (which are exempt from tax). By a separate deed, the father and sons exchanged State Bonds for real property, and paid the Registration Tax. The authorities claimed that this was really a gift of the real property, which would have been subject to a Donation Tax. The Court of Cassation held that the two transactions were aimed at achieving a different result from that typical to the transactions in quesion, and that they really amounted to a gift of real property, giving rise to Donation Tax.

Both the IBA Report and the 1983 IFA Report[62] expressed misgivings about this decision. The IBA Report said that the court did not identify the provisions which empowered the tax authorities to tax the "final result" and, in fact, such provisions do not exist. It was noted that a similar interpretation was contained in the Court of Cassation decision No. 5563 of 6th October, 1980. These decisions, it was stated, were reached as if the Italian tax system contained a general anti-avoidance provision. Furthermore, the same Court of Cassation on 24th April 1979, in a ruling on a case involving tax avoidance, stated that a tax can be applied only in a case provided for by the law, although, as a consequence of loopholes in the legislation, instances may occur which escape taxation. Only Paliament, not the judge, said the court, is empowered to eliminate such loopholes.

The 1983 IFA Report said[63] of the May 1979 decision, that the new interpretation adopted by the court was in conflict with Article 23 of the Consititution.[64] The National Reporter considered this to be a departure from the earlier principle, rather than a change in it, and expressed the view that this was not acceptable. He said:

> "If this road will be followed - apart from the violation of Article 23 of the Constitution... - the uncertainties, the doubts and therefore, litigation will be further increasing, for all the more since, while for purposes of legal interpreation it will always be possible to use as landmarks, the general principles which underly the whole tax system, an interpretation based essentially on the strictly strictly economic effect of phenomena, alien as it would be to our tradition, would be a sort of free-floating mine with no anchor."[65]

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62. pp43-4 interpretation based essentially on the
63. p 454
64. Supra.
65. p 460

It remains to be seen which way the Italian courts will go in this matter. Until this quesiton is resolved, there will be a period of considerable uncertainty in Italian tax law.

Denmark

There are very few anti-avoidance provisions in Denmark[66] and yet, despite the country's relatively high tax rates, only a few cases involving tax schemes ever end up in court. It is interesting to consider the reasons for this.

The view was expressed in the IBA Report[67] that the Duke of Westminster case[68] would probably have gone the other way in Denmark on the grounds that the whole arrangement was a "sham". That term means something slighlty different in Denmark than in the UK. In Denmark, a sham exists where the facts of a transaction do not reflect a legal reality.[69]

The IBA Report commented:

> "If ..... a legal reality is at hand, the question arises whether invalidity may be established on the grounds that the parties involved in the transaction have tried to avoid a legal provison prohibiting the intended result. In other words, if the legislator had known of the misuse, he would have legislated against it. Traditionally, the tax administration has asserted that such transactions be deemed invalid. In court some cases have been decided on grounds which probably come close to this doctrine, but it should be noted that the Supreme Court has never supported it. On the contrary, the Supreme Court has ruled that the motive of avoiding taxes being the main element in an arrangement does not in itself disqualify the transaction: Instead, where a transaction has been deemed invalid, the result is

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66. Section 12 of the Company Tax Act, which concerns transfer pricing, being the only one which specifically deals with tax avoidance.
67. p 33
68. Duke of Westminster v IRC (1935) 19 TC 490, see Chapter 11
69. See Chapter 11 for the UK understanding of the word.

based on interpration of the law or the principles of law. However, where the motive is clear, it may be that such interpretation tends to be more expansive."

When a tax provision is being considered by the courts they begin by looking at the actual working of the provisions. However, the courts go further, and consider the purpose of the provision. Therefore, the actual words in themselves may not be decisive. Furthermore, the courts look to the substance of a transaction rather than its form.

The National Reporters in the 1983 IFA Report[70] were of the opinion that the lack of a general provision on tax avoidance is remedied to a certain extent by this "realistic" method of interpretation. They went further and expressed the opinion that this approach, together with an efficient assessment system, may have a far better effect in practice than a general provision would have.

They said that they were of the impression "that the existing legal measures suit Danish legal traditions well, and that there is no obvious need to introduce general rules on tax avoidance and tax evasion."[71] They continued that the problems which other countries have found it necessary to solve by general legislation, seem to have been solved in Denmark, partly by virtue of the general law interpretation and partly by virtue of the fact that the Danish system has an advanced assessment system.[72]

Another factor is probably the harsh treatment taxpayers and their advisers can expect in the courts if they overstep the mark, in situations falling short of evasion

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70. p 320
71. p 326
72. The "EDP technique"

or fraud in some other jurisdictions. The IBA Report[73] mentions two cases which seem to illustrate this.

One case involved a tax lawyer who, using controlled companies, offered clients tax schemes. The lawyer was in charge of all of the transactions. The court found that, although the formalities were complied with, the transactions were without business reality. The court held that the transactions were fictitious and shams. The court further held that the lawyer intended to give false or misleading information with the intent to avoid paying taxes. The lawyer was fined D.Kr 1.5 million, with an alternative of 6 months in prison.

The other case concerned the owner of a Danish furniture commission company who formed a Liechtenstein Anstalt and transferred the commission to the Anstalt, although the administration of the commission business remained with the Danish company: the Anstalt had no real business activity. The court held that the owner of the companies had acted with the intent of forwarding false or misleading information with the further intent to avoid paying taxes. The owner was sentenced to 6 months imprisonment and a penalty of D.Kr 800,000 was imposed. In addition, an increased personal tax liability of the transferred amount of D.Kr 515,099 was levied on him.

In view of decisions like this, perhaps it is not too surprising that so few cases involving tax schemes reach the courts.

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73. pp 36-8

Israel

It may seem odd that Israel has been included for consideration. However, it demonstrates that the problems faced by such countries tend to be rather different from those seen in the major industrial countries.

Tax avoidance appears to be a particularly bad problem in Israel. From the late 1960's tax avoidance and tax evasion grew rapidly and it is practised by all sections of the community.

The National Reporters to the 1983 IFA Report[74] attribute this to a number of factors. For example:

(i) the economy is shaky;

(ii) the tax rates are high;

(iii) the Tax Code is verbose in form, and cumbersome in content;

(iv) the civil service is overworked and often ineffectual.

Unlike in some other countries, public opinion in Israel does not seem to have set its face against tax avoidance. The attitude of the courts, for example, is that the payment of taxes is a legal matter not a moral one. As to the attitude of the general public, the 1983 IFA Report has this to say:

> "After a generation in which they proved to be a heavy burden for the citizen to carry, the tax laws have, gradually, lost musch of their meaning for him. The repeated amendments to the basic Income

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74. p 431

Tax Law have become complicated and cumbersome, often idfficult to explain or understand. Many who wished to comply with the Tax Code found its verbose language unintelligible and gave up the unequal, time-consuming struggle."[75]

The Report continues:

"There were few tangible rewards for the full taxpayer and no appreciation of his moral integrity. .... Public opinion may have paid lip service to the notion that we should all pay our taxes down to the last cent but is condemnation of avoidance and evasion has, in recent years, been superficial, expressing little negative reaction...."

One particular problem prevalent in Israel is the high rate of inflation. High inflation does, of course, devalue the currency and it can also prompt increased tax avoidance. In Israel this problem was faced by the introduction in 1982 of the Income Tax (Taxation in Periods of Inflation) Act, 1982. The object of this Act was to try to adapt the income tax rules to the situation where nominal business values lose their meaning through the ravages of high inflation.

This Act tried to cover all of the loopholes the legislators could think of, as well as curing the deficiencies that had been exposed over the previous few years. The result is that the Act is complicated and difficult to understand, and it soon became apparent that there were many errors in it requiring amendment.

Because of the effect of inflation, the most common tax avoidance schemes in Israel in recent years have involved subsidised interest rates which exploited the differences between the cost of the financing and the high rate of inflation.

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75. p 432

Treaty shopping is treated as legitimate planning by the Israeli authorities. Furthermore, transfer pricing is not challenged unless the taxpayer becomes careless or greedy.

The Income Tax Ordinance contains a general anti-avoidance provision: section 86. It is headed "Fictitious or Artificial Transaction" and reads as follows:

> "Where the Assessing Officer is of the opinion that any transaction which reduces or would reduce the amount of tax payable to any person is artificial or fictitious or that any disposition is not in fact given effect to, or that one of the main purposes of a given transaction is improper avoidance of tax or reduction of tax, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly. An avoidance of tax or a reduction of tax may be regarded as improper although they are not illegal. For the purpose of this section 'transaction' includes 'operation'."

Many difficulties have arisen over the application of Section 86. Initially, for example, it was not invoked unless the transactions were shams. In 1942 the Attorney General said the following about the predecessor to Section 86:

> "It has always been my view that before the Assessing Oficer can put [the section] into operation he must be satisfied that the transaction is artificial or fictitious, and that the artiiciality or fictitiousness has been hidden by reason of some undisclosed relevant factors, such as a secret deed which would nullify the effect of the

transaction. It is not sufficient to establish that a transaction was unusual or unbusiness-like. It is a fundamental principle of the Common Law that a man can dispose of his property at his own sweet will, subject only to the limitation that he must not infringe a statutory provision, such, for instance, as the sale of shares in a ship to a foreigner."

Adopting this line, section 86 would have little effect because sham transations can be ignored even without section 86.

The courts, however, came to adopt a different interpretation. They considered that "artificial" was not restricted to mere shams, but referred to transactions which "assumed a form repugnant to the accepted norms of economic life and deviated from the paths customarily adopted by persons seeking to attain a certain aim."[76]

The 1983 IFA Report[77] noted that the "economic approach" assumed a different nature in more recent cases. In a case involving a transfer of deductible losses from one company to another, the transaction was ignored for tax purposes because it was regarded as "artificial", although the transaction was legal. It was ignored because it was evident that, but for the tax advantage, it would not have been carried out. The taxpayer could not show any other purpose whatever for the purchasing of the company which had sustained losses.[78]

In subsequent cases, the courts have resorted to a business purpose test holding that transactions entered

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76. I.T. App. Tel-Aviv 6/50, Pessakim Mehoziyim, Vol 7, p 347
77. p 438
78. C.A. 265/67, Piskei Din, Vol 21 (part 2), p 593.

into with no business purpose, except the avoidance of tax can be ignored for income tax purposes.[79]

When section 86 was amended to its present wording in 1968, the Legislature introduced the business purpose element into the ewording,[80] so that a taxpayer is now caught if one of the main purposes for a transaction is tax avoidance. The avoidance must, however, be "improper". The section does not define "improper" except to say tha "improper" avoidance is not necessarily illegal. Few cases have come to the courts under the amended section 86 since 1968.

Over the years, Israel has tried both specific and general provision to combat tax avoidance, but with only limited success. This appears to be due to the inadequate drafting of the legislation combined with a liberal public view of avoidance caused by the poor state of the economy.

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79. C.A. 11/74, Piskei Din, Vol 29 (Part 1), p 297;
C.A. 634/73, Piskei Din, Vol 29 (Part 1), p 517;
C.A. 450/73, Piskei Din, Vol 28 (Part 2), p 287;
C.A. 734/74, Piskei Din, Vol 30 (Part 1), p 27.

80. Supra

CHAPTER 11

THE SUBSTANCE DOCTRINE

Introduction

Few concepts of tax law have given rise to as much confusion as that of the concept of the substance of a transaction and the extent to which it takes precedence over the form in which the transaction is cast. Part of the difficulty lies in the fact that there are no universally accepted meanings of "form" and "substance" and these words have been used to mean different things in different contexts by different judges. The picture is further confused by the fact that the scope of these two words varies from country to country.

What is more, the substance doctrine has developed over the years in line with the increasing sophistication of the tax system and in the methods employed by taxpayers to reduce their tax burdens.

Another contributory factor is that the substance doctrine has been the subject, on occasion, of some particularly loose analysis in the courts. Some judges appear to have used the substance doctrine to help them to reach the decision they thought was justified, when a more technical analysis of the application of the law to the facts might have caused inconvenient difficulties. Sometimes it seems that the substance doctrine has been used to save the court the trouble of entering into a detailed examination of the technicalities.

The result is that there is a great deal of confusion and inconsistency, and often terms and concepts are used by lawyers and commentators, and sometimes judges, without a clear understanding of what those terms and concepts really entail. This Chapter attempts to bring some order to the chaos so far as the use of the substance doctine in the UK is concerned. The use of the doctrine in some other countries has been touched on in Chapter 10.

The first sections of this Chapter deal with the two areas of the subject in which there is relative certainty: first, the clear notion that the name given to something cannot change its real nature; and, secondly, the concept of the "sham". The rest of the Chapter is devoted to an examination of the development of the substance doctrine, with particular reference to what are commonly known as the "Duke of Westminster" principle and the "Ramsay" principle.

Substance Versus Nomenclature

There is one point that is almost too obvious to need stating here, namely the form of a transaction has always been disregarded if that has been no more than a name applied to something that is in reality something else.

An early authority on this is Nizam's Guaranteed Railway Company v. Wyatt,[1] in which Pollock B said:

> "I quite agree that the mere use of the words 'an annuity' cannot be taken as governing and deciding this question; you must see what in substance that sum of money which was called 'an annuity' which was paid annually is".[2]

This line was followed in Scoble v. Secretary of State for India,[3] and has not seriously been challenged or doubted since.

Similarly, one can have a deed which is perfectly good according to its tenor, but which does not govern the parties who purport to enter into it. The "partnership deed" in Dickenson v. Gross[4] fell into this category. The parties to the deed did not pay the slightest attention to it and did not act on it. This is not preferring substance to form; it amounts to no more than saying that the name or facade of "partnership" was used when the legal position was something else.

A case making the same point, but from opposite facts, is

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1. (1890) 2 TC 584
2. p588 Hawkins J made a similar point at p591
3. (1903) 4 TC 618; fpr example pp621 and p624
4. (1927) 11 TC 614. The judge also considered the deed to be a sham, infra

Fenstone v. Johnstone,[5] in which two men agreed to be associated in a business venture, but a letter between them setting out the terms of their association stated that the arrangement "shall not constitute any partnership between us". The court, however, held that there was in fact a partnership.[6]

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5. (1940) 23 TC 29. See also Cozens-Hardy MR in Weiner v. Harris [1910] 1 KB 285 at p. 290; Lord Halsbury LC in Adam v. Newbigging, 13 App Cas 308 at p. 315; Wilmot Breedon v. Haddock [1974] STC 223, in which a purported subvention payment "effected nothing and implemented nothing" (per Russell LJ at p. 228); Perrin v. Dickson, (1930) 14 TC 608 at pp. 614 and 165 per Rowlatt J, p. 619 per Lord Hanworth MR, pp. 612-7 per Lawrence LJ and Henley v. Murray, (1950) 31 TC 351 at p. 365 per Sir Raymond Evershed MR.
6. See Wrottesley J at p35

The Doctrine of the Sham

What has come to be the "classic" definition of a "sham" was given by Diplock LJ in a case which did not even concern taxation[7]: Snook v London & West Riding Investments Ltd[8] in which Diplock LJ said:

> "As regards the contention of the plaintiff that the transactions between himself.... and the defendants were a 'sham', it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the Court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create".[9]

A transaction purported to be entered into by a taxpayer is found to be a sham, it can be ignored for tax purposes because it has no real existence.

It is generally accepted that for a transaction to be ignored as a sham, two conditions must be fulfilled:

(i) *the parties must have a common intention that their actions or documents are not to create the legal relationships which they give the appearance of creating; and*

(ii) *there must be some element of incompleteness or lack of genuineness.*[10]

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7. It related to the Higher Purchase Acts
8. [1967] 2 QB 786
9. p802
10. See Yorkshire Railway Wagon Co v Maclure (1882) 21 ChD 309

These are, in practice, difficult criteria to establish except in clear cases of fraud. Even in highly artificial schemes, documents and transactions cannot be dismissed as "shams" however artificial and contrived they might be, as long as the document or transaction is genuine and properly and completely implemented.[11]

Because of this, the Inland Revenue have had great difficulty in using the doctrine of the sham as a weapon against tax avoidance and they have generally abandoned arguments based on the doctrine in favour of other lines of attack. As will be seen below, some judges have even expressed surprise or regret that the Revenue did not put forward an argument based on the sham doctrine in cases of involving highly artificial transactions.

The difficulties facing the Revenue in putting forward arguments based on the sham doctrine in tax avoidance cases became apparent very early on. For example, in IRC v Sansom,[12] a case considered in Chapter 1, the Crown had argued that transacations under which a company made unsecured, interest-free loans to a sole shareholder was were shams. Although Lord Sterndale MR admitted that "anybody would approach the matter with a very considerable amount of suspicion",[13] he accepted the Commissioners' findings of fact as to the genuineness of the loans. They could not, therefore, be ignored as shams.

A similar result was reached in IRC v Morgan - Grenville - Gavin,[14] the facts of which are given below. It will be seen that this case concerned an artificial and circular scheme. One of the arguments put forward by the Revenue in their attempts to defeat this scheme was that the transactions were not real, but were artificial, illusory and a sham, so that they should be disregarded.

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11. Compare the situation in the USA; see Chapter 10
12. (1921) 8 TC 20
13. p28
14. (1936) 20 TC 529

Lawrence J referred to Rowlatt J's judgment in the Sansom case and said:

> "Rowlatt J, in the first place distinguishes between the two lines of attack upon such transactions as these, where he first of all says the circumstances may be such that the company in question ought to be disregarded and treated as a sham. That was the case which was put forward before the Commissioners in this case and was negatived by them, and, in my judgment, properly negatived by them, having regard to their finding that the actual transactions were, in fact, legal transactions."[15]

The judge also referred to another of the Crown's contentions, namely, "that the substance of the matter was that, by means of the exchange of cheques and in the circumstances of the case, the [taxpayer] was not under any necessity or required to bear any annual sum by way of annuity or otherwise,[16] and had not in fact paid away the sum of £3,000 as claimed by him." Lawrence J said that this was only another way of saying that the transactions were shams. He therefore rejected this contention.[17]

It is only on rare occasions that the Revenue have succeeded in establishing that transactions are shams. One such case, which can be compared with the Samson case was Jacobs v IRC.[18] Here, "loans" were made by a company to a controlling shareholder. The Special Commissioners, however, found:

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15. p536. The second line of attack concerned the question of agency; see Chapter 12.
16. In an attempt to obtain a surtax deduction, infra
17. p535. See also IRC v Marbob Ltd (1939) 22 TC 580; IRC v L.B (Holdings) Ltd (1946) 28 TC 1; Joseph Smith (Checkheaton) Ltd v IRC [1949] 2 All ER 211; and Mobil Oil Australia Ltd v Australia Commissioner of Taxation [1966] AC 275.
18. (1925) 10 TC 1

"that the loans in question had not been made in the course of the businesses carried on by the [company]; the appellant as shown by his conduct..... had no intention of repaying them; that he treated them as his own moneys; and that we could not regard them as genuine loans but must treat them as his income for the purpose of Super-tax."[19]

This clear finding was upheld by the Court of Session.

Similarly, in Dickenson v Gross,[20] Rowlatt J rejected the existence of a partnership. He stated:

"A partnership, of course, is a legal position and a legal result, but like every other legal position it depends on facts, and what the Commissioners are saying here is: 'The facts are not those from which a legal partnership results, because although there was the deed they are not acting on it; it is not governing their transactions; they are not paying the slightest attention to it. They are going on just as before. They have not used the word 'fictitious', and they have not used the word 'sham', but I think they have put it even more clearly. They say: 'The facts here were not a partnership although there was a bit of paper in the drawer, which if the facts had been according to it, would have shown there was a partnership'."[21]

There is also the dividend stripping case of Johnson v Jewitt,[22] in which Danckwerts LJ referred to "alleged" losses as "fictitious". However, the difficulties facing the Revenue in establishing that transactions were shams

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19. p9
20. Supra
21. (1927) 11 TC 614 at p620
22. (1961) 40 TC 231; see Chapter 1

can be seen from the fact that this was the only one out of the series of cases concerning highly artificial dividend stripping arrangements in which any of the transactions were treated as shams. For example, in J.P Harrison (Watford) Ltd v Griffiths,[23] Upjohn LJ contrasted the Johnson v Jewitt transactions with the "real" transactions before him.[24]

It appears that the Revenue became discouraged and ceased to bother putting forward arguments based on the sham doctrine even where highly artificial tax avoidance schemes were concerned. For instance, in IRC v Europa Oil (NZ) Ltd,[25] although the Crown argued that the transactions which resulted in the offshore company earning a profit were "paper transactions", it was not contended that they were shams.[26]

Faced with a mass of highly artificial tax avoidance schemes, it was the judges who began to question whether transactions were shams, giving hints that the Revenue were surprisingly slow to pick up. Templeman J in Black Nominees Ltd v Nicol,[27] for example, clearly thought the case before him was near the borderline. *He noted that* the Crown had conceded that the transactions were not shams, the documents were "not untrue", but in the same breath he said the transactions amounted to a "trick" and the purchase price was a "fake".[28]

The signals were even clearer in Williams v IRC[29].

At first instance, Brown-Wilkinson J commented that there *was a "strong suspicion that the transactions.....* may

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23. (1962) 40 TC 281, see Chapter 1
24. p289
25. [1971] AC 760, infra
26. See p770
27. (1975) 50 TC 229, see Chapter 1
28. See p280
29. (1980) 54 TC 257, see Chapter 1

have been mere paper shams" because the relevant company minutes were prepared after the event by solicitors. The fact that the sham argument was not raised was not really the Crown's fault because the relevant information only came to light during the hearing before the Commissioners, but the judge expressed regret "that the Court is required to treat as genuine certain transactions which may well not have been genuine."[30]

The signals from the Bench became unmistakeable in IRC v Garvin.[31] Like Williams, this case involved a highly artificial, pre-packaged scheme marketed by the well-known purveyor of avoidance schemes, Godfrey Bradman. In the Court of Appeal, both Buckley and Templeman LJJ made their views abundantly clear, Buckley LJ said:

> "It is clear that the scheme was highly artificial, as is common with tax avoidance schemes. The Special Commissioners did not, however, find, nor has the Board suggested, that the scheme or any part of it was a sham. That a transaction is a sham must be a question of fact. In this jurisdiction the function of determining the facts of the case belongs exclusively to the Commissioners. We cannot treat as a sham any transaction which the Commissioners have found to have taken place and which they have not found to be a sham..... I must add, however, that anyone who creates a series of 999-year leases in the knowledge that they are to be determined within a week, or is privy to such an arrangement, or who accepts a purchase price upon terms that much the greater part of it will not be payable for 200 years in the knowledge that within a fortnight he will receive a substantial capital sum as the price of all future

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30. p288
31. (1981) 55 TC 24, see Chapter 1

instalments of the delayed payments, seems to me to run a very real hazard of being held to enter into a sham transaction. However, no such finding was made in this case."[32]

Templeman LJ was also clearly of the opinion that it would have been open to the Crown to argue that the transactions were shams.[33]

Admittedly, it was only to most extreme and artificial schemes that would have been susceptible to an attack under the sham doctrine, but the Revenue, taking their cue from what Buckley and Templeman LJJ had said, began to raise arguments based on the sham doctrine in each case involving an artificial tax avoidance scheme.[34] This was to have very far reaching effects. As will be seen below, the backlog before the Special Commissioners was getting worse and worse, with arguments being raised on the sham principle as well as the technical aspects of the schemes in question. With the system grinding to a halt, it seems that the House of Lords eventually decided to take matters into their own hands to deal with tax avoidance.

However, despite these comments of some of the judges, it was only the highly artificial schemes that could have been successfully attacked under the sham principle. This is clear from the leading cases of WT Ramsay Ltd v IRC and Eilbeck v Rawling themselves.

At first instance in Eilbeck v Rawling, for example, Slade J commented:

"In the present case, though Mr Millett, on behalf of the Crown, has described the relevant

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32. p62
33. See p72
34. This fact was disclosed by Counsel for the Crown in W.T Ramsay Ltd v IRC (1981) 54 TC 101 at p177

> transactions as artificial and as charades, he has accepted that they were not sham transactions used as a cloak to conceal different transactions."[35]

Similarly, Counsel for the Crown, before the House of Lords, conceded that the Ramsay and Rawling schemes were not shams, but were "paper transactions" without any objective economic reality.[36] Counsel did say, however, that in the Rawling case, the investment provisions "were something of a sham" in that the money was never meant to be invested.[37] Furthermore, Lord Fraser, referring to the facts of the two cases[38] said:

> "There was apparently no evidence before the Special Commissioners that Thun[39] actually possessed the sum of £543,600 which they lent to the taxpayer to set the scheme in motion, not to mention any further sums that they may have lent to other taxpayers for other similar schemes which may have been operating at the same time, and it might well have been open to the Special Commissioner to find that the loan, and all that followed upon it, was a sham. But they have not done so. In Ramsay 'real' money in the form of a loan from Slater Walker was used so that a finding of sham in that respect would not have been possible."[40]

In <u>Furniss v Dawson</u>,[41] the facts of which are set out below, the Crown did raise an argument based on the sham doctrine. It was argued before the Special Commissioners that any representation of the intermediate company, Greenjacket, as an independent entity, with an independent will, discharging an independent role was no

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35. p150
36. p176
37. p178
38. As to which, see Chapter 8
39. One of the companies in the Rawling scheme.
40. p198
41. (1984) 55 TC 324

more than a sham.[42] However, the Commissioners said:

> "We have found nothing in the scheme or in the steps taken to implement it which could be designated as a sham in the sense that a transaction purporting to have a particular legal effect was in fact never intended to have that effect. In particular, on the basis of the evidence adduced, we do not find that [Greenjacket] purported to acquire beneficial ownership of the shares in the operating companies while all the time intending to acquire no more than legal ownership."[43]

In the light of this finding, the sham argument was understandably not raised in the courts in that case.

It can be seen that the sham doctrine has been kept within very narrow limits by the courts in the UK and it is only the most extreme avoidance schemes containing documents and transactions purporting to be something they are not that can be attacked as shams. This now appears to be almost universally accepted, although Sir John Donaldson MR in Sherdley v Sherdley[44] did have a rather novel notion of a sham, including the rather peculiar suggestion that an order of a court could be a sham.[45] Not surprisingly, the House of Lords[46] rejected the Master of the Rolls' formulation.[47]

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42. p331. See also the Crown's argument in Cairns v MacDiarmid (1982) 56 TC 556 at pp568-9 where the documentation was referred to as "colourable, plansible and spacious", which did not have the legal effects which they purported to produce. The Commissioners, however, upheld the validity of the documents, see p571.
43. p333
44. [1986] STC 266, infra.
45. See p272
46. [1987] STC 217
47. p225, infra.

Substance As Legal Effect

There has been a great deal of confusion over the case which, for over 40 years, dominated the thinking of judicial minds in the United Kingdom on the question of form and substance: IRC v. Duke of Westminster.[48] The Westminster case did not decide that form must take precedence over substance, as many commentators have supposed. The House of Lords judgements, following an earlier line of cases, are authority for the principle that the substance is the decisive element in the analysis of any transaction, regardless of the form the arrangements take. Confusion has arisen in the way the word "substance" has been used and, following the Westminster decision, a string of cases applied the concepts of form and substance in an inconsistent way on a misunderstanding of the proper doctrine.

An important distinction must be drawn between "substance" in the sense of "legal effect", and "substance" as meaning "practical effect", "commercial effect" or "economic equivalence". The over-riding principle is that substance in the sense of "legal effect" must prevail. For example, in Re Hinckes, Dashwood v. Hinckes,[49] Warrington LJ stated that "In order to ascertain the substance, one must look at the legal effect of the bargain into which the parties have entered".

The true principle did not arise out of the Westminster case, it was current in the last century. In Helby v. Matthews,[50] for example, Lord Hershell LC remarked:

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48. (1935) 19 TC 490
49. [1921] Ch 475. See also Romer LJ in John Cronk & Sons v Harrison (1936) 20 TC 612 at pp630-1
50. [1895] AC 471

"My Lords, it is said that the substance of the transaction evidenced by the agreement must be looked at, and not its mere words. I quite agree. But the substance must, of course, be ascertained by a consideration of the rights and obligations of the parties, to be derived from a consideration of the whole of the agreement."[51]

This approach was applied by Singleton J in Earl of Carnarvon v. IRC.[52] This case was concerned with section 27(1)(b), Income Tax Act 1918. The Earl of Carnarvon took out an insurance policy for a single premium, a part of which was advanced to him by the insurance company as a loan. The loan agreement provided that, if the interest was not paid on time, it would be deemed to be a new loan and capitalised and added to the original advance, the total amount of the loans and accrued interest being deductible from the sums due on the maturity of the policy. No interest was in fact paid and the net amount due (after deduction of income tax) was each year added to the loan.

Singleton J held that the taxpayer must be deemed to have paid the interest, and that such interest was therefore admissible as a deduction in computing his income for Surtax purposes. The Crown had contended that the loan agreement contemplated and provided for the non-payment of the interest year by year, and for its satisfaction out of the capital sum assured by the policy and the interest had not in fact been paid. Therefore, they claimed, the taxpayer's income had not been diminished.

The ratio of this case was disapproved, on the construction of the proper legal effect of the transactions, in the Court of Appeal in

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51. p475
52. (1934) 19 TC 455

IRC v. Lawrence Graham,[53] and was, in effect, overruled in IRC v. Oswald[54] However, the application by Singleton J of the approach of Lord Hershall LC is still relevant. Singleton J said:

> "..... I think I am bound to look at the terms of the agreement or agreements between the parties in order to ascertain the substance of the matter, it being agreed that no question arises as to the reality of the agreement itself."[55]

He added:

> "..... I am not at liberty to deal with the matter on my conception of what the parties intended: I must look at the documents; and I cannot, under the plea of looking at the substance of the matter, re-write the contract between the parties."[56]

Some cases have talked of substance in terms of "reality" or "the real nature" of a transaction. Such descriptions must, however, be treated with care because sometimes "reality" is used to relate to the legal character of the transaction and, in other cases, it is used to mean economic consequence. This distinction was made clear by Lord Greene MR in Southern-Smith v. Clancy,[57] in the following passage:

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53. (1937) 21 TC 158
54. (1945) 26 TC 435
55. p465
56. Ibid. See also Lord Moncrieff in Barr, Crombie &- Co. Ltd. v. IRC, (1945) 26 TC 406 at p. 413 and Lord Greene MR in Craddock v. Zevo Finance Co. Ltd., (1946) 27 TC 267 at pp. 279 - 80. In this latter case Counsel for the Crown had framed his argument in terms of the wider economic substance approach. This was emphatically rejected by Lord Greene.
57. (1941) 24 TC 1

"It is no doubt true to say that in order to answer the question [whether a payment is income or capital] the real nature of the transaction must be ascertained. The proposition has an engaging appearance of simplicity but it is not so simple as it sounds. For the expression 'the real nature of the transaction' is ambiguous. It may mean the 'real nature' of the legal relationship of the parties which results from the transaction - a matter which may not be in doubt. Or it may include as well the 'real nature' of the transaction from a financial point of view, a matter which at once raises a number of difficulties. If the transaction be one under which A, being or becoming indebted to B for a sum of £1,000, agrees with B to repay this sum by ten yearly instalments, or if A being the purchaser of property from B for £1,000 agrees to pay the purchase price by ten yearly instalments, the 'real nature' of the transaction from the legal point of view is that A is contracting to pay by instalments in the one case a debt and in the other a purchase price. In such cases the very nature of the legal relationship constituted by the contract prevents the annual payments from being payments of capital."[58]

Before the Westminster case there were cases in which form was preferred to substance, but normally only in the sense that "substance" can be treated as meaning commercial or economic effect. There are many instances in which the same commercial result can be achieved in more than one way. If one way is chosen which avoids tax, the substance doctrine, as understood in the Westminster case, does not mean that the transactions can be taxed as if another, less tax efficient method, had been implemented.

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58. p6

An early example of this is Whitmore v. IRC.[59] In this case undivided profit was appropriated for distribution among ordinary shareholders by the issue of debentures redeemable at one month's notice. All the debentures were issued to the one person who held all of the ordinary shares. That person was assessed to Super-tax in respect of the debentures. The Special Commissioners upheld the assessment, deciding that the transaction was not a capitalisation of profits, but was merely a cloak to cover the distribution of profits to the shareholder. Rowlatt J decided, however, that, it not having been argued that the debentures were shams, their form must be respected, as opposed to the economic effect of the arrangement. Dealing with the Commissioners' finding that the debentures were only a cloak to cover the distribution of profits to the taxpayer, he said that it was not argued that the debentures were fictitious or merely pieces of paper to present to the Inland Revenue, and that the real transaction was that the profits were to be distributed in cash at an early date. He continued:

> "If what is meant is that the company adopted this transaction, being a real transaction, and one which does not make the shareholder liable to Super-tax, in lieu of another transaction which would have made him liable, that circumstance has no materiality, as many cases show, in a contest of this kind."[60]

Rowlatt J was equally forthright in his rejection of economic equivalence in Thompson v. The Trust & Loan Company of Canada,[61] a bond washing case which would now be covered by section 729 ICTA 1988.[62] The taxpayer company was a loan and finance company. It acquired

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59. (1925) 10 TC 645
60. p665
61. (1932) 16 TC 394
62. See Chapter 1

Treasury Bonds cum-coupon and sold them ex-coupon on the same day. The coupons had already suffered tax by deduction under Schedule C. The Revenue tried to bring in the net coupon under Schedule D Case I. Rowlatt J and the Court of Appeal rejected this, Rowlatt J saying:

> "It may indeed be true to say that financially the transaction was the equivalent of buying a money order, to use Mr. Stamp's [Counsel for the Crown] phrase, for the amount of the interest after deduction of tax. But equivalence will not do. The Crown cannot treat a transaction which has its own character for income tax purposes as if it were something of a different character, because in money result the two would come to the same thing."[63]

The treatment of economic equivalence arguments is analysed in detail below.

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63. p400

The Rejection of Economic Equivalence

There is a strong line of cases after the Westminster decision in which form was preferred to commercial substance/economic equivalence.

Hall v. Marians,[64] was an example of a method, available before 1953, of circumventing the remittance provisions. This scheme was stopped by section 24 Finance Act 1953.[65] This case, and the scheme in question are considered in Chapter 9. In fact, the High Court and Court of Appeal decisions were after their corresponding stages in Westminster but were shortly before the House of Lords decision in the Westminster case.

The taxpayer was entitled to a share of the profits of a business carried on in Colombo. Her share was paid into a current account with the Colombo branch of a bank which had its head office in London. The profits were invested in Indian Bonds. From time to time she had borrowed certain sums from the bank in London on security of the Bonds and she subsequently requested the bank in London to instruct its Colombo branch to sell sufficient securities to extinguish the loan. The following day the bank informed her that the amount of her loan account was being debited to the Colombo branch, which was being instructed to realise securities to pay it off. The transfer was effected by cross entries in the books of the two offices. A small credit balance in Colombo was thereupon converted into an overdraft which was subsequently discharged in Colombo out of the proceeds of the sale of the Indian Bonds. The taxpayer was assessed to tax in respect of the amount of the overdraft transferred from the London office to the Colombo branch, on the footing that, when the proceeds of the sale of

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64. (1935) 19 TC 582
65. Now section 65(6)-(9) ICTA 1988

the Bonds were credited to the Colombo account, the debt due to the bank from the taxpayer was extinguished, and this constituted the receipt by her in the United Kingdom of a taxable remittance. Finlay J, at first instance, agreed and found for the Crown.[66] However, the Court of Appeal overturned this decision, Romer LJ commenting that the fact that the taxpayer was in precisely the same position financially as though income had been remitted to her in the UK was irrelevant. She was perfectly entitled to adopt this particular form and the court is not entitled to say that in substance it is the same as if she had remitted income to the United Kingdom.[67]

Macnaghten J took the same line in another case dealing with a similar remittance device: Wild v. King Smith.[68] The Court of Session and the House of Lords also adopted the same approach to this device in IRC V. Gordon.[69]

However, by 1960 the courts were taking a different view of these remittance schemes. In Thomson v. Moyse,[70] Wynn-Parry J and, in the Court of Appeal, Jenkins and Romer LJJ followed the earlier line,[71] but Pearce LJ and a strong House of Lords took a more broad brush approach, finding that a remittance had occurred in the following circumstances. The taxpayer was resident in the UK but domiciled in the United States. He was entitled to life interests in the United States under the will of his late father and in the residuary estate of his late mother. The income from his two life interests was paid in dollars into a New York bank. Over a number of years, the taxpayer asked UK banks to purchase or convert into sterling the proceeds of certain cheques which he had drawn in their favour in dollars on his New York bank.

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66. See p593
67. p602
68. (1941) 24 TC 86
69. (1952) 33 TC 226; see p. 231 per The Lord President (Cooper) at p. 231 and Lord Cohen at p. 242.
70. (1960) 39 TC 291
71. See pp313-4 per Jenkins LJ and pp315-6 per Romer LJ

The UK banks then sold the dollars to the Bank of England and the respondent's account at the relevant UK bank was credited with the sterling equivalent. The cheques were cleared on the New York bank and the proceeds credited to the account of the Bank of England with the Federal Reserve Bank.[72]

Finlay J, who adopted the wider commercial substance approach in Hall v. Marians, also did so in the case of IRC v. Ramsay,[73] and he was again overruled by the Court of Appeal. Lord Wright MR accepted that he had to look at the substance of the transaction, but held that substance in the sense that he was using it could only be ascertained "by a careful consideration of the contract which embodies the transaction." This was to be done by an examination of "the particular clauses of the contract of sale, the agreement in question".[74]

A firm and clear rejection of the economic equivalence approach came from Romer LJ in that case in the following terms:

> "If a man has some property which he wishes to sell on terms which will result in his receiving for the next 20 years an annual sum of £500, he can do it in either of two methods. He can either sell his property in consideration of a payment by the purchaser to him of an annuity of £500 for the next 20 years, or he can sell his property to the purchaser for £10,000, the £10,000 to be paid by equal instalments of £500 over the next 20 years. If he adopts the former of the two methods, then the sums of £500 received by him each year are exigible to income tax. If he adopts the second method, then

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72. See also the decision of Templeman J in Harmell v Wright (1973) 49 TC 149, see Chapter 9
73. (1935) 20 TC 87
74. p94

the sums of £500 received by him in each year are not liable to income tax, and they do not become liable to income tax by it being said that in substance the transaction is the same as though he had sold for an annuity. The vendor has the power of choosing which of the two methods he will adopt, and he can adopt the second method if he thinks fit, for the purpose of avoiding having to pay income tax on the £500 a year. The question which method has been adopted must be a question of the proper construction to be placed upon the documents by which the transaction is carried out."[75]

See also Lawrence J in IRC v. Morgan-Grenville-Gavin,[76] in which a circular Plummer-type scheme[77] was upheld by the judge who felt that he could not overrule the finding of the Special Commissioners (although his own view may have been to find for the Crown). This was a circular scheme in that the money in question went round in a circle, servicing the various transactions.

By a deed, the taxpayer, in consideration of £19,100 paid to him by Company A, covenanted to pay to the company for seven years, or during his life (whichever should be the shorter), an annual sum of such an amount, as after deduction of income tax, would leave £3,000. The company, which was incorporated a few days before the deed, obtained the £19,100 by the issue of its shares at a large premium. All but two of its shares were taken up by Company B (also incorporated a few days before the deed), which in turn obtained its capital by issuing its shares at a large premium to the taxpayer, and by a loan from him. Company B went into liquidation two weeks later. Three weeks after the deed, the taxpayer made the

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75. p98
76. (1936) 20 TC 529
77. Similar in structure to that used in IRC v Plummer (1979) 54 TC 1, infra

first payment of £3,000 to Company A, but the taxpayer's cheque was not collected until two weeks later. On the latter date, Company A paid £3,019 by way of interim dividend to the liquidator of Company B who, on the same day, applied part of this sum in repayment of the taxpayer's loan to the company, and paid the balance to him as a distribution of assets in the liquidation.

It was held that the sum of £3,000 paid by the taxpayer under the deed, grossed up for income tax, was an admissible deduction in computing his income for surtax purposes. Lawrence J would have been inclined to hold that the scheme failed on the basis of agency[78] but he felt bound by the Commissioners' finding on the legal effect of the transaction. Regarding the Crown's contention that the substance of the matter was that, by means of the exchange of cheques, the taxpayer was not required to bear any annual sum by way of annuity, and had not in fact paid away the sum of £3,000 claimed as a deduction, the judge said that this seemed to be only another way of stating that the transactions were artificial, illusory and a sham.[79] He later[80] underlined his view by drawing attention to Lord Wright's dictum in the Duke of Westminster case[81] that the legal effect of the document is its substance.

It can be seen that Lawrence J was firm in his rejection of the economic equivalence argument; it being no more, in his view, than saying the transactions were a sham. This is, in fact, a narrow construction of the commercial substance argument, as submitted by the Crown, which did *not depend on the transactions being held to be shams.*[82]

One of the leading cases on the rule that form prevails

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78. See Chapter 12
79. p535
80. pp536-7
81. (1935) 19 TC at p529, infra
82. See also Ruskin Investments Limited v. Copeman, 25 TC 187 per Scott LJ at p. 198.

over economic substance is IRC v. Wesleyan & General Assurance Society.[83] Macnaghten J went too far and preferred economic substance to the form of the transactions. The higher courts rejected this approach.

The Society, in consideration of the payment of £500, agreed to pay to an individual an annuity of £7.11.0d per annum and, on his death, a sum equal to the aggregate of £4.14.8d for each completed month between the date of the agreement and the date of his death. The agreement provided that the individual should have the option of borrowing such sums as he might request up to the amount that would have been payable by the Society if he had died on that date. These sums were to be free of interest and recoverable only on the individual's death by set-off against the lump sum payment due under the bond. The individual informed the Society that he wished to exercise the option to the maximum extent and the Society accordingly paid to him the annuity plus £4.14.8d each month as a loan. Income tax was deducted by the Society from the annuity but not from the loan. The Society was assessed to income tax on the total payments made under the agreement each year. The Society appealed against the assessment of the loans on the ground that they were not income payments. The Crown had argued that the payments in question, although they were called loans, had none of the characteristics of a loan and were, in fact, an annuity since there was no interest and they were not repayable. Macnaughten J agreed with this contention. He commented:

> "A loan which carries no interest and which neither the borrower nor any other person can ever be under any obligation to repay seems almost too good to be true .....".[84]

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83. (1948) 30 TC 11
84. p14

In the Court of Appeal, Lord Greene MR rejected this approach as:

> "no more than an attempt to revive the old suggested principle of substance and form. It is really saying that this transaction has produced the same financial result as if it were an annuity and, therefore, the contract must be construed as a contract to pay an annuity and not to pay what it says it is to pay."[85]

Lord Greene MR's judgement contains the well known passage in which he rejects the economic substance approach. He said that where there are two methods of achieving a particular result, one attracting tax and the other not, there have been cases where the substance of the transaction has been thought to enable the court to construe the transaction in such a way as to attract tax. That doctrine was, he said, "finally exploded" by the Duke of Westminster case. He thought that the Crown's contention here was an attempt to resurrect it.[86]

The Master of the Rolls appeared to be taking rather a narrow view of the form and substance doctrine, however, because he went on to say that:

> "The doctrine means no more than that the language that the parties used is not necessarily to be adopted as conclusive proof of what the legal relationship is."[87]

He gave as an example the case of parties entering into a contract which they call a licence, but the contract, according to its true interpretation, creates the relationship of landlord and tenant. The contract will

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85. pp21-2
86. p16
87. Ibid

be a lease, despite the fact that the parties call it a licence. As mentioned above, this seems to be taking rather a narrow view of the substance doctrine, contrasting it really with nomenclature, although he did make it clear later on in his judgement that it is the legal effect of the transaction that must prevail regardless of the commercial or economic substance.[88]

The House of Lords unaminously confirmed the decision of the Court of Appeal.[89]

Lord Greene MR took the same line in a post Duke of Westminster case on the distinction between capital and revenue, in which the economic equivalence approach was rejected: Henriksen v. Grafton Hotel Limited.[90] He said:

> "It frequently happens in income tax cases that the same result in a business sense can be secured by two different legal transactions, one of which may attract tax and the other not. This is no justification for saying that a taxpayer who has adopted the method which attracts tax is to be treated as though he had chosen the method which does not, or vice versa."[91]

Lord Greene MR's approach was the same as that adopted by Romer LJ in IRC v. Ramsay,[92] namely that the form of the documents themselves was not decisive in capital/income questions. Later, however, it was decided that the whole transaction, including the circumstances leading up to the deal, could be considered. On this, see Vestey v. IRC.[93] This was not a new development; Vestey was following much earlier cases such as Scoble v

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88. p19
89. See, for example, Viscount Simon at p25
90. (1942) 24 TC 453
91. p460. See also Lawrence J, at first instance, at p456
92. Supra, at p98
93. (1961) 40 TC 112

Secretary of State for India,[94] and Foley v. Fletcher[95]. The basic rule that can be derived from Vestey is that the form of the documents is important but not decisive.

The rejection of economic substance in favour of form can work against, as well as for, the taxpayer. This can be seen, for example, in IRC v. Fleming & Company (Machinery) Limited.[96] The taxpayer company carried on the business of manufacturers' agents and general merchants. For many years it had been sole selling agents in Scotland for certain products of a manufacturer, but the agency was terminated at the insistence of the manufacturer, by an agreement under which the company received a payment as compension for the loss of the agency. The company claimed that the compensation was a capital receipt, but it was held by the Court of Session that it was a trading receipt.

The Lord President (Cooper) said that "if the business substance of the transaction" were considered, he might almost have been prepared to treat the payment as capital.[97] However, relying on the Duke of Westminster case, he held for the Crown, saying:

> "The company have only themselves to blame if we take them at their word, for the transaction could have been carried through in a manner which would have obviated the present difficulty."[98]

The rule that form prevails over commercial substance applies even where an anti-avoidance provision containing the following words is being considered:

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94. Supra
95. (1858) 3 H & N 769
96. (1951) 33 TC 57
97. p61
98. p63. Lord Russell agreed with this, p64

> "In determining whether an individual has power to enjoy income within the meaning of this section regard should be had to the substantial result and effect of the transfer and any associated operations ...."

These words, taken from the provisions aimed at transfers of assets abroad in section 18 FA 1936[99] were considered in Vestey v. IRC.[100] In that case the House of Lords refused to construe those words as requiring, or even permitting them to consider the commercial substance. Lord Normand commented that the above direction:

> "does not in my view authorise any laxity in construing any of the documents by which the transfer or the associated operations are effected. The court must first determine the meaning and effect of the documents before this provision is applied and it must then consider whether their effect, though in form not beneficial to the settlor, is so in substance. The contrast is between substance and form, so if it can be shown in the present case that the effect of the transfer and the associated operations is to vest a benefit in (for example) a company over which the settlor has complete control, the court may then say that, although in form the company benefits, in substance the company and the settlor are one and the settlor therefore benefits. But the court cannot take this last step unless it is shown that the settlor has himself the legal control and no reliance must be placed on his influence over others who are not in

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99. Now section 742(3) ICTA 1988, see Chapter 9
100. (1949) 31 TC 1

law bound to follow his directions."[101]

See also the dissenting speech of Lord Donavon and Viscount Dilhorne in IRC v. Europa Oil (NZ) Limited.[102] The majority judgement, given by Lord Wilberforce, disavowed the economic equivalence test and the end result principle[103] but, as will be seen below, this case can be viewed as part of the development by Lord Wilberforce of the "whole transaction" principle. It was only the dissenting judgement that followed the traditional line.

It will be seen below that the wider economic substance approach was byno means universally rejected. Both points of view were expressed in the case of Potts' Executors v. IRC,[104] 32 TC 211. This case is considered in detail in Chapter 2 but the relevant facts can be briefly mentioned here. A company was indebted to the settlor of a settlement. If it merely discharged its indebtedness directly, a charge would have arisen under what is now section 677 ICTA 1988. So instead the company discharged the debt of the settlor to third parties. Commercially, this had the same result in substance as a payment direct to the settlor by the company. In fact, the law has now been altered so that a tax charge under the section will now arise in these circumstances.[105]

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101. See also Bradbury v. Arnold (1957) 37 TC 665; the majority decision of the House of Lords in J.P. Harrison (Watford) Limited v. Griffiths (1962) 40 TC 281 infra; Lord Pearce in Rae v. Lazard Investment Company Limited (1963) 41 TC 1 at pp. 29 - 30, and Lord Guest at p. 29; and Walton J in IRC v. Montgomery (1975) 49 TC 679 at p. 686 in which he rejected an extension of the decisions in the House of Lords case of Thomson v. Moyse (1960) 39 TC 291, and Templeman J in Harmel v. Wright, (1973) 49 TC 149, both involving schemes to exploit the remittance rules, see Chapter 9.
102. [1971] AC 760, infra
103. pp771-2
104. (1951) 32 TC 211
105. See section 677(10) ICTA 1988

The House of Lords, by a majority, firmly rejected the Revenue's contention that a charge arose under the legislation as it then stood. Lord Normand said that the terms of a Taxing Act are not to be enlarged by reasoning that the same result had been achieved as by a loan made to the settlor followed by a payment made by him to the third party.[106] He added:

> "The court is not entitled to say that for the purposes of taxation the actual transaction is to be disregarded as 'machinery' and that the substance or equivalent financial results are the relevant consideration."[107]

Similar views were expressed by Lord Simmonds[108] and Lord MacDermott[109] and, at first instance, Singleton J.[110] However, a strong Court of Appeal (Sir Raymond Evershed MR, Somervell and Denning LJJ) and, in the House of Lords, Lord Morton of Henryton came to the opposite conclusion, holding that the sums in question were in substance paid to the settlor within the meaning of section 40 FA 1938.[111]

The majority line in Potts was followed by Slade J, in a judgement given the day before the House of Lords handed down their judgement in Ramsay and Eilbeck v. Rawling, in Piratin v. IRC.[112]

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106. p229
107. p230
108. pp227-8
109. p236
110. pp216-7
111. See, for example, Lord Morton at pp233-4
112. (1981) 54 TC 730 at pp747-8

The Wider Substance Approach

Although the Duke of Westminster case decided that substance, in the sense of commercial or economic effect does not rule, there were cases before Duke of Westminster where the courts did look to substance in its wider context, and it was this manifestation of the substance concept that was critized in the Duke of Westminster case itself. The wider substance approach also began to gain ground again in later years.

Whereas the Duke of Wesminster judgements showed that the substance approach must be limited to an analysis of the legal rights and obligations of the parties determined upon ordinary legal principles, some earlier cases had looked at the substance in the wider context.

In St. Louis Breweries v. Apthorpe,[113] Wills J made first the point that nomenclature cannot override the reality of the situation (here the words in question were the description of a company's business in its Memorandum of Association). He then went on to observe that one ought to look at the "substance" and not at "matters of machinery and form".[114] The business of an American company was carried on by an English company through the influence over the American company by the English directors. As Bruce J put it, "The real and substantial control of the American business was exercised by the English directors."[115]

The wider substance of the transaction was also considered in Royal Insurance Company v. Watson.[116] In this case, the taxpayer company acquired the business of another insurance company and it was a term of the

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113. (1898) 4 TC 111
114. p120
115. p122
116. (1897) 3 TC 500

agreement that the manager of the latter company would be employed by the taxpayer company at a salary of £4,000 a year, with liberty for the taxpayer company to commute the same by payment of a gross sum on condition that the manager would not work for any other insurance company. Shortly after the transfer of the business, the taxpayer company did pay the manager a sum of over £55,000 in commutation of his annual salary. The taxpayer company sought to deduct this sum from their profits for the year in which the payment was made. The House of Lords, however, held that this payment formed part of the consideration for the transfer of the business and was therefore capital. This conclusion was reached by examining the "substance and essence" of the matter and Lord Herschell was influenced by the substance in its wider context.[117]

An important case on this point is IRC v. Blott.[118] It is also important in another area in that the decision in this case was one of the major factors forcing the introduction of section 21, Finance Act 1922.[119]

The taxpayer was a shareholder in a company which declared a bonus out of its undivided profits and, in satisfaction of the bonus, allotted to its shareholders fully paid up ordinary shares. The taxpayer had no option to receive cash in lieu of shares in satisfaction of the bonus. It was held in the House of Lords, Lords Dunedin and Sumner dissenting, that the shares, being distributed as capital, were not income in the hands of the taxpayer. The Crown had sought to levy tax by relying on what the courts (with the exception of Lords Dunedin and Sumner) held to be "bare" or "mere" machinery. Viscount Cave was quite clear that

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117. See, for example, p505
118. (1921) 8 TC 101
119. The first "apportionment" provisions, see Chapter 1

the declaration of a bonus was "bare machinery". He accepted that the taxpayer could sell the bonus shares, but he took the view that he would then be only realising a capital asset, and the proceeds would not be income in his hands. He said that, if the substance of the transaction is considered, the declaration of the bonus was "bare machinery" for capitalising profits and there was therefore no distribution of profits to shareholders which would attract Super-tax.[120]

Lord Sumner took a different view. He did not base his view on the fact that the directors had recommended a "further dividend", or the fact that the resolution declared a "bonus" - this was, in his view, irrelevant[121]. He did not, however, unlike the majority, regard the intermediate steps as "mere machinery" which could be ignored. He likened substance to legal reality and, in one sense, could be said to have favoured the form of the transaction. He said:

> "To call the steps that might be relied on as satisfying that scheme 'mere machinery' is to evade the difficulty. It is just as reasonable to call the shares allotted 'mere machinery' for wrapping up a distribution of profits as to call bonus shares 'mere machinery' for effecting a distribution of capital. 'Looking at the substance and not at the form' is a good guide for judicial conduct, but what is substance? If a form has to be gone through in order to satisfy the law for my part I should think it was pretty substantial."[122]

Pollock MR in <u>IRC v. Paterson</u>,[123] was equally forthright in his preference for the substance:

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120. p135
121. See p141
122. p144
123. (1924) 9 TC 163²

> ".... whatever be the effect of legal documents or the scheme whereby the transaction is carried out, for the purposes of taxation one has to look at the substance of the matter."[124]

The latitude in judicial thought in the years before Westminster on this point is shown by the case of IRC v. Fisher's Executors[125]. Here a company capitalised part of its undivided profits and created debenture stock which it issued to ordinary shareholders by way of bonus. It was held that the bonus was not a distribution of profits and did not constitute income in the hands of the shareholders for the purpose of Super-tax.

Rowlatt J found for the Crown using the wider substance approach. This can be seen from the following passage from his judgement:

> "The shareholders, of course, were put in a very different position by the receipt of the stock; they got, to begin with, a right to call for the amount of their share of the undivided profits preferencially to any outside creditors if the company was wound up. The result to the company was that no longer would there appear in their balance sheet this great preponderance of undivided profits, because against them there would stand the securities which had been issued. It seems to me that when you issue a security upon your property, which sooner or later has to be realised, you are putting in the hands of the person to whom you issue it part of the property, not physically for the moment, but you are giving him part of the value, in substance."[126]

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124. p178
125. (1926) 10 TC 302
126. p316

Rowlatt J also took this approach in IRC v. Wright.[127] In both Fisher's Executors and Wright, the Court of Appeal overturned Rowlatt J. In both cases the Court of Appeal purported to look at the substance, but adhered to the form of the transaction in holding that there was no taxable distribution. The distinction between the two approaches is that Rowlatt J was looking at the substance question in a wider perspective; the commercial result was that distributable profits left the corporate level and found their way into the hands of the shareholders. On the other hand, the Court of Appeal adopted a narrower approach to the substance question, equating substance with legal reality.[128]

The House of Lords judgements in Fisher's Executors are interesting. Of the three reasoned judgements, Viscount Cave followed the Blott approach (he was a member of the House of Lords in that case). He said:

> "No doubt, the shareholders got debenture stock which, like the shares in Blott's case, was a valuable thing; but they have no power to call in the stock, which gave them no present right to receive any part of the company's assets either in money or money's worth, but only entitled them to a sum to be carved out of those assets if and when the stock was paid off. It is true that debenture stock, unlike shares, creates a debt; but he debt in this case was not presently payable and may never become payable while the company is in existence. The whole transaction was "bare machinery" for capitalising profits and involved no release of assets either as income or as capital."[129]

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127. (1927) 11 TC 181 at pp199-200
128. See Lord Hanworth MR at p. 203. Lord Hanworth MR was consistent in this approach see John Cronk & Sons v. Harrison, (1936) 20 TC 612 at p. 626.
129. p333-4

The other two law lords who gave reasoned judgements, Lords Shaw of Dunfermline and Sumner, took a different line (as Lord Sumner had done in Blott). Their conception of the substance approach was more in line with the true Duke of Westminster principle, in that they adhered more to the form of the transaction as compared with economic substance. Lord Shaw, for example, said:

> "*Upon the legal side of the matter it must not be* forgotten that all the necessary resolutions, confirmations, new Articles of Association, etc., required to regularise the transaction have been carried through. It is a transaction in itself unassailable in law. The result of it was to negate emphatically the idea of distribution to shareholders as income; on the contrary, it was to withdraw from each shareholder the sum which might have been given to him as income and to withdraw it definitely from an income fund. It was stamped as a capitalisation transaction. Such a transaction was within the power of the shareholders of the company, *and all, including the Crown, are bound by that.* It is incorrect in principle to attempt to get behind that transaction, legal and competent and regular in form, and to endeavour to construct a cannon of liability to income tax out of conjecture as to the motive or scheme for the defeat of the Revenue which underlay its various stages."[130]

Lord Shaw firmly rejected the economic equivalence argument. He noted the fact that:

> "On the side of its economics ..... the nature of the transaction shows that it was to all intents and purposes equivalent to a distribution of dividend in cash by the company and a receipt of income by the shareholder."

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130. p336

He, however, did not reject the form in which the transaction had been cast.[131]

Lord Sumner was of a similar opinion. He referred to the references to "substance" in Blott, but thought that they did not affect the present case. He was of the opinion that in those cases both the form and the substance were considered and, not only were the deeds and resolutions construed, but the scheme of the transaction, its financial results and the intentions of the company were examined.[132]

He continued:

> "The proposition, that the substance of a transaction must be looked to and not merely the form, is generally invoked against those who have carried it out. I think that it is unusual, where the form of a transaction is against those whose transaction it is, to invoke the substance in their favour, in order to eke out what they have left defective in form .... At any rate, in the present case, there is no need to distinguish between form and substance in the transaction itself or to refer to desires or intentions, further than to examine what was done, for everything was carried out in plain terms and without concealment. What the requisite majorities of the shareholders desired and intented is pretty plain too, but that is another matter."[133]

Lord Sumner was of the opinion that part of the profits of the company, equivalent to a dividend of 5/- for every £1 paid up, had been by the use of "mere machinery" converted into debenture stock. This, he said, was "valid as against all the world"[134]

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131. p335
132. p339
133. Ibid
134. p341

In this case there were, therefore, two approaches. Viscount Cave LC and the three judges in the Court of Appeal, considered that the substance of the matter was that no profits ended up in the hands of the shareholders. On the other hand, Rowlatt J and Lord Shaw and Lord Sumner seemed to be of the opinion that the economics of the transaction were that value representing the company's profits ended up in the hands of the shareholders. Rowlatt J considered that this was sufficient to impose a Super-tax liability on the shareholders. However, Lords Shaw and Sumner felt themselves bound by the form of the arrangements.

The wider substance concept had further support in the courts both before and after the Duke of Westminster case. Before the Duke of Westminster, see for example, J.H. Young & Co. v. IRC;[135] Overy v. Ashford Dunn & Co. Limited;[136] and IRC v. Adam.[137]

After the Duke of Westminster see IRC v. Ross & Coulter (Bladnoch Distillery Company Limited);[138] the Court of Appeal and Lord Morton of Henryton (dissenting) in Potts' Executors v. IRC;[139] the dissenting judgements of Lord Keith of Avonholm and Lord Somervell of Harrow (who took a similar view in the Court of Appeal in Potts' Executors) in Saunders v. IRC;[140] Sargaison v. Roberts;[141] and Associated Insulation Products Limited v. Golder,[142] in which Uthwatt J said:

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135. (1926) 12 TC 827 at p839 per the Lord President (Clyde)
136. (1933) 17 TC 497 at p506 per Finlay J
137. (1928) 14 TC 34 at p43 per Lord Blackburn (dissenting)
138. [1948] 1 All ER 616 at p639 per Lord Porter
139. (1951) 32 TC 211
140. (1957) 37 416 at pp437-8
141. (1969) 47 TC 612 at pp617-8 per Megarry J
142. (1944) 26 TC 231

"It is clear from the cases of [Blott and Fishers' Executors] that it is for the company which proposes to make a distribution to decide whether or not the distribution is to take the form of a capital distribution or an income distribution and to translate its decision into action. Its decision so translated into action is conclusive. The action taken by the company, considered in relation to the surrounding circumstances, is the decisive matter, but any statement made by the company as regards the distribution is relevant and must be taken into account, though a statement which does not correspond with the reality of the distribution in fact made is of little, if any, value. The company may paint the picture but not decide that it is a masterpiece. The substance of the transaction is to be looked at and its nature ascertained by the court."[143]

In Lord Howard de Walden v. Beck,[144] Wrottesley J took note of the fact that the taxpayer purchased the right to receive a number of sums over a period of 30 years of such an amount as to return to him the whole of his capital together with a profit upon it (i.e. interest at 4%). He therefore dissected the receipts (in the form of promissory notes) so that the income element could be subjected to income tax (adopting the method used in Scoble's case).[145]

The wider substance approach began to gain ground in later years.[146] This was particularly so when the courts had to deal with artificial schemes. See, for instance, the dissenting speeches of Lords Reid and Denning in the

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143. p240
144. (1940) 23 TC 384
145. Scoble v Secretary of State for India, supra
146. See for example, Thomson v Moyse (1960) 39 TC 291, see Chapter 9, and the analysis of the development of the composite transaction, infra

dividend stripping case of J.P. Harrison (Watford) Limited v. Griffiths.[147] Their approach can be seen from the following passage from Lord Reid's judgement:

> "If the law requires that I look solely at the purchase and sale of the shares, then that was undoubtedly trading. A company having power to deal in shares bought 1,000 shares and sold them a few months later. But if the law does not prevent me from looking at the substance of the matter, then the operation appears in a very different light. What the Respondent did was to lay out £16,900 in such a way that it was able to ensure that nearly 95% of that sum would quickly come back into its hands in the form of dividend which had borne tax. The only advantage which it sought to get, or could get, out of the transaction was the acquisition of a right to recover from the Revenue tax which had been paid by somebody else. It could not buy such a right directly; the purchase and sale of the shares were steps which it had to take in the process of acquiring it. If I am entitled to have regard to the substance of the transaction, the real question appears to me to be whether acquiring a dividend which has borne tax for the sole purpose of using it to recover tax from the Revenue must be held to be trading because in the course of acquiring it shares were bought and sold."[148]

The majority of the House of Lords in this case did, however, find for the taxpayer, holding that the "backward stripping" operation was trading. They were drawn to the form of the transaction. This was in 1962, the early years of dividend stripping cases before the courts. In the other cases the taxpayers all failed.

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147. (1962) 40 TC 281 see Chapter 1
148. pp294-5

Judicial attitudes towards them changed. An analysis of the dividend stripping cases is contained in Chapter 1.

The case of Campbell v. IRC,[149] is interesting mainly for the wider substance approach adopted, but also of interest are the arguments advanced by Templeman QC on behalf of the taxpayer. In this case the taxpayers were trustees of a charitable trust set up to acquire a tutorial business. The vendors covenanted to pay the appellants annually for seven years 80% of its trading profits chargeable to income tax (less capital allowances) which it was understood would be used by the taxpayers, together with any income tax recoverable, to purchase the business. However, the Revenue refused the taxpayers' claims to repayment of the tax expressed to have been deducted by the vendors from the payments. It was held that the payments were not income of the taxpayers because they were instalments of capital in their hands, being paid under a contract which required them to be used to purchase the business. The approach of Buckley J at first instance was indicative of the overall view of the courts in this case. He said:

> "If any question of recovery of tax by the trustees be for a moment put aside, the substance of the arrangement is that [the vendor] makes gratuitous transfers to the trustees of shares in the business at a rate geared to the proportion which 80% of [the vendor's] profits from the business bears to £50,000, the value put upon the goodwill, and the cost of any other assets. The payments under the deed merely pass from [the vendor] to the trustees and back again as machinery for determining how quickly and by what stages the business shall be transferred. The business costs the trustees nothing. They acquire the business as a pure act of bounty from [the vendor]."[150]

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149. (1968) 45 TC 427
150. p442

In view of his subsequent attitude when on the Bench, particularly as regards the composite transaction doctrine,[151] the arguments of Templeman QC are interesting. He said in the course of his submissions to the House of Lords:

> "The two documents cannot be added together to substantiate a submission that it would be a relationship of creditor and debtor. The fact that the transaction could have been carried out by way of a creditor-debtor relationship is irrelevant. The form of the covenant is quite contrary to a creditor-debtor relationship."[152]

The wider substance approach was not, however, confined to tax avoidance devices. In 1967 the Court of Session heard the case of McCrone v. IRC.[153] Here a settlor inadvertently fell foul of section 408 Income Tax Act 1952.[154] He executed a settlement in favour of his three daughters with power to the trustees to accumulate income. Years later, at the taxpayer's suggestion, the trustees advanced to him £45,000 at interest of 6%, out of the accumulated income. The advance was satisfied by the transfer to him of securities valued at £45,100, the balance of £100 being refunded by him. The advance, which was secured by a bond on a farm belonging to him, was repaid a few years later. The taxpayer was assessed to Sur-tax on the £45,000, grossed up at the standard rate of income tax, as being a sum paid to him by way of

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151. Infra
152. p454
153. (1967) 44 TC 142
154. Now section 677 ICTA 1988, see Chapter 2. Other capital/income cases in which the courts considered the substance of the transaction were Mobil Oil Australia Limited v. Commissioner of Taxation [1966] AC 275 (see, in particular, an exchange between Lord Reid and counsel for the taxpayers at pp. 281 - 2); IRC v. Land Securities Investment Trust Limited (1969) 45 TC 495 which was applied in Littlewoods Mail Order Stores Limited v. McGregor (1969) 45 TC 519 (see pp. 537 - 8 per Sachs LJ and pp. 538 - 9 per Karminski LJ).

loan within section 408. It was held that the taxpayer was taxable. This was so even though the form in which the transaction was carried out involved a transfer of securities, the amount of which depended upon their realisable value at the time in the open market. The court held that the way in which the loan was carried out could not detract from its nature as a loan of £45,000.

The Duke of Westminster Case

As Duke of Westminster v IRC[155] has dominated legal thought on the form and substance issue for over 50 years, the judgements demand careful analysis.

The facts were straightforward. The Duke executed deeds of covenant to make payments to persons who, when the deeds were executed, were employed by him. In most cases, the covenantees remainder in his employment throughout the relevant period. In a typical case, it was recited that the Duke desired to make provision for the employee in recognition of past services, notwithstanding that he might re-engage the employee or the employee might continue in the Duke's service, in which event he would become entitled to remuneration in respect of his future services. The Duke covenanted, in consideration of the employee's past services, to pay him during their joint lives, or for a period of seven years, a stated weekly sum. It was explained to the employee by letter that the deed did not prevent him being entitled to, and claiming, full remuneration for his future services, but that he was expected to be content with the provision made for him by the deed, with the addition of such sum, if any, as might be necessary to bring the total periodical payments up to the amount of salary or wages which he had lately been receiving. The employee acknowledged the letter and accepted the arrangement.

In one case, the deed provided for the payment for past services but no letter of explanation was written to the employee.

The Duke admitted that all the covenantees were, in fact, getting the amounts which they would respectively have received as wages or salaries if they lived during the

155. (1935) 19 TC 490

period and continued in employment and that, if they ceased to work, the payments had still to be made.

The Special Commissioners decided in favour of the Crown by looking at the substance of the transactions. They held that the payments made under the deeds to those persons who remained employed by the Duke were, in substance, "payments for continuing service ejusdem generis with wages or salaries" and were not annual payments which were deductible from the Duke's assessment to Surtax.[156]

In the High Court, Finlay J also found for the Crown, but he did not ignore the documents or the form. He said that he was looking at the substance, but he found the substance by looking at the documents together. He cited Lawrence LJ in Perrin v. Dickson,[157] and continued:

> "The principle, as I understand it, is that one has got, of course guiding oneself by the documents and of course remembering that, unless the documents are impeached, which is not the case here, they must be taken as being genuine documents, to look nonetheless at the substance of the thing...... If the matter rested with the deed itself, I should have thought that the Duke was entitled to succeed, but it does not rest with the deed itself, and I cannot help thinking that the real nature of the transaction, to adopt the words of Lord Justice Lawrence, is got when one looks at the letters."[158]

He took note of the fact that there was nothing in the deed to prevent the employee claiming full remuneration but, considering the terms of the letter, the employee had assented to the terms and had therefore precluded

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156. p493
157. (1930) 14 TC 608 at p626, supra
158. p498

himself from claiming any sum beyond the difference paid to him under the covenant and his wages. Finlay J was therefore of the opinion that the substance of the matter was that it was understood between the Duke and the employees that they were to get the same wages as before. However, once the employees left the service of the Duke, the matter was quite different because, in his view, the payments under the covenants were not then in respect of services rendered. The payments would then be wholly and exclusively as a recognition by the Duke of the long service of the employees.[159]

The taxpayer's appeal to the Court of Appeal was allowed. Lord Hanworth MR considered that, once it is accepted that the covenants are genuine, they must be effective, and no distinction can be made between the time when the services are rendered and the time when they are not being rendered.[160]

Slesser LJ agreed. He perceived clearly the difference between the loose and the proper uses of the term "substance". He said the real nature of the transaction must be looked at, and that may include the situation of the payer and the payee and all the surrounding circumstances. However, once the whole of the substance has been considered, the court must still examine it from the point of view of the law and see what the legal relationships are. Looking at the whole substance of the transaction here, and reading the letters with the deed, he thought that, at most, it was an agreement modifying the right to wages which the employee might otherwise claim as well as a sum of money which he is entitled to under the deed; but they do not indicate any intention to waive any rights under the deeds themselves.[161]

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159. p500
160. pp505-6
161. See pp507 and 509

Similarly, Romer LJ said that it was not permissible, under the plea of looking at the substance, to re-write contracts. The legal effect of the contract as it stands must be ascertained, and not what the legal effect might be if the words of the contract were disregarded and the substance of the matter considered. It is permissible to regard the substance once the legal effect of the contract has been ascertained, regardless of how that legal effect has been described in the contract.[162]

In the House of Lords, the first speech for the majority was given by Lord Tomlin who gave his well known criticism of the "substance" approach:

> ".... It is said that in revenue cases there is a doctrine that the court may ignore the legal position and regard what is called 'the substance of the matter and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioners apparently acted), seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting 'the incertain and crooked cord of discretion' for 'the golden and streight metwand of the law'. Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland

162. p509

Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay, notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."[163]

Lord Tomlin then referred to the main passages relied on by the Crown. The first of these was Lord Herschell LC in Helby v. Matthews.[164] Lord Tomlin said that this meant that the substance of a transaction embodied in a written instrument is to be found by construing the document as a whole. The second passage relied on by the Crown was Lord Halsbury LC in Scoble's case[165] and, again, Lord Tomlin considered that this merely meant that surrounding circumstances must be regarded in construing a document.

Lord Tomlin did not think that either of these passages helped the Crown in the present case. He cited with approval the dictum of Lord Warrington of Clyffe in the case of *In re Hinckes, Dashwood v. Hinckes*[166] which was as follows: "It is said we must go behind the form and look at the substance. I do look at the substance, but, in order to ascertain the substance, I must look at the legal effect of the bargain which the parties have entered into." Lord Tomlin commented:

> "So here the substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles".[167]

Contrary to what many commentators have believed, Lord Tomlin was not rejecting substance in favour of form; on

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163. pp519-20
164. [1895] AC 471 at p475, supra
165. Scoble v Secretary of State for India [1903] AC 299 at p302
166. [1921] 1 Ch 475 at p489, supra
167. p521

the contrary he was looking to the substance of the transaction, but saying that the substance must be found by examining the legal rights of the parties found from considering the transaction as a whole. In the Duke of *Westminster case itself, taking the deed with the letter* and the acknowledgement, the substance of the matter was that the payments under the deed did not constitute remuneration. He said that, as the deeds were admitted to be bona fide, they had to be given their proper legal operation, and they could not be ignored or treated as operating in some different way because less tax would have been payable under the alternative arrangement.[168]

Lord Russell *of* Killowen also could *find nothing* in the letter and acknowledgement which constituted a contract; there was merely a hope or expectation that the covenantee would not claim the full amount of his wages. He said:

> "In my opinion, the letter has no operation at all and has no effect upon the legal rights and liabilities of the parties created by the deed".[169]

However, he went on to say that, even if he were wrong and that the letter did constitute a contract, it would be no more than a contract by the employee that his remuneration for future services would not be full remuneration, but only the additional sum referred to in the letter.

Lord Russell referred to the finding of the Commissioners and Finlay J, namely, *that looking at the substance of* the thing the payments were wages. Lord Russell's view of this was that this was disregarding the true legal position and substituting different legal rights and liabilities. He continued:

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168. Ibid
169. p523

> "I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a court's view of what it considers the substance of the transaction, the court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or by analogy, but only by the plain words of a statute applicable to the facts and circumstances of the case."[170]

He then cited with approval the dictum of Lord Cairns in Partington v. Attorney General.[171] He then went on:

> "If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non-taxability in accordance with the legal rights, well and good. This is what this House did in the case of Secretary of State in Council of India v. Scoble [1903] AC 299; that and no more. If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine."[172]

Here again, Lord Russell was not preferring form to substance, but was saying that the rights and liabilities of the parties must be determined by the substance of the transaction as found by respecting the legal effects of the transactions. He said that the Crown could not recharacterise the transaction to comply with the spirit of a legislation.

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170. p524
171. (1869) LR 4HL 100, see Chapter 14
172. p524

Lord MacMillan treated the case differently. He did not discuss the question in terms of form and substance. He said that it was difficult to see how a sum which is payable irrespective of employment can be said to be a profit arising from that employment. He did, however, say that if the collateral documents had effected the independent nature of the obligation under the covenant, different considerations might have arisen.[173]

Lord Wright, on the other hand, did look at the question from the point of view of form and substance. He noted that, as the deeds were intended to operate as such and were accepted as genuine, one could not go behind what appears on the face of the document, or qualify its effect by other documents. His view was that the character of the payments for tax purposes must be detemined by what the legal effect is between the covenantor and the covenantee. In determining the character of the payments he declined to take the letter of acknowledgement into account because, as the letter itself explained, there was nothing to prevent the covenantee from claiming full remuneration for his work for the Duke.[174]

Lord Wright agreed with Lord Russell that, even if the letter of explanation, together with the acknowledgement, were treated as constituting a contract, it would only be a contract to pay the additional sum.

Lord Wright could not understand what the Commissioners meant by the expression "payments for continuing service ejusdem generis with wages or salaries". He said that, once it is admitted that the deed is genuine, there is no room for the phrase "in substance". He was of the view that the true nature of the legal obligation is "the substance".

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173. p526
174. p528

Lord Atkin, on the other hand, was of the opinion that the letter constituted a contract. He was not impressed by the fact that the deed would have a different effect on the Surtax liability of the Duke if the covenantee left his employment because then the letter would not be in operation and there could be no ground for saying that the Duke was paying remuneration.[175]

Lord Atkin agreed with the Commissioners and Finlay J that the substance of the transaction was that the payments under the deed constituted remuneration, taking the letter into account. He agreed that the court must not go beyond the legal effect of the agreements made, construed in accordance with ordinary rules, taking into account the surrounding circumstances.

As regards the one employee to whom no letter was written, Lord Atkin accepted that the deed alone applied and that the sums under this deed did not constitute remuneration.

It can be seen that, basically, Lord Atkin was differing from the majority on a question of fact, namely, that the letters constituted contracts which must be read with the deed, and that those contracts did not affect merely the additional sum payable under them. (compare the position of Lord Tomlin, Lord Russell and Lord Wright).[176]

The result of the judgements in the House of Lords was <u>not</u> to say that a series of documents or transactions must be viewed on a step by step basis; but that the courts can look to the legal effect of a series. The courts would not thereby be considering each document or transaction in isolation, but rather the legal rights and obligations created by each document or transaction as

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175. p517
176. Supra

effected in law by the others. This is not, however, looking to the substance of the series; or, to put it another way, you do not look at the practical end result. Relating this to the facts of the Duke of Westminster case itself, the majority view was that a collateral agreement would not have made any difference to the deed because it would not have altered the legal obligation of the Duke to make payments under the covenant even if the covenantee ceased to be an employee. Lord MacMillan was of the view that the position would have been different if the collateral agreement had changed the Duke's obligations under the covenant if, for example, it had provided that payments under the covenant would only be made to an individual during the time he was an employee.

The House of Lords were therefore saying that a court could view a scheme as a whole, as long as the separate and independent legal rights and obligations were not netted off against one another. It was this aspect of the Duke of Westminster principle which came under growing strain when the courts had to consider increasingly complicated and artificial tax avoidance schemes. It is here where the Ramsay case[177] broke new ground, and it is here where the Law Lords in Ramsay were wrong in claiming that the Duke of Westminster principle was untouched by their decision.

How the Duke of Westminster case stood up to the increasing complexity of tax avoidance schemes can be seen by examining the development of the composite transaction doctrine culminating in the new approach adopted by the House of Lords in the Ramsay case.

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177. W.T Ramsay Ltd v IRC, infra

The Advance of the Composite Transaction

It has been seen that in the Duke of Westminster case there are dicta to the effect that the documents must be looked at as a whole. This is an important concept followed in subsequent cases, and it will be demonstrated below that this is where the new approach in the Ramsay case broke new ground and superseded the Duke of Westminster case.

The whole transaction principle was not new in the Duke of Westminster case. As early as 1904, for example, in Hunter v. Attorney General,[178] Lord Davey was looking at the whole transaction and, just two years before Duke of Westminster, Finlay J decided the case of IRC v. Clarkson Webb.[179] This case concerned mutual covenants executed by two brothers in favour of the other's children. Finlay J held that the mutual covenants were part of an arrangement which must be looked at as a whole and that, in substance, the two covenants constituted one disposition for the purposes of section 20(1)(c), Finance Act 1922.[180] The judge said that the court was entitled to look at the two deeds together. In his view, if the court looked only at the deed whereby the taxpayer covenanted to pay a sum of money to his brother's son, there would not be a disposition for the benefit of his own son. But, taking into account the fact that the deed was part of one composite transaction and that, by making provision for his nephew, he was directly procuring the making of a covenant of the same amount for the benefit of his own son, looking at the substance of the matter, the true effect of the arrangement only arose by considering the two deeds together. This was so even though the brothers went through the form of handing over cheques.[181]

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178. (1904) 5 TC 13 at p24
179. (1933) 17 TC 451
180. See Chapter 2
181. See pp456-7

It is noticeable that Finlay J looked at the end result of the composite transaction. Further, he only did so to establish the legal substance of the whole transaction; he did not disregard any intermediate steps.

After the Duke of Westminster case, the "whole transaction" approach was to return. The principle was developed in the 1960s and 1970s and took a radically different turn in Ramsay itself. However, even before the 1960s, the principle was recognised. In John Cronk & Sons v. Harrison,[182] Lord Hanworth MR expressed himself as justified in looking at the "totality of the transaction" and he said it was not possible or right to look at only one part of what might be called a tripartite transaction. In this case it was the Crown that wanted the transactions treated separately. His Lordship found it impossible to separate one portion of the tripartite agreement from the others: he refused to break the transaction down into its separate parts.[183] This was the approach he had adopted in the Duke of Westminster case itself. In the House of Lords in the Cronk case, Lord Thankerton agreed.[184]

In the early years of the development of the composite transaction principle, it could not be stretched too far, and in particular, intermediate steps could not be ignored. For example, there was a pre-arranged plan in Williams v. Davies,[185] and the Crown argued that the plan must be looked at as a whole. The taxpayers in that case

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182. (1936) 20 TC 612
183. pp626-7
184. p641. See also Prendergast v. Cameron, (1940) 23 TC 122 at pp. 151 - 2 per Lord Romer. (Compare the comments of *Sir Wilfrid Green MR at* pp. 131 - 2), The different results achieved by the two judges was a question of different interpretation of the facts rather than a difference of principle, although Sir Wilfrid Green MR appeared more prepared to treat the two transactions as distinct than did his brethren in the Court of Appeal and the House of Lords.
185. (1945) 26 TC 371

had been concerned for many years in buying and selling and developing building land. The two taxpayers each purchased one half of three adjoining plots of undeveloped building land, and a few days later, they conveyed the land by a Deed of Gift to their wives who, acting on their husbands' advice, sold the land to a land development company of which the taxpayers were the directors, and in which each held one half of the shares. Two years later further undeveloped building land was purchased and dealt with in the same way. The proceeds of both sales were invested by the wives in securities and they received the dividends. It was admitted or proved in evidence that the whole scheme was discussed and arranged between the two taxpayers prior to their acquisition of the property as a means of enabling their wives to make a good profit. The taxpayers were assessed to income tax under Cases I and VI of Schedule D. The Special Commissioners found that the wives were the beneficial owners of the properties in question and did not hold them as nominees or as trustees of the taxpayers and that, in selling the properties, the wives were not carrying on a trade or an adventure in the nature of a trade and that the taxpayers were not liable under either Case in respect of these transactions.

It was held by Wrottesley J that it could not be said that there was no evidence on which the Commissioners could have reached their decision and dismissed the Crown's appeal.

The judge acknowledged that the husbands, by means of their prearranged plan, had avoided the income tax that would have arisen if they had made the profit themselves.

The Crown had argued that, in finding as they did, the Commissioners must have failed to weigh the fact that the whole plan was contrived by the husbands and that, looked at as a whole, it was impossible to say that no trade was carried on by the wives. The Crown's contenion could not stand up in the face of the finding that the transactions were genuine. It would have been otherwise if the wives had been merely nominees for their husbands - this is fair enough. Furthermore, the judge indicated that the position might have been different if the wives had been "party to the plan from the beginning".[186] This too appears to be in line with the composite transaction principle to be derived from the Duke of Westminster case, but the judge did not develop this point.

At about the same time, Macnaghten J heard the case of Frodingham Ironstone Mines Limited v. IRC.[187] This was an excess profits tax case considered in Chapter 1. The taxpayer company made excess profits and another company, owned by the same trustees, was being run at a loss. With a view to reducing the taxpayer company's liability to excess profits tax, the trustees sold the loss-making company to the taxpayer company so that the profits of the taxpayer company could be reduced by the losses of the other company. The Inland Revenue made a direction under section 35, Finance Act 1941[188] that the excess profits tax liability of the two companies should continue to be computed on the basis that they remained independent companies. The judge upheld the Special Commissioners decision that the direction should be confirmed.

It had been argued that a direction given by the Revenue under section 35, Finance Act 1941 must not be construed in such a way as to impose a greater liability to excess profits tax than if the transactions giving rise to the direction had not been given. The purchase of the shares, however, undoubtedly constituted a payment of capital monies for the acquisition of an investment, and

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186. p379
187. [1946] 1 All ER 168
188. See Chapter 1

it was held that it must be so treated, although the scheme for tax avoidance failed by reason of the direction of the Revenue. The Revenue's decision was that the sum expended in the purchase should be properly regarded as an investment by the appellant company and not as capital employed in its business, and that the company's liability to excess profits tax should be computed accordingly. It had already been conceded that the main purpose of the transaction was the reduction of excess profits tax. The case was only concerned with the true construction of the direction. The judge said that, until the direction was given, the profits of the two companies were treated as separate for the purposes of excess profits tax. In the assessments the liability of each company remained separate from the other. In ascertaining the amount of tax, all the transactions which had taken place during the accounting period had to be taken into account, including the transaction whereby the taxpayer company purchased the shares in the loss-making company. It was a purchase of an investment and it must be treated as such.

The effect of the direction was, therefore, not to treat the transactions implemented purely for tax avoidance reasons as if they had never happened. The intermediate steps were given effect to, with the result that the actual excess profits tax was increased above the amount that would have been payable if nothing had happened.

This case, under one wide anti-avoidance section, should be compared with the post-Ramsay decision on another wide anti-avoidance provision involving directions[189]: Bird v. IRC[190] where, again the intermediate steps were not ignored, even following Lord Brightman's judgement in Furniss v. Dawson.[191] The Bird case is considered in detail in Chapter 1.

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189. Section 703 ICTA 1988, see Chapter 1
190. [1988] STC 312
191. (1984) 55 TC 324, infra

In this respect, the way in which the particular anti-avoidance provision works will be relevant in determining the tax effects of treating the transaction as a whole. A different type of provision was section 260, Income Tax and Social Services Contribution Assessment Act 1936 - 1951, the Australian "blanket" anti-avoidance provision examined in Chapter 10. The section was considered by the Privy Council in Newton v. Federal Commissioner of Taxation[192]. This was a dividend stripping case caught by section 260. Although the various tax-avoidance transactions were genuine as between the parties, they were "absolutely void" as against the Commissioner. In other words, the Commissioner could disregard them completely. However, unlike in the Frodingham and Bird cases, section 260 operated so that the ignoring of the transactions did not itself give rise to tax.

Section 260 is interesting in that it allowed the Commissioner to look at the end result by ignoring the intermediate steps inserted solely for tax-avoidance. This comes near to Lord Brightman's formulation of the Ramsay principle in Furniss v. Dawson.[193]

In Campbell v. IRC,[194] despite the arguments to the contrary of Templeman QC,[195] the two documents in question in that case were read together. The House of Lords held that the covenant and the understanding that payments under it would be used in a certain way had to be read together, and the sole legal effect of what was done was the effect of both obligations taken together.

Similarly, in IRC v. Horrocks,[196] Plowman J said that it was "completely unreal" to divide up a single scheme into parts in that case because there was only one transaction

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192. [1958] AC 450, see Chapter 9
193. Infra
194. (1968) 45 TC 427
195. p545
196. (1968) 44 TC 645

which was a composite of all its parts. In this case the facts were that it was decided that a company would make a payment to its shareholders (including the taxpayers) of £43,875, by means of a reduction of capital. It was also decided that the company ought to continue to have an issued share capital of its current amount, £45,000. The capital of the company was reduced from £45,000 to £1,125 by the return to shareholders of 19/6d per £1 share, and contingently on the reduction taking effect, the issued capital was increased to £45,000 by the capitalisation of £43,875 standing to the credit of the general reserve fund, the additional amounts being credited to the shareholders in proportion to their holdings. The Inland Revenue served notices under section 28(3), Finance Act 1960.[197] It was held that, taking the stages in the transaction together, the directions were correct.

Similarly, in cases on the distinction between capital and income, in the years immediately following the Duke of Westminster case, the form of the document itself was decisive but, beginning in Vestey v. IRC,[198] it was decided that the surrounding circumstances and the events leading up to the transaction could be considered and that the form of the document was not decisive.

A similar process of reasoning was used by Megarry J in Thompson v. Salah,[199] in which he held that two separate deeds should be taken together as constituting a conveyance. The taxpayer received an offer for a piece of land and, instead of a straight conveyance, she mortgaged the land to the company which had made the offer, and conveyed the fee simple in the property to the company in consideration of a release from the obligation to repay the mortgage. The judge said:

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197. Now section 703(3) ICTA 1988
198. (1961) 40 TC 112
199. (1971) 47 TC 559

> ".... The transaction was in substance a sale even though it was carried out by two separate documents. The legal charge provided for repayment in six months time; but there was obviously no reality in that provision. In my view the two deeds taken together constitute a conveyance just as much as did the old device of lease and release."[200]

Megarry J was, however, doing no more than reading the two deeds together to discover the legal nature of the arrangement as a whole. He was therefore not going beyond the true Duke of Westminster doctrine. This development, as will be seen below, was to start at about the same time, largely at the instigation of Lord Wilberforce.

The approach of Megarry J was consistent with that taken by Sir Wilfrid Greene MR who, shortly after the Duke of Westminster case, examined the substance principle in the light of Duke of Westminster and also commented on the whole transaction rule. The case in question was <u>IRC v. Mallaby-Deeley</u>.[201]

Here, the taxpayer undertook to pay a sum in five equal instalments to finance the completion of a literary work. A few years later he entered into a Deed of Covenant to pay in each of seven years sums which, after deduction of income tax, amounted in total to the balance remaining under the original undertaking. He claimed to deduct the sums payable under the covenant for Surtax purposes. However, it was held that the payments under the covenant were of a capital nature and were not admissible as deductions.

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200. pp653-4
201. (1938) 23 TC 153

At first instance, Lawrence J had adhered to the form of the covenant alone, without reference to anything outside it, and held that the taxpayer could adopt any form he chose.[202] In the Court of Appeal, however, Sir Wilfrid Greene MR said that this was not an admissible approach. He stated:

> "It appears to me that ..... it is not merely legitimate, but necessary, to examine what the true legal position was and what the true legal transaction was of which the execution of the deed ..... formed part. It is not legitimate to isolate that element in that legal transaction and to pay attention to that alone."[203]

Counsel for the taxpayer had argued that this would be adhering to the substance as against form, as understood in the Duke of Westminster case. The Master of the Rolls, however, dismissed this argument saying that his interpretation did not involve giving the transaction entered into by the parties a character which in law it did not possess. Rather, it involved discovering what the true character in law of the transaction was.[204] In closing his judgement, he said that:

> "It is quite wrong to say that you must look at the document alone and disregard the other elements in the legal relationship between the parties and the legal results which the transaction achieved."[205]

It is interesting to note that the Master of the Rolls said that it is not legitimate to consider one legal transaction in isolation, and that the court must consider the legal relationships of the parties as a whole. It is acknowledged that the Duke of Westminster

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202. p161
203. p167
204. Ibid
205. p170 See also Bulmer v IRC (1966) 44 TC 1 at p26 per Pennycuick J.

case is fully in accordance with this.

In IRC v. Church Commissioners for England[206], it was decided that in tax cases extrinsic evidence is admissible if it tends to show the true character of a transaction.[207]

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206. [1976] STC 339
207. See Lord Wilberforce (p. 346) and Lord Fraser (pp. 357 - 8). Compare, however, the approach of Lord Morris who held that the true nature and substance was to be found in the written agreements between the parties (pp. 353 - 4).

The Wilberforce Factor

The composite transaction doctrine was developed in the years leading up to the Ramsay case, a development in which Lord Wilberforce featured prominently.

In IRC v. Europa Oil (NZ) Limited[208] Lord Wilberforce said that it was possible to consider documents and transactions as a whole. The taxpayer company sold gasoline in New Zealand. It obtained its oil from a company called Gulf Oil Corporation, through a subsidiary of that company, at the normal posted price under a products contract. Another contract provided for the incorporation, in the Bahamas, of a company called Pan Eastern which was owned by Europa and Gulf in equal shares. Pan Eastern purchased from Gulf at posted prices sufficient crude oil to produce the gasoline required by Europa under the products contract. That crude oil was processed for Pan Eastern by Gulf for a fee, and the gasoline was repurchased by Gulf at posted prices. Other petroleum products were purchased by Gulf at prices sufficient to ensure that Pan Eastern earned approximately five cents per gallon of gasoline purchased by Europa from Gulf under the products contract. Europa's share of this was 2½ cents per gallon. The Inland Revenue contended that this was in effect a discount off the purchase price of the gasoline purchased by Europa, and that the expenditure incurred by Europa under the products contract was not exclusively incurred in order to produce assessable income through the resale of products, but was incurred in part for the purpose of producing a return to Europa through Pan Eastern and was therefore not deductible the relevant New Zealand provision.[209]

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208. [1971] AC 760
209. Section 111 of the Land and Income Tax Act 1954

Lord Wilberforce held that, by considering the documents and transactions as a whole, the expenditure in question was not exclusively incurred for the purposes of the trade, but was incurred in part to channel non-taxable income into the tax haven company. He said that:

> "The documents ..... therefore point unequivocally towards an interdependence of obligations and benefits under a complex of contracts which, though embodied in separate documents, represent one contractual whole."[210]

Lord Wilberforce claimed to be adhering to the Duke of Westminster principle (as he did throughout his development of the composite transaction doctrine). He thought that he was not looking at substance in the wide sense. After affirming the Duke of Westminster principle he said:

> "It is not legitimate in this branch of the case ..... to disregard the separate corporate entities or the later of the contracts made and to tax Europa on the substantial or economic or business character of what was done."[211]

The interrelation was, according to Lord Wilberforce, shown by the fact that the intergration of Europa's agreement to buy gasoline with Gulf's agreement to provide earnings for Pan Eastern was far too close, and far too carefully worked out, to permit the isolation of the sale agreement and the treatment of the expenditure incurred as exclusively incurred for the purchase of trading stock. He also relied on the contemperaneous date of all the agreements. In Lord Wilberforce's view, there was no doubt that Europa never intended to bind

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210. p775
211. p771

itself to buy gasoline from Gulf without the benefit of the advantage from the processing contract through Pan Eastern. Furthermore, Gulf undertook a direct obligation with Europa to carry out the processing contract and to pay Pan Eastern all money due under it, and that Pan Eastern's earnings should be as provided in the processing contract.[212]

Lord Donovan and Viscount Dilhorne dissented strongly from this view, holding that the contracts between the various companies could not be disregarded as "mere machinery" citing as authority the case of Gas Lighting Improvements Company Limited v. IRC,[213] in which Lord Sumner had said:

> "It is said that all this was 'machinery', but that is true of all participations in limited liability companies. They and their operations are simply the machinery, in an economic sense, by which natural persons, who desire to limit their liability, participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership, but legally speaking, this machinery is not impersonal though it is inanimate. Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person, real though artificial, the company itself, and the business carried on is the business of that company, and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It is a figure

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212. See pp 774-5
213. (1923) 12 TC 503

of speech, which cannot alter the legal aspect of the facts."

Lord Donovan and Viscount Dilhorne said that if the parties to a bargain agree upon what they want and execute contracts, the legal effect of which is to carry out their wishes, a taxing authority cannot refuse to recognise the contracts and their legal effects when assessing the parties to tax (assuming that the contracts are not shams). They continued:

> "The Revenue must take the rough with the smooth, and the Commissioner in the present case is not entitled to brush aside the contracts which produced a share of the refining profits of Gulf to Europa, and to say that what the parties bargained for and what Europa got were something quite different."[214]

The dissenting judges were not influenced by the fact that the court was faced with a complex of contemperaneous and interrelated contracts, because that fact meant no more than that, when seeking to discover the purpose of Europa in paying out particular sums, the court should have regard to all the contracts because the answer may have to be deduced from more than one of them.[215]

In Ransom v. Higgs,[216] Lord Wilberforce used his judgement in the Europa case as authority in deciding whether the taxpayer was trading in this case, which involved a complicated tax avoidance scheme. It was, in fact, a stock-stripping arrangement.[217]

A group of companies under the control of the taxpayer agreed to sell land at an undervalue (£67,000) to a newly formed property dealing partnership consisting of the

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214. p778
215. p779
216. (1974) 50 TC 1
217. See Chapter 1

taxpayer's wife, who had a 90% interest, and two independent companies, which had 5% each. The taxpayer's wife settled her interest on discretionary trusts for herself, the taxpayer and his issue. The trustees immediately sold this interest to an independent company for £170,000 by means of the grant of an option and its oral exercise. The taxpayer's wife then resigned from the partnership and was replaced by the purchasing company. The partnership sold the land to the purchasing company for £87,000, and the purchasing company then sold the land and the 90% interest to another company, not controlled by the taxpayer, for £286,000. This second company sold the land for £286,000 to another company not controlled by the taxpayer, and the 90% interest to a further company not controlled by the taxpayer for £275,000.

The Revenue argued that the transactions in the arrangement were carried out in pursuance of a single scheme and had to be considered as such, with the result that the taxpayer had carried on a trade within Schedule D Case I, and that he was assessable on the £170,000 received by the trustees. By the time the case had reached the House of Lords, the Crown had dropped their claim against the taxpayer personally, but they contended that he had engaged in an adventure in the nature of trade by procuring others to enter into the relevant transactions, and that the trustees were liable to tax in respect of the ensuing profits. The House of Lords, however, held that, merely by procuring others to enter into a scheme which involved trading by some of those others on their own account, did not mean that the taxpayer himself engaged in any trade.

In this case it was the Crown which had argued that it was legitimate to break down the scheme into its isolated component parts and, having done that, to concentrate on a single element; the receipt of £170,000 by the trustees in return for the sale of the partnership interest, and then to claim that that was an isolated sale by the trustees of a capital asset. This is the opposite argument to the one the Revenue used increasingly in subsequent years where the single element in a composite scheme gave rise to, say, a capital loss.

It was to the Revenue's benefit in future cases that their arguments in this case were rejected. Roskill LJ (who was in the House of Lords in each of the three main Ramsay cases: Ramsay/Eilbeck v. Rawling itself, Burmah Oil and Furniss v. Dawson),[218] for example, said that the entirety of the scheme had to be regarded; it must be looked at as a whole and not broken down into a number of separate component parts.[219]

Russell LJ (who was in the House of Lords in Ramsay/Eilbeck v. Rawling) agreed.[220]

Lord Reid did not accept this approach to the problem,[221] although he did take a broad view of the overall activities of Mr. Higgs in deciding whether he was trading. A similar line was taken by Lord Morris.[222]

Lord Wilberforce, in his development of the composite transaction doctrine, gave a judgement similar to the Roskill/Russell line. He did not have the same difficulty that Lord Reid had in accepting the approach of the lower courts. He accepted the findings of the Commissioners and held that the scheme must be regarded as a whole. Citing the first Europa Oil case as an example (in which, of course, he gave the majority judgement), he said:

> "... I accept that it is legitimate to consider the 'scheme as a whole' where there is evidence, as

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218. Infra
219. See pp46 and 49-50
220. p64
221. See, for example, p80
222. See pp83 and 85

there is here, that each separate step is dependent on others being carried out."[223]

Lord Wilberforce, however, did not have it his own way. This is shown by IRC v. Europa Oil (NZ) Limited (No. 2),[224] where he gave a dissenting judgment.

This case concerned a second set of contracts relating to the relationship between Europa and Gulf. The economic effect of the two sets of contracts, and the commercial reasons for executing them, were similar in both cases, but section 111 operated on them in a different way as will be seen below.

Lord Diplock gave the judgement for the majority and his speech shows precisely the extent to which a scheme could legitimately be viewed as a whole at that time. This approach was in accordance with the strict Duke of Westminster doctrine that there could be no taxation by end result. Lord Diplock said:

> "In the majority judgement in the previous appeal, however, one thing was said in connection with the need to analyse the legal character of the contractual arrangements, that would appear to have given rise to some misunderstanding in the instant appeal, i.e. the passage where it is stated:
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> > '... The Crown is not bound by the taxpayer's statement of account, or by the heading under which expenditure is placed. It is entitled to ascertain for what the expenditure was in reality incurred.'

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223. p90
224. [1976] STC 37

> Taken in isolation this might be thought to suggest that the court was entitled to look behind the legal character of the payment made pursuant to the provisions of a contract and to take into account economic benefits which would in fact accrue to the taxpayer otherwise and as a matter of contractual right. Any such suggestion had, however, already been emphatically repudiated in a preceding paragraph in which Inland Revenue Commissioners v. Duke of Westminster had been referred to as authority; and the repudiation was repeated in the same paragraph as that in which the passage which their Lordships have just cited appears. Its concluding sentence is:
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> > 'Taxation by end result, or by economic equivalence, is not what the section really achieves.'
>
> Read in this context it becomes clear that the reference to 'reality' was directed only to the legal character of the payment and not to its economic consequences."[225]

It is clear from this that the strict Duke of Westminster doctrine was being applied at the highest level almost immediately before the Ramsay case, and this was so even though the Privy Council accepted that they were dealing with "a complex of inter-related contracts .... in connection with the same goods."[226]

Lord Diplock said that the first Europa Oil case differed from the second one in the following way. In the first case, the combined effects of the various contracts was that, whenever the taxpayer company placed an order with

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225. p43
226. Ibid

Company 1 for delivery of an instalment of goods, and accepted an obligation to pay the sums it pledged in that contract as the purchase price, it acquired an enforceable right to have payments made by Company 2 to the Bahamian company, so as to ensure that the Bahamian company made a profit of five cents per gallon. In this case, the position was different because the taxpayer company was not a party to any of the contracts entered into with companies which were members of the same group as Company 1 and Company 2. Therefore, whenever the taxpayer company entered into a contract with Company 3 for the sale and delivery of cargo, and thereby accepted an obligation to pay the sum stipulated in that contract as the purchase price, the only right it thereby acquired, which was legally enforceable against anyone, was the right to delivery of the cargo.

Lord Wilberforce did not accept this analysis, and in his minority judgement he said that "in reality" the results would be exactly the same as under the contracts in the previous case and that, looking at the scheme as a whole, the taxpayer company's payments were not "exclusively" incurred for the oil. Lord Wilberforce, however, claimed that he was not advocating taxation by economic equivalence or end result.

The approach adopted by the majority in the second Europa Oil case was also adopted by the majority of the Court of Appeal in Floor v. Davis.[227] The Inland Revenue's contention that a disposal of shares by A to B, followed by a disposal by B to C, could be treated simply as a disposal by A to C for CGT purposes, was rejected because the contract in the second disposal did not alter or otherwise affect the contract for the first disposal, and to uphold the Inland Revenue's argument would be contrary to the Duke of Westminster case. As explained in Chapter 8[228], the taxpayers in Floor v. Davis failed because,

227. (1979) 52 TC 609
228. The case is also dealt with infra

under the pre-arranged scheme, the three individuals concerned together "exercised control" even though only one of them had voted at the relevant meeting. Sir John Pennycuick said that the pre-arranged series of transactions meant that the three individuals had collectively exercised control.

The next case to consider in the development of the composite transaction doctrine is IRC v. Plummer.[229] The scheme here was relatively straightforward and, as in the Duke of Westminster case, the aim was to generate annual payments to reduce the taxpayer's total income. In outline, what happened was that the purveyors of the scheme (the Rossminster organisation) made available for a fee a lump sum representing the price of the taxpayer's undertaking to pay an annuity. As each annuity payment was made, an instalment of the lump sum was used to fill the gap. As a result, the money went in a circle and the taxpayer was, in financial terms, no better or worse off at the end of the day.

In the Court of Appeal, Buckley LJ followed the authority of the Scoble, Wesleyan & General Assurance Society and Church Commissioners cases,[230] holding that the court has to look at the whole transaction to ascertain the true character of the payments and, in doing so, it must pay due regard to the terms and legal effect of any formal legal documents employed. Regard may also be had to extrinsic evidence, but only to supplement the formal legal documents by throwing light on the true nature of the whole transaction; not to contradict the terms and effect of the documents (following Perrin v. Dickson and Church Commissioners).[230] He also followed Lord Wilberforce in

229. (1979) 54 TC 1
230. Supra

Ransom v. Higgs in stating that, if the transaction involves a series of preconceived steps, the performance of each of which is dependent on the others being carried out in accordance with a common intention of the parties, the nature and effect of the whole scheme may have to be taken into consideration in determining the nature of the annual payments.[231]

It is interesting, in view of the fact that Plummer was heard only shortly before Ramsay[232] to see how the Crown were formulating their arguments. Buckley LJ noted the approach of the Revenue as follows:

> "Mr. Medd [Counsel for the Crown] says that in consequence of the fact that the only purpose of the scheme was to secure tax advantages it is *particularly incumbent on the court in this case to* look behind the way in which the transaction is dressed up to see what its true nature is. It is to be distinguished, he says, from a case in which the parties have some legitimate object which they wish to attain other than a mere fiscal advantage, for which purpose they have devised machinery which will incidentally also produce the most satisfactory fiscal consequences."[233]

The House of Lords recognised the arrangements in this case as constituting a tax avoidance scheme and they considered that this entitled them to look at the plan as a whole. But, as Lord Wilberforce said: "It does not entitle us to disregard the legal form and nature of the transactions carried out".[234] Lord Wilberforce did not, however, look at the plan as a whole and consider merely the end result (as he did in Ramsay). The approach of Lord Wilberforce in Plummer was really that the legal form of the constituent transactions is unaffected,

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231. See p26
232. The Court of Appeal heard Plummer in 1978
233. p27
234. p39

although it may be clarified by the intention of the parties as appears from the scheme as a whole.[235]

Lord Wilberforce's approach at this stage in his development of the composite transaction doctrine can be seen from his reaction to the argument advanced by the Crown that the annuity payments were no more than instalment repayments of the lump sum. He said:

> "If it were possible to disregard the legal form of the documents and to look beyond them for an underlying substance there would be attractions - beyond those of ingenuity - in this argument".[236]

Lord Wilberforce's view was that the legal effect of the arrangements entered into by the taxpayer was the effect which the documents purported to achieve. He concluded:

> "In short, unless we are prepared to disregard the legal structure of these transactions, their nature is clear: a covenant, for a capital sum, to make annual payments, coupled with security arrangements for the payments. But no attack was made on the transactions as a sham and we must accept the consequences of them."[237]

Lord Fraser said, of the Revenue's argument:

> "In practice, of course, the £2,500 invested in promissory notes was the obvious source from which the annuity payments were to be made, but it was only a matter of convenience and if the respondent had chosen to make all or any of the payments from

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235. This was also his approach in Chinn v. Collins, (1980) 54 TC 311, where he again spoke of viewing the scheme as a whole without disregarding the legal form of the individual transactions.
236. p40
237. Ibid

some other source, he was free to do so."[238]

Compared to Lord Fraser's approach beginning in the Ramsay case,[239] it is rather a naive view of the transaction to say that it was "only a matter of convenience" that the promissory notes were the source from which the annuity payments were to be made. This was a pre-packaged scheme and the whole point, and the understanding in furtherance of which this scheme was carried out, was that the promissory notes were to be used in this way. However, Lord Fraser's approach in this case is in accordance with the undiluted Duke of Westminster principle that one must take a document at its face value.

After the Ramsay case, a similar (but not identical) pre-1977 reverse annuity scheme to that used in Plummer was argued before the Special Commissioners. The Commissioners were at pains to distinguish Plummer holding, not too convincingly, that the scheme in point was more circular and self-cancelling and less commercial. This Commissioners' decision shows two things: first, that the Revenue continued to challenge reverse annuity schemes despite their set back in the Plummer case; and secondly, that the Special Commissioners would be reluctant to follow Plummer unless faced with an identical scheme in identical circumstances.

In the light of subsequent events, it may well be that the judges of the Chancery Division would not have been so ready to distinguish Plummer, but the House of Lords would have sought to distinguish it if at all possible. In fact, it is hard to envisage Plummer itself now succeeding in the House of Lords; it being a pre-ordained series of transactions having steps inserted solely for tax avoidance purposes.

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238. p56
239. Infra

The Templeman Contribution

In his development of the composite transaction doctrine, Lord Wilberforce was aided and abetted by Lord Templeman. Whereas Lord Wilberforce was working from the top of the judicial tree in the House of Lords, Lord Templeman produced judgements along the same lines in both the Chancery Division and the Court of Appeal before he reached the Lords. Consequently, he found it rather harder to prevail, although the Wilberforce approach was, of course, having its effect upon the lower courts.

The case of T. & E. Holmes Limited v. Robinson,[240] is instructive in this respect. Goulding J in the Chancery Division took a more formalistic approach. Throughout the development of the doctrines of substance and the new approach in the 1970s and 1980s, the judges of the Chancery Division tended to take a more traditional view of arrangements. This is demonstrated here in the different approaches of Goulding J, on the one hand, and the Special Commissioners and the Court of Appeal on the other hand.

The facts of the case were that the taxpayer company granted a lease to an associated company for 21 years of certain land, containing sand and gravel, at a rent of £60 a year. The lease specifically excluded any authority to extract sand or gravel. However, by a licence, executed on the same day and for the same period, the taxpayer company authorised the associated company to extract sand and gravel on the payment to the taxpayer company of royalties. The taxpayer company was assessed to excess rents under Case VI of Schedule D on the basis that the payments under the licences were "rent payable under a lease" under section 175, Income Tax Act 1952.

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240. (1979) 52 TC 267

The Revenue maintained that, in order to determine the legal relationship between the parties as regards the lease and licence, it was necessary to look at the two documents together. The Commissioners agreed holding that the lease and the licence were part of one bargain whereby the associated company leased the land with a right to take sand and gravel for a rent and royalty and that, to get at the true nature of the legal relationship, the two documents should be read together.

Goulding J accepted that the lease and the licence formed one transaction, and also accepted that the same legal situation could have been produced by a single instrument. However, that was as far as he went. He respected the two types of payment, saying that the parties had endeavoured to make a real distinction between the two classes of payment "and the court should not be astute to defeat their contractual intention".[241]

Templeman LJ, however, in the Court of Appeal, adopted a much wider substance approach. He said:

> "The Crown contend that the lease and the agreement together formed one lease. The taxpayer concedes that the lease and the agreement formed one transaction, but argues that the royalties were paid under the agreement and not under the lease. In my judgement section 175 is concerned with facts and not with documents, with realities and not with labels. The recording of one transaction by two separate pieces of paper did not alter the nature of the single transaction. That transaction was a demise or lease of land in consideration for a fixed rent and a fluctuating royalty and certain covenants."[242]

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241. p579
242. p584

Lord Templeman was particularly scathing when dealing with schemes which contained steps which had no commercial justification and which were circular in nature. One of the early cases of this type to be considered by him was Black Nominees v. Nichol.[243] In this case Templeman J (as he was then) had some strong things to say about a very complex arrangement which resulted in the payment of what he termed "a fake" cheque for £475,000. He said that: "No one in his senses would in 1965 have handed over £475,000 undisputed, unrestricted, uninsured, uninflated pound notes for what Black Nominees had to offer".[244] He concluded that real money did not pass in a circle by virtue of the various transactions in this scheme.

Regarding the Duke of Westminster principle, he said that the various transactions had to be considered in order to determine their legal effect. He stated:

> "The legal effect was that the taxpayer company disposed of its rights and powers under the first and second settlements and acquired the rights to a part of the profits on the Christie rights. That was the legal effect, not merely the substance."[245]

In the Duke of Westminster case, by comparison, the legal effect was that the sums paid were an annuity because they continued irrespective of the continued employment of the servant, although, as long as he did remain in employment, it could be said that the sums received were "in substance" (i.e. economic substance) part of his remuneration. In Templeman J's words, there was no "disappearing trick" or "fake price".

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243. p584
243. (1975) 50 TC 229, see Chapter 1
244. p280
245. Ibid

Templeman J also distinguished the Wesleyan and General Assurance Society case.[246] He said:

> "In the Wesleyan case the policyholder might not borrow; if he borrowed, he might not repay. Both possibilities were remote, but they existed and weighed with the House of Lords in distinguishing between a loan and an annuity. In the present case there is no difficulty in distinguishing between the receipt of profits and the repayment of a loan just because the former is tricked out to look like the latter."[247]

During the course of Counsel's arguments in this case, Templeman J spoke in terms of tax evasion. This was on the basis that the scheme was so complicated that the many steps could only have been inserted to form a smokescreen to keep the true facts from the Inland Revenue. It was only when he was informed that the scheme had been approved by six eminent counsel, some of whom had already been elevated to the Bench, that he abandoned this approach.[248]

In the Court of Appeal, in a dissenting judgement, he was also scathing about the Bradman scheme in IRC v. Garvin,[249] which, in fact, succeeded, the House of Lords unanimously giving judgement in favour of the taxpayer in May 1981, two months after they had handed down the Ramsay decision.[250] It is also noticeable that three of the Law Lords were the same in both cases. Templeman LJ in the Court of Appeal, however, held for the Crown. He referred to "book entries which were necessary to create and destroy fantasies"[251], the Bradman companies as "a faithful and well-trained pack of

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246. IRC v Wesleyan & General Assurance Society, supra
247. p281
248. This information was disclosed to the writer by one of the solicitors in this case.
249. (1981) 55 TC 24
250. Infra
151. p72

"In that case it was sought to say that the payments under covenant were not such but were payments of wages. I do not seek to say that the transfer to FNW was not a transfer. The important feature of the present case is that the destiny of the shares was at all times under the control of the taxpayer who was arranging for them to be transferred to KDI. The transfer to FNW was a step in that process. In the Westminster case the legal position was that there existed a covenant imposing upon the Duke a liability to make payments thereunder. The Crown was not permitted to say that those payments were anything else. Effect had to be given to the legal position .... in deciding that there was a disposal within the plain words of the statute to KDI, I in no way deny the legal effect of the transfer to FNW .... I take the view that the taxpayer was dealing with the shares right up to the time when they reached KDI and that the transfer to FNW was conveyancing machinery."[262]

The operation of the new approach in the case of Floor v. Davis type schemes in the light of the Eveleigh approach is considered below. Basically the same scheme was used in Furniss v. Dawson, Craven v. White and Baylis v. Gregory.[263]

It appears, from the report of the case in Appeal Cases, that the Crown did not argue the "new approach" before the House of Lords.[264] Their Lordships restricted themselves to the technical "control" point.

The final step before the formulation of the Ramsay principle was the case of Chinn v. Collins,[265] in which the House of Lords gave judgement at the end of 1980.

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262. p634. Compare Buckley LJ at p635
263. Infra. See also Chapter 8
264. See [1980] AC 695 at pp697-703
265. (1980) 54 TC 311

Templeman J heard the case in the High Court (in 1977), and the House of Lords was headed by Lord Wilberforce.

This case concerned a UK discretionary trust which held shares showing a substantial gain. The English trustees were replaced by Guernsey trustees and the management of the settlement was moved to Guernsey. A Deed of Appointment was executed whereby the trustees appointed shares to the taxpayer (a UK beneficiary) contingent on him surviving for three days. By a Deed of Assignment made on the same day, the taxpayer assigned the contingent interest to a Jersey company in return for the Jersey company's covenant to pay him £352,705 four days later. The covenanted sum was the market value of the underlying shares. On the same day, the Jersey company agreed to sell to the taxpayer a number of shares in the same company which corresponded in amount to those appointed out contingently under the Deed of Appointment. The sale price was to be about £350,000. Completion of this agreement took place on the same day as the Jersey company's covenant was due to be paid.

The taxpayer argued that the disposal of the interest under the trust was not chargeable because of what is now section 58(1) CGTA 1979.[266] The Crown did not contest this point. The taxpayer also claimed that, when the deemed disposal took place when the three day period expired, and the Jersey company became absolutely entitled as against the trustees (within what is now section 54 CGTA 1979), there could be no charge under section 17 ibid because the Jersey company was not resident in the UK. Furthermore, the trustees could not be liable because they too were not resident.

The Crown not only argued the case on technical grounds, they also submitted that the scheme was a composite

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266. See Chapter 8

transaction, the sole legal effect of which was the intended end result, so that the purchase by the Jersey company was to be disregarded as mere machinery for achieving the taxpayer's purpose.

The Special Commissioners found that the scheme was *indeed a single composite arrangement* which was planned from the beginning. There never was any possibility that the various steps would not be completed. Nevertheless, the end result argument failed.

In the High Court, Templeman J surprisingly did not mention the end result argument. He held for the Revenue on technical grounds. He did, however, consider that the steps were interdependent and conditional on one another. No party was free to enter into one step and reject the other. Therefore, the contract to purchase shares could not be regarded in isolation and ignored. Alleged differences between the assignment of the interest and the contract were "differences in form but not differences in meaning or effect".[267] This is a wide substance approach.

The Court of Appeal did not mention the end result argument either, but found for the taxpayer on technical grounds. Buckley LJ ruled that the legal effect of the documents, both severally and collectively, must depend upon their terms as contrued in the light of any admissible extrinsic evidence. He accepted that it was legitimate to have regard to the fact that the transactions were interrelated. Where he differed from Templeman J was that Templeman J considered that the interrelated steps could only be explained on the basis that the settlement shares were the shares that would find their way to the taxpayer, and he so held. Buckley LJ, on the other hand, determined that the documents

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267. p328

themselves did not restrict the transactions to those specific shares. He said:

> "On the faces of these documents I can see no justification for saying that the share sale agreement was a contract for the sale and purchase of particular shares to which Rozel [the Jersey company] would become entitled under the settlement and appointment."[268]

Templeman J was taking into account the tax avoidance motive in construing the documents. Buckley and Goff LJJ rejected this on the authority of the Wesleyan & General Assurance case.[269] Buckley LJ was taking the narrow substance approach, as was Goff LJ.[270]

In the House of Lords, Lord Wilberforce found the taxpayer's argument, which the Court of Appeal had accepted, "wholly unreal". He went beyond the form of the documents and took a pragmatic approach. In his view, it was clear that the Jersey company would not go into the market to buy the requisite number of shares in the specific public company in question. It had no money and, in any case, there was no certainty that it could have acquired so large a number of shares at the quoted price, particularly as they had to be delivered in such a short time. He therefore concluded that the intention could only have been that the shares to be sold to the taxpayer would be the settlement shares. The reason that the agreement did not specify the source of the shares was that the transaction could only be carried out in one way.[271]

Lord Russell of Killowen summed up the prearranged nature of the transaction thus:

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268. p334
269. See pp333 and 342 respectively
270. See p341
271. p350

> ".... The record on the turntable which was switched on contained the whole story from beginning to end and there was no provision for switching it off half way."[272]

The contract for the sale of the shares could not therefore be read in isolation. Lord Roskill was of the same opinion.[273]

In the Ramsay case,[274] Lord Wilberforce stated that Chinn v. Collins showed that:

> "although separate steps were 'genuine' and had to be accepted under the Westminster doctrine, the court could, on the basis of the findings made and of its own analysis in law, consider the scheme as a whole and was not confined to a step by step examination".[275]

This is considered further below.

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272. p352
273. p355
274. Infra
275. (1981) 54 TC 101 at p186

The Ramsay Era

> "I cannot help thinking ... that from decisions of the House of Lords (decisions which are, of course, correct) there may have followed difficulties which were not altogether foreseen or anticipated by those who gave the decisions".

Thus said Finlay J in 1937.[276] He could easily have been referring to the culmination of the development of the substance doctrine by Lords Wilberforce and Templeman in the cases of W.T. Ramsay Ltd v. IRC and Eilbeck v. Rawling.[277]

These two cases were dealt with separately until they reached the House of Lords. The facts are given in Chapter 8.

In the Ramsay case, at first instance, Goulding J accepted that there had been a series of transactions forming part of one scheme with the sole object of avoiding tax. However, given that the transactions were real, he held that the court was not entitled simply to look at the end result for the purposes of determining whether they had achieved their object. He found for the taxpayer. It should be noted, however, that the Crown's main "new approach" contentions were not argued before the Chancery Division or the Court of Appeal in Ramsay.

Goulding J had taken the same line in Floor v. Davis where he had said:

> "To my mind, it is quite impossible to apply the very detailed code contained in the relevant sections of and Schedules to the 1965 [Finance] Act in so general a way as that, ignoring the legal and

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276. Collyer v Hoare & Co Ltd (1937) 21 TC 318 at 326
277. (1981) 54 TC 101

formal steps and simply placing the start against the finish and saying [that there is or there is not an allowable loss]".[278]

In Eilbeck v. Rawling, Slade J in the High Court was of the same opinion although, on the facts, he found for the Crown. He firmly rejected the end result principle on the basis that it was really the doctrine of the substance rejected by Lord Tomlin in the Westminster case.[279]

The High Court decisions in Floor v. Davis, Ramsay and Eilbeck v. Rawling are indicative of the rejection by the Chancery Division of the end result principle. In fact, even Templeman J in Chinn v. Collins did not rely on it, but he did not have to; Templeman J would probably have resorted to it if he had needed to.

The Court of Appeal in both Ramsay and Eilbeck v. Rawling contained Templeman LJ and, in Ramsay, also Lord Scarman.[280]

Templeman LJ's judgement in the Court of Appeal in the Ramsay case was basically a restatement of the wider substance argument. The core of his judgement is the following, rather colourful, passage:

> "The facts as set out in the Case Stated by the Special Commissioners demonstrate yet another circular game in which the taxpayer and a few hired performers act out a play; nothing happens save that the Houdini taxpayer appears to escape from the manacles of tax. The game is recognizable by

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278. 52 TC 609 at p620
279. 54 TC 101 at pp150-1
280. Who was in the House of Lords in the Burmah Oil case, infra

four rules. First, the play is devised and scripted prior to performance. Secondly, real money and real documents are circulated and exchanged. Thirdly, the money is returned by the end of the performance. Fourthly, the financial position of the actors is the same at the end as it was at the beginning save that the taxpayer in the course of the performance pays the hired actors for their services. The object of the performance is to create the illusion that something has happened, that Hamlet has been killed and that Bottom did don an ass's head so that tax advantages can be claimed as if something had happened. The audience are informed that the actors reserve the right to walk out in the middle of the performance but in fact they are the creatures of the consultant who has sold and the taxpayer who has bought the play; the actors are never in a position to make a profit and there is no chance that they will go on strike. The critics are mistakenly informed that the play is based on a classic masterpiece called 'The Duke of Westminster' but in that piece the old retainer entered the theatre with his salary and left with a genuine entitlement to his salary and to an additional annuity."[281]

Lord Scarman agreed with the approach of Templeman LJ and he also expressed the hope that the majority decision of the Court of Appeal in Floor v. Davis would be reviewed by the House of Lords in a future case. He said that it was a misfortune that, when Floor v. Davis itself reached the House of Lords, it was decided on the technical point.

Tenpleman LJ gave a judgement in a similar vein in Eilbeck v. Rawling. There he stated that a single circular contract or a series of interdependent contracts

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281. p128

which involved one party and which go in a circle could not be divided into separate transactions in order to determine the effect of a contract or series of contracts. Unlike Slade J, he did favour the end result principle, saying that one had to look at the arrangement as a whole and look at the position of the taxpayer at the beginning and end of the series of transactions. The effect of the overall arrangement was that the taxpayer made neither a gain nor a loss, and therefore had no allowable loss to offset against other gains.

He was at this stage, however, referring specifically to a circular scheme in which the parties were contractually bound (although this latter factor was not present in Ramsay, it is clear from the passage cited above from his judgement in that case that the understanding present in that case was treated as giving rise to the same result). In the Eilbeck case he said that the effect of a contract cannot be judged by isolating one clause and ignoring the remainder, and that a circular contract, which requires one asset to pass in a circle, must be judged by the difference, if any, between the positions of the parties at the start and at the finish of the contract.[282]

He criticised Slade J's reliance on the Duke of Westminster case. He considered that the judge had confused substance and effect. This is a novel interpretation of the Duke of Westminster principle. Templeman LJ's distinction was that:

> "In the Duke of Westminster case the effect of the transaction was that an employee of the Duke became entitled to an annuity. The employee remained entitled to wages for his services. The substance of the transaction was that the employee received an

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282. p165

annuity in lieu of wages because he was not expected to claim, and did not in fact claim, wages in addition to the annuity. The House of Lords declined to take into account the substance of the transaction. The circle was not complete because the employee remained entitled to his wages. The taxation consequences to the Duke followed the effect of the transaction. The effect on him was that he paid an annuity and, in conformity with the then current law, he was entitled to deduct the annuity for the purpose of arriving at his taxable income. The employee began with a legal claim to wages if he worked. The employee ended with a legal claim to wages if he worked plus a legal claim to an annuity whether he worked or not. Thus the effect of the transaction on the employee was that he gained an annuity. In the present case the effect on the taxpayer of the contract was that he gained and lost nothing."[283]

This is using "substance" to mean commercial or practical substance. "Effect" appears to have been used in the sense of legal substance and, in that sense, Templeman LJ's distinction is correct when applied to the Duke of Westminster facts, but he then goes on to say that the "effect" of the Eilbeck v. Rawling's scheme was that the taxpayer gained and lost nothing by virtue of the circularity of the arrangement: this is not as restricted as the narrow legal substance. He said that, in Duke of Westminster, on the other hand, there was no circularity because the employee remained entitled to his wages.

Templeman LJ's criticism of Slade J's analysis was unjustified. Slade J was taking the traditional line on the Duke of Westminster case and Templeman LJ was being innovative in phrasing his findings in terms of

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283. p165

circularity. Templeman LJ was going further than merely looking at the plan as a whole, as the principle had previously been understood, namely, as not entitling the court to disregard the legal form and nature of the transactions.

Templeman LJ's approach was taken up by Peter Millett QC for the Crown before the House of Lords.[284] This was a distinct departure from the true Duke of Westminster principle, despite Templeman LJ's comment that his view was the true Duke of Westminster principle.

However, Millett QC specifically restricted his contentions to self-cancelling transactions, and did not suggest that the Law Lords should adopt the widest principle of America's "multiple step transaction".[285]

In the House of Lords, Lord Wilberforce dealt with this matter when he discussed the fourth of his "familiar principles".[286] He phrased the principle as follows: "Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance". Referring to the Duke of Westminster case, he said:

> "While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of the wider transaction intended as a whole, there is nothing in the

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284. p178
285. See Chapter 10
286. p185 et seq

doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, *intended to operate as such*, it is that series or combination which may be regarded."

For authority he cited the Chinn and Plummer cases.[287]

Lord Wilberforce held that the Duke of Westminster case does not oblige a court to consider individually each separate step in a composite transaction intended to be carried through as a whole. This he described as "a logical development from existing authorities, and a generalisation of particular decisions."

In justifying his view to look at a chain of transactions as an indivisable whole, Lord Wilberforce expressed the similarity of this with the process of reasoning used to defeat dividend stripping.[288]

Lord Wilberforce said that Plummer was a case in which it was legitimate to have regard to all the arrangements as a whole. But the conclusion was that there was commercial reality in the arrangements so they should be upheld. It can be seen above that the basic ingredients of Plummer was that there was a covenant for a capital sum to make annual payments tied in with security for the payments. But, it could be argued that there was nothing more in Ramsay. The essence of the Ramsay scheme was that the taxpayer company should make the required loss on the liquidation of a company provided for the purpose and in which it had shares, and that the allowable loss

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287. Supra
288. See Lord Donovan in Lupton v FA & AB Limited (1971) 47 TC 580 at p629, see Chapter 1.

should be matched by a non-chargeable gain on the loan for which the taxpayer company would also subscribe, of which the terms would be so manipulated that the holder could collect a substantial and tax-free gain.

Where Lord Wilberforce was going further than he had gone in the previous cases in which he had been developing the composite transaction doctrine, was in saying that the intermediate steps should be ignored and their legal consequences left out of account: the series as a whole was the only thing giving rise to legal consequences. The result of this analysis was that there was neither a gain nor a loss.

Lord Fraser also cited the Plummer and Chinn cases as authority for considering the scheme as a whole. He phrased his attack on the two schemes in Ramsay and Eilbeck v. Rawling in terms of circularity. On the question of form and substance and the Duke of Westminster principle, Lord Fraser claimed that he was not being inconsistent with Duke of Westminster, and that he was not suggesting that the legal form of any transaction should be disregarded in favour of its supposed substance.[289] He distinguished the Duke of Westminster case by saying that there was in that case only one transaction - the grant of an annuity - which did not form part of a larger scheme.

Despite the fact that both Lord Wilberforce and Lord Fraser claimed that they were fully respecting the Duke of Westminster case, there is no doubt that their judgements made inroads into the Duke of Westminster principle. The exact extent to which this was so was unclear, particularly as the two Law Lords denied any such encroachment; but the post-Ramsay Duke of Westminster principle can perhaps be expressed by the

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289. p198

following formula: assuming the transactions are not shams, a court cannot disregard the legal effect of the transactions or any series of which they form part. However, the court is entitled to consider the series as a single integrated whole.

Lord Fraser came to a different conclusion from Lord Wilberforce about the consequences of looking at the scheme as a whole. Lord Fraser held that there was no disposal; whereas Lord Wilberforce thought that there was a disposal but that it gave rise to no gain and no loss. The Law Lords obviously did not attach much importance to precision in this area. This is shown, firstly by the fact that the other three Law Lords agreed with both Lord Fraser and Lord Wilberforce (so we do not know whether they thought there was a disposal or not) and, secondly, by the fact that Lord Fraser in Burmah Oil[290] came to the conclusion that there was a disposal, but no loss (i.e. the Wilberforce line in Ramsay).

Lord Wilberforce and Lord Fraser also used slightly different terminology. Lord Wilberforce said that it was "the task of the court to ascertain the legal <u>nature</u> of any transaction",[291] whereas Lord Fraser said that the legal <u>form</u> of any transaction should not be disregarded.[292] Nothing, it appears, turns on this dichotomy. What is important, however, is that, despite what they said, they did consider the substance of the transaction in a wider sense and ignored the legal rights and obligations created by the intermediate steps.

Such a situation is not in itself novel in tax law; a similar rule exists in stamp duty.[293] However, leaving aside the different nature of stamp duty and capital gains tax, the CGT principle enunciated by Lords

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290. Infra
291. p185
292. p198
293. The "all one transaction" rule discussed in <u>Cohen & Moore v IRC</u> [1933] 2 KB 126

Wilberforce and Fraser was introduced into our law by a piece of outright judicial legislation under the pretence of applying accepted principles to new situations.

The question of judicial lawmaking is examined in detail in Chapter 13.

Following the Ramsay case, the courts had the tasks of reconciling the Duke of Westminster case, which the Law Lords in Ramsay had claimed was untouched by their decision, with the actual decision in Ramsay itself.

Some judges made statements which appeared to show that, despite what the Law Lords said, they would act in a manner inconsistent with the true Duke of Westminster principle. For example, Lord Scarman in the Burmah Oil case[294] said, perhaps without thinking through the full consequences of what he was saying, that "it is now crucial when considering any ... scheme to take the analysis far enough to determine where the profit, gain or loss is really to be found".[295]

This is in direct conflict with Lord Tomlin's rejection in the Duke of Westminster case of the substance approach. Lord Scarman seems to be advocating disregarding the legal effect in favour of "the so-called doctrine of substance" as Lord Tomlin had put it.[296]

The next major case in the conflict between the Duke of Westminster principle and the new approach was <u>IRC v. Burmah Oil Co. Limited</u>.[297] This case is also dealt with in Chapter 8, from which it can be seen that the arrangement in question concerned Burmah and the wholly owned subsidiaries, OMDR Holdings Ltd ("Holdings"),

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294. Infra
295. (1982) 54 TC 200 at p222
296. Supra
297. (1982) 54 TC 200

Manchester Oil Refinery Holdings Ltd ("Manchester"); and Burmah Oil Trading Ltd ("Trading"). Holdings had a share capital of 7,001 shares of £1 each of which one was owned by Trading as Burmah's nominee. The rest of the shares were held by Burmah itself. The share capital of Holdings was represented by a debt owed by Burmah to the company. In March 1969, Burmah transferred BP stock worth £380,625,000, at market value, to Holdings. However, the purchase price was left outstanding, so that Holdings owed Burmah £379,924,999. This transfer was carried out to secure fiscal advantages.

In April 1971, Holdings transferred the BP stock back to Burmah at market value, which was then £220,625,000. This transfer was carried out for good commercial reasons. As a result, of the original loan arising from the March 1969 transfer, £159,299,999 remained outstanding as owed to Burmah by Holdings.

The scheme in question in the case had to be effected because the loss incurred by Holdings was not allowable by virtue of section 273 ICTA 1970 (inter-group transfers producing neither a gain nor a loss). Furthermore, Burmah could not have liquidated or sold Holdings to create an allowable loss because the £159,299,999 outstanding was not a debt on a security.[298]

Because of this, Burmah executed the following scheme:

1. Burmah lent Manchester £159,299,999, and Manchester lent Holdings the same amount. Holdings then repaid Burmah the £159,299,999 arising from the March 1969 and April 1971 transactions.

2. A few days later, Holdings made a rights issue of 700,001 £1 shares at £228 per share. These were allotted to Burmah which paid £159,500,000. Trading, as nominess, was allotted one share at

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298. Section 134 CGTA 1979

£228. Holdings then repaid Manchester the £159,299,999, and Manchester then repaid that sum to Burmah.

3. The following day, Holdings went into liquidation and Burmah claimed the £159,600,228 as allowable expenditure.

The Special Commissioners, taking their lead from Slade J at first instance in Eilbeck v. Rawling, declined to ignore the effect of the individual intermediate transactions and look at the scheme as a whole. The Crown also failed in the Court of Session.

In the House of Lords the Revenue failed on their technical arguments. They argued that the rights issue was an acquisition of the new shares of Holdings and was a transaction otherwise than at arm's length, and so should be deemed to be for a consideration equal to its market value under section 19(3) CGTA 1979.[299]

The House of Lords rejected this argument. It was held that the new shares in Holdings were not an asset for CGT purposes because Burmah's holding of shares in Holdings as a whole was a relevant asset for CGT by virtue of section 65(2) CGTA 1979. Furthermore, the arrangement constituted a reorganisation under section 77(2) CGTA 1979, and so no new acquisition took place by virtue of section 78 ibid.

The Revenue, however, attacked the arrangement under the Ramsay principle. The reasoning of the two Law Lords in Burmah Oil who gave reasoned judgements leaves a lot to be desired.

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299. Now repealed

The main judgement was given by Lord Fraser. He accepted that the transactions were genuine and not shams and that real money was used. He further accepted that the scheme was not a prepackaged off-the-shelf scheme. These factors were held by Lord Fraser to be immaterial. He also accepted that the situation Burmah Oil found itself in as regards the tax treatment of the debts, was unfair. None of this, however, was relevant to the application of the Ramsay doctrine. There was no contractual obligation for the arrangement to be carried through to its conclusion, but there was no real likelihood that the scheme, once started, would not be carried through.

Lord Fraser supported the ratio of the Ramsay case, and he concluded that the real question the court had to decide was "whether the present scheme when completely carried out, did or did not result in a loss such as the legislation is dealing with, which I may call for short, a real loss".[300] His reasoning was basically that Burmah received back all the money it had subscribed for the new issue of shares and it still had the BP shares where the real, but unrealised, loss lay.

Lord Fraser considered that there was no real loss because, according to Lord Wilberforce in the Ramsay case, capital gains tax is to operate in the real world and is a tax on gains less losses, not arithmetical differences. It is true that the Burmah group still owned the BP shares and that, at the relevant time, the group had not sustained a real loss. However, the judgements in the Burmah Oil case suggest that the decision would have been the same even if Holdings had made a loss on the sale of the BP shares to a third party, instead of on the sale back to Burmah Oil.

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300. p220

There is an inconsistency in Lord Fraser's speech in this case with his speech in Ramsay. In Burmah Oil, he found against the taxpayer because there was an artificial scheme which produced no real loss as contemplated by the CGT legislation. His authority for this decision, he stated, was the Ramsay case. However, he expressly supported Lord Wilberforce's reasoning in Ramsay; he did not rely specifically upon his own reasoning in Ramsay which led him to his decision in that case. It can be seen above that, in Ramsay, Lord Wilberforce was of the opinion that there was a disposal which gave rise to no gain and no loss, whereas Lord Fraser was of the opinion that the scheme gave rise to no disposal.

The other reasoned judgement in this case was given by Lord Diplock. His judgement contains the following oft quoted warning:

> "It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a preordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of liability to tax which in the absence of those particular steps would have been payable."[301]

Lord Diplock accepted that the company, in the present case, had acted in accordance with advice obtained from advisors of the highest integrity who were relying on Lord Tomlin's dictum in the Duke of Westminster case, and who did not foresee the difference in approach to tax avoidance schemes adopted by the House of Lords nine

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301. p214

years after they had devised the scheme in this case.[302]

The retrospective effect of the adoption of the new approach was therefore fully appreciated by Lord Diplock, but this did not prevent him applying the new approach which, in the Ramsay case, concerned a tax avoidance scheme, involving interconnected transactions between artificial persons without minds of their own who were directed by a single mastermind.

Lord Diplock stated that the court was entitled, following the Ramsay case, to look at the end result of the transactions in the Burmah Oil case. Lord Diplock's reasoning was that there was a real loss, but it was not a debt on a security. In other words, the loss was not converted from a book debt to a loss on the shares, if one considered the end result. In fact, what Lord Diplock is doing is treating the loss capitalisation transactions as if they had never been implemented. This differs from Lord Fraser's analysis (with which Lord Scarman appears to agree) that there was no real loss.

Again it can be seen that there is a lack of real consistency in the judgements given in the House of Lords.

Despite the development of the whole transaction approach, the Crown were not averse to splitting a transaction artificially if they thereby could gain by it. E.V. Booth (Holdings) Limited v. Buckwell[303] was a case of the Revenue splitting up a composite transaction in order to tax a non-existent gain.

A new company was formed with a share capital consisting of two £1 shares which were issued at par to Mr. and Mrs. Booth as nominees of the taxpayer company. On the same

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302. The result might have been different had the Revenue not delayed for 5 years in bringing the case before the Special Commissioners.
303. [1980] STC 578

day, the taxpayer company transferred assets to the new company in exchange for those two shares plus £61,680, which was left outstanding in the new company's loan account with the taxpayer company. Five years later the taxpayer company agreed to sell the shares in the new company to an unconnected purchaser. The total consideration payable was stated in the agreement to be £35,000 and, in addition, the taxpayer company was to be entitled to withdraw "in full and final settlement of any balance due to the [taxpayer company] ..... on loan account, such an amount as shall be equal to the excess of current assets (excluding stock in trade) over current liabilities in the accounts of the [new company]". At that date, the balance on the loan account was £55,839 and the excess of its current assets over its current liabilities was £20,969. On completion, the purchaser paid £35,000 to the taxpayer company and the taxpayer company withdrew £20,969 from the loan account in full and final settlement of the new company's liability.

The taxpayer company was assessed to corporation tax in respect of the chargeable gains arising on the sale of the shares on the basis that the consideration for the sale was £35,000. The taxpayer company contended that the consideration was, in fact, only £130 because, of the £55,669 received by the taxpayer under the agreement (i.e. the sum paid for the shares plus the amount withdrawn from the loan account), £55,839 was referrable in satisfaction of the debt.

Browne-Wilkinson J, however, held that the assessment was correct. His judgement is something of a throwback to more formalistic times and this was only a few months before the great leap forward in the composite transaction doctrine in Ramsay.

For example, he accepted that the disposal of the shares and surrender of the balance of the loan "were inexplicably linked"[304] but, nevertheless, he was of the opinion that the form of the agreement showed that the taxpayer company received consideration for the disposal in two forms, namely, £35,000 from the purchaser, and part repayment of the loan. The consideration for the whole composite transaction was the aggregate of those sums. The parties had appropriated each of the sums to a particular disposal. The £35,000 was expressly stated to be "the total consideration payable by the Purchaser for the said shares", whereas the part repayment of the loan account was expressly stated to be "in full and final settlement of any balance due" on the loan account. The parties themselves had therefore allocated the constituent elements in the composite consideration to the two disposals making up the transaction.

The judge said that, where parties to a composite transaction have expressly provided that one part of the consideration is to be paid for one part of the transaction, and another part of the consideration for another, they cannot subsequently seek to reallocate the consideration for tax purposes. The tax consequences must flow from the particular manner in which they have chosen to implement the transaction. The judge accepted that the transaction could have been carried through by the new company repaying the debt in full, with the price for the shares being reduced accordingly. But, once they have chosen to adopt one method, they must accept the taxation consequences which that method produces, and they cannot subsequently argue that the transaction ought to be taxed as if a different method had been adopted. The judge sympathised with the taxpayer because a method had been adopted which generated a liability to CGT but, he said the Crown's contention must succeed.[305]

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304. p583
305. p584

Had the scheme as a whole produced a result more beneficial to the Crown than dividing the transaction up in this way, the Crown would undoubtedly have argued that the composite transaction ought to be looked at as a whole, and that it was inappropriate to divide the transaction up into its constituent parts.

Even after Ramsay the Revenue could be found not respecting the composite transaction when it suited them. However, they did not find judicial support for their approach in Pattison v. Marine Midland Limited.[306] In this case, Sir John Donaldson MR, while greeting the Ramsay case as introducing "a new and refreshing philosophy", commented that Counsel for the taxpayer in the Marine Midland case:

> "exercised extraordinary restraint in not accusing the Crown of 'doing an inverted Ramsay' on the taxpayer - inventing an artificial accountancy scheme which serves no commercial purpose and is designed solely to create a liability to tax".[307]

Taxpayers have been singularly unsuccessful in arguing the Ramsay doctrine although there is no reason in principle why they cannot use it in appropriate circumstances. The taxpayers, for example, sought to use the doctrine in Ewart v. Taylor.[308] In this case, assets held by non-resident trustees were appointed to beneficiaries, and then sold back to the trustees in such a way, it was hoped, as not to generate a charge to CGT.

It was contended by the taxpayers that the transactions constituted a single composite scheme, undertaken for fiscal purposes, and since the shares in the hands of the trustees at the beginning were also in their hands at the

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306. [1983] STC 269
307. p276
308. [1983] STC 721

end, the intermediate transactions should be disregarded and no disposal therefore occurred.

The Crown, however, contended that, even if the transactions were treated as part of a single scheme and the scheme was taken as a whole, there was still a deemed disposal because the result of the scheme, taken as a whole, was that the shares, initially held by the trustees in their capacity as trustees of the settlement, were held at the end by them in their capacity as trustees of the appointment.[309]

The taxpayers failed on the facts because the Commissioners could not be said to have been satisfied that there was a singular comprehensive scheme. However, Vinelott J implied that, had the Commissioners been satisfied that there had been a single composite scheme, the taxpayers may have succeeded. This should be compared with the judge's comments in the Bird case[310] where he seemed less inclined to accept that the taxpayers could use the Ramsay case.

The Ewart v. Taylor case was before the formulation, by Lord Brightman in Furniss v. Dawson,[311] of the two criteria for the application of the Ramsay doctrine, non-adherence to which allowed the taxpayers to triumph in Craven v. White, Bowater and Baylis v. Gregory.[311] However, even before Lord Brightman's judgement, Vinelott J, as he had done in Furniss v. Dawson itself and as other Chancery Division and Court of Appeal judges were doing around this time, was tending to circumscribe the situations in which the Ramsay doctrine could be used with increasing precision - this time to the Revenue's advantage - despite the House of Lords' warnings that the Ramsay doctrine was to be "developed" case by case.

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309. The taxpayers had claimed that there had been no separate settlement created.
310. Bird v IRC, infra; see also Chapter 1
311. Infra

This case underlines the fact that, even before the House of Lords in Furniss v. Dawson, it was recognised that the Ramsay principle could not be applied merely because there was what Vinelott J here described as "an elaborate and highly artificial series of transactions".[312]

The Commissioners findings on the composite transaction argument were not sufficiently precise for the taxpayers' argument on the Ramsay principle to succeed. They had not been referred to the Ramsay case. Although the judgements in the House of Lords in the Ramsay case had been handed down before the Commissioners gave their decision in Ewart v. Taylor, it had not actually been reported at that stage. Whether this would have affected their findings is not clear. All in all, it probably would not have; they did specifically find that there was insufficient evidence to link the last stage with the earlier ones, even though that stage was contemplated from the beginning. As was to become clear in Craven v. White, Bowater and Baylis v. Gregory,[313] this was not enough for the application on the Ramsay principle.

It is interesting to note that, in this case, Counsel for the Crown was arguing that this was not sufficient for the new approach to be applied, but the Crown took the opposite view in Craven v. White, Bowater and Baylis v. Gregory.

In the circumstances, Vinelott J came to the conclusion, "after considerable hesitation" that he could not infer that the Commissioners were satisfied that there was a single comprehensive scheme within the Ramsay principle.[314] There was no single integrated scheme entered into by the parties on the understanding that the scheme would be carried through as a whole or not at all.

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312. p758
313. Infra
314. p771

The Boundaries Defined - Furniss v Dawson

The next main case in the development of the Ramsay principle was Furniss v. Dawson.[315] The scheme used in this case was a version of the same arrangement used in Floor v. Davis, Craven v. White and Baylis v. Gregory.[316]

The Dawson family wished to sell their shares in two companies to an unconnected purchaser, Wood Bastow. An outright sale to Wood Bastow would have given rise to large CGT liabilities. Therefore, with a view to deferring (not avoiding) this liability, a company was incorporated on the Isle of Man (Greenjacket), and the Dawson family transferred their shares in the companies to be sold to Greenjacket in exchange for the issue of shares in Greenjacket to them. On the same day, Greenjacket sold the shares in the underlying companies to Wood Bastow for cash. This gave rise to no CGT because, it was hoped, the share exchange would come within the CGT reorganisation provisions and, on the sale by Greenjacket to Wood Bastow, the base cost of the shares in the underlying companies was its market value at that time. No capital gain would have arisen until the Dawson family sold their shares in Greenjacket (or Greenjacket was liquidated).

Vinelott J in the High Court felt that, given the facts as found by the Commissioners, even if the composite steps were taken as part of a single whole, the share exchange had enduring legal consequences. At the beginning, the taxpayers owned shares in their companies; at the end they owned shares in Greenjacket, which beneficially owned the proceeds of sale of the shares originally owned by the taxpayers. The court, he said, could not ignore the legal consequences and substitute

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315. (1984) 55 TC 324
316. See Chapter 8

for them some more straightforward transaction, on the ground that it would have achieved a similar economic or business result. To do so, he said, would be to divorce the facts existing in the real world (to use Lord Wilberforce's phrase) and to substitute for them facts assumed to exist in an unreal fiscal world. This was precisely what the court was forbidden to do by the Duke of Westminster case. In saying this, Vinelott J was in conflict with Lord Wilberforce in Ramsay. However, the real conflict lies more in Lord Wilberforce's specific acknowledgement of the continued binding effect of Duke of Westminster. Vinelott J was, in fact, taking the strict Duke of Westminster line.

He was also in conflict with Lord Scarman in Burmah Oil who said that "It is now crucial when considering any ... scheme to take the analysis far enough to determine where the profit, gain or loss is really to be found". Lord Scarman was there really advocating the wider economic substance approach and Vinelott J would have none of it.

He also took a different view from Lord Wilberforce and Lord Fraser to the judgement of Eveleigh LJ in Floor v. Davis. Vinelott J held that the judgement of Eveleigh LJ had to be read in the light of the particular facts of Floor v. Davis. He further held that he was bound by the majority decision of the Court of Appeal in that case. In holding this, he clearly rejected the application of the Eveleigh doctrine to cases which involve enduring legal consequences, and which are not merely concerned with the artificial creation of a loss with no real economic loss.

Vinelott J pointed out that, in Floor v. Davis, the proceeds of sale of the shares were part of the whole scheme and were part of the disposal by the vendors. To treat the intermediate steps (namely, the disposal by the vendors to the middle company, and the disposal on of the shares by the middle company to the ultimate purchaser) as steps to be ignored under the Ramsay principle, was consistent because, in Floor v. Davis, those intermediate steps had no enduring effect on the rights and obligations of the parties at the end of the scheme. This was not so in Furniss v. Dawson: it was no part of the scheme that the proceeds of sale by Greenjacket to Wood Bastow should be put at the disposal of the original vendors.

The Crown had argued that, if the intermediate company which acquired shares in exchange for its own was under the control of the taxpayer (in the same way as Greenjacket was), then the control of the company, the shares in which were acquired in the exchange, could be disregarded as not being real control. Vinelott J rejected this because it involved writing into the relevant relieving provisions of the CGT legislation an exemption which was missing (and which was, in fact, later introduced by Parliament). In this respect, Vinelott J felt that he was bound by the Court of Appeal's decision in Floor v. Davis that, for the purposes of that legislation, such an exchange conferred control on the part of the intermediate purchaser over the shares acquired in the exchange, and this was sufficient for the purpose of sustaining the relief conferred by the CGT legislation. This again was an area of potential conflict between Vinelott J and the House of Lords.

Vinelott J concluded that he was not bound by the House of Lords decisions in Ramsay and Burmah Oil, so he did not have to find that the taxpayers realised a gain by means of a disposal of their shares in the initial companies to the ultimate purchaser. It was immaterial that it might be said that the taxpayers had disposed of their shares indirectly to the ultimate purchaser, because the indirect disposal was effected by means of a disposal passing the entire legal and beneficial interest in the shares acquired by Greenjacket, which later received and held the proceeds of their sale to the ultimate purchaser. The Court of Appeal's decision in Floor v. Davis (which was unanimous on this point) bound the High Court to hold that, as a result of the exchange, Greenjacket obtained control of the underlying companies, and this was sufficient to ensure that the exchange was not treated as a disposal.

As a result of Vinelott J's analysis, the new approach was believed to be subject to two major limitations:

(i) the courts could not recharacterise a transaction, and the courts must either give effect to it according to its proper legal effects or ignore it; and

(ii) the courts cannot ignore transactions with enduring legal consequences.

The Court of Appeal also took a more traditional view of the transactions.

The Revenue accepted that, except for tax purposes, the sales by the Dawson family to Greenjacket, and then by Greenjacket to Wood Bastow, were effective to transfer both the legal and beneficial interests. However, the Court of Appeal considered that the Revenue's approach must give rise to three disposals and that, in addition to the two disposals accepted by the Revenue, there was a third from the Dawsons to Wood Bastow.[317]

The Court of Appeal considered that the backing given by the House of Lords to the Duke of Westminster case meant that genuine steps must be given their proper legal operation and they cannot be ignored or recharacterised.

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317. See Oliver LJ at pp359-60 and Slade LJ at pp381-2

They considered that the Ramsay principle did not cover the facts of the present case. They were of the opinion that the Ramsay principle did not mean that, where there was a series of transactions, these must be regarded as one composite transaction with the intermediate steps being ignored.

The Crown argued that Ramsay extended beyond self-cancelling arrangements to any series or combination. Oliver LJ rejected this. He said that there was nothing in Lord Wilberforce's speech to prevent a court considering the legal result of the steps in the combination if they had a necessary bearing on the series as a whole.

He examined the judgement of Eveleigh LJ in Floor v. Davis. In his opinion, Floor v. Davis contained two stages: the first was, as in Furniss v. Dawson the share swop and the onward sale by the intermediary company; the second (which was not present in Furniss v. Dawson) resulted in the taxpayers receiving the proceeds from the intermediate company. Lord Wilberforce in the Ramsay case had approved Eveleigh LJ's judgement only in the context of limiting the Duke of Westminster principle; it was not the dicta of the case (see Lord Fraser in the Burmah Oil case), it was merely approval of Eveleigh LJ's reasoning.

Oliver LJ could not see "how for fiscal purposes a man can be treated as having disposed of shares when, again for fiscal purposes, the law requires him to be treated as still having them".[318]

Oliver and Kerr LJJ thought that, when Lord Wilberforce referred to the judgement of Eveleigh LJ in Floor v. Davis, he was only approving the <u>appoach</u> of Eveleigh LJ,

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318. p365

not the correctness of his decision. Admittedly, Lord Fraser had gone further than this, but his words were not part of the ratio in Ramsay.

Slade LJ was more forceful. He said that references to the judgement of Eveleigh LJ were unnecessary to the decision in Ramsay and they were not intended to bind inferior courts even when faced with facts identical to those found in Floor v. Davis.

According to Oliver and Kerr LJJ, the conclusion reached by Eveleigh LJ could be explained in three ways. These were:

(i) that the intermediate company was a mere nominee of the vendors and the intermediate company did not acquire beneficial ownership of the shares in question; or

(ii) the involvement of the Cayman Islands company in that case negatived the first steps involving the disposals by the vendors to the intermediate company, and the intermediate company to the purchasers and, therefore, the scheme was self-cancelling; or

(iii) although the intermediate company did acquire beneficial ownership, this could be ignored regardless of the additional stage of the introduction of the Cayman Islands company.

Oliver and Kerr LJJ considered that the third alternative was wrong if that, in fact, was the one adopted by Eveleigh LJ. Slade LJ went further and said that the second alternative would also be wrong.

In any case, Oliver and Kerr LJJ thought that the facts in Floor v. Davis were distinguishable from those in Furniss v. Dawson. This was also the view of Vinelott J in the High Court. On the other hand, Slade LJ did not think the facts were distinguishable and he thought that the judgement of Eveleigh LJ could potentially catch the scheme in Furniss v. Dawson even though the latter case lacked the additional stage. Nevertheless, Slade LJ considered that the judgement of Eveleigh LJ was simply wrong.

As in the High Court, the three judges in the Court of Appeal emphasized that the enduring legal consequences of the scheme had to be respected.

When the Crown appealed to the House of Lords, its Counsel claimed that the Court of Appeal had misrepresented the Crown's argument. Counsel said:

> "The Crown does <u>not</u> contend that the transfer to Greenjacket ought to be disregarded in the sense of treated as if it did not happen, but contends that it should be disregarded in the sense that it is not the relevant disposal. Likewise, the Crown does <u>not</u> contend that the taxpayers ought to be taxed as <u>if</u> they had transferred the shares directly in a single step to the ultimate purchaser, but contends that they ought to be taxed on the basis that they transferred them by two steps to the ultimate purchaser, those two steps being planned and implemented as the component elements of a single transaction, together constituting the relevant disposal for the purpose of capital gains tax."[319]

It can be seen that the Crown were leading on from Ramsay. It would have done them no good to disregard the transfers to Greenjacket. Following Ramsay strictly, the sale by Greenjacket on to Wood Bastow should also have been ignored. If these two steps had been disregarded, it is difficult to see what would have triggered a CGT disposal. Instead, the Crown argued that there should be

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319. See [1984] AC 474 at p510; Counsel's emphasis

constructed a composite transaction different from the actual transaction implemented by the parties. In the event, the House of Lords did this. The composite or "relevant" transaction was the sale by the Dawsons to Wood Bastow for cash, the cash being paid, not to the Dawsons, but to Greenjacket on their instructions. This is, in one sense, recharacterising a transaction rather than creating a composite transaction and acting on the legal rights created by that composite transaction, disregarding the legal rights created by the intermediate steps; although it is still some way from the type of recharacterisation allowed in American courts.[320]

Lord Brightman set out the two basic rules for the application of the Ramsay principle as follows:

> "The formulation by Lord Diplock in Burmah expresses the limitations of the Ramsay principle. First, there must be a preordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. The composite transaction does, in the instant case; it achieved a sale of the shares in the operating companies by the taxpayers to Wood Bastow. It did not in Ramsay. Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax - not 'no business effect'. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied."[321]

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320. See Chapter 10. Compare Sir John Donaldson MR in Cairns v MacDiarmid, infra
321. p401

The Ramsay case had decided that a composite transaction which has no commercial or business purpose can be disregarded for tax purposes in its entirety. Lord Brightman, however, was dealing with a composite transaction which does have a commercial or business purpose, and he was saying that any steps inserted into it which do not have a commercial business purpose will be disregarded for tax purposes, although the composite transaction overall will still be respected. To put it another way, it is irrelevant that the overall scheme has a legitimate commercial or business end. Furthermore, it is irrelevant that the intermediate steps achieve a business effect. It could also be the case that it is irrelevant that the intermediate steps have a business or commercial motive.

If there is only one transaction, presumably the Duke of Westminster principle would still apply. In fact, it could be argued that there were two transactions in the Duke of Westminster case itself: the making of the covenant and the "understanding" that the gardener would not enforce his right to the wages. In any case, Lord Roskill warned that the Westminster case may be decided differently today. However, despite Lord Roskill's warning, the House of Lords claim not to have overruled the Duke of Westminster case.

The House of Lords expressly approved Eveleigh LJ's judgement in Floor v. Davis and they did so by reference to the first stage.[322] The House of Lords considered that the attempt by the Court of Appeal to rationalise the judgement by reference to the second stage was wrong.

The House of Lords set out fairly clearly the circumstances in which they will apply the Ramsay

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322. Supra

principle. However, what they did not clarify at all are the consequences of applying it. Greenjacket was ignored for tax purposes and the Dawsons were treated as having made their disposal directly to Wood Bastow but it is not clear what Greenjacket's position is in other respects. The money paid by Wood Bastow did go to Greenjacket in fact, and this was accepted by the House of Lords. The value of Greenjacket's shares in the hands of the Dawson family were correspondingly increased. The House of Lords did not explain what would happen, for example, if Greenjacket were to be liquidated.

One effect of the principle, in its present state of development, is that it can be applied to recharacterise a transaction; in fact, the steps in Furniss v. Dawson itself had to be recharacterised. However, unlike in the USA,[323] it seems that, so far, the recharacterisation can do no more than enable the court to look at the end result of the series. This comes out of Lord Brightman's speech and also in that of Nichols J in Young v. Phillips.[324] Recharacterisation of particular steps along American lines is still not allowed. All that the English courts can do is to identify the "relevant transaction".

Despite the warnings in Ramsay and Burmah Oil that the new principle would be developed case by case, Lord Brightman did put the new approach into precise terms, within clear limits. These limits, as will be seen, were adopted and applied eagerly by the lower courts, who had to use the principle as it stood, leaving it to the House of Lords to make any further extension to the principle. By the time of Furniss v. Dawson, however, the pressures to develop the Ramsay principle as a powerful weapon to stamp out the artificial tax avoidance industry were gone; Ramsay (plus the generally bad name tax avoidance

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323. See Chapter 10
324. Infra

had been given by such episodes as the "Rossminster affair") had ensured that the market for widespread exploitation of prepackaged or highly artificial and circular bespoke schemes has gone. Peter Millett QC leading Counsel for the Crown in Floor v. Davis, the Ramsay and Rawling cases and Furniss v. Dawson, has said[325] that it had been estimated that the Ramsay case would yield £1,000,000,000 in tax from pending cases alone. It will have yielded even more in subsequent cases; many schemes that would have been put into operation, some of which would no doubt have succeeded, would have been left unimplemented. The courts could therefore settle back into their more traditional role of interpreters and appliers of the law, rather than as law makers.[326]

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325. "A New Approach to Tax Avoidance Schemes", (1982) 98 LQR 209
326. See Chapter 13

Coming to Terms with Ramsay

Following Ramsay there was some inconsistency in how the courts treated form and substance in the light of the new approach. For example, the different views expressed on the status of the Duke of Westminster case in Ramsay, Burmah Oil and Furniss v. Dawson have been noted above. The courts had the job of applying the Ramsay principle to a wide variety of tax avoidance techniques.

Cairns v. MacDiarmid,[327] concerned an arrangement called the "Non-deposit" scheme devised by the well-known inventor of schemes, Roy Tucker. This was an artificial and circular arrangement aimed at generating an income tax deduction for the payment of annual interest which is now caught by section 787 ICTA 1988.

The taxpayer was employed by the Rossminster Group and he was offered a bonus of £5,000 by Roy Tucker. The following scheme was implemented with a view to enabling him to take the bonus tax-free. Roy Tucker made an interest-free loan of £5,000 to him for seven days. The following day a company called Rossminster Acceptances Limited offered the taxpayer a loan of £37,740 with interest at 13.25% per annum, payable annually in advance on that day, and on the following anniversary of that day. Interest at that rate on £37,740 amounts to £5,000. The loan was repayable in full on the second anniversary of the date the loan was offered, with provisions for earlier payment in the event of the taxpayer's bankruptcy or death. The taxpayer immediately accepted the offer, and Rossminster's cheque for £37,740 was handed to him in exchange for his cheque for £5,000 in favour of Rossminster.

A few days later the taxpayer and Roy Tucker, on behalf of one of his companies called Boreton Limited, agreed

327. (1983) 56 TC 556

that the taxpayer would pay £32,740 to Boreton, and Boreton would be substituted as the debtor to Rossminster for the full amount of £37,740. The result of this was to remove the taxpayer's liability to Rossminster, at a cost to him of £32,740. On the same day, the taxpayer paid Boreton £32,740 and, on the following day, he used the remaining £5,000 to repay the original interest-free loan made by Roy Tucker.

Boreton deposited the £32,740 with a Rossminster company along with similar amounts paid by other participants in non-deposit schemes. A few months later Boreton's debt to Rossminster was assumed by another Rossminster company. Rossminster accepted early repayment of the debts in question so that the £37,740 became payable on the first anniversay of the loan being offered to the taxpayer. When the original loan was offered, Rossminster had confidentaly expected that the balance of the £37,740 (i.e., the £32,740 not already received back) would be returned a few days later and so become available to finance further non-deposit schemes. The Revenue refused to allow a deduction for the payment of £5,000.

Nourse J heard the case at first instance only a few months after the House of Lords handed down their judgements in Ramsay, yet he did not refer to it. He decided against the taxpayer on the basis that the "interest" was not a just recompense to Rossminster for being deprived of the use of its £37,740, because it only lost the use of that money for four days and so it could not therefore be annual interest. There is nothing original in this view. In Re Euro Hotel (Belgravia) Limited,[328] it was made clear that "interest" might not in fact be interest if the surrounding circumstances negatived that conclusion.

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328. [1975] 3 All ER 1075. See also Ridge Securities Ltd v IRC (1964) 44 TC 373

The Court of Appeal, however, went further. They held that the taxpayer failed not only on the narrower ground that the "interest" was not annual, due to the certainty that the novation would take place within a few days, but also on the wider Ramsay principle, according to Sir John Donaldson.[329] Kerr LJ was also of this view: he said that the Ramsay decision made the present case "a hopeless appeal".[330] Kerr LJ's view is interesting. At this time, just after Ramsay, he was applying the modified form and substance rules differently to circular arrangements (as in this case) than to linear arrangements.[331]

Kerr LJ was not alone in making this distinction; it was quite a common view. In fact, in the Ramsay case itself, the Crown had restricted its new approach arguments to circular self-cancelling arrangements.

An important point about this case is that there are indications in the judgement of Sir John Donaldson MR, albeit obiter, that the Ramsay doctrine might be used to recharacterise transactions. It has already been seen that the Furniss v. Dawson formulation requires a certain amount of recharacterisation, but the Master of the Rolls was going further. He was of the opinion that the payment of £5,000 by the taxpayer was not ignored - it was still a payment - but it was not a payment of annual interest. If this approach is followed, it represents a significant extension of the Ramsay principle. In the circumstances, it is a pity that the case was not heard by the House of Lords (the Appeal Committee refused permission), as this case would have provided the House of Lords with a further opportunity to give guidance on their new approach. If the Law Lords are to develop the

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329. p581
330. Ibid
331. See his later decision in the Court of Appeal in <u>Furniss v Dawson</u>, supra

new approach on a case by case basis[332] then they ought not to refuse to hear cases which might provide an opportunity for them to further clarify the operation of the Ramsay principle.

Sir John Donaldson MR has taken a rather individual approach to the Ramsay doctrine; and is not using it as a precise tool in the same way that many of the other Chancery Division and Court of Appeal judges are. He had used it in a more broad-brush way. See, for example, his judgement in Sherdley v. Sherdley[333] in which he was overturned by the House of Lords who, unlike the Master of the Rolls, considered that the Ramsay doctrine did not apply to the facts in that case.

On the subject of recharacterisation, compare the approach of Nicholls J in Young v. Phillips.[333]

Another case involving a circular scheme, decided two months after the Cairns case, was Bayley v. Garrod.[334] Mervyn Davies J did not rely on Ramsay to defeat the scheme and did not make any comment on the potential application of the new approach to the facts of that case.

Neither was the new approach used in Coates v. Arndale Properties Limited.[335] The courts were more concerned to examine the legislation in detail and to apply the legislation to the facts. The taxpayer was defeated without the need for the Courts to have recourse to the Ramsay line of cases. However, the taxpayer won in the Nova Securities case[336] on a similar scheme. These two cases are considered in more detail in Chapter 8.

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332. See Lord Scarman in Furnishh v Dawson, supra.
333. infra
334. (1983) 56 TC 695
335. [1984] STC 637
336. Infra

A Revenue challenge under the Ramsay principle in the Arndale case is not surprising given the fact that the transactions were part of one scheme, they all took place intra-group on the same day, and the monetary transactions were effected by means of book entries which did not affect the overall financial position of the group. Furthermore, it was not disputed that the only motive of the group channelling the property as they did rather than making a direct transfer was to save tax.

It can be seen from Chapter 8 that Arndale Propeties Limited was a property dealing company. Within the same group were SPI, a development company and APT, an investment company. SPI had a leasehold property which had cost £5,313,822. The taxpayer company acquired that property for £3,090,000 and, on the same day, assigned it to APT for its then market value of £3,100,000. The taxpayer company had previously acted as a property dealing company within the group, and the taxpayer company claimed that it had acquired the property as trading stock for the purposes of section 274(1) ICTA 1970 and it made an election to have the property brought into its trading account at £5,513,822 under paragraph 1(3), Schedule 7, Finance Act 1965.[337] As mentioned above, it was not disputed that the motive for channelling the disposal through the taxpayer company, rather than making a direct transfer from SPI to APT was to secure the favourable tax consequences of making the election.

The Crown claimed that the taxpayer company had not acquired the property as trading stock in the normal course of its business and that therefore section 274 did not apply.

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337. Now section 122 CGTA 1979

Goulding J once again took a different view from the higher courts. He consistently took a more formalistic, traditional Chancery approach than many of his brethren.[338]

In the High Court[339] Goulding J held that the transaction was genuine and bore all the characteristics of trading. He was therefore adhering largely to the form in which the transaction was presented. This being the case, the *fiscal motive did not rob the transaction* of its trading status. Although he considered Ramsay, he thought that the dividend stripping cases were of more relevance in that they were specifically concerned with the presence or absence of a trade. The transaction was not so affected and inspired by fiscal considerations as to lose its trading character. The fiscal considerations were not inherently or structurally part of what was a trading transaction, even though it was designed to secure a tax advantage.

His judgement was not particularly convincing at the time and it is not surprising that the House of Lords overruled it. He placed great weight on J.P Harrison (Watford) Ltd v. Griffiths,[340] which, on the basis that the House of Lords in Ramsay stated that they were not overruling any earlier decisions, still stood as good law. But, even in the field of dividend stripping cases, the decision had been limited, in effect, by later cases.[341] In fact, the taxpayer in Harrison v Griffiths was lucky to win, considering the way later dividend stripping cases were treated in the courts. The usual attitude of the courts to dividend stripping can be seen

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338. See, for example, T. & E. Homes Limited v. Robinson, Floor v. Davis, Ramsay and Berry v. Warnett, supra, in which he found for the taxpayers but was overruled by higher courts.
339. [1982] STC 573
340. (1962) 40 TC 281
341. See Chapter 1

from the following analysis by Megarry J in Lupton v. F.A. & A.B. Limited[342] on the question of whether a loss was incurred in the trade of dealing in shares. This analysis was approved by the House of Lords in that case. Goulding J's judgement cannot easily be reconciled with Megarry J's analysis. Megarry J said:

> "What then are the 'occasions when it is helpful to consider the object of a transaction when deciding as to its nature?' (I again quote the words of Lord Morris). I do not think that it can merely be that the transaction is unusual or extraordinary. The question under section 341 [ITA 1952][343] is not that of a loss in any 'ordinary trade' but that of a loss in a 'trade' simpliciter; and many transactions, though clearly extraordinary, are nonetheless trading transactions. Nor, for the reasons that I have just given, do I consider that the test can be whether the transaction would have been entered into if there had been no question of tax advantage; in any case that would, I think, be contrary to the Harrison case. But if, when the constituent elements of a transaction are examined, it is found that there are many elements the presence of which cannot be explained on any sensible trading ground but which are readily intelligible on fiscal grounds, then, in my judgement, the fiscal grounds may become relevant; for the fiscal element has invaded the transaction itself, moulding and explaining it, and is not merely the purpose or object for which a trading transaction is carried through."[344]

The Court of Appeal,[345] held that, when the two

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342. (1971) 47 TC 580
343. See Chapter 4
344. p597
345. [1984] STC 124

transactions were considered as a whole, and the court did not confine itself to the separate legal effect of the two assignments, the transactions in question did not bear the badges of trade. See, for example, Lawton LJ[346] and Fox LJ[347] who did refer to Ramsay as reinforcing the whole transaction principle arising out of the main body of dividend stripping cases such as the Finsbury Securities Ltd v Bishop, Lupton and Thompson v. Gurneville cases,[348] as opposed to the "component part" doctrine followed by the majority of the House of Lords in the Griffiths v. Harrison case (and, of course, Goulding J in this case).

The House of Lords decision in the Arndale case is considered below.

Reed v. Nova Securities Limited[349], like the Arndale case, was concerned with the question of whether assets were acquired as trading stock. It can be seen from Chapter 8 that the facts were that Nova Securities, which had traded in shares for many years, was acquired by Littlewoods. A few months after the acquisition, Littlewoods disposed of certain shares and debts to Nova for £30,000 which was their market value. The shares and debts did not form part of the trading stock of Littlewoods and had been acquired by them for £3,936,765. Nova claimed that the assets were acquired within section 274(1) ICTA 1970 as trading stock, and made an election under paragraph 1(3), Schedule 7, Finance Act 1965 that, in computing its profits or losses, the market value of the assets acquired should be treated as increased by £3,906,765, which was the amount which would have been the allowable loss accruing to Nova had no election been made. The Revenue, as in the Arndale case, rejected the claim.

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346. p132
347. pp135-6
348. See Chapter 1
349. [1985] STC 124, see Chapter 8

Although the group had considered the tax consequences of the sale, that did not make it necessary to approach the matter as a tax avoidance scheme. Walton J at first instance[350] firmly rejected the submission that the facts fell within the Ramsay and Burmah Oil cases as "entirely wide off the mark". The only question, in his view, was whether each step in the necessary chain of conditions had been properly and correctly fulfilled.[351] He held that they were, and so the effect of the relieving provisions was to convert a capital loss into a revenue one, as claimed by the taxpayer company. He did not look at the transaction as a whole.

In this case, as in the Arndale case, the Revenue did not argue that a transfer from A to B, closely followed by one from B to C was really a disposal from A to C (and this is despite the fact that the disposals were in return merely for book entries). The Court of Appeal,[352] where, the Arndale and Nova cases were heard together, said, as in the Arndale case, that the principles of the main dividend stripping cases (that the scheme must be looked at as a whole) were reinforced by the Ramsay principle. Lawton LJ, who dissented, said that the transaction must be viewed as a whole and, if the court does so, it ought to reach the conclusion that the debts and shares were not acquired as trading stock.[353] Fox and Kerr LJJ, while agreeing with the approach, came to a different conclusion on the facts.

In the House of Lords, Lord Templeman said that the new approach could not be used by the Revenue when a statutory provision specifically enables the taxpayer to gain a tax advantage. He said:

> "The Revenue cannot complain that Littlewoods have secured a fiscal advantage by the statutory method

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350. [1982] STC 724
351. See pp728-9
352. [1984] STC 124
353. pp133-4

> presented by section 274 of the 1970 Act and paragraph 1 of Schedule 7 to the 1965 Act. The only requirement in these circumstances is that, apart from section 274 considerations, there must be an acquisition by a trading company 'as trading stock'."[354]

On this basis, Lord Templeman, delivering the judgement of the House, held that the debts were acquired as trading stock, based on the findings of fact by the Commissioners, but that the shares were not trading stock.

Lord Templeman's view of the application of the Ramsay principle to the legislation in question in the Nova case is interesting in that he is saying that some statutory provisions are not within the ambit of the principle because, if the taxpayer uses them, he is only doing what the Legislature had in mind when those provisions were enacted. The result of this must be that, if the Ramsay principle cannot be applied, all of the steps in the transaction must be respected and the legislation must be applied to those steps. This does not mean, of course, that the transaction cannot be considered as a whole; it is just that the process of doing so would not include ignoring the legal effect of any inserted steps. It would be otherwise if the taxpayers' transactions were not such as were envisaged by the Legislature. In these circumstances, applying Lord Templeman's analysis, the Ramsay principle could be applied, and the inserted steps could be ignored, and the legislation would then apply to the end result.

To apply Lord Templeman's analysis in future cases, a court would presumably have to consider both the purpose of the transaction and the purpose of the Legislature when enacting the provisions in question.

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354. [1985] STC 124 at p131

Vinelott J made a similar point in IRC v. Bird[355] which is considered below and in more detail in Chapter 1. In that case he said that, if the Revenue apply what is now section 703 ICTA 1988, they cannot also apply the Ramsay principle because, if section 703 applies, the steps taken achieve what they were designed to achieve so, in other words, the Legislature envisaged the steps taken by the taxpayer. Compare, however, the approach of the Court of Appeal in that case.[356]

The House of Lords decision in the Arndale case was more straightforward. Arndale did not trade and did not have the intention of trading with the lease, and did not acquire the lease as trading stock. The transaction was carried out entirely for tax reasons. The company could not, therefore, make the relevant election.

The result of the Arndale and Nova cases is that it is still possible to convert capital losses into trading losses by using sections 274 and 122 but the courts, in determining whether there is a genuine trade, will look at the substance of the transaction, rather than accepting the trappings of trade (i.e., the form). In a sense, this is going right back to Scoble[357] and the other early cases which determined that mere nomenclature would not prevail over the realities of an arrangement.

Further, inconsistency in the application of the Ramsay principle can be seen in the case of Young v. Phillips.[358] This case contained some interesting dicta about the application of the Ramsay principle.

The facts of the case are set out in Chapter 9, from

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355. [1985] STC 584
356. [1987] STC 168, infra
357. Scoble v Secretary of State for Indian, supra
358. [1984] STC 520

which it can be seen that it involved non-domiciled taxpayers who sought to avoid capital gains tax under the remittance basis[359] by selling renounceable letters of allotment, relating to shares in their UK companies, abroad. The intention was, as this was a disposal of assets situated outside the UK, that no CGT should arise.

However, in the High Court, Nicholls J held that the renounceable letters of allotment, being documents relating to shares in UK companies, were assets situated in the UK. He went on to say that the scheme was probably caught by the Ramsay principle anyway. The Inland Revenue had argued against the scheme on both grounds. As the judge had held that the scheme failed on technical grounds, his comments on the possible application of the Ramsay principle, were obiter. They are, nevertheless, very interesting, in the context of the developing doctrine.

Nicholls J identified the end result as the new shares being issued to the two new Jersey companies in exchange for shares in the Jersey companies being issued to the individuals. The individuals still held their original shares in the UK companies.

The steps ignored by the judge consisted of the self-cancelling cash transactions, whereby money was borrowed and used to subscribe for the shares in the two Jersey companies, which came back to the taxpayers when they sold their allotment letters, and which were ultimately used to repay the borrowings.[360] But if the analysis stops there, all that the taxpayers have done so far is to receive bonus shares on renounceable letters of allotment, and exchange them for an issue of shares by the two Jersey companies. This is not, however, what the judge found; he held that the end result, or relevant

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359. See now section 14(1) CGTA 1979
360. p537

transaction, was an issue of bonus shares to the two Jersey companies in return for an issue of shares by the Jersey companies to the taxpayers. It is not clear exactly how the Ramsay principle would have been used to defeat the scheme. This question did not strictly arise in this case, of course.

The scheme was ultimately defeated by the application of the value shifting rules whereby value passed from the original shares into the new bonus shares.[361] What Nicholls J appears to have done is to pass to the end result and consider the application of the CGT legislation to this end result.

There is an interesting comment by Nicholls J regarding the application of the relieving provisions. He identified the substance of the transaction as being a share exchange and, that being so, he said that the relief for share exchanges, in what is now sections 77 - 88 CGTA 1979, could be used by the taxpayers in appropriate circumstances (although they could not do so in the present case because the main purpose or one of the main purposes of the transation was the avoidance of CGT[362]). So, not only do the normal charging provisions apply to the end result as found from using the Ramsay principle; it appears that the relieving provisions also apply to that end result.[363] The Revenue had argued that the process by which the end result was achieved should be ignored (on which analysis the relieving provisions would not apply). This was rejected by the judge.

There was a further argument advanced by the Revenue which was rejected by the judge. This relates to attempts by the Revenue to recharacterise a transaction, and is particularly interesting in the light of the comments of Sir John Donaldson in the case of Cairns v.

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361. See Chapter 8
362. See section 87 CGTA 1979
363. See pp538-9

MacDiarmid.[364] The Revenue in Young v. Phillips attempted to recharacterise the transactions in the following way. They said that the disposal of the letters of allotment did not occur at a particular point in time, but the process representing that disposal began in the United Kingdom prior to the taxpayers' visit to the Channel Islands, and the taking of the letters of allotment to the Channel Islands was part of this process of disposal. Nicholls J rejected this attempt with the following words:

> "The Ramsay principle is concerned with identifying the relevant transaction by looking at the end result of a composite transaction, disregarding for fiscal purposes the artificially inserted steps. This argument by the Crown assumes that the relevant transaction thus identified involved the issue of letters of allotment to the taxpayers. As is apparent from my formulation of the relevant transaction, I do not accept this."[365]

Following the analysis of the Ramsay principle by Nicholls J, the important point arises that it is not only the taxpayer who has to abide by the end result reached by ignoring the intermediate steps; the Revenue are also bound by the legislation as applied to the end result.

Another case which failed on the technical merits but which would also, according to the courts, have failed under the Ramsay principle was <u>Magnavox Electronics Co. Limited v. Hall</u>.[366] In the judgement of Nicholls J at first instance there can also be seen an extension of the principle.

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364. Supra
365. p539
366. [1986] STC 561

The facts were that the taxpayer company in 1978 contracted to sell a factory to a company called Jomac for £1.4 million. Magnavox had trading losses which it could use to set off against the gain on the sale of the factory. Subsequently, however, the taxpayer company went into liquidation and Jomac was unable to complete the contract. The liquidator could, of course, find a new buyer but the pre-liquidation trading losses would not be available to set against the gain.

In an attempt to overcome this problem, the taxpayer company acquired an off-the-shelf company, Safemark, and Jomac assigned its rights and liabilities under the original contract to Safemark. Magnavox and Safemark varied the terms of the contract, mainly by the insertion of a lower price. Safemark then sold the factory to a new purchaser. The Revenue claimed that Magnavox sold the factory under a contract made after it had gone into liquidation and so the pre-liquidation losses were not available.

The main ground on which Nicholls J found for the Crown at first instance[367] was that there was a new contract, not an extension of the old one. He did, however, deal with the Ramsay argument which was raised by the Revenue. The Special Commissioners expressly made no finding about whether the relevant transactions were part of a preordained series. They did find that the earlier transactions, namely, the original 1978 contract and the resolution to wind up Magnavox, were not part of a preordained series; but they did not go further than this.

Nicholls J, on the other hand, said that it was an inescapable conclusion that the relevant transactions did form part of a single composite transaction or

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367. [1985] STC 260

preordained series. Furthermore, the *artificial* steps had no commercial purpose other than tax avoidance.

The steps in question which he said were part of the composite transaction were:

1. The assignment by Jomac of its beneficial interest in the 1978 contract to Safemark.

2. The variation of the 1978 contract.

3. The exchange of contracts for the sale of the factory by Safemark and the ultimate purchaser.[368]

Nicholls J held that the relevant transaction was the sale of the factory by Magnavox to the ultimate purchaser under the new contract. This conclusion is not consistent with Lord Brightman's two limitations in Furniss v. Dawson;[369] it can only be justified as an extension of the Furniss v. Dawson test (although Nicholls J rejected a submission that this was such an extension[370]). *The reason it is an extension is that,* it is not just inserted steps that are being ignored, because the original contract is also being ignored, and the original contract is not part of the preordained series according to the facts found by the Special Commissioners.

In the Court of Appeal[371], the scheme again was held to fail on the technical merits, the Ramsay doctrine being dealt with in one paragraph in the judgement of Dillon LJ (with whom Sir John Donaldson MR and Croom-Johnson LJ agreed). The judge did not analyse the application of the doctrine in detail, merely confining himself to saying that the interposition of Safemark was as ineffective as the interposition of Greenjacket in

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368. p278
369. Supra
370. p280
371. [1986] STC 561

Furniss v. Dawson.[372] The positions of the two companies as regards the schemes of which they were part were not identical and it is a shame that Dillon LJ did not discuss this further but, having decided that the scheme failed anyway, it was not necessary to examine the application of the Ramsay doctrine in detail.

There was some confusion over the application of the Ramsay principle in Sherdley v Sherdley,[373] arising mainly out of Sir John Donaldson MR's unusual conception of what the principle entails. The facts were that, in the course of divorce proceedings, the father obtained custody, care and control of the three children. Subsequently, he applied to the court for periodical payments orders to be made against him requiring him to pay to each of the children an amount equivalent to the sum which, after the deduction of basic rate income tax, equalled each child's school fees. It was conceded that the father's application was made for the sole purpose of obtaining tax advantages which would not otherwise be available, and it was accepted that, if the orders were not made, the father would continue to pay school fees.

The aspect of this case which is of interest here is the decisions of the Court of Appeal and the House of Lords on whether it was proper for a court of make orders where the sole purpose was to obtain a tax advantage. The Court of Appeal applied Ramsay and Furniss v Dawson, whereas the House of Lords distinguished those two cases.

The Court of Appeal[374] decided that a court was entitled, when ordering financial arrangements, to have regard to tax considerations so that where two orders were equally appropriate, the court could select that which was the more tax effective. However, the court should also apply

372. p564
373. [1987] STC 217
374. [1986] STC 266

the general principles of tax avoidance law when considering what order to make. Sir John Donaldson MR accepted that a taxpayer is entitled so to order his affairs that his liability to tax is as low as possible.[375] However, he said, a taxpayer is not entitled to "pretend" so to order his affairs by entering into a sham transaction.[376] So far, of course, the Master of the Rolls was on firm ground. However, he continued:

> "It would, in my judgment, be quite unacceptable that the commissioners and, on appeal, the courts who are concerned with taxation matters, should be required to consider whether an order of the courts which are concerned with matrimonial matters was a sham, or with the true nature of the order. No court should make an order which is a sham. No court should make an order which does other than proclaim its true nature. The court can properly have regard to the effects of its orders in terms of tax liability when deciding whether to make such an order and, where there is a choice, what order to make, but that is as far as it can go."[377]

It seems a strange use of the word "sham" to apply it to an order of the court, even if that order is made purely for tax reasons. Such an order cannot be a sham in the accepted sense of that term in the UK.[378] Neither Neill or Balcombe LJJ used the sham doctrine in this strange way, and the House of Lords rejected it.[379]

Regarding the application of the Ramsay principle and the idea that a father could seek an order against himself to make payments in favour of his children, the Master of the Rolls said:

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375. p271
376. p272
377. Ibid
378. Supra
379. See [1987] STC 217 at p225 per Lord Brandon

> "This is cloud cuckoo land. If the Revenue chose to challenge this transaction before the court which deals with revenue matters, a gravely embarrassed judge would be bound to hold that the transaction was a sham or, at best, that the reality was that the court was ordering the father to pay the school fees, the insertion of the bursar as a agent for the child and the 'contract' between the child and the school serving no real purpose."[380]

Neill and Balcombe LJJ steered clear of the sham doctrine, contenting themselves with saying that, if the sole purpose of an order is to obtain a tax advantage, the order should be refused because a court will not recognise a step in a transaction which has no commercial or business purpose and which is only designed to avoid a liability to tax.[381]

The House of Lords[382] disagreed, holding that a divorced parent could obtain an order against himself for the payment of school fees, even though his sole purpose, in seeking the order, was to obtain tax advantages, and the fact that he could maintain his children at school without the help of such an order was not a good reason for the court to refuse the order.

Lord Brandon pointed out that, if the decision of the Court of Appeal was right, the law would practice a strange form of fiscal discrimination in the way in which it treated two different but comparable situations arising on the breakdown of a marriage. A mother could apply for an order against the father for payment of the children's school fees, but the order would have to be denied if the father had custody.[383]

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380. p273
381. See p276 per Neill LJ and pp277-8 per Balcombe LJ
382. [1987] STC 217
383. p224

He said that he could not agree with the Court of Appeal that it would be wrong for the court to make an order because it sole purpose is to obtain tax advantages because this involved justifiable discrimination between families following the breakdown of a marriage. He did not regard Ramsay or Furniss v Dawson as in any way applicable to the exercise by the court of the powers conferred on it by the matrimonial legislation.[384]

The decision of the House of Lords is a sensible and, it is suggested, a correct decision on the relationship between the Ramsay principle and the powers specifically given to the court by statute, in this case, mainly for ensuring the well-being of children on the breakdown of a marriage. However, the opposite decision of the Court of Appeal shows the confusion and uncertainty that surrounds the application of the Ramsay principle to new situations.

The position was hardly clarified by the Privy Council in IRC v Challenge Corporation Ltd,[385] where the majority, for whom Lord Templeman gave judgment, held that the general anti-avoidance provision in New Zealand[386] applied to a particular scheme, whereas Lord Oliver gave a strong dissenting judgment. Once again this shows personalities can affect this important area of the law. As has been seen in this Chapter, Lord Templeman has an intense dislike for tax avoidance and his judgments strike down attempts to circumvent the tax laws whenever possible. Lord Oliver, on the other hand, strongly adheres to the view that it is a taxpayer's right to organise his affairs as he likes, within the law, and that judges should not manufacture principles or stretch the statutes to catch them.

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384. p225
385. [1986] STC 548. Compare the attitude of the Canadian courts in Stubart Investments Ltd v The Queen [1984] CTC 294; see Chapter 10
386. See Chapter 10.

Apart from this clash of philosophies by two senior judges, this case is important for two main reasons:

1. It dealt with the question of how a general anti-avoidance provision applies where another provision specifically grants a relief. In this case the general provision prevented the specific provision from being available, whereas, in Shepherd v Lyntress Ltd,[387] the Ramsay principle failed to achieve the same result.

2. Lord Templeman, and the rest of the judges in the majority, purported to discern a distinction between tax avoidance, which they considered to be reprehensible, and tax mitigation, or tax planning, which is legitimate. Despite what Lord Templeman said, this is a distinction alien to UK law.

The facts were that the taxpayer company was a member of a group. In 1978 the group stood to make a large taxable profit. New Zealand, like the UK, has a law allowing for losses incurred by one member of a group to be set against the profits of another. The New Zealand provision was section 191 of the Income Tax Act 1976. As no losses were available within the group. the taxpayer company purchased a company, Perth Property Developments Ltd, which had accumulated losses. Following the acquisition, an election was made to set Perth's losses of $5.8 million against the profits of the taxpayer company's group under section 191.

However, this claim was rejected on the grounds that the agreement bringing Perth into the group was "an arrangement..... absolutely void as against the Commissioner for income tax purposes..... to the extent that...... its purpose or effect was tax avoidance"

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387. Infra

within the meaning of New Zealand's general anti-avoidance provision, which, namely section 99, Income Tax Act 1976.

The majority in the Privy Council upheld the rejection of the claim. Lord Templeman said that section 191 was intended to give effect to the reality of group profits and losses. Where one group company makes a profit of $5.8 million, and another makes a loss of that sum, the reality is that the group has made neither a profit nor a loss. Section 191 in these circumstances is not "an instrument of tax avoidance". However, in the present case, the reality is that the Challenge group had not made a loss; the loss was made by Perth before it became a member of that group. In the circumstances, section 191 was an "instrument of tax avoidance" which falls foul of section 99.[388]

In other words, Lord Templeman was applying the general words of section 99 to override the specific relief in section 191 after the Challenge group had taken great care to come within the precise terms of section 191. Lord Templeman justified this decision by distinguishing between "tax mitigation" and "tax avoidance". He said that income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to a reduction in his tax liability. Lord Templeman said that section 99 does not apply to tax mitigation because the taxpayer's advantage is not derived from an "arrangement", but from the reduction of income which he accepts or the expenditure which he incurs.[389]

Lord Templeman gave[390] some examples of tax mitigation. These were:

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388. p552
389. p554
390. pp554-5

1. "Seven-year" covenants.[391]
2. A settlement of capital which deprives the settlor of a source of taxable income.
3. Expenditure on a qualifying insurance policy which reduces the taxpayer's tax liability.
4. Expenditure on export business or on capital, or other expenditure which, by statute, entitles the taxpayer to reduction of tax liability. The tax advantages result from the expenditure for which Parliament grants specific tax relief.

Lord Templeman applied his distinction to the two section in question. He said:

> "When a member of a specified group of companies sustains a loss, section 191 allows the loss to reduce the assessable income of other members of the group. The tax advantage results from the loss sustained by one member of the group and suffered by the whole group.
>
> Section 99 does apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.
>
> Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."[392]

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391. See now section 347A ICTA 1988
392. p555

Lord Templeman said that, in the present case, Challenge had practiced tax avoidance to which section 99 applied. The taxpayer company had not practiced tax mitigation because its group never suffered the loss which would entitle it to a tax reduction. It should be noted that, in 1980, the statute was amended to say just this.

Lord Templeman then gave some examples of tax avoidance cases. He cited Black Nominees, Chinn v Collins, Ramsay, Eilbeck v Rawling and Burmah Oil.[393] It cannot be denied that these cases were, indeed, concerned with tax avoidance devices. However, he also cited the Duke of Westminster case. This is surprising, given that the House of Lords in Ramsay expressly stated that they were not overruling the Duke of Westminster case.[394] This seems to confirm what was stated above that, whatever the Law Lords in Ramsay may have said, that case did impose severe restrictions on the Duke of Westminster principle. Lord Templeman stated clearly that, in his view, section 99 would have applied to the Duke of Westminster case.[395]

This is not right even according to Lord Templeman's own analysis, unless the Duke of Westminster case is fully overruled, because the Duke did suffer a loss. Neither the Ramsay case, nor any of the subsequent cases dealing with the Ramsay principle, have, according to the judges who heard those cases, detracted from the fact that the Duke was entitled to the deduction because the Duke incurred a real liability to make the covenanted payments, in addition to paying the normal wages to his employees, although, of course, his employees never exercised their right to be paid twice in practice. The Law Lords should either respect the Duke of Westminster case and treat it as, to use Lord Templeman's

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393. All of these cases are dealt with supra
394. Supra
395. p556

classification, tax mitigation; or come clean and say that it is unacceptable tax avoidance and that it is now overruled.

Lord Oliver would have none of this. He accepted that if section 99 stood alone "it would be difficult to imagine a clearer case than this of a transaction entered into for the purpose of tax avoidance as defined by the section".[396] He pointed out that section 191, in subsection 191(1)(c)(i), had its own anti-avoidance provisions. In order for section 99 and 191 to be read together, the operation of section 99 must be limited so as not to avoid a transaction which is outside the specific and exhaustive anti-avoidance provisions in section 191 itself. Were it otherwise, there would be an overlap between the two sections.[397] Lord Templeman, on the other hand, considered that the New Zealand Parliament "was indifferent to or unmindful of any overlap" between the two sets of anti-avoidance provisions.[398]

So far, subsequent courts have been less than enthusiastic about using Lord Templeman's distinction between avoidance and mitigation. There are also many unclear aspects of this distinction. To take just one, if the distinction is accepted as valid, are steps taken for tax mitigation purposes (as opposed to tax avoidance purposes) unimpeachable under the Ramsay principle? This question, plus many more, awaits further "clarification" from the courts. Taxpayers should not hold their breath.

Another question to be considered recently by the courts was the interaction of the Ramsay principle with specific anti-avoidance provisions. This came up for discussion in Bird v IRC,[399] a case examined in detail in Chapter 1.

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396. Ibid
397. p557
398. p553
399. [1988] STC 312

At first instance, the case was heard by Vinelott J.[400] Although the case is mainly about the application of section 460 ICTA 1970[401] to a very complicated "Bradman" avoidance scheme, Vinelott J did mention the interaction of the new approach and section 460. He said that the Revenue could attack a transaction under one, but not both. If they argue section 460 they are accepting that the scheme works apart from the application of the section. They cannot then seek to ignore certain steps under the new approach. The judge said:

> "When the Crown relies on section 460 it in effect asserts that the transactions entered into by the taxpayers had the effect which those transactions were desired to achieve; section 460 enables the Crown to counteract and cancel any tax advantages so obtained. When the Crown relies on the Ramsay principle the Crown asserts that at least some of the steps taken as part of a composite transaction are to be treated for fiscal purposes as if they had not been taken. It cannot in relation to the same taxpayers and in relation to the same transaction both rely on every step taken for the purposes of section 460 and disregard intermediate steps under the Ramsay principle."[402]

On the taxpayers' side, Counsel submitted that, as Ramsay applied, certain steps taken to avoid liability under section 286 ICTA 1970[403] failed and so a section 286 liability arose which must be deducted by the taxpayers in quantifying the tax advantage. Vinelott J was unsympathetic to this line of reasoning, noting that "the court is invited by the taxpayers to treat as fiscally ineffective steps taken by them to achieve a result which they now seek to say the scheme failed to achieve".[404]

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400. [1985] STC 584
401. Now section 703 ICTA 1988
402. pp646-7
403. Now section 419 ICTA 1988, see Chapter 1
404. p646

In other words, Vinelott J appeared to be saying that, if a person implements a scheme designed to avoid tax, he cannot argue the Ramsay principle against the Revenue. The judge said:

> "It is not to my mind clear that a taxpayer who has embarked on a series of transactions with a view to avoiding liability for or evading the payment of tax can later be heard to say, when faced with a counteracting notice under section 460, that the transaction should be treated as fiscally a nullity."

In the Court of Appeal,[405] Sir Nicholas Browne-Wilkinson V-C agreed, in even stronger language.[406] The three reasons the Vice-Chancellor gave for rejecting the taxpayers' arguments are set out in full in Chapter 1. They can be summarised here as follows:

1. The taxpayers put forward the whole scheme as a series of real transactions and it does not lie in their mouths to claim to disregard what they had done.
2. The Ramsay principle is a principle of statutory interpretation. It does not treat the steps to be disregarded as shams; it accepts that they occurred but requires that, for tax purposes, they are to be disregarded.
3. Referring to the definition of "tax advantage" in section 709 ICTA 1988, what was done by the taxpayers certainly avoided a "possible assessement" to tax, and so the requirements of the section had been satisfied.

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405. [1987] STC 168
406. p177

In the House of Lords,[407] Lord Keith, with whom the other Law Lords agreed, also declared the taxpayers' argument to be unsound. Of the taxpayers contention that they had failed to obtain any tax advantage because, by virtue of the Ramsay principle, they should be treated as having been participators in "Interlude" at the time of the loans, he pointed out that the circumstance that the Revenue might have raised a section 286 assessment did not detract from the situation that the taxpayers were the beneficiaries of receipts accruing in such a way that they did not bear tax on them.[408] The House of Lords did not expressly deal with the question of whether the Revenue could raise both the Ramsay principle and section 460, but the lower courts inclined to the view that they could not. As the Vice-Chancellor put it in the Court of Appeal, to apply the Ramsay principle to disregard the very transactions which the legislation requires to be considered in meticulous detail:

> "flies in the face of all rules of construction. Parliament had required those transactions to be looked at in detail, not to be disregarded."[409]

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407. [1988] STC 312
408. pp317-8
409. [1987] STC 168 at p177

The Boundaries Applied

It is now necessary to examine the three cases which were the most important in the application of the Ramsay principle since Furniss v. Dawson. In these cases the judges of the Chancery Division, the Court of Appeal and the majority in the House of Lords applied the principle to artificial schemes strictly in accordance with Lord Brightman's two criteria.[410] Two of the cases are of additional interest in that they involve essentially the same scheme as was used in Furniss v. Dawson and Floor v. Davis. The third of the three involved a Development Land Tax "fragmentation" scheme.[411] The cases were Craven v. White, IRC v. Bowater Property Developments Limited and Baylis v. Gregory.[412] These three cases were heard by three separate judges in the Chancery Division but were heard together by the Court of Appeal and the House of Lords.

Peter Gibson J heard the first of the three cases to be dealt with in the High Court: Craven v. White.[413] When at the Bar, Peter Gibson J argued a number of tax cases on behalf of the Crown in which questions of form and substance arose (IRC v Plummer, Chinn v. Collins and Vestey v IRC[414] among them). He was therefore thoroughly familiar with the points at issue.

His approach, as with the other judges in the High Court in these three cases, was to adhere strictly to Lord Brightman's two criteria in Furniss v. Dawson as if they were statutory tests. This contrasts with the approach of Nicholls J in Young v. Phillips[414] and the Magnavox case[414] who adopted a looser and more imprecise approach.

The Crown had submitted that it was not necessary that

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410. In Furniss v Dawson, supra
411. See Chapter 3
412. [1988] STC 476
413. [1985] STC 531
414. Supra

all of the transactions should have been preordained in the sense that they were deliberately fitted together as in Floor v. Davis and Furniss v. Dawson. The Crown was arguing for an extension of the principle.[415]

Peter Gibson J refused to allow any extension. Despite warnings by the House of Lords that the Ramsay doctrine will be developed case by case, there is little else that the lower courts can do, in keeping with the rules of precedent, than to follow the guidance available at the time from the House of Lords.

The judge said that the doctrine relied on the "practical certainty" that the steps will be completed once the series of steps had been started. He thought that practical certainty that the series of transactions would be completed once started was a feature of the rationale of Lord Brightman's analysis of the Ramsay principle. The justification for equating non-contractual and contractual arrangements is that, looking at the realities of a preplanned scheme where every step had been arranged, there is no distinction between the two, because both would in practice be carried through to their intended conclusion. If, on the other hand, there is a distinct possibility that the series would not be completed as planned, the position is not equivalent to a contractual arrangement.[416]

Peter Gibson J found that there was no such practical certainty here.[417] He further found that Lord Brightman's second criterion[418] was unsatisfied. The insertion of Millor (the intermediary company) was not

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415. See p546
416. p560. This was the same conclusion reached by Vinelott J - in the Crown's favour - in <u>Ewart v. Taylor</u>, supra.
417. p561
418. Supra

solely for tax avoidance purposes; there was a commercial purpose as well, namely, to provide a holding company for the merger with Cee-N-Cee which, as it happened, did not go through.[419]

The second of the three cases to come before the High Court was IRC v. Bowater Property Developments Limited[420] which was heard by Warner J who, when at the Bar, like Peter Gibson and Vinelott JJ, argued many Revenue cases on behalf of the Crown, including some of the dividend stripping cases and other cases in which the form and substance issue arose. So, again, he was fully aware of the importance and the relevance of the matters at hand.

It was conceded by the taxpayer company that the transfer of the beneficial interest in the land in question to the five group companies had no business purpose other than the avoidance of liability to DLT. However, Counsel submitted that there was no composite transaction or series of transactions because, when the transfer to the five group companies took place, there was no near certainty that the hoped-for onward sale to the ultimate purchasers would take place. At that date, the commercial decision by the purchaser to commit itself to the deal had yet to be taken. In fact, when the relevant decision was taken, it was not to proceed. Counsel said that there was no single integrated scheme in the sense that the parties entered into it on the understanding that the scheme would be carried through as a whole. They argued that, even if the sale had gone through as originally envisaged, there would not have been a composite transaction so as to be caught by the Ramsay principle.

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419. See pp561-2
420. [1984] STC 783

However, Counsel submitted that, even if they were wrong in the above contention and the original sale to the purchaser would have been a composite transaction, the sale did not in fact follow the original plan. There was complete break in July 1980, and the purchaser who actually acquired the land in February 1981 happened to be the original purchaser, but that was fortuitous. The sale which in fact occurred was a wholly different sale from that originally envisaged. The circumstances and the price changed, and the purchaser could be regarded as an entirely new purchaser, the original negotiations having been scrapped. Counsel argued that the required nexus between the transfer to the five group companies (conceived in connection with the former planned sale), and the actual sale giving rise to the charge to DLT, could not be established.

On behalf of the Revenue it was argued that the circumstances of the schemes which had so far been adjudicated by the courts formed an insufficient guide to the ambit of the Ramsay principle. Each of the cases had shown the principle to be applicable to a new set of circumstances, and it was clear from Lord Scarman's speech in Furniss v. Dawson that the ambit of the principle was not finally defined by that decision. It was argued that the use of the word "preordained" in the Burmah Oil case and in Furniss v. Dawson was natural in the light of the facts of those cases, but too much weight should not be placed on it.

The Special Commissioners rejected the Revenue's arguments saying that they did not represent the true Ramsay principle which was as analysed by Lord Brightman. There could, in their opinion, be no composite transaction unless everything had been, to all intents and purposes, fixed in advance.

However, they did decide that, had the original deal gone through, they would have applied the Ramsay principle because such "ifs and buts" as remained at that stage were insufficient to prevent the transactions being treated as one composite whole.[421]

Warner J said that it was not disputed that the disposal to the five group companies had no business purpose; the sole object being to avoid DLT. At the time of this transaction there was a firm expectation on the Bowater side that the sale would go through.

The judge noted that Counsel for the Crown submitted that the Ramsay principle applies whenever it is found that a step has been taken with a view to avoiding tax in a certain event and that event actually occurs. The break in the negotiations between the Bowater Group and the purchaser was therefore irrelevant. Indeed, Counsel for the Crown submitted that the Ramsay principle would have applied in just the same way if Bowater had no specific purchaser in mind at the time of the first transaction.

The judge, however, rejected this.[422] Warner J was of the opinion that this amounted to ignoring the first of Lord Brightman's requirements. What Lord Brightman had in mind as a single composite transaction was one in which all of the steps have been prearranged or preordained.[423]

The judge related the new approach directly to the substance doctrine:

> "The only function of the courts in this sphere is to interpret and apply the legislation enacted by Parliament in accordance with relevant legal principles. Among relevant legal principles is the principle that the courts are bound to seek to ascertain the true nature of a transaction and to

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421. See pp792-3
422. p797
423. See pp797-8

give effect to it. That, to my mind, is the real basis of the Ramsay principle. (I choose the phrase 'true nature', but other expressions such as 'reality' or 'substance' - in the sense in which I understand the latter term to have been used by Lord Bridge in Furniss v. Dawson - will do just as well)."[424]

Warner J was in complete agreement with the approach of Peter Gibson J in Craven v. White regarding the first of Lord Brightman's two requirements.[425]

He dismissed the Crown's appeal from the decision of the Commissioners, but he did differ from the Commissioners in one very important respect concerning Lord Brightman's first criterion. He did not agree with them that, had the original deal gone through, the Ramsay principle would have applied.

The third of the three cases, Baylis v. Gregory was also heard at first instance[426] by a judge who, when at the Bar, represented the Crown in cases dealing with matters of form and substance, Vinelott J.

The Baylis v. Gregory scheme was very similar to that used in Furniss v. Dawson except that, here, the consideration received by the intermediate company was extracted by the original owners in the form of loans.

As in Craven v. White (which itself used a similar scheme), it was held that the Ramsay principle did not apply because there was not a preordained series of transactions: the sale to the ultimate purchaser had not been prearranged or preordained at the time of the share exchange so that the two transactions could not be treated as a single composite transaction.

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424. p798
425. p799
426. [1986] STC 22

In passing, it is interesting to note that the first directors of the intermediate company were also directors of Greenjacket in Furniss v. Dawson.

The Special Commissioners found for the taxpayer, but they were of the opinion that the position would have been different if the sale to the original purchaser, in relation to which the share swap was planned, had gone through. But the sale was abandoned. The incorporation of the intermediate Isle of Man company, and the share exchange were nevertheless carried out, and the taxpayer admitted that this was done in the hope that some other purchaser could be found in the future. Before the Commissioners, the Inland Revenue's solicitor suggested an alternative way of connecting the transactions, namely, continuous control of the subject matter. The Commissioners found this "a tempting argument" but they formed the view that continuous control cannot itself constitute a link between transactions so as to make them elements of a composite transaction.

In the High Court the Crown advanced an argument that was rejected by Peter Gibson J in Craven v. White, namely that, to bring the Ramsay principle into play, it is sufficient that the exchange was made solely in order to obtain the benefit of the exemption in paragraph 6, Schedule 7, FA 1965[427] and to ensure that, if a favourable opportunity for an onward sale were to occur, the capital gains tax that would otherwise arise would be postponed indefinitely, notwithstanding that the shareholders would obtain the benefit of the purchase price by means of the interest-free loans. It was submitted that the transactions were preordained in that the first step created the machinery which was designed and intended to be used if a purchaser was found. Therefore, the exchange was, in the words of Lord Wilberforce in Ramsay, "intended to have effect as part of a nexus or series of

427. Now section 85 CGTA 1979

transactions, or as an ingredient of a wider transaction intended as a whole". It was further submitted that the two conditions set out by Lord Brightman in Furniss v. Dawson must be understood with that observation by Lord Wilberforce in mind. Those conditions, it was submitted, should not be read restrictively as requiring, in the case of the first condition, that each step in a preordained series must be one which the parties contemplated would for all practical purposes follow inevitably once the first step was taken.

Vinelott J noted that this argument was rejected in Craven v. White and in the Bowater case. He too rejected the Revenue's submissions.[428]

He said that the facts in the present case demonstrated the fallacy in the Crown's case even clearer than the facts in *Craven v. White and Bowater*. It was accepted by the Crown that the share exchange was effective to pass the full legal and beneficial interest in the target shares to the intermediary and that, following the exchange, the intermediary had control of those shares, and the exchange therefore fell within the CGT exemption. It was, according to Vinelott J, immaterial that the taxpayer had de facto control of the intermediary and that the exchange was made with a view to the avoidance or postponement of capital gains tax.[429]

The transactions in this case could not be reconstructed into a single tripartite transaction as they could in Furniss v. Dawson; the sale by the intermediary to the ultimate purchaser had not been arranged at the time of the exchange.

The Revenue tactics in the conduct of these appeals are

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428. p43
429. Ibid

questionable. Their best chance of success was in Craven v. White, and their worst was in Baylis v. Gregory. They therefore manoeuvred to get Craven v. White before the High Court first and Baylis v. Gregory last, even though the Baylis case was heard by the Special Commissioners a year before the Craven case.[430] On the other hand, they appear to have made a mistake by allowing all three cases to be heard by the Court of Appeal at the same time, because they would always be arguing from their weakest position and their chances in their best case would probably have been prejudiced by the difficulties they experienced as regards their worst case, namely, Baylis v. Gregory. They appear then to have compounded their error when they appealed to the House of Lords. The Court of Appeal gave leave only for Craven v White (the Revenue's best case) to go to the House of Lords, but the Revenue pursuaded the Appeals Committee to hear their weaker cases as well.

The Court of Appeal[431] came down heavily in favour of the taxpayers. The judgements handed down in the Court of Appeal underline the limits being placed on the Ramsay doctrine by the Chancery judges and deserve careful consideration. It will be seen that there is a slight difference in emphasis in the three judgements; Parker LJ in particular, basing his findings more on traditional form and substance doctrines than his two brethren.

Slade LJ identified what he called "the Crown's basic contention" as the following, taken from the notices of appeal in the Baylis v. Gregory case:

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430. This manoeuvring reflects badly on the integrity of the Revenue. Consider the following dates. In the Craven v White case the Special Commissioners decision was given on 18 January 1984 and the Case Stated was signed on 21 August 1984. The corresponding dates for Baylis v Gregory were 17 May and 1 August 1983. Despite this, Craven v White was heard in the High Court in May 1985, and Baylis v Gregory did not come before the High Court until November 1985.

431. [1987] STC 297

"It is submitted that in order to prove a preordained series of transactions which culminates in an ultimate disposal it is only necessary to prove that at the time of the first transaction it was intended by the taxpayer that the first transaction should be used as conveyancing machinery in order to achieve a final disposal of the assets if a disposal was ultimately made. It is submitted that provided the machinery by which the commercial end is to be achieved is preordained, it is irrelevant that there remains a possibility that its execution may be frustrated by failure to achieve the commercial end itself or that at the time of the first transaction there was no immediate prospect or intention of finally disposing of the asset."

The Crown were contending that the Ramsay principle is not applicable only where, as in Furniss v. Dawson, there existed at the time of the first transaction a known purchaser, a known price and known terms, because the purpose of the Ramsay principle is to identify the real transactions by ignoring artificially inserted steps. Therefore, it was submitted, the actual identification of the purchaser and the price was not critically important.

The Crown were therefore pressing for a wide interpretation to be given to "preordained"; they were saying in effect that it should apply where the whole scheme was in the minds of the parties at the outset, even if the precise details of the subsequent steps had not been finalised. This would have been taking the Ramsay principle from the grounds of tax avoidance into the area of tax planning. The Crown were therefore urging the court to ignore the ordinary meaning of preordained and the way that the word was used in Furniss v. Dawson.

Slade LJ accepted that it would be wrong to apply Lord

Brightman's criteria as if they had statutory effect[432] but until the House of Lords give further guidance on the application of the Ramsay principle, the lower courts are bound to apply Lord Brightman's "careful and considered formulation of the limits of the Ramsay principle .... according to what we understand to be its true meaning and intent".[433]

On that basis he rejected the Crown's contention, considering that it would involve an unwarrantable extension of the Ramsay principle.

He took Lord Brightman's first criterion - that there must be a preordained series - as not including two transactions, each of which itself had legal effect, unless, at the time when the first was effected, all the essential features of the second had already been determined by a person or persons who had both the firm intention and the ability to procure the implementation of the second. It was not enough, in Slade LJ's view, that just the general nature of the second transaction had been worked out at the time of the first.[434]

He put this in terms of an A, B, C transaction in the following way:

> "Normally .... it seems to me that a transfer by A to B followed by a sale by B to C could not, on the ordinary meaning of words, be together described either as 'one single composite transaction' or as 'a preordained series of transactions' unless at the time of the first transfer C had been identified as the prospective purchaser, and all the main terms of the sale to him had at least in principle been agreed; if this is not so, they have to be regarded as independent transactions."

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432. As did Mustill LJ at p339
433. p306
434. Ibid

This supposed condition was satisfied in the Ramsay/Eilbeck v. Rawling, Burmah Oil and Furniss v. Dawson cases. The question then arises as to how far it was a prerequisite of the Ramsay principle, particularly in the light of the Law Lords warning that the principle would be developed case by case. Slade LJ was reassured in his opinion by the fact that the House of Lords in those cases had been at pains to emphasize the inevitability of the respective schemes being completed. While this is true, it does rely on the Ramsay principle having been frozen and strictly limited to the boundaries set out by the Law Lords in the three main Ramsay cases (Ramsay itself,[435] Burmah Oil and Furniss v. Dawson) - something the Law Lords themselves warned would not be the case. But, having said that, the lower courts can do no more than apply the law in its state of development at the time.

Slade LJ was further comforted by the fact that both Lord Wilberforce and Lord Brightman said that there was no distinction in reality and, therefore, no distinction for tax purposes, between the case where the parties were contractually bound to take each step in a scheme and the case where the arrangement falls short of a binding contract. This can only be the case where, in the non-contractual situation, the essential features of the second transaction were planned and intended as in the contractual situation.[436]

Slade LJ further justified his view by the claim that the Crown's contention would lead to "formidable uncertainty and practical difficulties" in the administration of our tax law which the House of Lords did not contemplate and cannot have intended. However, in response to Slade LJ's point it can be argued that the very nature of the doctrine gives rise to uncertainty and practical

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435. Combining Eilbeck v Rawling, supra
436. p308

difficulties, particularly if the House of Lords is going to "develop" the principle from case to case. Slade LJ's justification cannot be supported because the House of Lords cannot have been so narrow minded as to have failed to foresee that uncertainty and difficulty would inevitably result from their new approach.

He developed this point by saying:

> "The whole essence of this principle when it applies is that the step inserted in the series of transactions which has no commercial purpose apart from the liability to tax falls to be wholly disregarded for fiscal purposes .... But the step so inserted may well, by itself, have immediately and permanently altered the legal rights of the parties, for example by transferring the legal and beneficial title to assets from A to B. In the circumstances envisaged in the Crown's basic contention, a substantial interval of time may elapse before any transfer of those assets by B to C ensues and, indeed, in the event, no such transfer may ever take place. In the meantime, the Revenue may well assess the interested parties to tax (prima facie quite properly) on the basis that there has been a disposal of assets by A to B, effective according to the tenor of the documents. (It can by no means be assumed that in the case of other tax saving schemes the first disposal will be wholly covered by a specific statutory exemption, such as was available in Dawson). What are then to be the fiscal consequences if and when a sale of assets by B to C at last ensues? If the original scheme was designed to avoid or mitigate tax, it is to be assumed that, if it could properly do so in reliance on the Ramsay principle, the Revenue would subsequently wish to claim tax on the basis of a disposal by A to C, when the sale to C eventuates.

> However, of one thing I am certain. The 1965 Act, on its true construction, does not permit one single transfer of assets by A to be treated for capital gains tax purposes both as a disposal of all those assets in favour of B and as a disposal of all those same assets in favour of C."[437]

Slade LJ thought that in cases in which there was a preordained series of transactions "there is no practical likelihood of a substantial 'limbo' period elapsing between the first and second stages of the series".[438] This is probably overstating the case. In most schemes, it is true that the time taken for it to run its course is short, but it need not be the case.

Applying this above analysis to the Craven v. White appeal, he agreed with Peter Gibson J in saying that there was no single composite transaction.[439]

He had a slightly different view from the judge of Lord Brightman's second criterion. He said:

> "Though it is clear that the steps involving the interposition of Millor in the series of transactions had business effect, the relevant question is whether or not, on the Commissioners' finding of fact, it could properly be said that the interposition of Millor had 'no commercial (business) purpose apart from the avoidance of a liability to tax'. Having studied these findings, I think that a proper reading of them indicates that the Commissioners (a) regarded the primary purpose of both the acquisition of Millor and the subsequent transfer of the Queensferry shares to Millor as being to avoid the tax which would otherwise have been immediately payable on the ultimate sale to

437. pp308-9
438. p309. See also Mustill LJ, infra
439. p315

Jones, if that sale were eventually to take place; (b) accepted that a subsidiary purpose of both that acquisition and that transfer was that Millor should act as a holding company of the Queensferry shares if a sale to Jones did not happen but a merger between Queensferry and Cee-N-Cee eventuated; (c) nevertheless, regarding the primary objective of the taxpayers at all material times as being to conclude a sale to Jones.

In these circumstances, I see the force of the submission made on behalf of the taxpayers and it cannot properly be said that the interposition of Millor had <u>no</u> commercial purpose apart from the avoidance of a liability to tax. Nevertheless, I would find some difficulty in accepting that the mere existence of what may be described colloquially as a 'long-stop' purpose, such as mentioned in (b) above can prevent the second Ramsay condition from being satisfied in a case where the Ramsay principle would otherwise apply on the facts. Such a conclusion would at present appear to me contrary to the true intent of the Ramsay and Dawson doctrines."[440]

On the Bowater appeal, he agreed with Warner J in finding that the first Lord Brightman condition was not satisfied, and he said that to call the true nature of the transactions a disposal directly to the ultimate purchaser by the taxpayer company "a travesty of the facts".[441]

Finally, he thought that the reasons for finding for the taxpayers in the first two appeals applied a fortiori in Baylis v. Gregory.[442]

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440. pp315-6
441. p319
442. p324

Parker LJ came to the same conclusion but by a slightly different route. He went back to the fundamental form and substance principles, and considered how they had been affected by the Ramsay line of cases, justifying this approach by pointing out that Lord Wilberforce in Ramsay and Lord Diplock in Burmah Oil had emphasized that the decisions giving rise to these old rules had not been overruled. In fact, it has been seen above that this was not entirely true, but Parker LJ can hardly be blamed for taking the Law Lords at their word.

He first examined the relevant provisions of the CGT and DLT legislation[443] to see if they could be so construed so as to give rise to a disposal directly to the ultimate purchaser. Having found, quite correctly, that this could not be done without implying unwarranted provisos[444], he then considered whether this could be achieved by the form and substance rules as construed in the Ramsay cases.

Referring to Lord Diplock in Burmah Oil, he said that Lord Diplock was being more specific than the Law Lords in Ramsay because he appeared to be limiting the new approach to those cases in which there are:

(i) a series of transactions, which
(ii) are preordained, and into which
(iii) there are inserted steps which have no commercial purpose apart from the avoidance of a liability to tax which, in the absence of those particular steps, would have been payable.

He continued:

443. Para 6, Sch 7, FA 1965, and section 20 DLTA 1976
444. p332

"It is important to realise that Lord Diplock is not saying that, given these elements, the tax which the inserted steps are designed to avoid is payable. He is saying only that, given those elements, it is a proper case for the new approach. That approach is one in which one must look for the real loss or gain.

In my view, he could not have been going further than I have indicated, for ultimately the question is one of construction of a taxing act and, previous decisions not being overruled, they as well as the Ramsay principle must be applied. He cannot, therefore, have been saying that, given the elements mentioned, the result follows whatever the language."[445]

Parker LJ then referred to Furniss v. Dawson which, he said, "clearly extended the Ramsay principle".[446] He noted that the Duke of Westminster doctrine was expressly accepted by the Lords Fraser and Scarman but that Lords Roskill, Bridge and Brightman did not see the Duke of Westminster doctrine as untouched by the Ramsay cases.[447]

Taking Lord Brightman's two criteria as expressing the limits of the Ramsay principle, he was of the opinion that in none of the present cases could the ultimate transaction be considered as part of a preordained series.[448]

Parker LJ was, in fact, troubled by some of the consequences of applying the Ramsay doctrine and expressed himself thankful that the House of Lords, rather than he, had to sort the problems out.[449]

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445. p334
446. Ibid
447. See pp335-6
448. p336
449. p337

Mustill LJ, in analysing Furniss v. Dawson and how the Ramsay principle was applied to it, said that the Ramsay principle gave rise to no problems in Furniss because the scheme went through in a short space of time, and no lasting rights were created by the intermediate dealings. Any fiscal consequences which may have flowed from the intermediate steps were so transient that they caused no problems in practice.[450] In fact, Mustill LJ's analysis here is flawed because Lord Brightman and the other Law Lords did not stress the time element in Furniss v. Dawson, and the problems of what happened to the intermediate transactions were not solved by merely saying that they were so transient that any rights and obligations created by them could be ignored.[451]

Mustill LJ then applied the time-span test to the three present cases: there was, he said, discontinuity between the stages by which the end result was reached so that the legal consequences could not so easily be disregarded. His Lordship was of the opinion that the "apparent tension between the two or more sets of legal and fiscal consequences" brought about by this time gap must be considered.[452]

However, as mentioned above, this analysis does not solve the problem: the true Ramsay principle as formulated in Burmah Oil and Furniss v. Dawson did not rely on any supposed conflict arising out of any conception of the time gap between the various transactions. The Law Lords did not, however, have to concentrate on the preordination test in Furniss v Dawson itself because it was not disputed that the various steps were preordained. In fact, all of the transactions were implemented at the same meeting. Their judgements did not deal with the subject of preordination in any depth. The Law Lords in

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450. p340 See also Slade LJ at p309
451. Supra
452. p340

Ramsay, Burmah Oil and Furniss v. Dawson all emphasized the importance of preordination, and barely mentioned any time element.

The examples Mustill LJ gave[453] would be outside the Ramsay principle through the lack of this preordination, a mental element, rather than the purely temporal one of the gap between the transactions. This is not to say that the problems mentioned by Mustill LJ[454] and Slade LJ[455] do not exist; they do, and they have not adequately been dealt with by the House of Lords.

The answers provided by Slade and Mustill LJJ (that there is no substantial time gap in a real preordained transaction) does not provide the answer either; a proper preordained transaction, as that concept has been explained in the Ramsay line of cases, might have a lengthy time gap between the various stages and be no less preordained for that.

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453. At pp340-1
454. p341
455. pp308-9

The decision of the House of Lords[456] is widely seen as a triumph for the taxpayers and a crushing defeat for the Revenue. However, although to a certain extent this is true, there are still many unanswered questions and predicting where the law will develop is still difficult. For a start, Craven v White was decided in the taxpayer's favour by a majority of 3-2, the other two cases being decided unanimously in the taxpayers' favour. What is more, in Craven v White the three members of the majority did not express themselves in identical terms. In fact, there appear to be three main approaches. Of the majority, Lords Oliver and Keith had similar, but not the same, views. The two judges who made up the minority, Lords Templeman and Goff took basically the same line. Lord Jauncey came somewhere between the two extremes. Nevertheless, it appears that Lord Oliver's judgment is the one most likely to have the greatest impact, particularly as both Lord Keith and Lord Jauncey said that they agreed with his reasoning.

Lord Oliver made no secret of the fact that he was a "less than enthusiastic convert" to Furniss v Dawson[457] because he had great difficulty in following the intellectual process by which judges were justified in going further than simply striking out a transaction for tax purposes from that which had actually taken place. He had, he said, originally suspected that the judges had usurped the role of the Legislature, but had eventually rationalised the House of Lords' decision as simply a matter of statutory construction. He said:

> "It seems to me, therefore, that the first and critical point to be borne in mind in considering the true ration of Dawson is that it rests not upon some fancied principle that anything done with a

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456. [1988] STC 476
457. It will be recalled that he was in the Court of Appeal in that case and found for the taxpayers.

mind to minimising tax is to be struck down but upon the premise that the intermediate transfer, whose statutory consequences would otherwise have resulted in payment of tax being postponed, did not, upon the true construction of the Finance Act 1965, constitute a disposal attracting the consequences set out in paragraphs 4 and 6 of Schedule 7 to the Finance Act 1965."[458]

Lord Oliver stressed that the Ramsay case did not decide that a transaction entered into with the motive of minimising the taxpayer's liability is, for that reason, to be struck down.[459] In other words, the principle is not, as is sometimes thought, a fiscal nullity doctrine.

Lord Keith made the same point,[460] as did Lord Jauncey[461] and Lord Goff.[462] Lord Templeman did not go quite so far, restricting himself to saying:

> "Dawson does not require a taxpayer to pay the maximum amount of tax and does not prevent a taxpayer from taking steps to mitigate tax."[463]

In applying the Ramsay principle, as construed above, the Law Lords took basically two approaches to the first of Lord Brightman's two criteria,[464] namely, that there must be a "pre-ordained series of transactions", or a "composite transaction". The two approached were what could be called the "no practical likelihood" test of the majority, and the "significant interruption" test of the minority.

The majority approach can be seen from this passage from the judgment of Lord Oliver:

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458. p497
459. p498
460. p480
461. p522
462. p510
463. p490
464. In Furniss v Dawson, supra

"As the law currently stands, essentials emerging from Dawson appear to me to be four in number: (1) that the series of transactions was, at the time when the intermediate transactions was entered into, pre-ordained in order to produce a given result; (2) that that transaction had no other purpose then tax mitigation; (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and (4) that the pre-ordained events did in fact take place. In these circumstances the court can be justified in linking the beginning with the end so as to make a single composite whole to which the fiscal results of the single composite whole are to be applied. I do not, for my part, think that Dawson goes further than that."[465]

Lord Oliver said that in each of the three cases before him, the first of Lord Brightman's two tests was not satisfied because the relevant transactions were not pre-ordained or composite because it could not be predicated with any certainty at the date of the intermediate transfer:

(i) what the ultimate destination of the property would be;

(ii) what would be the terms of any ultimate transfer; or

(iii) even whether an ultimate transfer would take place at all.[466]

The approach of the minority was to ask whether there was a "significant interruption" between the first and second

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465. p507. See also Lord Keith at p481 and Lord Jauncey at pp522-3
466. pp494-5

steps. Lords Templeman and Goff held that there was such an interruption in the Bowater and the Baylis v Gregory cases, but not in Craven v White.[467]

Given that, for the time being at least, the "*no practical likelihood*" *test is the one to be applied*, what does it entail? The judgments of the majority seem to provide a pointer.

Both Lord Oliver and Lord Jauncey proposed the guideline of a "continuous process". Lord Jauncey put it this way:

> "If it were appropriate to prepare a formula defining 'composite transaction' in the light of the passages in the speeches in Ramsay, Burmah and Dawson to which I have referred I should be tempted to suggest the following:
>
> > 'A step in a linear transaction which has no business purpose apart from the avoidance or deferment of tax liability will be treated as forming part of a pre-ordained series of transactions or of a composite transaction if it was taken at a time when negotiations or arrangements for the carrying through as a continuous process of a subsequent transaction which actually takes place had reached a stage when there was no real likelihood that such subsequent transaction would not take place and if thereafter such negotiations or arrangements were carried through to completion without genuine interruption.'
>
> However, I am conscious that this may well constitute too rigid an approach to the problems and I therefore put it forward as a tentative guide

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467. See pp491-3 per Lord Templeman and p515 per Lord Goff

rather than as a definite exercise."[468]

Lord Oliver said that if a formula is to be devised which will serve as a touchstone for the guidance of the Special Commissioners, he did not think it can or should go beyond Lord Jauncey's formula set out above.[469]

So, Lord Oliver and Jauncey consider it important to consider whether there is a "genuine interruption", whereas Lords Templeman and Goff would look for a "significant interruption". It is not clear where the distinction lies, although it is obvious that the Templeman/Goff interruption must be more substantial than the Oliver/Jauncey one.

There is another area of uncertainty surrounding the Oliver/Jauncey test. Lord Jauncey referred to "arrangements" being carried through. When Lord Oliver talked of "arrangements", he clearly was talking about bilateral arrangements so that, for example, in the case of an ultimate sale to a third party, the Ramsay principle cannot apply unless the third party is lined up and the price agreed.[470] Lord Jauncey, on the other hand was of the opinion that it was not a pre-requisite of the application of the Ramsay principle that all the essential features of the ultimate transaction have been finalised at the time of the intermediate transaction. In other words, there does not have to be a specific buyer or a final price.[471] The two judges appear therefore to be prepared to use the same test from different standpoints. This matter remains unresolved at the moment, although Lord Oliver's analysis is sounder. However, Lord Jauncey's view on this point is closer to the views of Lords Templeman and Goff so it is unclear which view will prevail in the House of Lords in the

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468. p521
469. p509
470. See p505
471. See p520

future. When the Shepherd v Lyntress Ltd case[472] reaches the House of Lords, as it presumably will, this question is likely to arise in clear focus because the ultimate sale there was through the Stock Exchange, so that a bilateral arrangement, as required in Lord Oliver's formulation, was not present, but a unilateral arrangement, might be found, depending on how Lord Jauncey's test is interpreted.

Another uncertain feature is how far future courts will agree that the Ramsay principle is purely a principle of statutory interpretation as some of the Law Lords in Craven v White thought it was.[473] It is submitted that, whether or not the Law Lords in Craven v White have restricted the Ramsay principle to being simply a question of statutory construction, this is <u>not</u> in line with the previous cases. For example, Lord Brightman in Furniss v Dawson was, it seems, working on the assumption that the Ramsay principle is used to find the end result and only then is the statute applied.

But probably the greatest uncertainty about the future of the Ramsay principle comes down simply to the attitude of the judges. The outcome of a future case in the House of Lords will depend to a great extent of which judges are sitting at that particular time. The judgment of Lord Templeman makes it abundantly clear that he was not at all pleased with the decision of the majority and that he has no intention of following it. He stated that:

> "These limitations [on the Ramsay principle by the decisions of the majority] would distort the effect of Dawson, are not based on principle, are not to be derived from the speeches in Dawson, and if followed would only revive a surprised tax avoidance industry

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472. Infra, see also Chapter 8
473. See Lord Oliver at p497 and 505; Lord Jauncey at p518; and to a certain extent, Lord Goff at p511.

and cost the general body of taxpayers hundreds of millions of pounds by enabling artificial tax avoidance schemes to alter the incidence of taxation. In Dawson, Lord Brightman was not alone in delivering a magisterial rebuke to those judges who sought to place limitations on Ramsay because they disliked the principle that an artificial tax avoidance scheme does not alter the incidence of tax. In my opinion, a knife-edged majority has no power[474] to limit this principle which has been responsible for four decisions of this House approved by a large number of our predecessors."[475]

Lord Templeman appears to be overstating the case when he says that the tax avoidance industry will be revived by the majority decision. Certainly the "scheme merchants" who sold the type of prepackaged arrangements seen in Ramsay and Eilbeck v Rawling will not come back onto the scene although those who advised the Dawson family would no doubt now be able to stay on right side of the line by restructuring the relevant arrangements in similar cases in the future.

Lord Templeman then gave this warning:

> "Adapting the words of Lord Diplock in Burmah, it remains disingenuous to suggest, and dangerous on the part of those who advise taxpayers to assume, that Ramsay and Dawson did not mark a significant change in the approach adopted by this House in its judicial role to artificial tax avoidance schemes...."[476]

Clearly, the law is not yet settled or certain and taxpayers and the Revenue will hope that future panels in the House of Lords will be made up of Lords from the Oliver and Templeman factions respectively.

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474. This is an astonishing statement which is, of course, correct.475. p489
476. Ibid

Since the House of Lords handed down their judgments in Craven v White, the lower courts have had a number of occasions to apply the Ramsay case and the Revenue have faired badly in their attempts to apply it.[477]

The first case to note is, in fact, one in which the Revenue did not raise an argument based on the Ramsay principle before the courts, although they did unsuccessfully cite it before the Special Commissioners. As this case involved essentially the same scheme as that used by the taxpayer company in Burmah Oil,[478] this calls for comment. The case in question is Dunstan v Young Austen & Young Ltd.[479] The reason the Ramsay argument failed before the Special Commissioner was that it was held, as a question of fact, that, disregarding tax considerations, the rights issue arrangement was the only real commercial option open to the company in the particular circumstances of that case.[480]

The second of Lord Brightman's two criteria in Furniss v Dawson was therefore clearly not satisfied. Faced with this finding of fact, the Ramsay principle was not raised before either Warner J, in the High Court or the Court of Appeal.

On the other hand, the Ramsay principle was fiercely argued in Shepherd v Lyntree Ltd,[481] which has been dealt with in Chapter 8, where the facts are set out in detail.

The Ramsay principle arose in two ways:

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477. As well as the cases mentioned, there are others, outside the scope of this examination, where the Revenue have had similar problems, such as the capital transfer tax case of Countess Fitzwilliam v IRC [1989] STI 848 and the VAT "pre-payment cases such as Dormers Builders (London) Ltd v CCE [1988] STC 735.
478. Supra
479. [1989] STC 69
480. The Commissioners findings are set out at [1987] STC 709 at pp717-8
481. [1989] STC 617

1. The Revenue argued that the two-stage acquisition of the Lyntress shares by News International should be treated as a single composite transaction so that the first sale of 35% of the Lyntress shares should be ignored as an artificial step inserted only for tax reasons.
2. The main argument was that the sales of shares by News International to Lyntress and Salcombe should be treated as fiscal nullities so that News International should be treated as having made the sales through the Stock Exchange itself.

The first question was dismissed briefly by Vinelott J. He said that the difficulty confronting the Crown was that, however widely the Ramsay principle is stated, if the composite transaction is to be treated as a single transaction which, once the first step has been taken, proceeded inevitably to its preordained end, the conclusion, to the judge's mind was that the sale of Lyntress to News International ought to be treated as having taken place on the date of the sale of the first tranche of shares. Vinelott J said that he could see no justification for taking what he described as the wholly illogical step of ignoring the sale of the first tranche of shares of Lyntress and treating that sale as having taken place at the later date.[482]

This particular aspect of the Revenue's case looks fairly weak because what they are in effect saying is that, even though the transaction as a whole would avoid tax, it can be split up into individual steps so as to give rise to a tax liability. This inverted Ramsay argument clearly did not impress Vinelott J. In any case, if the Revenue are to succeed on this point in the higher courts they will have to get round the fact that the two stage sale seems

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482. pp650-1

to have had a commercial purpose, namely to get round pre-emption rights in the articles of Monotype Holdings.

The main interest centred on the wider, second question. On this important issue, Vinelott J had, of course, to be guided by and to follow the decisions of the House of Lords in Craven v White.

The judge noted[483] that Lord Oliver had ruled that the Ramsay principle was essentially one of construction and he set out the four essential elements identified by Lord Oliver for the operation of the Ramsay principle.[484] Vinelott J then said that, in applying the Ramsay principle, the question in any given case is going to be: "what has the taxpayer actually done and does it amount to a single composite transaction which is different from the constituent parts?"

In applying the "no practical likelihood" test[484] to the facts of the present case, Vinelott J said that:

> "it is clear that the shares of LWT were transferred to Lyntress and Salcombe after a decision had been made by those responsible for the conduct of the affairs of the group to sell them through the Stock Exchange. However, there is no suggestion in the evidence and more importantly no finding by the Special Commissioners that any arrangement had been made to sell the shares at the time when the shares were transferred to Lyntress and Salcombe..... There is similarly no finding that arrangements had been made for the sale of the shares of News Corporation before they were transferred to Lyntress and Salcombe.... and in the case of News Corporation the gap between the transfer to Lyntress and

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483. pp653-4
484. Supra

> Salcombe and the sales on the Stock Exchange.... was even longer...... In my judgment in these circumstances it is impossible to conclude that the transfer of the shares of LWT, News Corporation and Broken Hill to Lyntress and Salcombe..... and the subsequent sales of these shares were in each case part of a single composite transaction within the Ramsay principle. It is simply not enough to say that the shares were transferred to Lyntress and Salcombe with the intention that they should be sold so that the gain could be offset against losses in those companies; and it is equally immaterial that the sales were 'master-minded' by Mr Ekberg who acted in accordance with the wishes expressed by Mr Murdock. In giving instructions for the sale of the shares by brokers through the Stock Exchange, Mr Ekberg acted as a director of Lyntress and Salcombe. There is nothing to suggest that he acted otherwise than in accordance with his duties as a director of those companies."[485]

Vinelott J was not, in the circumstances, bothered by the short time gap between the various stages here. He said that:

> "there is no ground for inferring from the brevity of the period between the transfer of the shares of, for instance, LWT to Lyntress and Salcombe and the sale of those shares on the Australian Stock Exchange alone that arrangements had been made for the sale before the transfers, nor indeed that those shares would have been sold if the price had collapsed on the day following the transfer."[486]

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485. pp658-9
486. pp659-60

Vinelott J concluded that the Commissioners cannot characterise a series of transactions as a single composite transaction unless they have found facts sufficient to support that inference. It is not enough to say they were transferred with a view to a sale and in order that the gains should be realised by Lyntress and Salcombe. That would, he said, be to make the fiscal motive alone a sufficient ground for imposing tax.[487] The influence of Lord Oliver's judgment in Craven v White is obvious here and, indeed, understandable because, for the time being, it represents probably the most coherent analysis of the present state of the Ramsay principle which lower courts can apply.

Vinelott J did not stop with his conclusion set out above. He said that his decision could be supported on a broader ground. Referring to the ruling that the Ramsay principle is one of construction, he said that the question in all of the previous Ramsay cases was whether, if true effect was given to a composite transaction, it fell within the underlying purpose of the relevant statutory provision. To ascertain the purpose of a statutory provision, that provision must be construed in the light of the relevant legislation taken as a whole.[488]

Reviewing the cases, particularly the observations of Lord Templeman in Reed v Nova Securities,[489] Vinelott J said:

> "It is a necessary but not a sufficient condition for the application of the [Ramsay] principle that there should be a finding that the intermediate step which it is sought to disregard as having no fiscal consequence was inserted for no purpose except that of saving tax. The intermediate step is disregarded

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487. p660
488. Ibid
489. [1985] STC 124, see Chapter 8

> because if a composite transaction is treated as a single transaction it is evident that it falls outside the purpose of the exemption or the relief or allowance which the taxpayer seeks to avail himself of....[T]he provisions in section 272 to 279 [ICTA 1970] permit assets to be shuffled round within a group and the transfer of an asset which has an unrealised gain to a company which has a loss which cannot be surrendered within the group but which can be set off against gains on assets transferred to it within the group cannot be said to conflict with the inferred statutory purpose even though the asset with an unrealised gain was transferred to the company with a realised loss as a step in the realisation of the gain. There is not in any relevant sense a step inserted for the purpose of tax avoidance."[490]

It seems difficult to argue with this: if the legislation allows the sale of a subsidiary with accumulated losses to a new group, taxpayers are entitled to use that legislation until it is changed.

In any case, the Crown have appealed against the decision of Vinelott J, and the higher courts will no doubt have a great deal to say on the various aspects of the Ramsay principle aired in this case. When the case reaches the House of Lords, which presumably it will, the Law Lords will have the opportunity to give further guidance on the present state of play in the application of the Ramsay principle. What that guidance is will almost certainly depend on which judges hear the case in the House of Lords.

The final case to consider is much more straightforward. It is Ensign Tankers (Leasing) Ltd v Stokes,[491] a case

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490. pp662-3
491. [1989] STC 705

dealt with in Chapter 5. It will be recalled that this case concerned a company which entered into two partnerships for the exploitation of films in order to obtain capital allowances.

This case was heard by Millett J and there are few (if any) people more qualified to consider the application of the Ramsay principle to a particular set of circumstance in the light of the fact that, as Leading Counsel he was responsible for presenting the Crown's case, successfully, in Floor v Davis, Ramsay, Eilbeck v Rawling and Furniss v Dawson.

In deciding on the application of the Ramsay principle to the facts of this case, Millett J was faced with two finding of fact by the Special Commissioners:

1. The transactions in question were a preordained series or a single composite transaction.
2. The creation of the two limited partnerships served no commercial or business purpose.

The first of these findings the judge found "unexceptionable"; but the second was, in his view "simply untenable".[492] He said:

> "It was commercially essential for there to be some structure to regulate the relationship of the parties, preferably one with limited liability. The chosen structure was that of a limited partnership, which not only served a commercial purpose but became the taxable entity (for the Crown seeks to tax the film receipts, whether or not they are trading receipts, while denying the deduction of the expenditure which made the receipts possible)."[493]

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492. p770
493. Ibid

The judge said that he was unable to comprehend how the creation of the two limited partnerships could be treated as a step in some other and larger transaction. The other transaction could only be the production and distribution of the films. But said the judge, the creation of the partnerships was not part of any larger transaction, but a preliminary step which was necessary to enable the partnerships to engage in further transactions of their own.[494]

The Crown also submitted that, not merely the creation of the partnerships, but all the arrangements entered into by them should be disregarded as mere paper transactions which had no impact on the making or distribution of the films. They had, it was argued, no commercial purpose apart from the avoidance of a liability to tax. Millett J said that this submission could not succeed as an independent point because it was logically impossible, at one and the same time, to find that the partnerships were trading and that the transactions into which they entered had no commercial purpose.[495] He said:

> "It is impossible (supposing it were permissible) to disregard the part played by Victory Partnership (for example) and to give effect to the remaining arrangements to make the film, without leaving a $3.25 million hole in the financing arrangements.... Victory Partnership's contribution of $3.25 million was real enough and cannot simply be ignored. But what was it paid for? It represented only part of the cost of acquiring the uncompleted film, together with the services of LPI to complete it, and the rights of the exploitation of the completed film. The full cost was $13 million. It is logically impossible to give effect to the payment of $3.25 million and disregard the payment of the balance or the acquisition of the rights obtained in return.

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495. Ibid

> Each step leads to another; no part can be ignored unless the whole is ignored. Yet, the whole cannot be ignored without leaving the financing arrangements incomplete or reverting to those which, for its own commercial advantage, LPI abandoned in favour of the arrangements with Victory Partnership."[496]

The partnership, unlike Greenjacket in Furniss v Dawson, was not merely a conduit-pipe; it was the taxable entity. Millett J therefore overturned the decision of the Commissioners.

Given the present state of the Ramsay principle, this decision is clearly right. Unfortunately, not many cases in which the Ramsay principle is argued are so clear-cut. It is to be hoped that a settled, logical and comprehensive set of guidelines are formulated soon by the House of Lords. The Furniss v Dawson and Craven v White decisions go some of the way towards achieving this, but the diversity in the five judgments in Craven v White itself, plus the ominous warnings by Lord Templeman, show that there are still large areas of uncertainty surrounding the doctrine.

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496. Ibid

CHAPTER 12

PIERCING THE CORPORATE VEIL

Introduction

This Chapter examines how far it is permissable to ignore or look through a legal entity, namely a validly established company, specifically where tax avoidance is involved. Ordinary company law considerations are not considered in detail, although they will be touched on where necessary, because that aspect of the subject is outside the scope of the present study.

The general rule is that it is not normally possible to ignore the existence of a corporate entity but, in certain circumstances, this general rule as been eroded. Company law, embodied in statutes such as the Companies Act 1985, and in case law, has evolved specific circumstances in which one can look through a company to its members or officers, but tax law has developed its own rules in this respect, and a company may be recognised under company law and ignored under tax law.

There have, of course, been many cases relating to non-tax matters such as Wallersteiner v Moir[1] and Gilford Motor Co. v Horne[2], but generally the conduct of the shareholder in those cases has been more reprehensible than one would normally encounter in a tax case.

The allied question of agency will also be considered. The courts have been more prepared to look through the existence of a company if it can be justified by the normal rules of agency. Even here, it is not clear how far the courts are prepared to go in implying

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1. [1974] 1 WLR 991
2. [1933] Ch 935

an agency, but the overall impression from the various cases is that the facts supporting the existence of an agency must be very clear and unambiguous before the courts will look behind a company. In a non-tax context, there have been isolated instances when a company has been held to be a trustee for the shareholders: see the Abbey Malvern Wells[3] and Re French Protestant Hospital[4] These cases are not relevant to tax avoidance except to the extent that it is interesting to note that no such principle has ever been established in a tax case.

The existence of a company can be ignored either because case law has set the appropriate precedent or because statute specifically allows the courts to do so. Each category will be examined in turn.

3. [1951] Ch 728
4. [1951] Ch 567

Case Law - Introduction

It will be seen that the Ramsay principle[5] changed the picture dramatically, in that the disregard of the interposed steps often involves ignoring the existence of the company, if its existence, or the way it is being used, is due to the intention to avoid tax and not bona fide commercial reasons. However, apart from the Ramsay principle, there has not been consistency of judicial attitudes, although the courts have, on the whole, been unenthusiastic about disregarding corporate entities, particularly when faced with general"substance" arguments from the Revenue. This should be compared with the position in, for example, the U.S.A. where the courts often ignore the separate legal existence of a company in such fields as personal service corporations.[6]

There has been greater consistency in those cases dealing with legislation enabling courts to look through companies but, apart from these cases, there is no noticeable judicial trend to make it easier to pierce the corporate veil to prevent tax avoidance and, indeed, as the Revenue have become bolder in their submissions, some of the dicta have been striking in their defence of the existence of the corporate entity.

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5. See Chapter 11
6. See Chapter 10

The Early Cases

The first batch of cases were all of a similar nature. Typical was St. Louis Breweries v Apthorpe[7]. This was an example of the wide substance doctrine in operation[8]. By virtue of the application of this wide approach, the court held that an English company was doing business in the UK, despite the existence of a separate US company because the US Board acted in accordance with the decisions of the UK Board. The existence of the US company was not ignored, but its Board was treated as acting at the behest of the UK Board or, according to one judge, as managers/agents.

The facts were that an English company was formed for the purpose of acquiring virtually the whole of the shares of an American company which had purchased breweries in the U.S.A. Under the by-laws of the American company, the directors had the general management and control of it. The books and accounts were kept in America and each year the accounts were audited there by an accountant sent over by the English company. At the end of each year, a balance sheet and profit and loss account of the American company were forwarded to the English company whose directors then agreed on the rate of dividend to be declared. They communicated their decision to the American company, which declared a dividend at the rate mentioned. The directors of the English company then declared a dividend upon its own shares. The amount necessary to pay the dividend due to the English shareholders of the English company was remitted to the UK.

It was held that the business of the American company was carried on by the English company, which was therefore assessable under Schedule D Case I upon the whole of the

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7. (1898) 4 TC 111
8. See Chapter 11

profits made, and not under Cases IV & V only on the amount remitted to the UK.

Wills J was clear in his view:

> "I myself entertain no doubt that the English company is carrying on effectively a business, and that the nature of that business was, through possession of a preponderating influence in the American company, to manage its affairs."[9]

He did not, however, feel himself obliged to decide on the question of whether the English company could have been said to be carrying on the business of the US company (as had been argued by the Attorney General) although he did seem inclined to that view.[10] So, he was not ignoring the existence of the US company, but treating its Board as the puppets of the English Board. In so doing, the full independence of the US company was not respected, but its actual existence was recognised.

Bruce J, too, in concluding that the US company was the agent of the UK company, did not ignore its existence but, again, the substantive effect was that the English company was taxable on the whole of the profits of the US company.[11]

The St Louis Brewery case and the others here mentioned in footnote 11 all concerned the basic issue of the effect of forming a separate legal entity overseas, and whether this was sufficient to ensure that the management and control of the business purported to be carried on in

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9. p121
10. See pp120-1
11. A similar result was reached on similar facts in the Frank Jones Brewing Co Limited v Apthorpe (1898) 4 TC 6, United States Brewing Co Limited v Apthorpe (1898) 4 TC 17; Apthorpe v Peter Schoenhofen Brewing Co Limited (1899) 4 TC 41; Bartholomay Brewing Co v Wyatt (1893) 3 TC 213; and Nobel Dynamite Trust Co v Wyatt (1893) 3 TC 224.

the country of incorporation of that entity was in fact carried on there. See also the case of Kodak Ltd v Clark[12]. In this case, a UK company owned 98% of the shares in an overseas company. Accordingly, it had a preponderating influence in such things as the control and election of directors, but there was no evidence that the UK company ever attempted to control or interfere with the management of the foreign company. Any control the UK company had was held by virtue of its position as a shareholder; not as principal, and so it was held that the overseas company was not the agent of the UK company and the UK company did not carry on the overseas company's business. Case 1 was not, therefore, the appropriate basis of liability.[13]

In the light of modern dicta, such as that of Walton J in Burman v Hedges and Butler Ltd,[14] it is unclear how far the authority of these cases has stood the test of time, especially insofar as they were relying on the existence of an agency between parent and subsidiary.

In any case, the need for the Revenue to use such arguments has diminished considerably. The UK now has a relatively low rate of corporation tax compared with most major industrial companies, and, as far as tax haven subsidiaries are concerned, the "Controlled Foreign Companies" legislation,[15] introduced in 1984, effectively pierces the corporate veil by allowing the appropriate proportion of the profits in the foreign company to be taxed directly in the hands of the UK parent.

Even in the early days, the cited mentioned above did not signal a trend that companies could be ignored willy

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12. (1903) 4 TC 549
13. The same result was achived in relation to a 100% linkage in Gramophone & Typewriter Ltd v Stanley (1908) 5 TC 758
14. Infra
15. See Chapter 9

nilly if their existence was merely part of a larger design.

The taxpayer tried to press for the existence of an overseas subsidiary to be ingored as mere machinery in IRC v The Gas Lighting Improvement Co Limited[16], but he did not get very far. The Court of Appeal and the House of Lords refused to look through the overseas subsidiary, saying that it was not a mere agent of the UK company, unlike the position in the St. Louis Breweries case.

The facts were that the taxpayer company was a petrol company and its held certain shares in a Belgian company, which was formed for the purpose of selling petrol, and certain shares, in two Romanian oil producing companies. The shares in the Belgian company were acquired as part of an arrangement under which the taxpayer company transferred its existing business in Belgium to another company for which the Belgian company was to act as distributor. The shares in the Romanian companies were acquired for the purpose of securing a supply of crude oil.

It was held that the shares in the Belgian and Romanian companies were "investments" of the taxpayer company, and that they must be deducted in computing the capital of the taxpayer company for the purposes of Excess Profits Duty.

The taxpayer was in effect, advancing the argument advanced by the Crown in the St. Louis Breweries case, and which found favour with the High Court in that case. However, on the facts of this case, this was rejected by the Court of Appeal and House of Lords. It is true that there was not the same unthinking obedience to the decisions of the UK company as in the previous case and this may have influenced the judges in this case.

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16. (1923) 7 TC 551

The judges in the House of Lords, in particular were forthright in their rejection of the same agency argument. Viscount Cave LC, for example, said:

> "As to the Belgian shares, it was said that the transaction was not an investment at all, but was mere machinery for defining the interests of the Appellant Company and the two Belgian firms in the profits of the distributing business proposed to be carried on by [the Belgian company]; that the last-mentioned company was nothing but a shell or shadow; and that in substance and in fact that Appellant Company continued after the transaction to carry on its distribution business in Belgium, and to receive the profits of that business. I cannot take that view. The documents show that there was a real sale to the Asiatic Company of the Appellant Company's distributing business in Belgium, and that the Appellant Company wholly discontinued that business and agreed no longer to be interested in the distribution of petroleum in that country, except of course as a holder of shares in the Belgian Company. It has been pointed out in many cases, of which Gramophone and Typewriter Co Limited v Stanley [1908] 2 KB 89 is an example, that the business and profits of a limited company are not the business or profits of the shareholders; and it would be an infringement of that principle to treat the Appellant Company as continuing to carry on its Belgian business through the agency of the Belgian company."[17]

Lord Sumner took a similar line. In particular, he pointed out:

> "It is said that all this was 'machinery', but that is true of all participations in limited liability companies. They and their operations are simply machinery, in an economic sense, by which natural persons, who desire to limit their liability,

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17. p 536

participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership; but, legally speaking, this machinery is not impersonal although it is inanimate. Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person real though artificial, the company itself; and the business carried on is the business of that company, and the capital employed is its capital, and not in either case the business or the capital of the shareholders. Assuming of course that the company is duly formed and is not a sham (of which there is no suggestion here) the idea that it is mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspect of the facts."[18]

So far, there can be discerned no difference in approach; the opposite result reached in the two cases so far considered was due to the widely different facts.

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18. pp542-3

"One Man" Companies and Similar Entities

The next batch of cases concern a vehicle which crops up again and again: the one man company.[19] This vehicle as been used in many ways and has not been treated consistently by the courts. It can be seen in Chapter 10 that the U.S.A. has a much more robust approach to such vehicles than is apparent in the UK.

The first case in point here is IRC v Sansom.[20] This case was concerned with the question of whether a business was carried on by a company or its sole shareholder and, if it was, whether "loans" made by the company to the sole shareholder constituted part of the shareholder's income for Super-Tax purposes.

The Special Commissioners found that the company was properly constituted and that it made real loans to the shareholder. The Crown had argued that the company was a sham, and that the business was in reality carried on by the taxpayer, or that the company was the agent of the taxpayer.

Lord Sterndale MR admitted that "anybody would approach the matter with a very considerable amount of suspicion".[21] This comment is understandable when it is considered that the "loans" were interest free and unsecured, and that no dividends were ever paid by the company. Nevertheless, the Master of the Rolls accepted the Special Commissioners' finding as to the genuineness of the loans.

Again, this case turned on a question of fact although, it must be admitted the facts did look rather contrived.

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19. Personal services companies are considered in detail in Chapter 1
20. (1921) 8 TC 20
21. p28

The Court of Appeal did not, however, consider that this gave them license to pierce the corporate veil or to go behind the form of the loan even though all members of the Court of Appeal appeared to have certain reservations about the loans.

As in the Sansom case, the findings of the Special Commissioners were also very important in IRC v Morgan-Grenville-Gavin[22], to the extent that Lawrence J's own view would have been that the business of the companies in question was the business of the taxpayer, had it not been for findings by the Special Commissioners to the contrary. This was another case in which the question of agency arose for consideration. The facts of this case have already been given in Chapter 11. It will be recalled that there was a circular series of transactions involving two companies, implemented with the object of engineering a tax deduction. It was held that the taxpayer had succeeded in manufacturing a tax deduction, even though it was admitted that the transactions were entered into with a view to reducing surtax.

The Revenue had attacked the arrangement under a number of heads although, perhaps surprisingly, they did not claim that the business of the two specially-created companies was the business of the taxpayer, even though they were as subservient to the wishes of the taxpayer as the US company was in the St. Louis Breweries case.

Instead, the Crown argued, inter alia, that the transactions were a sham, and also that the Court ought to look at the substance of the arrangements.

Lawrence J appeared to have a great deal of sympathy with the Crown's case. He said that:

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22. (1936) 20 TC 529

"The inclination of my own view would have been to hold that, in the circumstances of this case, when the entire assets are derived from an alleged taxpayer and returned to that taxpayer, and when the only business of the companies which are incorporated by the taxpayer and in which the taxpayer holds all the shares by himself or his nominees is to receive from the taxpayer and to repay that money to the taxpayer, the business of those companies is the busines of the taxpayer, that the companies must be regarded merely as agents for the taxpayer, and that, therefore, such an annuity as is in question in this case, being paid by the taxpayer to his own agent, is not a deduction for the purposes of surtax."[23]

In the circumstances, and on the authority of the St. Louis Brewery case, such a finding against the taxpayer would not have been surprising. However, the judge continued:

"But in view of the contentions put forward by the Crown and the findings of the Commissioners, I do not think that that view is open to me or that it would be proper for me to hold that that was the proper judgement in this case."[24]

The Crown's contentions on the sham and substance principles were negatived by the Commissioners, and the judge could not fault them on that score. The one area the judge felt would have won the Crown their victory was not raised by them.

So again, the decision comes down to a question of fact and, in particular, the findings of fact by the Commissioners, although there was a marked reluctance on

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23. p535
24. Ibid

the part of Lawrence J to overrule the Commissioners. It appears that many later judges, for example, Lord Templeman,[25] would have found that no reasonable Commissioners could have reached the decision they did. The key, though, seems to be that the Crown did not frame their arguments in the right way.

Another factor that appears to have had a bearing on the judge's approach is that he seems to have taken a strict view of agency, certainly stricter than the line taken by the High Court in the St. Louis Breweries case. For example, Lawrence J pointed out that:

> "Mr. Latter [leading Counsel for the taxpayer] drew my attention to the Gramophone case, 5 TC 358, where, I think it was pointed out that 'agency' in that sense means a very real agency, an agency in such circumstances that any person who had entered into a contract with the alleged agent could sue the alleged taxpayer as the undisclosed principal for that agent. As I have said, no such contention was put forward before the Commissioners, and, in view of the fact that no such contention was put forward for them, I do not think it is proper for me to make any finding upon that or to decide this case upon the basis of agency."[26]

The question of agency in the context of a one man company arose a few years later in the case of <u>OK Trust v Rees</u>.[27] In this case the Crown, instead of trying to look through the company, was relying on the separate existence of the company to levy tax, successfully as it turned out.

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25. See Chapter 11
26. pp536-7
27. (1940) 23 TC 217

The facts were that a Mr. Kohn, a stockbroker, wished to acquire the business and assets of a company with a view to the promotion of a new public company. He therefore entered into an agreement with the old company to buy its business and assets for £45,000 in cash and 16,333 ordinary £1 shares in the new company. Subsequently, it was though desirable that Mr. Kohn, as a stockbroker, should not himself undertake the promotion of the new company, and the taxpayer company was therefore formed for that purpose, Mr. Kohn being the beneficial owner of the whole of the share capital. The directors of the old company agreed to the substitution of the taxpayer company for Mr. Kohn in the performance of the agreement on condition that Mr. Kohn personally guaranteed the fulfillment of all the taxpayer company's undertakings and obligations. By an agreement between the new company and the taxpayer company, the taxpayer company undertook to pay the £45,000 required for the purchase of the old company shares in consideration of the allotment to it of 333,326 ordinary 2 shilling shares in the new company. The £45,000 was, in fact, paid by Mr. Kohn.

Assessments were raised to income tax on the profits arising from the purchase and sale of the shares. The taxpayer company contended that it was not liable to be assessed on the profits of the promotion since it acted merely as the agent of Mr. Kohn. The Crown contended that the company was a duly constituted separate legal entity carrying on its own business, and that the transactions in relation to the acquisition and disposal of the shares were precisely the transactions which it was formed to carry out, and that they were trading transactions undertaken by it for the purpose of, and in the course of, its own business. As a result, the profit arose from the company's trade, and it was immaterial that Mr. Kohn was beneficially entitled to all of its shares.

Macnaghten J acknowledged that the company was effectively the alter ego of Mr. Kohn, that he was the only person beneficially entitled in the company, that he provided all the finance, and recorded the transactions in his own books. However, he was firmly of the opinion that there was no evidence that the company was Mr. Kohn's agent.

It is true that Mr. Kohn's motive was not tax avoidance, in that he interposed the taxpayer company because he did not want to appear as the promoter of the new company. There is, however, nothing in the judgement to suggest that this coloured the judge's view of the arrangement.

It can be seen that the separate legal existence of the one man company in the case was fully respected, as it happens, to the benfit of the Crown.

A particular manifestation of the one man company concept arose in respect of personal service companies, against which section 775 ICTA 1988 is aimed. This section and the cases relating to it are dealt with in Chapter 1. It will be recalled that, in the four main cases, namely, Crossland v Hawkins[28] John Mills Production Limited v Mathias[29], Mills v IRC[30], and Black Nominees Limited v Nicol[31], the taxpayers all failed, but this was not because of any piercing of the corporate veil.

The subject of companies being under the control of one man recurred in a more modern and, in keeping with the times, a much more complex context in the involved tax avoidance scheme in Ransom v Higgs.[32] This stock stripping scheme has already been analysed in detail in Chapter 1.

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28. (1961) 39 TC 493
29. (1967) 44 TC 441
30. (1974) 49 TC 367
31. (1975) 50 TC 229
32. (1974) 50 TC 1

Mr. Higgs, it will be recalled, put the scheme into operation and effectively controlled it and the companies involved. The Crown's argument to defeat the scheme amounted to an attempt to charge Mr. Higgs to tax in respect of acts of the companies , in other words, to impute their trading activities to him. Indeed, Roskill LJ in the Court of Appeal acknowledged that:

> "The acts of the companies which were an essential prerequisite to the achievement of the scheme were not in any real sense acts of the companies carried out in those companies' own interests. They were acts forced upon or enjoined upon the companies by Mr. Higgs and those acting with him against the companies' own interests but in the interests of those who controlled the companies. The dominating actor was Mr. Higgs. He was exploiting the companies and his necessary fellow actors are found to have been acting at all times at his behest."[33]

Nevertheless Roskill LJ did not think that this justified the lifting of the corporate veil. He said:

> "I would only add that, while I fully accept Mr. Walton's [Counsel for the taxpayer] argument that it is not legitimate to disregard the separate legal entities involved, Mr. Higgs on the one hand and the Higgs companies on the other - see Commissioner of Inland Revenue v Europa Oil (NZ) Limited [1971] AC 760, per Lord Wilberforce at p771 - in my judgement, the reason why Mr. Higgs is to be held to have been trading or engaged in an adventure in the nature of trade is because of what he personally did and procured and not because of what the Higgs companies did or were procured to do by him and those acting with him."[34]

The reference to Mr. Higgs' counsel, Raymond Walton QC, is interesting because, when he was on the Bench, Walton

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33. p47
34. p50

J persistently refused to pierce the corporate veil, in keeping with his arguments for the taxpayer in this case.[35] Similarly, in the House of Lords, the separate identity of the various companies was fully respected, see, in particular, Lord Wilberforce who put the position quite succinctly:

> "Unless under specific statutory provisions, English law has never made individuals, on the basis of control or shareholding fiscally responsible for companies' activities."[36]

He continued:

> "The Crown's case was in the end quite candidly rested on Mr. Higgs' 'procurement' of the actions of the trading actors - procurement by persuasion, by bargaining..., by the natural influence he held over his wife and his fellow directors, and, so far as relevant, shareholders. This approach has at least the merit of some concordance with the facts, though one would doubt whether Mr. Higgs played so Napoleonic a role; but once it is so stated it reveals its nakedness in law. How can a man who procures others to do acts which amount to trading by them with their own assets be said to trade within any conception, however wide, one may have of trading? None of the characteristics of trading are present - the implications of so wide and vague an extension are alarming.... Since 'procurement' has no statutory warrant, or, this case apart, basis in authority, this would open a new and completely uncharted field, placing the taxpayer at the mercy of findings of fact which he could not challenge. In particular this doctrine would lead inevitably to claims being made, over a wide range, resulting in individuals being assessed in respect of the profits of companies. Secondly, the result would in many cases be that the same profits in respect of the

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35. See, for example, the Vestey, Pratt and Hedges & Butler cases, infra
36. p90; see also Lord Morris at p85

same activity would be taxed twice, once in the hands of the actual trader, again in the hands of the procurer. Admittedly, in the present case it is said that the trustees' 'profits' were, apart from the present claims, tax-free; certainly it was the object of the scheme that they should be so. I express no opinion about that: but what is clear is that, on the Crown's argument, tax would be leviable on those profits as profits of Mr. Higgs' trade even if any of the participators in the scheme were themselves assessable as traders. So wide an extension of the concept of trading, to a set of facts which contains none of the normal ingredients of trade, is one that I find unacceptable."[37]

An even more modern and striking example of how the indepedence of a one man company cannot be brushed aside is given by the case of Stephens v T. Pittas Limited.[38]

The facts were that Mr. Pittas held 99 out the 100 shares in a company which he managed. He appropriated sums of money for his own use which should have been shown as receipts of the company on its Tax Returns. Further assessments to income tax were issued on the company for its relevant accounting periods on the footing that the sums appropriated by Mr. Pittas were loans or advances by the company to him. These assessments were raised under what is now section 419 ICTA 1988.

Despite the very close association between Mr. Pittas and the company, and the wrongful conduct of Mr. Pittas, the Special Commissioners refused to pierce the corporate veil. In paragraph 12 of their Case Stated, they concluded:

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37. Ibid
38. [1985] STC 576

"It is clear that there was confusion in the mind of Mr. Pittas about the nature of his relationship with the company and about its status as a separate legal entity. Mr. Pittas regarded the company as his alter ego. Legally, however, the two are distinct legal persons and must be treated as such. We find that in appropriating the monies which he diverted to his own use, Mr. Pittas acted for himself, and not as an agent of the company, which, although a separate legal entity, was not represented in the transaction by anyone."[39]

In the High Court, Goulding J, in keeping with his traditional attitudes in other matters, took the same line. For example, he said:

"It is of course tempting to identify an individual with a company where you have a case that is so nearly a one man company as this, but one cannot answer questions under this legislation by any identification of that kind, for as I have said the very basis of the scheme of taxation is the distinction between the company and those interested in it. If Mr. Pittas and the company could be regarded as one person, the same sums could hardly be brought into account both for corporation tax and for income tax. Nor can the outstanding share, of which Mr. Pittas was not shown to be the beneficial owner, be ignored. There is no evidence that its beneficial owner (whether Mr. Pittas' wife, in whose name the share was registered, or some third party) consented to the taking of the money."[40]

Furthermore, he added:

"In my view an outright misappropriation of a company's money cannot be treated as the act of the company except possibly if all the corporators of a solvent company consent to it. I do not think that

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39. p584
40. p587

the company's submission to assessments under section 36 of the Taxes Management Act 1970 can be treated as an admission to the contrary. At one time I felt that perhaps Mr. Pittas should be treated as intending to defraud the Revenue for the benefit of the company, and in that sense to have been acting for the company in what he did. However, if he was not intending to account to the company for the money that he took, the fraud on the Revenue was merely ancillary to his fraud on the company and its minority shareholder or creditors. Once you treat Mr. Pittas and the company as separate persons, as you must under this legislation, in my view the company cannot be said, in the circumstances found by the Commissioners, to have made an advance or loan to Mr. Pittas."[41]

So, even in a blatant case like this, the integrity of the corporate entity was respected.

This approach to cases of companies under the control of one man cannot, however, be taken too far: it does not apply in all circumstances.

Consider, for example, the "remittance" scheme case of Harmel v Wright[42] examined in Chapter 9. Counsel for the taxpayer in that case had argued that the court could not find for the Revenue unless the corporate veil was lifted and one looked behind Artemis (one of the companies used in this scheme). Templeman J, however, dismissed this argument saying that it did not depend on the corporate veil. As mentioned in Chapter 9, Templeman J followed the emoluments through the conduit and found that there was a remittance.[43] In fact, Templeman J's approach did not entail lifting the corporate veil as such.

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41. p588
42. (1973) 49 TC 149
43. See p157

Cases on Statutory Provisions

The reluctance of Lawrence J in the Morgan - Grenville - Gavin case to pierce the corporate veil has already been noted. However, in two cases involving settlement provisions, he came to a different decision.

In Copeman v Coleman[44], the corporate veil was, in one sense, lifted in connection with an anti-avoidance provision, namely, section 21 Finance Act 1936 which was a predecessor of section 663 ICTA 1988, dealing with settlements on infant unmarried children.[45] This case concerned transactions involved in shares in a family company. Preference shares of £200 were issued to the taxpayer's children in return for £10 cash (i.e. £190 was uncalled on each share). A dividend of £40 was declared and a call of £40 was made. The taxpayer claimed, on behalf of the children, repayment of income tax on the dividends. The Crown claimed that, having regard to the control the taxpayer had over the company, the resolution declaring the dividend and making the call, and the allotment of the preference shares, constituted an arrangement of assets which was a settlement within section 21. Lawrence J held that there was a settlement and the income belonged to the taxpayer, not his children.

Although this was not a genuine example of the lifting of the corporate veil, the taxpayer was held to be a settlor in relation to the arrangements here, due to the control he had over the family company, so that he could, for example, procure the payment of dividends. The taxpayer used the legal framework of the company to make the settlement to provide his children with income and, by so

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44. (1939) 22 TC 594
45. See Chapter 2

using the company, he indirectly provided funds for the settlement. The Crown, by looking through this device, which was not a bona fide attempt to raise capital, effectively looked through the existence of the company.

A similar result was reached by Lawrence J and the Court of Appeal in another case involving settlement provisions, IRC v Payne, IRC v Gunner.[46] The provision in question here was section 38, Finance Act 1938 dealing with revocable settlements. The facts of this case have already been given in Chapter 2.

The Crown argued that the taxpayer could revoke the settlement because he controlled the company which was part of the settlement. Lawrence J in the Court of Appeal agreed. For example, Sir Wilfred Greene MR noted tha the taxpayer "deliberately placed himself into a certain relationship to the company as part of one definite scheme".[47]

At first instance, Lawrence J said:

> "In my opinion, the words "revoke or otherwise determine" [in section 38] on their proper interpretation do cover the power Mr. Payne had under this settlement. He controlled [the company] and had, therefore, power under this covenant at anytime to put an end to it; that is to say, in my opinion to determine it within the meaning of section 38."[48]

A similar and more recent case of settlement provisions was the decision of Goff J in IRC v Wachtel.[49] The facts were that the taxpayer made a settlement of £1,000 on his children. On the next day, the trustees contracted to buy the whole of the issued shares of an investment

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46. (1940) 23 TC 610
47. p626
48. p620. See also Sir Wilfrid Greene MR at pp624-5
49. (1970) 46 TC 543

company for £7,691. An arrangement was made with a bank to advance to the trustees a sum sufficient to pay for the shares, on the basis that the taxpayer would guarantee the trustees' overdraft and would place on deposit with the bank an amount equal to the overdraft. It was agreed that interest on the trustees' overdraft would be limited to 1% and that no interest would be paid on the amount deposited with the bank in support of the trustees' overdraft. The guarantee in favour of the bank was signed by the taxpayer before the date of the settlement. The bank stipulated that the income of the trust should be applied to reduce the trust's indebtedness to the bank and that the taxpayer's deposit could be reduced accordingly.

The taxpayer was assessed to surtax on the footing that the trust income applied in reducing the overdraft was income applied for the taxpayer's benefit as settlor within sections 405 and 411 ITA 1952[50], or alternatively, that the sums withdrawn from deposit by the taxpayer were capital sums paid directly or indirectly to the taxpayer within section 408 ITA 1952.[51]

It was held that the taxpayer was a settlor of the whole fund and not merely of the £1,000 originally settled, because the fund could not have been provided without his assistance, and the trustees were only able to borrow the necessary funds, virtually free of interest, as a result of the taxpayer's depositing his money and foregoing the interest thereon. It was further held that the payments of trust income by the trustees to the bank released the taxpayer's deposit pro tanto and that, accordingly, the income of the trust was indirectly applied for the setllor's benefit within section 405.

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50. Now section 673 and 681 ICTA 1988, see Chapter 2.
51. Now section 677 ICTA 1988 see Chapter 2

The judge was clear that, in the circumstances, and in the context of the legislation in point, the corporate veil could and should be pierced, in the same way as Macnaghten J and Lawrence J had done in the Copeman v Coleman,[52] Payne[52] and Lee[53] cases. He said:

> "There remains the subsidiary question whether the position was altered when the company took over the settlor's position vis-a-vis the bank and deposited its own money, but in my judgement it was not. Mr. Lomas [Counsel for the taxpayer] argued at first that one could not pierce the corporate veil, but he was driven to concede, and in my judgement rightly, that a discretion in the settlement to pay income to a company in which the settlor and his wife owned all the shares would be within the section, so the veil can be pierced. Then, if I am right that the release of the settlor's frozen funds was a payment indirectly for his benefit, it follows that the release of the frozen funds of a company in which and his wife were the sole shareholders would be no less so."[54]

The courts had been ready to look through companies in similar circumstances in connection with similar legislation. An example under the close company apportionment legislation (then section 21 Finance Act 1922 as amended[55]) is <u>IRC v Tring Investments Limited</u>.[56]

Here, by virtue of the control the taxpayer had over the company as a permanent director, and as holder of options to acquire shares, he was held to have an "interest" in the company under section 21 and he was in a position to procure virtually all of the value of the company came to him.

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52. Supra
53. Infra
54. p559
55. See Chapter 1
56. (1939) 22 TC 679

The taxpayer company, an investment company, appointed the Marquis of Queensbury as permanent director with wide powers and granted him an option to purchase, at par, any number of its ordinary shares. Initially, the company had only issued two preference shares and ten deferred shares (none of which were held by the Marquis of Queensbury), but he was subsequently allotted ten ordinary shares. The company went into voluntary liquidation soon afterwards.

A direction was made under section 21 in respect of the income of the company and it was apportioned to the Marquis of Queensbury. However, on an appeal against this apportionment, the Special Commissioners decided that the Marquis of Queensbury had no right to the assets of the company unless and until he had exercised his option to take shares and that, since the option had not been exercised during the year in question, the apportionment could not be sustained.

It was held that, by virtue of his option and his position to control the company, the taxpayer had an "interest" in it and that he was in a position to procure that virtually all the value came to him.[57]

Another case heard by Macnaghten J was Lee v IRC[58]. This concerned section 18 Finance Act 1936[59] where it was held that the taxpayer was able to control the application of a Canadian transferee company's income within section 18(3)(e), and by his holding of shares, was entitled to receive a benefit out of that income within the section and, therefore, that the income payable to the company in consequence of his transfer of assets abroad was deemed to be his income.

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57. See Macnaghten J at pp691-2 and, in the Court of Appeal, du Parq LJ at p694
58. (1941) 24 TC 207
59. Now section 739 ICTA 1988, see Chapter 9

This is an illustration of how a section, in this case section 739, can permit the court to look through a company and tax the individual who has used the company in his plans.

Consider also Congreve v IRC.[60] The 1979 Vesty case,[61] of course, overruled one of the rationes decidendi, but the other remains intact. The remaining ratio once again shows how the application of section 739 can entail the lowering of the corporate veil. For example, in the Court of Appeal, Cohen LJ said:

> "But even if we were prepared to accede to the argument that the preamble [of the section] connoted activity by the individual concerned, we think this condition would be fulfilled if the execution of the transfer were procured by the individual concerned, even though it was not actually executed by him or his agent. Mr. Tucker [Counsel for the taxpayer], in commenting on the judgement of the learned judge in the court below said, and Mr. Jenkins [Counsel for the Crown] agreed, that execution by a company could not be said to be execution by the individual, even though the individual owned all or practically all of the shares in the company. We think, however, that the decision of the learned judge can be upheld on the ground we have stated, since it is, we think, in the present case, a reasonable inference from the facts found that the execution and performance of the transfers and associated operations in question by all the companies concerned were procured by Mrs. Congreve acting through her agent Mr. Glasgow. We should have been prepared, if it had been necessary, on this alternative ground to uphold the decision of the Commissioners."[62]

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60. (1948) 30 TC 163
61. Vestey v IRC (1979) 54 TC 503
62. p197

In other words, a non-transferor can be treated as a transferor if he procured the transfer through his control of a company. To this extent the separate existence of the corporate entity is not respected.

This is not to say that this can be taken too far and that every section 739 case and similar situations can lead to a piercing of the corporate veil, even when artificial tax avoidance arrangements are in question. This was emphatically shown by Vestey v IRC (No.2) at first instance[63], a decision by Walton J, never one to brush aside corporate entities lightly. The facts of this case are set out in Chapter 9.

The judge referred to the Special Commissioners' finding regarding one of the trust investments, the purchase of shares in a Jersey company, Commercial Insurance Co. Limited. The Special Commissioners had said:

> "The next matter is the income of Commercial Insurance Co. Limited. It was said that the purchase of its shares broke the chain of transfers and associated operations. For the purposes of subsection (1) [of what was then section 412 ITA 1952] we can see no warrant for treating its income differently from that of the other offshore companies. So to do would, in our view, create a distinction between the subscribers' shares and purchased shares for which we can see no justification. In each case the individual has 'power to enjoy' the income of the offshore company by virtue of the wide definition of subsection (5)."

Walton J's opinion of this was forthright:

> "And Mr. Nolan, for the Crown said much the same thing in more felicitous language. The answer to this fantastic suggestion - for, if those who

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63. (1978) 54 TC 550. This point was not directly addressed by the House of Lords.

subscribe to it will allow me to say, it is utterly fantastic - is the very simple one that, as was pointed out by Mr. Potter in replying, the income of the company and the income derived from the company by the shareholders are two quite different incomes. Indeed, I know of no manner in which a shareholder can under any circumstances enjoy the income of a company in which he is interested. He may hope, and frequently if not invariably does hope, that a distribution by way of dividend will be made to him out of its profits: but income and profits are, in the case of commercial undertakings, often two vastly different things.

Once again, the fact that the section is a penal section would fully justify one in reading 'income' as meaning income and not profits; but even were that solid rock to be swept away it would not avail the Crown in this instance, for in Canadian Eagle Co. Limited v The King 27 TC 205, at page 257, Lord Macmillan made it perfectly plain that

> 'For the purposes of income tax, the income of a foreign company and the income received from it in dividends by its British shareholders are not to any extent or effect one and the same income, but are two distinct incomes.'

So here the dividends received by the trustees from Commercial Insurance Co. Limited are part of the income of the trustees derived from the transfer of assets and associated operations, and it is upon that income, and no further component provided by that company, that section 412 fastens."[64]

However, in <u>IRC v Pratt</u>[65], Walton J did accept the alternative ratio in the Congreve case as analysed by Cohen LJ.[66] On Cohen LJ's analysis, and referring to the

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64. p562
65. (1982) 57 TC 1
66. Supra

person who procured the transfer as a "quasi-transferor", Walton J said:

> "Now, founding himself upon Congreve, Mr. Nicols [Counsel for the Crown] submitted that in a company case there might well be more than one quasi-transferor. For example, there might be a two man company, A & B being the directors and shareholders, or a three man company, X, Y & Z being similarly situated. It would be absurd to think that if all two or three procured the company to effect a transfer, that would not be within the provisions of the section."[67]

It can, therefore, be seen that the courts are more likely to look behind the existence of a company if a specific statutory provision enables or forces them to do so but that, even in these cases, the piercing of the corporate veil cannot be taken too far and the courts will normally go only so far as the particular provision forces them to go.

As to the type of legislation under which the separate identity of a company can be ignored, the first point to make is that English statutes contain no general all embracing anti-avoidance provision to enable courts to pierce the corporate veil just as there is no general anti-avoidance provision applying across the board. However, specific provisions do allow the corporate veil to be lifted in particular circumstances. The ways in which the veil is lifted and the effects of doing so are not the same in each case, as will be seen below.

In the provisions noted here - which are all analysed in detail in other Chapters - it will be noted that they do not specifically refer to the piercing of the corporate veil, but that is the effect of the particular method of tackling the tax avoidance device at which they

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67. p50

are aimed. This is not an exhaustive list; but the main provisions are noted.

1. Section 775 ICTA 1988. This section, which concerns personal service companies, is dealt with in Chapter 1.

2. Section 703 ICTA 1988.[68] This section can give rise to the piercing of the corporate veil because the individuals who manipulate the shares in the companies in question can be taxed as if the avoidance device had not been implemented. In other words, the section often involves the ignoring of a comany and the taxing of the individuals who were seeking to exploit it.

3. Section 739 ICTA 1988.[69] Some cases on this section have already been considered above in relation to the piercing of the corporate veil. Schemes caught by this section often involve the transfer by the individual resident in the UK of income producing assets to a company situated outside the UK. When the taxpayer receives a capital sum or has "power to enjoy", he will be taxed on the income received by the overseas company as if the overseas company were not there.

4. The "controlled foreign companies" legislation (section 747 ICTA 1988).[70] The United Kingdom controlled foreign companies legislation has its parallels in many other countries. A UK company can be taxed on all or part of the profits of a non-resident company. The effect of this legislation is that the non-resident company's existence is ignored and the UK resident corporate

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68. See Chapter 1
69. See Chapter 9
70. See Chapter 9

shareholders assessed directly on the non-resident company's profits.

5. Section 776 ICTA 1988.[71] This section can operate to cause a piercing of the corporate veil. For example, a UK resident individual can be assessed on the gains of an overseas company (or trust) if the individual has provided the overseas entity with the opportunity of making the gain.[72] The existence of the overseas company (or trust) is therefore ignored in that its gain is taxed on another person.

6. The close company legislation. The history of the close company legislation in the UK is charted in detail in Chapter 1. It will be seen that legislation dates from 1922. Throughout the development of this legislation to 1989, its effect has been to apportion certain income of the company to its participators and to tax it in their hands. This is not ignoring the existence of the company although, for tax purposes, it can be said to be looked-through to the extent of the apportionment.

7. Section 15 CGTA 1979.[73] This is another section imposing directly on shareholders (individuals or companies) tax that has accrued to a non-resident company, so that the existence of the company is disregarded for the purpose of imposing the charge to tax. In fact, the Revenue can in some cases look through a series of companies in order to impose a liability on the UK residents.

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71. See Chapter 3
72. See Sugarwhite v Budd [1987] STC 491. See also Yuill v Wilson (1980) 6µ52 TC 674 at p691-2 per Templeman J
73. See Chapter 9

Group Relationships

The position of companies forming a group within company law or the tax legislation is fairly clear: each company must be treated separately as an individual legal entity regardless of the group relationship. The one judge who took a different view, and who was prepared to pierce the corporate veil of group companies if their interrelationship demanded, it was Lord Denning MR. If the interdependence was sufficiently strong, he has treated group companies together as a single entity.

This was brought out - as was the reluctance of the other judges to follow his lead - in Littlewoods Mail Order Stores Limited v McGregor.[74] The facts of this case were that the taxpayer company had a 99 year lease of business premises at an annual rent of £23,444. The freeholder offered to sell the freehold, and a scheme was implemented as follows. A wholly-owned subsidiary of the taxpayer company acquired the freehold, the former freeholders acquiring a head lease for 22 years and 10 days at a rent of £6 a year. The taxpayer compant took a sublease for 22 years at a rent of £42,450, the original lease being surrendered.

The effect of the above scheme was that the taxpayer company was paying a higher rent (which it claimed to be able to deduct in full) for a shorter lease but that, after the head lease expired, it subsidiary would own the unencumbered freehold.

As a preliminary point, it should be noted that Lord Denning MR's view was not based on agency although, in other cases, he has been prepared to lift the corporate veil where an agency relationship has been held to exist.

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74. (1969) 45 TC 519

In Littlewoods, Lord Denning MR differed in approach to Sachs and Karminski LJJ as far as the integrity of the individual companies was concerned. Lord Denning MR had no hesitation in drawing aside the corporate veil here. In a forthright passage he said:

> "That case[75] would be virtually indistinguishable from the present case but for the interposition in this case of the wholly owned subsidiary, Fork Manufacturing Co. Limited. If that subsidiary were identified with Littlewoods, so as to be one with Littlewoods, the net result of the transaction would be that Littledwoods could give up the 88 years outstanding at £23,444 a year and would get instead the freehold of Jubilee House, paying therefore a rent of £42,450 a year for 22 years. The case would then be on a par with the Land Securities case.... Mr. Hayworth-Talbot [Counsel for the taxpayer company] was inclined to agree but he said that the interposition of the Fork Manufacturing Co. Limited made all the difference, albeit it was a wholly owned subsidiary of Littlewoods. He said that the Fork Manufacturing Co. Limited was to be regarded as a separate and interdependent entity, just as if its shares were owned by someone quite unconnected with Littlewoods. In that case the freehold of Jubilee House would be acquired by the Fork Manufacturing Co. Limited. Littlewoods would have acquired no capital asset at all. They would be able to deduct the whole £42,450 a year. I cannot accept this argument. <u>I decline to treat the Fork Manufacturing Co. Limited as a separate and independent entity.</u> The doctrine laid down in Salomon v Salomon & Co., [1897] AC22 has to be watched very carefully. It has often been supposed to place a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can, and often do, draw aside the veil. They can, and often do, pull off the mask. They look to

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75. <u>IRC v Land Securities Investment Trust Ltd</u> (1969) 45 TC 495

see what really lies behind. The Legislature has shown the way with group accounts and the rest. And the courts should follow suit. I think that we should look at the Fork Manufacturing Co. Limited and see it as it really is - a wholly owned subsidiary of Littlewoods. It is the creation, the puppet, of Littlewoods, in point of fact: and it should be so regarded in point of law. The basic fact here is that Littlewoods, through their wholly owned subsidiary, have acquired a capital asset, the freehold of Jubilee House: and they have acquired it by paying an extra £19,006 a year. So regarded, the case is indistinguishable from the Land Securities case. Littlewoods are not entitled to deduct this extra £19,006 in computing their profits."[76]

It can be seen that Lord Denning was paying scant regard to the separate legal identities of the group companies. The other judges of the Court of Appeal, however, made a point of respecting the separate identities of the various group companies, adhering closely to the principal of Salomon v Salomon.[77] Sachs LJ was content to deal with the matter by splitting the expenditure, allocating £19,000 to capital in the subsidiary.[78] Karminsky LJ, however, having recognised the separate identities of the two companies, appeared then effectively to ignore the subsidiary, and treat the case as indistinguishable from the Land Securities case.[79] Karminski LJ's judgement is, unfortunately, neither very full nor enlightening.

See also the compulsory purchase case of <u>DHN Food Distributors Limited v London Borough of Tower Hamlets</u>[80], where all three members of the Court of Appeal were of

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76. p536
77. See Sachs LJ at p537 and Kerminski LJ at p538
78. p538
79. pp538-9
80. [1976] 3 All ER 462

the opinion that the Court was entitled to pierce the corporate veil in a group situation, and to look at the realities of the case. The group was treated as a partnership; indeed Lord Denning MR referred to the group as "the firm".

DHN was in the business of importing and distributing groceries. In order to purchase premises in which to trade, it agreed certain borrowing arrangements with a bank whereby the bank would buy the property and sell it to DHN for £120,000, £20,000 to be paid on exchange of contracts, and the remainder within one year. The premises were bought for £115,000 and transferred to a wholly owned subsidiary of the bank, Bronze Investments Limited. DHN went into possession and began trading. Bronze contracted to sell the property to DHN, but completion was postponed and the contract was never completed. DHN in the meantime arranged a loan of £100,000 from a separate source and, in order to save stamp duty on a conveyance by Bronze, instead agreed with the bank to purchase the share capital of Bronze and then repay the loan from the bank for a total sum of £120,000. That transaction was carried out and, thereafter, DHN and Bronze had the same directors. Bronze retained the legal title to the premises and DHN continued to use them for the purpose of their business. Subsequently, the local authority made a compulsory purchase order and paid Bronze compensation for the value of the land. DHN claimed also to be entitled to compensation for disturbance, but the local authority contended that DHN was only a licensee of Bronze and, therefore, were not entitled to compensation for disturbance, except for the value of their interest in the land as a tenant from year to year.

It was held that the court was entitled to look at the realities of the situation and to pierce the corporate veil. The group was virtually a partnership and for the purposes of compensation, the two companies should be treated as one. Accordingly, DHN were entitled to claim compensation for disturbance.[81]

Later cases, however, threw doubt on this view of group relationships and it appears that Lord Denning MR's attempts to establish a unity of identity within a group has failed.[82]

Lord Bridge however, in reply to a hypothetical example put forward by counsel in Pilkington Brothers v IRC,[83] appeared to be prepared to ignore the existence of a sub-holding company in a linear group structure,[84] but the point was clearly obiter, and nothing can be read into Lord Bridge's remarks.

The Revenue argued that a subsidiary was agent for its parent in relation to a tax avoidance scheme in Burman v Hodges and Butler[85]. Walton J who, it has already been seen, was not usually susceptible to arguments urging him to pierce the corporate veil, refused. The facts of this case are set out in Chapter 8.

The Crown contended that, at no time did either of the specially formed companies, Vostoka and Zagal, perform any act as a principal. Vostoka performed all its acts as agent for, or nominee of, Bass Charrington Vintners, and Zagal performed all its acts as agent for, or nominee of, Segram. Accordingly, the disposal by Bass Charrington Vintners of its holding in Bushmills was a disposal to Zagal as nominee for Segram.

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81. See Lord Denning MR at p467 and Goff LJ at pp468-9.
82. See Woolfson v Strathclyde Regional Council [1977] SLT 159 and Rakusen Properties Limited v Leeds City Council [1979] SJ 848.
83. (1982) 55 TC 705; see Chapter 4
84. See p739
85. (1978) 52 TC 501; see Chapter 8

Of this submission, Walton J had this to say:

> "It is of course of the essence of any subsidiary company that, broadly speaking, it should conform to the wishes of its parent company. The parent company, of necessity, appoints its directors, directly or at a remove; the parent company is often its main, and frequently its sole, source of finance; its directors are often directors of the parent company and thus carry the policy of the holding company directly into the boardroom of the subsidiary. All these factors may, and indeed sometimes do, lead to the Board of the subsidiary company pursuing policies which commend themselves to the parent company but which, reviewed objectively, ought not to commend themselves to an independent board of directors. None of these factors, however, whether separately or in conjunction, leads to the conclusion that, in thus obeying or indeed possibly being made to obey, the whims and caprices of the Board of the parent company, the subisidiary company is in any manner acting otherwise than on its own behalf: it is not thereby acting as an agent or nominee for its parent company."[86]

Walton J put the question of agency in a group situation into clear focus in the following passage:

> "Whilst of course there is no reason at all why a subisidiary company (like anybody else, but doubtless, just because it is a subsidiary company, with a rather greater degree of likelihood) should not be an agent or nominee for its parent company, whether or not it is in fact such is a pure question of fact to be determined by a consideration, not of actions on the part of the subsidiary which can property be characterised as imprudent and which might indeed well be so if there was not in the backround a benevolent parent company ready, if

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86. p513

> required, to advance any moneys necessary to finance the activities of its subsidiary, but of the whole of the facts of the case, of the relationship between the parties and the documents and engagements which each of them has entered into."[87]

So, even when questions of agency are concerned, the group relationship does not necessarily make it any more likely that an agency will be found so as to enable the corporate veil to be pierced.

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87. pp513-4

The Impact of the New Approach

Reliance on arguments urging the court to lift the corporate veil has been less in evidence since the Ramsay principle[88] became established because it achieved more than a mere lifting of the corporate veil could do in most cases.

The Ramsay principle itself entails a form of lifting of the corporate veil where companies form part of an interposed step.

At the very genesis of the principle, in Floor v Davis,[89] the Revenue had tried to persuade the Special Commissioners to pierce the corporate veil, and look through the transactions of the companies "to see what really happened". They relied on the Littlewoods case[90] which was, of course, on an entirely different point. The Special Commissioners rejected any arguments along these lines. For example, they said:

> "We derive no great assistance from figures of speech which identify the circumstances of incorporation with a veil which cloaks a company's transactions."[91]

Circumstances soon took a fundamental turn for the better, as far as the Revenue were concerned, with the Ramsay case, so the corporate veil arguments did not play any significant role in the development of the Ramsay principle, although the Revenue did argue for the corporate veil to be pierced before the Special Commissioners in Furniss v Dawson[92], but this can be explained by the fact that the Special Commissioners' Hearing was in 1975, six years before the Ramsay case and, in fact, less than two years after the Special

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88. See Chapter 11
89. (1979) 52 TC 609
90. See p615
91. Ibid
92. (1984) 55 TC 324

Commissioners' Hearing in Floor v Davis. The Revenue had argued that:

> "The entire transaction looked at as a whole was so invaded by fiscal considerations as to lose its character, and because of the fiscal considerations the corporate identity of Greenjacket should be pierced and Greenjacket recognised as the alter ego of the Dawson family."[93]

The Special Commissioners, one of whom (H.H. Monroe) also presided over the Floor v Davis appeal, rejected this. The Special Commissioners said:

> "The first ground advanced is to the effect that the whole scheme, the formation of the Manx Company, the exchange of shares in the operating companies for shares in the Manx Company, the sale by that company of those shares for cash to the ultimate purchase, was 'so invaded by fiscal considerations as to lose its character' and that the fiscal implications require the corporate identity of the Manx Company to be looked through and the company identified as the alter ego of the Dawson family. We take this argument to mean that because, as we find, the transactions here in question were designed to achieve a certain fiscal result, the existence of the Manx company as a separate entity should be ignored and the exchange of shares, which we find took place, should be disregarded or at least regarded as of no effect, for tax purposes. We know of no principle or statutory provision which requires us to reach this conclusion. We find that the Manx Company existed, that it issued its own shares in exchange for the shares in the operating companies and that in consequence of that exchange it became the holder of those shares. We consdier that we should take the facts as we find them. Why

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93. Para 6 of the Case stated, p331

the shares were exchanged - for example, whether they were exchanged for a fiscal or a commercial purpose - is not in issue. However, since we have been told that a case may shortly come before the High Court in which the same or a similar argument may be raised, we record the argument as we understand it to be put and we reject it."[94]

The same argument was not pursued as such in the courts; the Ramsay principle, as developed by Furniss v Dawson, did not entail ignoring the interposed company and treating it as the alter ego of the Dawsons, but rather entailed treating the transaction involving the company as a fiscal nullity in the sense that the relevant legislation was applied to the "end result".[95]

Having said that, an analysis of the House of Lords judgements does not resolve the question of precisely how the corporate entities were considered or how their integrity was honoured. Lord Brightman, for example, considered the effect of applying the Ramsay principle to the Furniss v Dawson facts. His view was that there had been a disposal by the Dawsons to Wood Bastow in consideration for the payment of money to Greenjacket with the concurrence of the Dawsons. In other words Greenjacket was to be ignored.

Furthermore, Greenjacket was not to be ignored for all purposes, because Lord Brightman acknowledged that Wood Bastow's money went to Greenjacket. Neither Lord Brightman nor, indeed, any of the other Law Lords fully explained the status of Greenjacket. In one sense, therefore, the House of Lords were lifting the corporate veil by treating the receipt by Greenjacket as a receipt by the Dawsons.

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94. p332
95. See Chapter 11

The question of agency was also considered in the Chancery Division and the Court of Appeal in Floor v Davis. At first instance, Goulding J held that FNW was a principal and not a mere nominee or agent for the individuals so they could not be considered as having made their disposal direct to KDI. In the Court of Appeal, Buckley LJ and Sir John Pennycuick agreed. The House of Lords heard no argument on the agency point and made no decision on it.

The question of agency also arose in Furniss v Dawson. Before the Special Commissioners, the Revenue had argued that the contractual relationship between the Dawsons and Greenjacket was such that Greenjacket must be taken to have acquired the shares as nominee for the Dawsons, with the result that Greenjacket never had more than bare legal ownership of the operating companies, and so did not have control of them within the relevant provision.[96]

Again, the Special Commissioners rejected this:

> "The third ground is that whatever may have been intended, there was a contract between the Dawson family shareholders and the Manx Company which resulted in the latter being no more than a nominee for the former. The Manx Company it is said was at all times contractually bound to sell the shares on to the ultimate purchaser so that it never could acquire anything more than the bare legal title to the shares in the operating companies which it held as nominees for the Dawson family shareholders. The sale to the ultimate purchaser was effectively a sale by the Dawson family shareholders carried out through the Manx Company as nominees. Consequently the Manx Company never had control of the operating companies. We do not find that any such contractual relationship existed. Of course, the Manx company as part of this scheme was intended to sell on the shares in the operating companies. There was little

96. Then para 6, Sch 7, FA 1965

or no likelihood that it would do otherwise. But we conclude that as a matter of law what was intended was achieved, that the Manx Company was not contractually bound to sell on the shares until, the exchange having been effected, the agreement for that sale was signed. We therefore conclude that the Manx Company had control of the operating companies within the meaning of paragraph 6(2)."[97]

The point did not arise in the same form in the courts.

This view appears to have become accepted law in subsequent cases. Even in Burmah Oil,[98] for example, where the company's subsidiaries played the roles mapped out for them in the overall scheme, the courts did not treat them as mere agents.

In Craven v White the agency point was summarily dismissed by the Special Commissioners.[99] It was not raised again in the courts.

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97. (1984) 55 TC 324 at p333
98. See Chapters 8 and 11
99. See para 22 of the Case Stated, [1985] STC 531 at p552

CHAPTER 13

JUDGES AS MAKERS OF TAX LAW

Introduction

Blackstone in Commentaries said:

> "For no subject of England can be constrained to pay any aids or taxes, even for the defence of the realm or the support of government, but such as are imposed by his own consent, or that of his representatives in Parliament. By the statute 25 Edw.1.c.5 and 6 it is provided, that the king shall not take any aids or taxes, but by the common assent of the realm."[1]

The assent of the realm is to be obtained through Parliament. Blackstone continued:

> "And as this fundamental law had been shamefully evaded under many succeeding princes, by compulsive loans, and benevolences extorted without a real and voluntary consent, it was made an article in the petition of right 3 Car.1, that no man shall be compelled to yield any gift, loan, or benevolence, tax or such like charge, without common consent by Act of Parliament. And lastly, by the statute 1 W. & M. c. 2 it is declared, that levying money for or to the use of the crown, by pretence of prerogative, without grant of Parliament; of for longer time, or in other manner, than the same is or shall be grated; is illegal."[2]

However fine this may sound in principle, it is far too simple a concept to be applied in practice today. For

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1. Book 1, Chapter 1
2. Ibid.

example, if one considers the notion of taxation by consent, how real is that consent by the subjects or their representatives to any of the lengthy and complicated Finance Acts? Very often, those who introduce tax legislation into Parliament do not understand it, let alone those who have to discuss it at Committee or Report Stages. A great deal of modern tax legislation is not adequately discussed in Parliament.

Lack of understanding and lack of discussion are just two ways in which the present system falls far short of Blackstone's ideal. A more sinister one is the deception of Parliament by the Executive. This has occurred, for example, when a piece of legislation has been placed before Parliament and Parliament has been assured that that the legislation in only to have a limited application; but, once it has become law, the Executive have argued for a much wider construction. As has been explained, this has happened for example, with section 17 CGTA 1979[3] and sections 703[4] and 739 ICTA 1988[3]. These specific matters are dealt with above. Here, another inroad into the taxation-by-Parliament ideal inconsidered: the creation of tax law by the judges.

Another constitutional principle is central to this issue: that of the separation of powers. Montesquieu stated in "De l'Esprit de Lois":

> "... there is no liberty , if the judiciary power be not separated from the legislative and the executive. Were it joined with the legislative, the life and liberty of the subject would be exposed to arbitrary control."[5]

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3. See Chapter 9
4. See Chapter 1
5. Book XI, Chapter 6

There has never been strict separation of powers in the British constitution in the sense that the legislature, the executive and the judiciary do not overlap. Such complete separation in the UK would not be practical. There is a much more distinct separation in the USA although American judges are much more active in the field of judicial lawmaking.[6]. The difference is that, in the UK, there is a traditional and fundamental rule of the independence of the Judiciary, one of the main manifestations of which is that judges have traditionally restricted themselves to the disinterested application of the law.

This is not to say that judges do not make law. Some areas are essentially judge made: the common law and equity, for example. Furthermore, this process continues as such areas of the law are adapted to modern conditions. Tax law, however, is different in that it is based on statute. This is considered further below.

In fact, there are some people who criticise the English Judiciary for its unwillingness to develop the law in the ever changing society of today. The conservatism of the judges was particularly highlighted when set against the enormous advances in tax avoidance beginning in the 1960s. Even faced with these changes, the attitude of UK judges to their role on the whole held firm until the House of Lords adopted the Ramsay principle.[7]

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6. See infra and Chapter 10
7. See Chapter 11

Advocates of Change

Given that the Ramsay principle did signal a departure from the traditional role of the judges, not everyone condemned the Law Lords for taking this course. For example, H.H. Monroe wrote:

> "In fostering a system under which judges in the House of Lords must continually guard against legislating and confine themselves rigorously to the legitimate judicial activity of interpreting the law, may we not be in danger of unnecessarily depriving ourselves of a sensitive and flexible technique for tempering the law to the shorn body of the taxpayers?"[8]

The faith Monroe had in the ability of the House of Lords to combat tax avoidance can also be seen in his book, "Intolerable Inquisition? Reflection on the Law of Tax",[9] in which he commented that:

> "a decision of the House of Lords can be even more effective in countering avoidance than a statutory provision. It is more subtle and more flexible, more readily adapted to a wide variety of circumstances than any specific statutory provision. If circumstances will not oblige by throwing up appropriate cases at an appropriate time - and currently there would seem to be no shortage of cases coming to the House of Lords from which principles may yet be derived as to how avoidance cases should be approached - there may still be something to be gleaned from the cases to guide the draftsman of anti-avoidance legislation."[10]

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8. "Fiscal Finesse: Tax Avoidance and the Duke of Westminster". [1982] BTR 200 at p 207.
9. (1981)
10. p 76

Similar sentiments have been expressed by Lord Roskill, who was one of the Law Lords in Furniss v Dawson. He dealt with the role of the Law Lords in his Presidential Address to the Bentham Club at University College, London on 29th February 1984, less than three weeks after he had delivered his speech in Furniss v Dawson.[11]

Lord Roskill referred to his "desire, indeed almost a burning desire, to see that the law develops so that it actually works in an ever changing and ever developing.... society."[12]

To this it could be commented that, with a statute-based area of the law such as tax law, where it has long been established that taxes can only be levied by Parliament, there ought to be strict checks on how far the Judiciary can "develop" the law because "development" can be merely a euphemism for judicial legislation.

Lord Roskill was, it is suggested, correct in saying:

> "If the law is to develop systematically and logically it must be because correct principles must first be established and then those principles so established systematically applied in individual cases."[13]

Thus limited, the developing function of the House of Lords is unobjectionable and, indeed, desirable. However, Lord Roskill did not so limit the role of the House of Lords, referring to development, <u>expansion and change</u> of the correct principles as being a matter for the House of Lords and, indeed, in his view, "that is the principal justification for having a second appellate court."[14]

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11. His address was reproduced in [1984] Current Legal Problems 247, "Law Lords, Reactionaries or Reformers."
12. p 247
13. p 251
14. Ibid

Lord Roskill referred to some of the areas in which the House of Lords have evolved the law such as the Donoghue v Stevenson principle in Tort and Lord Reid's developments in Administrative Law in Ridge v Baldwin and Padfield v Anisminic.[15] But these areas of the law are fundamentally different from Revenue Law. Lord Roskill obviously did not see the matter this way, referring to Lord Wilberforce's speech in the Ramsay case, he said:

> "There not for the first time and I trust not for the last, the House is declaring loudly that it has a law reforming function and that is a function that it will discharge where it thinks it proper so to do."[16]

Lord Roskill is here at odds with the overwhelming majority of the Judiciary as regards "reforming" tax law. Even in the post-Ramsay era, few judges are prepared to go as far as Lord Roskill.

He referred to another of Lord Wilberforce's speeches; this one was in <u>Miliangos v George Frank (Textiles) Ltd</u>.[17] In this case the House of Lords reversed their earlier decision regarding the currency in which judgments must be given. Lord Wilberforce had said:

> "My Lords, in conclusion I would say that, difficult as the whole matter undoubtedly is, if once a clear conclusion is reached as to what the law ought now to be, declaration of it by this House is appropriate. The law on this topic is judge made; it has been built up over the years from case to case. It is entirely within this House's duty, in the course of administering justice, to give the law a new direction in a particular case where, on principle and in reason, it appears right to so do.

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15. p 254
16. p 257
17. [1975] 3 All ER 801

I cannot accept the suggestion that because a rule is long established only legislation can change it - that may be so when the rule is so deeply entrenched that it has infected the whole legal system, or the choice of a new rule involves more far-reaching research than courts can carry out. A recent example of the House changing a very old-established rule is Birmingham City Corpn v West Midland Baptist (Trust) Association.[18] Lord Reid thought that it was proper to re-examine a judge-made rule of law based on an assumption of fact (as to the stability of money) when the rule was formulated but which was no longer true and which in many cases caused serious injustice. So in that case the House selected a new date and did not think it necessary or right to wait for legislation and I would not think it necessary or right here. Indeed, from some experience in the matter, I am led to doubt whether legislative reform, at least prompt and comprehensive reform, in this field of foreign currency obligation, is practicable. Questions as to the recovery of debts or of damages depend so much on individual mixtures of facts and merits as to make them more suitable for progressive solutions in the courts."[19]

On Lord Wilberforce's approach, Lord Roskill commented:

> "There is a clear modern declaration that when circumstances demand, judge-made law however old can be and should be changed."[20]

Lord Roskill seemed to be unable to differentiate between judge-made law, as in the Miliangos case, and statute law in Ramsay. Not only was Ramsay dealing with law that was fundamentally not judge-made, but it did not concern an

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18. [1970] AC 874
19. [1975] 3 All ER 801 at pp814-5
20. p256

area dependent "so much on individual mixtures of facts and merits", to use Lord Wilberforce's words.

Lord Wilberforce saw the distinction, even if Lord Roskill did not. What Lord Roskill overlooked, it seems, was Lord Wilberforce's views on altering statute-based laws, which are evident from the following dicta. In Ransom v Higgs[21], he said that:

> "if schemes such as these succeed in taking trading stock profits - by a stripping process - outside the net, the remedy, as in the case of dividend-stripping, lies in legislation."[22]

Similarly, in IRC v Plummer[23], Lord Wilberforce commented:

> "My Lords, it seems to me to be clear that it is not possible to read into the definition an exception in favour of commercial transactions whether with or without the epithet 'ordinary' or 'bona fide'. To do so would be legislation, not interpretation; if Parliament had intended such an exception it could and must have expressed it."[24]

Lord Wilberforce spoke in even stronger terms later in his judgment in Plummer when he said:

> "the familiar argument was used that Parliament can never have intended to exempt from the taxing provisions an arrangement solely designed to obtain fiscal advantages. But this is not the question, not is a canon of interpretation of this kind admissible - or indeed a workable canon. The question is whether a certain series of transactions in a certain legal form do or do not fall within the

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21. (1974) 50 TC 1
22. p91
23. (1979) 54 TC 1
24. p42

taxing words. If they do not, and if Parliament dislikes the consequence, it can change the law - as in fact it has done since the scheme in question was operated. The subject is entitled to be judged under the law as it stood at the relevant time."[25]

Even in the common law, judicial opinion is by no means unanimous as to how far it is legitimate for judges to go in changing the law. In the Miliangos case itself, Lord Simon of Glaisdale delivered a strong dissenting judgment. He was of the opinion that the matter in issue in that case was not a reform which judges should undertake. The question demanded a far wider review that the adversary system was able to provide, it demanded expertise from outside that available to a court of law, such as monetary theory, public finance, international finance, commerce, industry and economics.[26]

Lord Simon cited Lord Kilbrandon in D.P.P for Northern Ireland v Lynch[27] who had said that:

> "....it is an unpermissible, or at least an undesirable, mode of law reform to use the occasion of an appeal in a decided case for the purpose of declaring that changing conditions and enlarging opinions have rendered the ratio decidendi of the lower Court obsolete and therefore susceptible of being set aside..... It would in my opinion be a necessary preliminary to the reform of that generally accepted version of the common law that consultations, on a far wider basis than discussions among lawyers, including the arguments of counsel before the highest tribunal, should have taken place and been seriously considered.... An alteration in a fundamental doctrine of our law, such as this appeal proposes, could not properly be

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25. p44
26. [1975] 3 All ER 801 at pp823-4
27. [1975] AC 653 at pp700-1

> given effect to save after the widest reference to interests, both social and intellectual, far transcending those available in the judicial committee of your Lordships' House.... It will not do to claim that judges have the duty - call it the privilege - of seeing to it that the common law expands and contracts to meet what the judges conceive to be the requirements of modern society. Modern society rightly prefers to exercise that function for itself, and this it conveniently does through those who represent it in Parliament. And its representatives nowadays demand, or should demand, that they be briefed by all those who can qualify an interest to advise them."

How much more is this true when the area of law in question is essentially statutory!

Just as the question in point in the Miliangos case required expertise beyond that available to the court in the areas identified by Lord Simon, fundamental principles of fiscal law such as those involved in the Ramsay principle require expertise outside that usually enjoyed by judges. As Lord Simon put it in the Miliangos cases: "Law is too serious a matter to be left exclusively to judges."[28]

Lord Roskill evidently did not share this view, despite the fact that his method of judicial lawmaking would lead to uncertainty.[29] Lord Roskill, in his address, accepted that the Ramsay principle may make the law uncertain and:

> "add to the difficulties of professional advisers who cannot know until the case ultimately reaches the highest tribunal (if it ever does) what rule of law is for certain likely to be applied to their

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28. [1975] 3 All ER 801 at p824
29. Infra

client's case...... But if every change in the law is to await legislation even where that legislation has been proposed by the Law Commission, changes will be few and far between. As Lord Wilberforce said [in Ramsay], Parliamentary congestion is likely to preclude all but a handful of changes however urgent and however necessary. There are no votes in law reform."

Dealing with Lord Roskill's last point, this is a fallacy. Lord Radcliffe, who was well-respected for his knowledge of tax law, spoke out against the mass of extra-statutory concessions saying that there was ample opportunity each year for the law to be changed through the Finance Acts.[30] In any case, Finance Acts tend to be more frequent than innovative House of Lords judgments and whereas it is true that there is some Parliamentary conjestion, at least legislation can be framed with the whole field in view, after consultation, if necessary. What is more, Parliament is not restricted to the facts of a particular case and the arguments put forward by counsel. The fact of the matter is that very few changes in tax law have to be put off through lack of Parliamentary time; normally, if legislation is postponed, it is because the consultative process has not been completed.

Recent examples of legislation being greatly influenced by the consultative process are the "Controlled Foreign Companies" the company and individual residence provisions.[31] There is no consultative process with judicial lawmaking.

In any case, the complaint that there is not enough time in Parliament for detailed changes in tax law simply cannot be maintained in the light of the lengthy and

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30. IRC v Frere (1964) 42 TC 125 at p154
31. The changes in the rules relating to the residence of individuals have, in fact, still not been introduced precisely because of the representations from the public about the original proposals.

extremely technical Finance Bills passing through the House of Commons every year. Take, for example, the 1989 Finance Bill. That year's Budget was widely viewed as being lacking in very interesting material and it cannot in any way be seen as a tax-reforming Budget; yet, when the Bill was published, it was found to contain 180 clauses and 17 schedules, even before amendments were made in its passage through Parliament. THe Finance Act 1989 eventually contained 188 sections. In reality there is no practical limit to the space that can be found for detailed changes originating from the Inland Revenue.

The fact that a great deal of the Finance Bill is not subject to adequate debate in Parliament is another matter. Undoubtedly, much of each year's Bill receives little or no real Parliamentary attention but this must not be confused with the objection that there is no room or time for changes in tax law to be effected by Parliament.

It must not be forgotten that changes in the law made by the courts are not considered by Parliament, the public's elected representatives, and are not debated outside the confines of the particular case being considered.

The important difference is this. If an important change is put into a Finance Bill, it may not receive prolonged consideration in Committee and MP's may be fobbed off by representatives made by the Inland Revenue and not appreciate the full implications of what they are enacting; but if the law goes wrong or it is unpopular, at least the general public can lay the blame at the door of the Government of the day; there may be pressure to amend the law, representations through local MPs, pressure groups etc; but the courts are not tainted. most people would trust the courts to operate even a bad or faulty law in an impartial way. If the courts themselves have been the source of the law which is the cause of the trouble, their role of the impartial arbiters of that or other laws is very seriously called in question.

It is true that the Evershed Committee[32] said that:

> "legislation is a slow and cumbersome process. Parliamentary time is in modern conditions notoriously limited and may well become in the future even more precious. Clarification of the law by judicial decision is a swift and surer process, which can go forward at all times without regard to parliamentary time and quite independently of political considerations."

However, apart from the fact that they were talking about "clarification" rather than the making of the law, it is questionable that whether judicial classification in the field of revenue law is as swift and sure as the committee seemed to think. Consider, for example, the Ramsay principle itself. There were over seven years of acute uncertainty as the Law Lords sought to develop the law, which uncertainty made matters very difficult for the taxpayer and which reflected little credit on the House of Lords. In the period from the Ramsay to the Craven v White decisions, and even after Craven v White, it has been shown in Chapter 11 that a great deal of uncertainty still exists. Consider also the question of company residence, to take just one more example, after something like a century of judicial "clarification" the law was in a lamentably uncertain state. Parliament, having lost patience with this long-winded process of judicial clarification, after a suitable period of consultation, introduced a clear legislative test[33] which, for all its shortcomings, at least leaves the taxpayer knowing where he stands.

This is not to say that the process by which tax legislation is introduced is perfect, far from it. As

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32. Final Report of the Committee on Supreme Court Practice and Procedure (1953) Col A 8878 para 642
33. See Chapter 9

the Renton Committee[34] commented:

> "There is fiscal legislation every year, much of it prepared in great secrecy and under severe pressure of time...."[35]

This is examined further below.

Few people will be satisfied by Lord Roskill accepting the validity of the criticism by making out that it does not really matter in the circumstances. In tax law, more than in most other areas of the law, taxpayers have a right to know exactly where they stand.[36]

The most outspoken and active opponent to artificial tax avoidance,[37] Lord Templeman, gave the opening address at a conference in Oxford dealing with the implications of the House of Lords decision in Furniss v Dawson organised by the Institute for Fiscal Studies. This address was summarised in "Fiscal Studies".[38]

Lord Templeman accepted that tax avoidance is not illegal, but that the tax avoidance industry that developed in the 1970's had to be destroyed. To be fair to Lord Templeman, most people would accept that the legislative process had proved to be defective in checking this development. According to Lord Templeman, the Ramsay principle was a reaction to the growth and activities of the tax avoidance industry which had grown to such a size that it had the capacity to make very considerable inroads into Government revenues. It created two categories of taxpayer; those with the knowledge and financial resources to enable them to use the artificial devices available; and those who were not

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34. "The Preparation of Legislation" Cmnd 6053
35. Para 17.1
36. Infra
37. See Chapter 11
38. August 1985, pp51-2

able to use such methods through lack of knowledge or resources. But this always has been and always will be the case, although perhaps not to such a striking extent as in the days of the pre-packaged scheme. Today, the best tax experts are very expensive and many of the acceptable tax planning and mitigation techniques are only available to those who can pay handsomely for the advice and for the structure to carry it through (possibly using companies and/or trusts - often set up abroad). The "ordinary" taxpayer has relatively few major tax mitigation arrangements at his disposal.

According the Lord Templeman, the features of the UK legal and tax systems that lay behind the success of the tax avoidance industry were as follows:

(1) In law, a company is a separate legal person and, accordingly, an endless number of easily manipulated persons could be conjured up for the purpose of a scheme. This is true: the reluctance of the judges to ignore the existence of a company has already been examined.

(2) UK tax legislation contains a number of exemptions and reliefs which the schemes endeavoured to exploit to the taxpayers' advantage. This is an unremarkable observation: it is almost human nature to take advantage of tax exemptions and reliefs if at all possible. Professional advisers would be failing in their duty to their clients if they did not point out ways of exploiting the exemptions and reliefs. Lord Templeman's view was that, had the courts not developed the Ramsay principle, a taxpayer with the appropriate means might almost have been regarded as not playing the game if he did not take advantage of the various schemes; and his advisers might have been considered negligent for failing to recommend them.

(3) There was no general anti-avoidance legislation

which could be called in aid to defeat these schemes.

(4) While there were many specific anti-avoidance provisions, these were directed at particular circumstances and, with time and thought, it was usually possible for the devisors of the complex schemes in question to find a way around those provisions. In many cases steps were inserted in the schemes for no purpose other than to get around some specific anti-avoidance provision; their presence was only explicable by reference to the provision to be circumvented.

Lord Templeman failed to mention another very important factor: the traditional principles of statutory construction adopted by most judges.

It is likely that very few people would argue with Lord Templeman's view that the tax avoidance industry that developed in the 1970's had to be stopped - at least that part of it that dealt with artificial, non-commercial and, in many cases, packaged schemes. However, a basic criticism that can be levelled against Lord Templeman's approach is that, assuming the brakes had to be applied, it was solely within the province of Parliamentto do so; it was not a matter for the Judiciary. Not only would Parliament have been the correct forum constitutionally; there is the practical point that, had Parliament introduced a statutory Ramsay principle, it is likely that it would have been much more precise and certain than the efforts of the House of Lords.

He then said that, if there was unacceptable uncertainty as a consequence of the adoption of the Ramsay principle, advisers should work together to ensure that cases reached the courts without undue delay to provide the courts with the opportunity to clarify and expand upon the principle and ensure that innocent transaction are not penalised. This comment shows startling naivety unworthy of a member of the highest court in the land. Why should individual taxpayers have to foot the bill for the development of the law? Why should a taxpayer have to risk £100,000 or more of his own money (for the costs if he loses) for this.

It is not good enough in most cases merely to say that tax avoiders get what they deserve, because the plain fact is that very few of them fit the common picture of devious, scheming men who are cut down by the crusading Law Lords wielding the Ramsay principle. Take taxpayers in the position of, say, the Dawson family.[39] They want to sell their shares. Like all sensible businessmen, they ask their professional advisers to tell them the way they can do it by paying the least amount of tax: it would be crass to suggest that any person in their position should do otherwise. Their advisers tell them that there is a perfectly legal arrangement, perhaps backed-up by an Opinion by an eniment Queen's Counsel. There will be costs, of course, but that is to be expected. What are the taxpayers to do? Assuming the costs are reasonable compared with the potential tax saving and the chances of success are high enough, they will participate in the scheme, not as people who are doing anything underhand, but as sensible businessmen, following professional advice in taking undeniably legal steps. Are they then to be told that certain judges in the House of Lords who, mostly, have little experience in tax law, have decided that what was perfectly acceptable when the transaction was carried out, has become unacceptable without warning, without Parliamentary debate, without consultation with the public and without the consideration of their duly elected legislators? What about the Burmah Oil company who were told by the Law Lords that their scheme was a perfectly sensible and unobjectionable arrangement that actually succeeded according to the statutory provisions but which was nevertheless being rejected by the Law Lords because of

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39. The taxpayers in Furniss v Dawson, see Chapter 11

an attitude towards such arrangements undreamt of when the scheme was implemented. Consider again the Dawson family, in whose case the judges' retrospective change of the law (which was what it was) was directly contrary to the wishes of the legislature, which itself introduced bona fide commercial criteria but expressly and unequivocally stated that the new criteria were not to apply before April 1977.

Are such taxpayers also to be told that, to challenge the Inland Revenue's stand on their case, and to clarify the mess in which the Law Lords have left the law, they are expected to participate, albeit unwillingly, in the development of the law, for which privileged they will have to gamble £100,000 of their own money and have to wait quite few years before the matter is finally resolved? Are they not entitled to ask what the Legislature is elected to do? Are they not entitled to ask why these unelected judges, who often have littled substantive knowledge of tax law, should usurp the powers of the Legislature and impose on an innocent taxpayer the burden of developing the law when those same judges, having displaced the old system that had stood for many years, had not the skill, courage nor knowledge to design a clear and workable system to replace it?

Such taxpayers can perhaps be excused for thinking that the law is, indeed, an ass.

Lord Roskill[40] also dealt briefly with this point. He mentioned the criticism that judicial activism leaves changes in the law to chance in that it depends on there being an appropriate case reaching the House of Lords. He dismissed this criticism in an unconvincing way by saying that it constantly happens that a particular case is brought, sometimes by agreement between the parties, with the express intention of obtaining an authoritative decision. Apart from not dealing with the point at all,

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40. Op cit p257

it is, like Lord Templeman's view, disturbingly naive. In fact, rather than professional advisers working to bring their clients' cases to the courts without undue delay, in most cases they should do all in their power to avoid lengthy litigation.

But what if a case does reach the House of Lords, can the Law Lords be trusted to clarify and develop the law so that taxpayers know exactly where they stand? After Lord Brightman in Furniss v Dawson had brought some sanity to the Ramsay principle by at least laying down two readily understandable tests which did, for the time being at least, provide a measure of the certainty taxpayers have the right to expect, Lord Templeman in Craven v White fought vigorously against attempts to keep the Ramsay principle within these bounds, preferring to allow the Inland Revenue to throw the whole question back into a state of confusion. In contrast to Lord Oliver's clear, closely reasoned and detailed speech, Lord Templeman's approach would not have left the law in a state such that taxpayers and their advisers could plan their actions with a reasonable amount of certainty, and Lord Templeman's petulant remark in Craven v White that a "knife-edged" majority had no right to limit the principle in the way they did[41] is unworthy of such a senior judge: it is precisely what they did have the right to do.

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41. [1988] STC 476 at p489, see Chapter 11

The Proper Role of the Judges

To appreciate fully the role the English judiciary has played, and will continue to play, and to answer the whole question of whether the judges should be developing, making or changing the law at all, an examination of the fundamental function of the Judiciary is required.

Compared with judges in the USA, English judges are remarkably slow in developing the law. American judges are currently very active in the field of judicial lawmaking, especially in the Supreme Court. The state courts are also active in this field. The UK has a far stronger tradition that judges must not make the law, a factor recognised by nearly all judges over the years, especially as regards tax law. The qualities required to produce good judges are very different from the qualities required to make good legislators. It is misleading, however, to compare directly the extent to which US and UK judges make law because the legal systems and the background in which they work are so different.

Professor Jaffe in his book "English and American Judges as Lawmakers" noted the political character of the American judiciary. He said:

> "Throughout American history nominations to the Supreme Court have been fought on the basis of the nominee's supposed political and social philosophy."[42]

He gave as a, perhaps, extreme example the cases of Hepburn v Griswold[43] and Knox v Lee.[44] In the former case the Supreme Court held by a four to three majority

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42. p60
43. 8 Wall 603 (1869)
44. 12 Wall 457 (1870)

that the Legal Tender Act was unconstitutional. Shortly afterwards President Grant appointed two new judges to the Court to fill vacancies that had arisen. In the latter case, both the new judges were in a five to four majority overruling the Hepburn case in holding that the Act was constitutional.

He further noted[45] that Warren had been a prominent contender for the Republical presidential nomination before withdrawing in favour of Eisenhower. He was rewarded with the Chief Justiceship. According to Professor Jaffe, he had been a county prosecutor, and then the Attorney General and a reasonably liberal Governor of California. As a lawyer, judge and thinker he was an unknown quantity.

Another judge appointed by President Eisenhower was Brennan. Professor Jaffe calls his appointment "something of a mystery". Although he had been a state judge with a good reputation, he probably owed his appointment "to being an Eastern Catholic at a moment when these were the desired qualifications."

Regarding the quality of American judges, Professor Jaffe said:

> "The judges of American are a mixed bag. The methods of selection and their tenure are only one set of determinants of their quality, their character and their performance. More important is the crucial role played in their selection by political considerations. Judgeships are a reward for party service. Many of our judges, particularly trial judges, are hacks, usually honest but sometimes, unfortunately, believed to be corrupt.

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45. p61

Even in the Federal system, where life tenures prevail, the district judges are of very uneven calibre. The reason is that they are normally selected by the senators from the state in which the district is situated. ......Presidents, such as Hoover, who try to oppose the system find that they will lose the necessary senatorial support for their programmes. President Kennedy was forced to appoint district judges in the South who were opposed to equal rights for negroes and were prepared to do what they could to sabotage Supreme Court decisions in their favour!

But we must not too much emphasise the seamy side of the American judicial scene. Both among the elected and the appointed judges there is a predominance of 'sound' men at the trual and even more at the appellate levels. The majority of these judges would be comparable to the English judges in competence and attitude, not quite so eloquent and assured in the trial of cases, a little freer in moulding doctrine and exposing their motivations. But beyond that there is a considerable leaven of judges on the Federal bench, and in the state courts of, for example, New York, New Jersey, Massachusetts, California, and Illinois, who have adopted the positive, activist manner which has come to characterise the American judiciary. They have been educated in law schools which promote free thinking about the law, and they have been encouraged by the Supreme Court and advanced public opinion to criticise and to innovate."[46]

As a contrast between American and UK judges, Professor Jaffe compared the way the concepts of freedom of speech and contempt of court are dealt with in the two countries. He said:

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46. pp62-3

"One of the most startling and symbolic developments in American law finds its explanation ultimately in the realisation that the judges are policy makers and should therefore be assessable to public opinion. It has long been the rule in England that any attempt to influence by word or deed the outcome of pending litigation is contempt of court and may be punished by summary judicial procedure without the intervention of a jury. 'Trial by newspaper', so customary in America, is completely forbidden in England.[47]

It was in 1941 that the Supreme Court held that trial by newspaper was constitutionally protected by the principles of freedom of speech and publication.[48]

This contrasts strongly with the position in England. Professor Jaffe noted:

"The English judiciary originally was a facet of the Kings Majesty. Criticism was lese-majeste. Something of that history may still explain the rigour with which the English courts suppress extra-judicial influences. On the other hand, the stress of the later independence of the English judiciary was on freedom from executive pressure. The very heart of England's famed justice was the subject's guarantee of a trial by judges whose sole allegiance was to the law. Both to protect and to symbolise this majestic insultation of the Chamber of Justice the judges were permitted to use their well-developed powers of contempt. And because the judges of the High Court were so invested with sanctity it became accepted that only lawyers of the

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47. p64
48. The cases in question were Bridges v California and Times-Mirror Co v Supreme Court, 314 US 252 (1941). The principle was emphasised a few years later in the cases of Pennekamp v Florida, 328 US 331 (1946) and Craig v Harney, 331 US 367 (1967).

highest learning and of unimpeachable character were to be chosen as judges."[49]

To show the difference between the two judiciaries, Professor Jaffe pointed out that the judge at first instance in the case of Craig v Harney[50] was not even a lawyer.

Because of the different backgrounds in which US and UK judges work, in examining how the judges perform, particularly in the area of lawmaking, it must be realised that these differences must be taken into account. For example, each state in the USA has its own legislature and there is, in addition, the Federal legislature. On the other hand, legislation in the UK all emanates from Parliament. Compared to the UK, the structure of the lawmaking process in the US is very complicated.

Not only are there a large number of legislatures, many of the legislatures at state level are badly organised and poorly staffed. Furthermore, at a Federal level, Congress is faced with a huge programme. Therefore, at both levels, a legislature of limited capacity is attempting to deal with a very full demand for legislation.

Parliament in the UK, on the other hand, appears to have a much greater capacity for dealing with the legislation with which it is expected to deal. There is thus probably a greater pressure for judicial lawmaking in America that there is in the UK.

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49. p67
50. Supra

Furthermore, the standard of drafting of legislation differs widely in the US and the UK. The Renton Committee[51] quoted Professor Reed Dickenson[52] and also Professor Dickenson's evidence to the Committee.

In Professor Dickenson's article he favourably contrasted the centralised drafting of the Parliamentary Counsel Office, staffed by full-time professionals, with the situation in Washington. He said:

> "Whereas in London the typical bill is drafted by a full-time professional, in Washington it is drafted by an inexperienced lawyer... or a partly experienced lawyer whose drafting duties are a mere incident to his other duties..... Certainly the most fertile single source of confused, difficult-to-read, overlapping and conflicting statutes in the lack of uniformity in approach, terminology and style. The ravages of heterogeneous authorship appear to be large in Washington and small in London.

In his evidence to the Committee he developed this theme:

> "Most legislation in the United States in drafted by people who, however good they may be in their substantive specialities, have only fleeting acquaintance with the expertise required for good drafting. This is perhaps the main reason why so much of American legislation is inadequate.... You are light years ahead of us in this respect."

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51. Op cit para 8.18
52. "legislature Drafting in London and Washington" [1959] Cambridge Law Journal 49.

This, no doubt, is relevant but the real reason, it is submitted, is more deep seated. Professor Jaffe appears to have been near the mark in his book. Commenting on the seeming conservative nature of the English judges, he said:

> "In the view of some commentators, in England a period of judicial retreat set in early this century. This was in part a consequence of attacks by politicians on the allegedly conservative bias of the judges. In the years after the First World War similar attacks by publicists may have reinforced the disposition to shed any appearance of making decisions which involved political problems or policy choices. The judges may have over-reacted."[53]

According to Professor Jaffe, the "self-avowed passivity of the English judges during the last half century[54] is an understandable response to the political pressures generated by the dynamic force of the merging social service state. We have seen that in the early part of the century and again in the thirties the English judges were under attack for reading the law, particularly statutes, with a too evident bias in favour of the status quo."[55]

An examination of the cases does indeed show that, throughout the period from the end of the First World War right through into the post-Ramsay era, the vast majority of English judges have spoken out strongly against judicial lawmaking.

Scrutton LJ, for example, was forthright in <u>IRC v The Gas</u>

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53. Op cit p15
54. He was writing inthe 1960's
55. p29

Lighting Improvement Co Ltd.[56] He said:

> "One has... to interpret the language used by Parliament..... and if Parliament has said in clear language a certain thing, it does not matter that it does not seem to us in accordance with the business meaning of capital or profit; that is a matter for the Legislature, and not for us."[57]

As he had said earlier in this judgment:

> "One has to be quite clear, when dealing with this and similar cases, that we are not here to legislate; we are not here to settle what is fair and reasonable; we are not here to explain what is the business meaning of capital or profits. We are here to administer an extremely artificial and conventional system laid down by the wisdom of the Legislature....."[58]

In this case the point in issue was what constituted "investments" for the purposes of Excess Profits Duty. The shares acquired by the taxpayer company could not, in any business sense, be termed "investments" but the artificial rules of the F(No2) Act 1915 clearly rendered the shares "investments" for the purposes of Excess Profits Duty.

Scrutton LJ was faced with a similar situation, but one decided in the taxpayer's favour, in Hall v IRC,[59] and once again was clearly of the view that it was solely up to Parliament to prevent taxpayers taking advantage of the law as it stood.[60]

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56. (1923) 7 TC 511
57. p527
58. p526 See also Viscount Finlay in the House of Lords at p539
59. (1926) 11 TC 24
60. See p43

Members of the House of Lords in the same year expressed themselves in similar terms in one of the cases in which a company capitalised part of its undivided profits and created stock which it issued by way of bonus in lieu of a distribution: IRC v Fisher's Executors.[61] It can be seen in Chapter 1 that, although the shareholders ended up in the same position as if they had received a distribution, it was held that no Super-tax liability arose, a situation contrary to the spirit of the legislation.

Lord Shaw of Dunfermline noted the argument that "the true meaning and intent of the Income Tax Acts is that this increment of wealth should be taxed for public uses" but said:

> "The other view, and the one which in my humble judgment is sound, is these things may, to speak generally, be very true, but they are not for the consideration of the judiciary; they may demand or require the attention of the Executive and of the Legislature, but the task of the Judiciary is simply to comply not with the law as it ought to be but with the law as it is and it is that law alone which forms the prescription for the decision of the case here stated. In that prescription note must be taken of any loyalty given to the decisions of this House; otherwise, neither the Crown nor the subject would ever know where they were."[62]

Lord Shaw underlined his view when he stated:

> "The administrative or financial questions underlying your Lordships' decision are for consideration, as I have said, by the Executive and the Legislature, but

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61. (1926) 10 TC 302
62. p335. The question of certainty in the law is dealt with, infra.

cannot control the loyalty which we must pay to the text of the statutes and the judicial interpretations thereof."[63]

This is clear and unequivocal. Lord Shaw would accept no inroads being made on the traditional position that the judges must not change the law, despite being faced with a scheme which was, as he acknowledged, contrary to the spirit of the Act. As has been seen in Chapter 11, this speech, and that of Lord Sumner, are also noteable for the uncomprising refusal of these Law Lords to move towards any principle of "substance" or economic equivalence.

Lord Sumner, on the separation of powers issue, was as clear as Lord Shaw. Referring to his finding that the taxpayer was not taxable, he stated:

> "How far this position is tolerable is, however, a matter for the Legislature. It is not material here, but I think it may well be doubted whether, in the long run, it should be permissible for a limited liability company to create obligations, for which no consideration has been given for it, or to increase its paid up share capital out of its own assets, without imposing on the holders of this additional share capital the usual obligations, which are involved in the subscription of shares."[64]

Precisely the same line was taken by Lord Hanworth MR, in connection with a similar scheme, in IRC v Wright.[65]

The same clear statements can be seen in judgments given from the end of the Second World War onwards. Speaking

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63. p336
64. p341
65. (1926) 11 TC 181 at p206

in 1946, Wrottesley J, at first instance, in Congreve v IRC[66] said that:

> ".....the Courts are not here to make the efforts of the Legislature to circumvent tax evasion more efficient than is provided by the language, particularly when that involves disregarding the ordinary plain language of the preamble, and the fact that that preamble is deliberately drawn into the fabric of the operative section. Here the Legislature has been careful to hedge about the operative section with words which indicate that the target is an individual who is trying to avoid tax by means of a particular course of conduct. It is not for the Courts to widen that target so as to include persons who have not evaded liability, at any rate by the means referred to."[67]

In fact, the decision of Wrottesley J (namely, in favour of the taxpayer) and his view of the role of the preamble[68] were overruled by the higher courts, but there was nothing said in those higher courts to detract from the underlying principle that the courts must not widen the law to make anti-avoidance provisions more effective.

This was emphasised, in no uncertain terms by dicta in two House of Lords decisions in 1949. The first of these was Wolfson v IRC.[69] This case is considered in Chapter 2 in connection with the settlement provisions. It was concerned with the question of whether a settlement was revocable or not. The House of Lords held that, on the facts, the settlement was not revocable so that the settlor was not liable to tax on the income of the settlement. This finding showed that there was an easy way to avoid income tax under what was then section 38 FA 1938.

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66. (1948) 30 TC 163
67. p186
68. In section 18 FA 1936; see Chapter 9
69. (1949) 31 TC 141

Lord Simonds stated:

> "I was urged that the construction that I favour leaves an easy loophole through which the evasive taxpayer may find escape. That may be so; but I will repeat what has been said before. It is not the function of a court of law to give the words a strained and unnatural meaning because only thus will a taxing section apply to a transaction which, had the Legislature though of it, would have been covered by appropriate words, it is the duty of the Court to give the words of this subsection their reasonable meaning and I must decline on any ground of policy to given to them a meaning which..... I regard as little short of extravagant."[70]

Lord Normand took the same line, declaring that the amendment of the section to cover the device in question was for Parliament not the Courts.[71]

In the other case in 1949, Lord Vestey's Executors and Vestey v IRC,[72] another case on the transfer of assets abroad, Lord Normand spoke out in even stronger terms against judicial lawmaking in the field of taxation. He declared:

> "Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden and it is disappointing to the Inland Revenue, but the Court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statute. Tax avoidance is an evil, but it would be the

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70. p169
71. p171 See also Lord Reid's very short speech on p172
72. (1949) 31 TC 1, see Chapter 9

> beginning of much greater evils if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapprove."[73]

The subject of the separation of powers came up in two interesting contexts in a later Vestey case: Vestey v IRC;[74] one related to judges making the law, the other concerned the Executive making the law. The House of Lords firmly set their face against each of these types of lawmaking.

It can be seen in Chapter 9 that the Inland Revenue claimed to have a discretion to select which of a number of beneficiaries they would tax, and to choose the apportionment between them.

As Walton J said at first instance:

> "This is not a simple matter of tax law. What is happening is that, in effect, despite the words of Maitland (The Constitutional History of England 1909) commenting on the Bill of Rights, 'This is the last of the dispensing power', the Crown is now claiming just such a power."[75]

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73. p90. See also Jenkins LJ in Heelex Investments ltd v IRC (1955) 35 TC 532 at p542; Lord Reid in Saunders v IRC (1957) 37 TC 416 at p436; Lord Upjohn in IRC v Cleary (1967) 44 TC 399 at p429 (who accepted that his finding for the Crown may have seemed harsh "but this is a matter for Parliament"); Salmon LJ in Hague v IRC (1968) 44 TC 619 at p641; Megarry J in IRC v Brown (1971) 47 TC 217; Lord Donovan in Mangin v IRC [1971] AC 739 at p749; Stamp LJ in C & J Clark Ltd v IRC (1974) 50 TC 103 at p116; Lord Wilberforce in Ransom v Higgs (1974) 50 TC 1 at p91 and in IRC v Plummer (1979) 54 TC 1 at pp42 (Lord Wilberforce's dicta are considered supra) and Viscount Dilhorne in Plummer at p48 who all refused to usurp the functions of Parliament.
74. (1979) 54 TC 503; see Chapter 9
75. p551

Walton J was not attracted to this idea at all. He commented:

> "If this is indeed so, we are back to the days of the Star Chamber. Again, I want to make it crystal clear that nobody is suggesting that the Crown has, or indeed ever would, so utilise the powers which it claims to bring about unjust results; or really, of course, which is not necessarily the same thing, results which are thought to be unjust. The root of the evil is that it claims that it has, in fact, the right to do so."[76]

Lord Wilberforce in the House of Lords was similarly appelled by the idea. He considered the Revenue's contention to be "frightening enough" but there were more fundamental objections. He stated:

> "Taxes are imposed upon subjects by Parliament. A citizen cannot be taxed unless he is designated in clear terms by a taxing Act as a taxpayer and the amount of his liability is clearly defined. A proposition that whether a subject is to be taxed or not, or, if he is, the amount of his liability, is to be decided (even through within a limit) by an administrative body represents a radical departure from constitutional principle. It may be that the Revenue could persuade Parliament to enact such a proposition in such terms that the courts would have to give effect to it: but, unless it has done so, the courts, acting on constitutional principles, not only should not, but cannot, validate it."[77]

Lord Edmund-Davies considered the "unconstitutional devices" resorted to by the Inland Revenue to be "remarkable" and "disturbing".[78]

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76. p552
77. p581
78. p602

Given that the submissions of the Revenue were condemned by all of the judges, the question then arose as to how they would deal with the matter. It has been seen in Chapter 9 that the House of Lords solved the problem by overruling the Congreve case. However, the attempt by Walton J to deal with the question in another way raised the other separation of powers point, the role of judges as lawmakers.

Again, can be seen in Chapter 9 that Walton J effectively added words to section 412(2) ITA 1952 so that it read:

> "Where, whether before or after any such transfer, such an individual receives or is entitled to receive any capital sum the payment thereof is in any way connected with the transfer or any associated operation, to the extent to which it comprises any income which, by virtue or inconsequence of the transfer etc."[79]

Not surprisingly, Counsel for the Crown strongly objected to this.[80] Furthermore, in the light of the Crown's arguments in some of the Ramsay principle cases, in which they sought to persuade the judges to go beyond the clear words of the statute, it is interesting to note that they complained:

> "Where, as in the case of taxing Acts, the great majority of subjects pay their tax, however unwillingly, in accordance with the wording of the relevant enactment, it is particularly undesirable that the courts should, many years after the relevant section first came into force, rewrite it in accordance with their own ideas of what at the time of the decision is considered to be fair."[81]

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79. Added words underlined
80. See p566
81. p567

Burmah Oil Ltd and the Dawson family, amongst others, would probably wholeheartedly agree.

The Law Lords, whilst having sympathy with what Walton J was trying to achieve (and he, of course, could not overrule Congreve), they were bound to reject his method.

Lord Wilberforce accepted that Walton J's amendment would produce a result "that would be intelligible, workable, certain, and, from some points of view, not unjust". Assessments would be "clear and mandatory, and lacking in any element of arbitrariness and discretion." However, he regretted that he was unable to accept the judges limitation. He said:

> "The Judge achieved it by means of what he (justly) described as a bold emendation through the insertion of words."[82]

But he added that inspection of the emendation:

> "shows that the process involved is not one of construction, even one of strained construction, but is one rewriting the enactment."[83]

Viscount Dilhorne, when considering Walton J's amendment, commented:

> "Such a radical alteration of the plain language of this part of the subsection is one that in my opinion can only be made by Parliament."[84]

Even in the Ramsay case itself, Lord Wilberforce was emphasising the principle that judges should not make law.[85] He said:

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82. p579
83. p580
84. p590
85. Although there is the question of how far he himself made law in that case; as to which see Chapter 11.

"For the taxpayers it was said that to accept the Crown's wide contention involved a rejection of accepted and established canons, and that, if so general an attack upon schemes for tax avoidance as the Crown suggests is to be validated, that is a matter for Parliament. The function of the courts is to apply strictly and correctly the legislation which Parliament has enacted; if the taxpayer escapes the charge, it is for Parliament, if it disapproves of the result, to close the gap. General principles against tax avoidance are, it was claimed, for Parliament to lay down.... I have full respect for the principles which have been stated..."[86]

Having made this clear pronouncement, he then went on to say, and this is the key to his approach:

"....but I do not consider that they should exclude the approach for which the Crown contends. That does not introduce a new principle; it would be to apply to new and sophisticated legal devices the undoubted power and duty of the courts to determine their nature in law and to relate them to existing legislation."[87]

Despite Lord Wilberforce's rationalisation of his approach, it has been seen in Chapter 11 that, in reality, the Ramsay principle did contain elements of pure judicial lawmaking.

Throughout the developments of the Ramsay principle, the courts did not directly address the question of judicial lawmaking. However, in the cases in which the judges, including a majority of those sitting in the House of Lords, limited the application of the principle, some of

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86. (1981) 54 TC 101 at pp186-7
87. Ibid

the judges did discuss the question of judges as lawmakers.

In Craven v White at first instance,[88] Peter Gibson J was very clear as to his role. He said:

> "It seems to me that what I am being invited to hold by the Crown would amount to judicial legislation. Parliament in other fiscal contexts, such as estate duty and capital transfer tax, has enacted provisions relating to associated operations so that a disposal by two or more such operations is made subject to tax. I am not prepared to do what Parliament has not thought fit to enact."[89]

Similarly, in IRC v Bowater property Developments Ltd in the High Court,[90] Warner J replied to the Crown's argument that the Ramsay principle was a judge made anti-avoidance rule which it was open to the courts to mould and develop in the light of their experience of tax avoidance devices, by declaring:

> "In my opinion, however, that would be nothing short of unconstitutional. Under our constitution the imposition of taxation is a matter for Parliament. Indeed, within Parliament itself it is a matter in which the House of Commons has a predominant role. The only function of the courts in the sphere is to interpret and apply the legislation enacted by Parliament in accordance with relevant legal principles."[91]

He also adopted the passage from Peter Gibson J's judgment in Craven v White quoted above.[92]

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88. [1985] STC 531
89. p562
90. [1985] STC 783
91. p798
92. p799

This approach was followed in the Court of Appeal when these two cases were heard together with Baylis v Gregory.[93] Slade LJ, for example, echoed Peter Gibson J's point about associated operations. He said:

> "Various fiscal statutes expressly state that the term 'disposition' includes a 'disposition effected by associated operations'. Simply, for example, section 51(1) of the Finance Act 1975 (in the context of capital transfer tax) so provides; and section 44(1)(b) of the Act provides that 'associated operations' means 'any two operations of which one is effected with reference to the other, or with a view to enabling the other to be effected or facilitating its being effected....' If the capital gains tax legislation had included similar provisions, the Crown's basic contention might have been easily sustainable. In my judgment, however, the gap cannot be filled by judicial legislation."[94]

Slade LJ also associated himself with the observations of Warner J set out above.[95]

In the House of Lords.[96] Lord Templeman, on of the champions of the Ramsay principle, clearly did not see it as judicial lawmaking; but rather as statutory interpretation. He commented:

> "Parliament intends that a taxpayers shall be free to place an asset out of reach of the taxing provisions. The courts have neither the power not the desire to interfere. Ramsay, Burmah and Dawson, however, decided that there is a distinction between an independent transaction carried out to avoid the ambit of a taxing statute in a manner authorised by Parliament and a transaction which is not an

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93. [1987] STC 297
94. pp309-10
95. p319
96. [1988] STC 476

independent transaction but forms part of an artificial tax avoidance scheme designed to enable the taxpayer to carry out a taxable transaction and to avoid an assessment to tax. Parliament cannot have intended that an individual taxpayer should be able to elect to carry out a taxable transaction without paying the tax which Parliament has imposed proportionately on all taxpayers. The court is entitled and bound to construe the taxing statute and to apply the taxing statute in relation to the scheme as a whole."[97]

Lord Templeman ought to know better. The decision he noted that was made in Ramsay, Burmah and Dawson certainly had no basis in any statute. Many statutes, particularly more recent ones, do have provisions giving rise to different consequences where the transactions are intended to avoid tax, but none of the provisions at point in those three cases were in such a form. In fact, the Dawson provisions, as has already been noted, was subsequently amended to contain a bona fide commercial condition[98] but Parliament expressly, deliberately and unequivocally decided that such a condition would not apply at the time when the Dawson transactions were carried out.

Furthermore, his point about independent transactions ignores the conspicuous absence - noted by Peter Gibson J, amongst others - of any "associated operations" rules in any of the provisions relevant to the Ramsay, Burmah and Dawson decisions. Accordingly, Parliament had not given the courts power in those cases to apply the taxing statutes in relation to the scheme as a whole.

Lord Oliver, as noted in Chapter 11, effectively restricted the Ramsay principle to being a rule of

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97. pp487-8; see Chapter 11
98. Now section 98 CGTA 1979

statutory construction but he did not confuse the concepts of statutory construction and judicial lawmaking. During his detailed and closely-reasoned judgment he said:

> "It has been said in the course of argument on the present appeals that Dawson is 'judge-made-law'. So it is, but judges are not legislators and if the result of a judicial decision is to contradict the express statutory consequences which have been declared by Parliament to attach to a particular transactions which has been found as a fact to have taken place, that can be justified only because, as a matter of construction of the statute, the court has ascertained that that which has taken place is not, within the meaning of the statute, the transaction to which those consequences attach."[99]

Lord Oliver also addressed this point directly as follows:

> "The suggestion that there should be introduced a moral dimension into the equation is important, however, since it forms the basis of the suggestion implicit in the Crown's submission on the instant appeals that the limits expressed by Lord Brightman in his speech are too narrowly drawn because, when so drawn, 'it would be easy for the taxpayer to circumvent them'. Your Lordships are thus invited not simply to analyse the transaction, to construe the statute and then to apply it to the analysis of what the taxpayer has really done, but to construe a general catch-all formula for rendering ineffective any step undertaken with a view to the avoidance or minimisation of tax on an anticipated transaction or disposition. That is an invitation to legislate and it goes a very long way beyond what, at any rate was

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99. p497

expressed to be the ratio of Ramsay and of Dawson itself....."[100]

He further examined the distinction between construction and legislating later in his judgment when he said:

> "..... on the footing which I believe to be correct and which I understand to be accepted by all your Lordships, that the question dealt with in all three of the cases of Ramsay, Burmah and Dawson is essentially one of statutory construction, I cannot for my part follow from what principle of statutory construction the proposition for which Dawson is now said to be authority derives. Essentially, Dawson was concerned with a question which is common to all successive transactions where an actual transfer of property has taken place to a corporate entity which subsequently carries out a further disposition to an ultimate disponee. The question is 'when is a disposal not a disposal within the terms of the statute?' To give to that question the answer, 'when, on an analysis of the facts, it is seen in reality to be a different transaction altogether' is well within the accepted canons of construction. To answer it, 'when, it is effect with a view to avoiding tax on another contemplated transaction' is to do more than simply to place a gloss on the words of the statute. It is to add a limitation or qualification which the legislature itself has not sought to express and for which there is no context in the statute. That, however desirable it may seem, is to legislate, not to construe, and that is something which is not within judicial competence. I can find nothing in Dawson or in the cases which preceded it which causes me to suppose that that was what this House was seeking to do."[101]

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100. pp501-2
101. p504

That is perhaps the clearest and most accurate distinction between construction and lawmaking that has been made in recent years.[102]

Lord Oliver considered that the Crown's submissions amounted to an attempt to reconstruct events because "one or more of them was motivated by a desire to avoid or minimise tax."[103] He firmly rejected this in a clear statement of principle that focuses on the proper role of the judges in such cases and is in stark contract to the muddled thinking of some of the other Law Lords in the Ramsay, Burmah Oil and Furniss v Dawson cases, and even in Craven v White itself. This passage deserves to be set out in full. Commenting on the contention that transactions should be reconstructed because of the motive to avoid tax, he said:

> "That may be a very beneficial objective but it has to be recognised that the rational basis of Ramsay and Dawson then becomes irrelevant and is replaced by a principle of nullifying a tax advantage derived from any 'associated operation'. The legislature has not gone this far and the question is should or can your Lordships?
>
> My Lords, I do not think so. I am at one with those of your Lordships who find the complicated and stylised antics of the tax avoidance industry both undefying and unattractive but I entirely dissent from the proposition that because there is present in each of the three appeals before this House the element of a desire to mitigate or postpone the taxpayers' tax burdens, this fact alone demands from your Lordships a predisposition to expand the scope of the doctrine of Ramsay and of Dawson beyond its rational basis in order to strike down a transaction

102. See also Lord Jauncey at pp521-2
103. p507

which would not otherwise realistically fall within it.

Nor do I consider that the Ramsay approach, which is no doubt applicable to a much wider variety of transactions than those embraced in the instant appeals, requires further exposition or clarification. Its basis is manifest and has been clearly explained by Lord Wilberforce. What the Crown urge upon your Lordships is a restatement of the approach in a formula based, as it seems to me, not upon seeking to identify the reality of sequential transactions, but upon a much wider, but at the moment undefined, general principle of judicial disapprobation of the lawful rearrangement of the subject's affairs designed to produce a result which if fiscally advantageous to him in relation to a transaction into which he anticipates entering. That is essentially a legislative exercise and one upon which, in my opinion, your Lordships should hesitate long before embarking."[104]

How different is this approach, clearly based on the traditional attitudes of the Judiciary, from that of Lord Templeman, who has appeared to have let his passionate dislike of tax avoidance blur the distinction in his mind between construction and lawmaking.

Lord Goff also denied that the developing Ramsay principle involves judicial lawmaking. He saw the "development" of the principle from case to case as an ordinary procedure. No case, he thought, should be read as completely encapsulating the law:

"Every case is, as always, a decision on its own facts; and every statement of legal principle tends to be coloured by the facts of the particular case and in any event is, in the ultimate analysis, no

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104. pp507-8

more than a working hypothesis. But it must not be thought that, as a consequence, the courts have gone beyond their proper function in these cases and have indulged, illegitimately, in legislation...... In each case, your Lordships' House has been seeking to ascertain the true intention of Parliament when it has applied the words of the statute to the facts of the case before it; and insofar as your Lordships have been attempting, in any particular case, a statement of principle, that statement of principle has been an attempt to formulate the Parliamentary intention with an eye to the facts of that particular case. We have therefore to exercise great care before we assume that every feature referred to in any particular statement of the law is necessarily applicable in later cases. Of course, as the cases have been decided, one by one, we have been enabled to perceive more clearly how the principle should be stated; but the process of formulation can never be absolutely complete, and that it is in fact still in a state of active development was expressly recognised in Dawson both by Lord Scarman and by Lord Bridge. It follows that it would be quite wrong to regard Dawson as containing any definitive statement of the law, or as marking the final limit of the development of the Ramsay principle; so to hold would, in my opinion, not only fly in the face of the express statements in that case to which I have just referred, but in truth constitute a rejection of the spirit of the decided cases."[105]

The real flaw in this reasoning is the use of the concept of developing the principle. This phrase, in the sense used by, for example, Lord Goff and Lord Scarman, is, in truth, no more than a euphemism for judicial lawmaking, despite Lord Goff's protestations to the contrary.

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105. pp511-2

An Analysis of Judicial Lawmaking

It has been seen that in pre-Ramsay and even in the post-Ramsay years, some judges have stated that they are not happy with the law as it stands, but that they must comply with it, any changes having to come from the Legislature. Some judges, such as Lord Denning, have to a certain extent rebelled against what they see as this straightjacket. In the field of tax law, it has been noted that this rebellion has occurred mainly in the Ramsay line of cases.

There are dangers for the Judiciary in this course. As Lord Devlin has said:

> "If a judge leaves the law and makes his own decisions, even if in substance they are just, he loses the protection of the law and sacrifices the appearance of impartiality which is given by adherence to the law. He expresses himself personally to the dissatisfied litigant and exposes himself to criticism. But if the stroke is inflicted by law, it leaves no sense of individual injustice; the losing party is not a victim who has been singled out; it is the same for everybody, he says."[106]

By leaving the realm of strict interpretation and embarking on a programme of "developing" (ie making) the law as a matter of policy, the Law Lords responsible have indeed exposed themselves to criticism. The law did need changing to stem the tide of highly artificial tax avoidance, but it was not the role of the House of Lords to take it upon themselves. It is precisely this role - acting on policy matters - that the subject traditionally looks to the Legislature to fulfil.

106. "Judges and Lawmakers" (1976) 39 MLR 1 at p4

The well-known US judge, Mr Justice Frankfurter has said:

> "Courts can fulfill their responsibility in a democratic society only to the extent that they succeed in shaping their judgments by rational standards, and rational standards are both impersonal and communicable. Matters of policy.... are by definition matters which demand the resolution of conflicts of value, and the elements of conflicting values are largely imponderable."[107]

A similar point to that made by Lord Devlin was made by another eminent Law Lord, Lord Radcliffe in his book "The Law and its Compass". He said:

> "We cannot run the risk of finding the archetypal image of the judge confused in mens' minds with the very different image of the legislator. We cannot run the risk that an institution which societies such as ours have never known how to do without should be destroyed merely through an untimely eagerness to be all things to all men, to be at the head and the rear and the centre of the column all at one time."[108]

The reason was that such a confusion would destroy the image of the judge as "objective, impartial, erudite, and experienced declarer of the law" which "lies deeper in the consciousness of civilisation than the image of the lawmaker".

This is the fundamental reason why the policy of judges such as Lords Roskill and Templeman is so destructive to both the image of the judges and the foundations of the system they control.

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107. A.F of L v American Sash Co 335 US 538 at p557 (1948)
108. p14

Herein lies the essential division of opinion which may be encapsulated by asking whether the absolute distinction between legislator and judge made by Lord Radcliffe is too definite in the context of modern tax law in that, like Lord Devlin's view, it encourages the passivity for which English judges have been criticised in other areas; or is this distinction an essential one, as Lords Radcliffe and Devlin argued, to protect the status of the judge. The answer must be that the distinction is essential and must be maintained. The chaos produced by the Ramsay principle and the almost unprecedented criticism of the Law Lords responsible, clearly bear out the accuracy of the observations of Lords Radcliffe and Devlin.

It is no answer to point out that much law is judge made, because this is generally only the cases where there is a void to be filled and where court decisions formulate rules which form the basis for future decisions by means of the principle of precedent. It is not the case, in areas where there is settled law, that judges generally go against that settled law to devise revolutionary new principles.

In particular, in tax cases, judges have traditionally restricted themselves, on the whole, to judicial lawmaking (such as it is) merely based on the points at issue between the litigants in the cases before them; they have not concerned themselves with wider issued. Numerous principles have been developed by case law in this way; for example, what constitutes a trade, what is revenue as opposed to capital, what expenditure is "wholly and exclusively" incurred for the purpose of a trade, what "plant" means, and so on. By their interpretations on these points, the judges have indeed, in one sense, "made" the law.

However, in the cases leading up to, and following Ramsay, many judges have concerned themselves with wider issues than the specific matters in point between the taxpayer and the Revenue in the case before them, and they have dealt with social issues such as each man must pay his fair share of taxes, and it is not right that those who can afford to pay tax experts should get away without paying taxes a normal member of the public has to pay. As a policy decision, it has been declared that artificial tax avoidance is an evil and the tax avoidance industry must be destroyed.[109]

These wider issues should not be the concern of judges because there is a danger that they may not discharge their judicial function properly if they take it upon themselves to consider these wider issues.

In tax cases, as in other areas of the law, the scope and content of judges' decisions are expanding, and their object tends to be different. More ground is covered; sometimes judgments are, or are intended to be, definitive surveys of he points in issue. This is particularly so in the House of Lords where the judgments in general tend to contain a broader discussion that those given in the lower courts. Nevertheless, a judge in a tax case still cannot hope to encompass, whilst adequately fulfilling his judicial function, all of the many factors that today effect the formulation of the law: commercial and business pressures, economic trends, the growth in the expertise and sophistication of taxpayers and their advisers, marketing techniques involving tax schemes, and so on.

This is the job of the Legislature. The legislators must attempt to keep pace with changes in society; to ensure as far as they can that the law develops in line with developments in the social structure and attitudes of the country. This can take two forms. Lord Devlin drew a

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109. See Lord Templeman's remarks at the Institute for Fiscal Studies conference, supra

distinction between "activist" and "creative" or "dynamic" lawmaking. In Lord Devlin's view, whereas the idea in "activist" lawmaking comes from the consensus, in "dynamic" lawmaking "the idea is created outside the consensus and, before it is formulated, it has to be propagated."[110] In other words, lawmaking is being used to alter the consensus. This, he said, needs enthusiasm which is not and cannot be a judicial virtue because it means taking sides.

If Lord Devlin's distinction is adopted between activist and dynamic lawmaking, the question arises; what kind of lawmaking was demonstrated in Ramsay?

It may be that someone following the Templeman/Roskill line would argue along the following lines. What is the consensus on the question of tax avoidance? If one were to ask a cross-section of ordinary people the question whether they thought wealthy taxpayers should be able to avoid all or part of their tax bills by artificial manoeuvres, a large majority would undoubtedly say "no". But that does not really get the Templeman/Roskill faction very far; even the leading anti-Ramsay Law Lord, Lord Oliver does not like the antics of the tax avoidance industry. Only on a superficial level could it be said that the Ramsay principle was activist lawmaking.

When considering this matter in depth in the context of tax law, it is necessary to remember that tax law is based on statute, not the common law. It is surely not irrelevant that a large number of Law Lords are from a common law background, and so may have imported common law attitudes to their consideration of tax law.

This distinction between common law and statute law such as taxation is important and sometimes overlooked when judicial lawmaking is examined. Lord Devlin said of the common law:

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110. Op cit p5

> "The public is not interested in the common law as a whole. When it becomes interested in any particular section of it, it calls for a statute; the rest it leaves to the judges. The consensus is expressed in a general warrant for judicial lawmaking. This warrant is an informal and rather negative one, amounting to a willingness to let the judges get on with their traditional work on two conditions - first, that they do it in their traditional way, ie, in accordance with precedent, and second, that parliamentary inference should be regarded as unobjectionable."[111]

However, on statute law, Lord Devlin was strongly of the opinion that:

> "there can be no general warrant authorising the judges to do anything except interpret and apply. Beyond that the support of the consensus depends on the subject-matter of each particular statute. When the consensus behind the purpose of a statute is clear and strong, a judge could perhaps risk...... going beyond interpretation towards development. But remember that to be effective a statute does not need to have consensus; it could be extremely controversial. Then a judge must be very cautious about any extension of the written word and may have to decide the case 'in typical English judicial fashion', as Professor Jaffe remarked of the decision in Rookes v Barnard, treating 'the matter as an exercise in abstract logic'. It is not, I believe, that an English judge is peculiarly fond of abstract logic, but he prefers it to taking sides."[112]

Lord Devlin concluded that:

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111. Ibid p9
112. Ibid

> "in the common law there is a general warrant for judicial lawmaking; in statute law there is not. In the common law development is permitted, if not expected; in statute law there must at least be a presumption that Parliament has on the topic it is dealing with said all that it wanted to say."[113]

It is submitted that this is right and that the Law Lords were wrong in importing into tax law the common law practice of developing the law. This seems to be implicit in the judgments of those judges in Craven v White who spoke out against the "development" of the Ramsay principle sought by the Crown.

As is explained in Chapter 11, the courts have moved away from the literal interpretation of statutory provisions and have to a certain extent moved into the realms of judicial lawmaking, ignoring the established principle that words must be given their natural and ordinary meaning. What is often misunderstood is that there is no necessary conflict between this traditional rule of statutory construction and looking to the purpose of a statute. A purposive approach can be adopted as long as the words are respected and given their normal meaning. This is not adopting a strict, literal approach which Lord Wilberforce, amongst others, has declared unsuitable in today's fast-moving world of tax avoidance.

There appears to have been a reaction against the traditional narrow interpretation by judges in tax cases. This is no doubt due, at least in part, to the way taxpayers have exploited the literal interpretation. But what was the root of this literal interpretation? It was probably a reaction to a social attitude of an earlier age. Lord Devlin, talking about statute law in general, not just about tax, appears to be near the mark with the following observation:

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113. Ibid

"In the past judges have been obstructive. But the source of the obstruction, it is very important to note, has been the refusal of judges to act on the ordinary meaning of words. They looked for the philosophy behind the Act and what they found was a Victorian Bill of Rights favouring (subject to the observance of the accepted standards of morality) the liberty of the individual, the freedom of contract and the sacredness of property, and which was highly suspicious of taxation. If the Act interfered with these notions, the judges tended either to assume that it could not mean what it said or to minimise the interference by giving the intrusive words the narrowest possible construction, even to the point of pedantry."[114]

The "clear words" principle[115] certainly appears to be a result of this attitude.

Even in the common law, as Lord Devlin pointed out, activist lawmaking must act within the consensus to be democratic. To act within the consensus there must be a consensus in the first place. If the matter is one on which the public are indifferent they are happy to leave it to the judges in the common law field. Examples cited by Lord Devlin are the Donogue v Stevenson principle in tort and punitive damages in Rookes v Barnard.

It is when the common law concept of judicial activism is transposed into statute based tax law that problems arise. It is not legitimate to seek the consensus as regards, for example, the Ramsay principle. In any case, even if it were proper to do so, the public would have to be asked the right question. It would not do merely to say: "Should tax avoiders be allowed to get away with it by using highly artificial schemes or should we, the

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114. Op cit pp13-14
115. See Chapter 11

judges put a stop to their antics?". They would also have to asked questions such as:

(1) "Is it alright if a taxpayer is caught if he does something legal but we, the judges, later change the law retrospectively?"

(2) "Do you mind that out new law leaves the position in a confused state so that it is difficult for you or your advisers to act with the certainty that is your right?"

Other similar question could be posed but it would be pointless to do so because the whole basis of adopting consensus principles to tax law is flawed. This was clearly recognised and demonstrated by Lord Radcliffe. In his book "Not in Feather Beds" he commented:

> "In this context there was never a more sterile controversy than that upon the question whether a judge makes law. Of course he does. How can he help it? The legislature and the judicial process respectively are two complementary sources of lawmaking, and in a well ordered state each has to understand its respective functions and limitations. Judicial law is always a reinterpretation of principles in the light of new combinations of facts, of which very relevant ones, unprovable by evidence, are the current beliefs of the society in which those facts occur. True, judges do not reverse principles, once well established, but they do modify them, extend them, restrict them or even deny their applicability to the combination in hand. But does Parliament do anything very different in its lawmaking, except in some revolutionary context to which no ordinary rules can be referred? I doubt it. It is not that the well known phrase 'That it not for us, it is for the legislature' does not carry plenty of significant meaning. What it means is, I think, that, while it is an illusion to suppose that the legislature is attending or can

possibly attend all the time to all aspects of the law, there are certain areas of public interest which at any one time can be seen to be a matter of its current concern. It has recently legislated on that subject according to certain principles (if they can be defected) or it regularly legislates on the whole field covered by that subject (as, for instance, the law of taxation). In those areas I think that the judge needs to be particularly circumspect in the use of his power to declare the law, not because the principles adopted by Parliament are more satisfactory or more enlightened than those which would comment themselves to his mind, but because it is unacceptable constitutionally that there should be two independent sources of lawmaking at work at the same time."[116]

This is the fundamental point, a point even recognised at one time by Lord Scarman, one of the judges involved in the formulation of the Ramsay principle. Compare his view expressed in Furniss v Dawson with his comment in Duport Steels Ltd v Sirs[117] where he noted that:

> "in the field of statute law the judge must be obedient to the will of Parliament as expressed in its enactments. In this field Parliament makes, and unmakes, the law: the judge's duty is to interpret and apply the law, not to change it to meet the judge's idea of what justice requires."

Leaving aside constitutional issues, from a practical point of view, a court is not an ideal forum for lawmaking in areas as detailed as tax law. A judge is necessarily limited by the facts and points in issue in the case before him. The arguments he considers are, in

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116. pp215-6
117. [1980] 1 WLR 142 at pp168-9

the main, put to him by Counsel; the amount of new material and research introduced by the judge is normally very limited. There are time constraints too: court time is extremely expensive and it is being paid for by the parties.

Counsel in general put forward only those arguments relevant to their respective clients' case; rarely are they interested in developing the law in a wider context. Some of the arguments advanced on behalf of the Crown in the Ramsay line of cases and cases leading up to Ramsay on such things as the "substance" doctrine and tax avoidance are among the exceptions to this general rule. This is primarily because the interests of the Inland Revenue often go beyond the precise facts of the case in question: a decision in one case often affects many taxpayers, not just the one whose case is being heard. Looked at another way, there will almost certainly be parties who are directly concerned with, and are affected by, the decision who are not represented in the case.

If the law is to be changed, particularly in such a far-reaching fashion as in the Ramsay case, it should only be done after consultation with the public and professional bodies. Consultation is becoming an increasingly important part of the legislative process and has always been a major part of the operations of the Law Commission.

Malcolm Gammie examined the whole question of consultation in his report "The Enactment of Tax legislation : An Analysis of the Consultative Process and the Finance Acts 1979 to 1987."[118] This report confirms the growth in consultation between the Government, the Inland Revenue and outside bodies in the years under review "the like of which has had previously been

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118. Published by the Law Society (1988)

experienced and which is perhaps not matched in any other area of legislature activity."[119]

Gammie's research also disclosed that, as well as the publicity acknowledged consultation, there is a great deal of undisclosed consultation. His findings show that:

> "where a particular interest group is involved in the implementation or administration of the tax system, it will be consulted (provided an appropriate professional or representative body or representative members can be identified). Guidance on tax matters provided by the professional and representative bodies to their members and to the wider public will often result from discussions with the Revenue Departments, sometimes initiated by the Revenue Department and on other occasions by the professional or representative body concerned..... There is an ongoing consultative process represented by the Government's willingness, directly through Ministers and indirectly through the Revenue Departments, to receive and listen to representations. In particular, there is a regular process (largely unpublished) of Budget and Finance Bill representations by the many professional, trade and other representative bodies. This leads to a wide range of topics being addressed and discussed with Government or its servants."[120]

The consultative process in the years under review "covered most aspects of the direct and indirect tax system in one way or another."[121] For example, at least six major areas of the direct tax system had been the subject of "fundamental review". These were identified as:

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119. Introduction, para 4
120. Paras A1.4 and A1.5
121. Para A2.1

(i) capital taxes;

(ii) international aspects of the direct tax system;

(iii) non-cash benefits for employees;

(iv) corporate taxation;

(v) the enforcement powers of the Revenue Departments; and

(vi) the personal tax system, especially the taxation of husband and wife.[122]

By comparison, judge made tax law does not have the care taken over it that tax legislation has in terms, of, say, consultation, and the work that is done to ensure that it fits properly into the tax code as a whole. What is more, a court can rarely take into account fully, if at all, the practical and administrative problems caused by judicial lawmaking.

At the heart of the matter is the fact that judges are just not the right people to be social reformers. It is submitted that Lord Devlin expressed the reason precisely in the following passage:

> "If judges were men endowed for such a task they would not truly be judges. In every society there is a division between rulers and ruled. The first mark of a free and orderly society is that the boundaries between the two should be guarded and trespasses from one side or the other independently and impartially determined. The keepers of these boundaries cannot also be among the outriders. The judges are the keepers of the law and the qualities they need for that task are not those of the creative lawmaker. The creative lawmaker is the squire of the social reformer and the quality they both need is enthusiasm. But enthusiasm is rarely consistent with impartiality and never with the appearance of it.

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122. Para A2.19

Why is it, I ask in conclusion, that the denunciators of judicial inactivity so rarely pause to throw even a passing curse at the legislators who ought really to be doing the job. They seem so often to swallow without noticing it the quite preposterous excuse that Parliament has no time and to take only a perfunctory interest in an institution such as the Law Commission. Progressives of course are in a hurry to get things done and judges with their plenitude of power could apparently get them done so quickly; there seems to be no limit to what they could do if only they would unshackle themselves from their precedents. It is a great temptation to cast the judiciary as an elite which will bypass the traffic-laden ways of the democratic process. But it would only apparently be a bypass. In truth it would be a road that would never rejoin the highway but would lead inevitably, however long and winding the path, to the totalitarian state."[123]

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123. Op cit p16

Certainty in the Law

Adam Smith in his "Wealth of Nations"[124] declared that "the tax which each individual is bound to pay ought to be certain and not arbitrary."

The fundamental importance of certainty in the law has been stressed many times since. In the context of tax law, for example, The Carter Commission[125] said:

> "The argument in favour of the traditional approach is that it provides a degree of certainty. It enables the taxpayer to plan his affairs and make business decisions with some assurance of what the tax consequences will be. If the courts were to depart from either the principles were have referred to[126] without very good reason, they would be embarking on a dangerous path. Their decisions would depend on the personal views of the judge as to what the law should be, or what it was intended to be, rather than on what the legislature has said that it is."

The Renton Committee[127] made the more general point that:

> "It is of fundamental importance in a free society that the law should be readily ascertainable and reasonably clear. To the extent that the law does not satisfy these conditions, the citizen is deprived of one of his basic rights and the law itself is brought into contempt. Whatever may be the pressures to increase the volume and extend the scope of legislation, it is our firm view that legislation which is complex and obscure may for that very reason be oppressive."

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124. (1863) Book V cII p371
125. Op cit Vol 3 App A pp547-8
126. Strict construction of tax statutes and the Duke of Westminster principle.
127. Op cit para 7.4

Even in the common law there are limits to how far judges ought to extend the law. For example, in Myers v DPP[128], Lord Reid said that he had never "taken a narrow view of the functions of this House as an appellate tribunal. The common law must be developed to meet changing economic conditions and habits of thought." However, he recognised the need to apply limits to this. He said that "if we are to extend the law it must be by the development and application of fundamental principles." He continued:

> "If an exception were created here, others should be created, and there would be a series of appeals..... If we are to give a wide interpretation to our judicial functions questions of policy cannot be wholly excluded, and it seems to me to be against public policy to produce uncertainty."[129]

Over the years until the 1980's judges, when dealing with tax avoidance devices, have always been careful not to produce uncertainty in the law by stretching the statutory provisions to cover the avoidance arrangements in question, even if they have not particularly liked what the taxpayer had done.[130]

Coming forward to around the time of the Ramsay case, it is interesting to compare Lord Wilberforce's lead in Ramsay with the view, cited in Chapter 11, which he expressed only just over one year before in IRC v Plummer.[131]

Three weeks later, in Vestey v IRC he again stressed that a taxpayer is entitled to know what tax is claimed against him.[132]

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128. [1965] AC 1001
129. pp102-2
130. See, for example, the comment by Lord Shaw in IRC v Fisher's Executors (1926) 10 TC 302 at p335, supra
131. (1979) 54 TC 1 at p44 (cited above)
132. (1979) 54 TC 503 at p581

But one of the major criticisms of the Ramsay principle is that it produces a climate of uncertainty and confusion in which it can be impossible for taxpayers, with the help of their advisers, to order their affairs so as to come within the known law. The words of the legislation are replaced by dicta of the judges which are often difficult to interpret and sometimes conflicting.

The Law Lords expressly declared in the early Ramsay cases that their new approach would develop case by case. Having cast aside the old principles, they set off down their new road with only a dim perception of where it would lead them. In an area of the law in which subjects have the right to demand certainty, this is a wholly irresponsible attitude. If the Law Lords themselves could not foresee where the new approach would lead them, what hope did the poor taxpayer have?

The problem was exacerbated by the Inland Revenue who used the uncertainty to their advantage. The Revenue knew that taxpayers would be reluctant to risk taking their case to court and there was a tendency, particularly immediately after the House of Lords decision in Ramsay, for Inspectors of Taxes to send a fairly standard letter, whenever they considered that there had been artificial tax avoidance, asking the taxpayer to agree that their scheme failed because of Ramsay, despite the fact that, in a great many cases, Ramsay could not possibly have applied.

It will be recalled that in Ramsay much was made by counsel for the Crown, and by the Law Lords, of the US cases of Knetsch and Gilbert.[133] The enormous difference between the Supreme Court and the House of Lords has already been noted, but there is another major difference between the two jurisdictions which alleviates

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133. See Chapter 10 and 11

uncertainty caused by the more "dynamic" approach of the US judges; that is the very comprehensive system of rulings which is described in Chapter 10. No such system operates in the UK.

There was a reaction against this uncertainty, particularly in the lower courts, but also in the judgments of the majority in the House of Lords in Craven v White itself. Following the House of Lords decision in that case there is, at least for the time being, a measure of certainty once again in the law; a certainty that would not have been produced by the Crown's submission or the Lord Templeman/Lord Goff approach. However, the limits placed on the Ramsay principle in Furniss v Dawson - limits which the Crown were not allowed to overstep in Craven v White - still leave many questions unanswered, as acknowledged by Parker LJ in the Court of Appeal in Craven v White.[134] Parker LJ was unable to answer these questions and was thankful that it was not necessary for him to do so.

Also in the Court of Appeal, Slade LJ commented:

> "I think that, if the Ramsay principle were to be held to apply to transactions of which the connecting link is so tenuous as that suggested in the Crown's basic contention, formidable uncertainty and practical difficulties would arise in the administration of our tax law, which the House of Lords, in formulating and developing the Ramsay principle, did not contemplate and would have intended."[135]

The judge's view about the Crown's basic contention is no doubt correct, but his comment regarding the intentions of the House of Lords appears to be fairly wide of the

134. [1987] STC 297 at pp336-7
135. p308

mark: the Law Lords, in developing the Ramsay principle had scant regard for the uncertainty they were producing.

In the House of Lords in Craven v White, Lords Templeman's judgment, had it carried with it the majority, would have thrown this area of tax law back into a state of confusion. The other Law Lord who spoke out against limiting the Ramsay principle, Lord Goff did not consider that his line would have lead to greater uncertainty. He said:

> "In the end, the question whether or not the overall transaction constitutes for present purposes a composite transaction is very much one of common sense, which the commissioners are well equipped to decide. I do not for myself regard this as giving rise to any unacceptable uncertainty in practice. I have no doubt that, in practice, the animal is easily recognisable."[136]

Presumably, like the elephant. This is rather an optimistic view of the likely effects of the Templeman/Goff line of reasoning.

At the end of the day, judges, and all those who advocate a more pioneering role for the Judiciary could do worse than remember these words of Lord Diplock. He said:

> "......in a civilised society which acknowledges the rule of law, individual members of that society are entitled to know when they embark upon a course of conduct what the legal consequences of their doing so will be so that they may regulate their conduct accordingly."[137]

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136. [1988] STC 476 at p514
137. IRC v Joiner (1975) 50 TC 449 at p488

The Retroactive Effect of the New Approach

One of he main objections to the Ramsay principle in particular and judicial lawmaking in general is the retroactive effect of such action. Taxpayers are entitled to be able to order their affairs in accordance with current law and to know what that law is. Lord Devlin's opinion was clear:

> "If it does become necessary to choose between a change in the law and a real injustice caused by retroactivity in the case at bar, surely the choice must be against change in the law: that puts a limit on judicial lawmaking."[138]

Lord Devlin pointed out that US Courts have begun to circumvent retroactivity by deciding the case before them under the existing law, but declaring that a new law will prevail in future.[139] The House of Lords is certainly aware of this practice, having commented on it in R.v National Insurance Commissioners, ex parte Hudson.[140] What is more, Counsel for the Crown in Ramsay itself expressly invited the House of Lords, if they found for the Crown on the wider submission, to declare that the new principle would only apply prospectively, as in the USA.[141] This helpful and sensible suggestion was ignored by the House of Lords, thus producing a great deal of unfairness. This fairness did not seem to bother the Law Lords: for example, the injustice of the retroactive effect of the New Approach was accepted in a very offhand manner by Lord Diplock in the Burmah Oil case[142] where he noted, apparently without remorse that:

> "Burmah was acting in accordance with advice

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138. Op cit pp10-11
139. Ibid p11
140. [1972] AC 914 at p1015 and 1026
141. See (1980) 54 TC 101 at pp181-2

obtained from advisers of the highest integrity who, in reliance on Lord Tomlin's dictum [in the Duke of Westminster case], did not foresee the difference in approach to tax avoidance schemes involving inter-company transactions that would have been adopted by this House by the time some nine years later when the particular scheme that they had devised in 1972 was eventually to come before it."[142]

Furthermore, consider Furniss v Dawson. The actual transactions were implemented in 1971, according to the law as it was then understood to be only for the taxpayers to find that, thirteen years later, the House of Lords decides that their "simple and honest scheme" which was "not a tax avoidance scheme" must fail due a change of approach by the Law Lords in the meantime. This along would be bad enough, but it is made worse by the fact that, in connection with the Dawson scheme, the Law Lords were acting directly contrary to the intention of Parliament.

What is now section 87(1) CGTA 1979 was introduced in 1977 as section 40(2) FA 1977. The effect of this section is that the CGTA relieving provisions in point in the Dawson case[143] now do not apply unless the share organisation is effected for bona fide commercial reasons, and not as part of a scheme the main purpose of which is the avoidance of tax. Section 87(1), had it been in operation in 1971, would undoubtedly have caught the Dawsons. But Parliament specifically enacted, in section 40(10) FA 1977, that it was not to apply to transactions taking place before 19 April 1977. Furthermore, it is clear that Parliament was aware of the type of scheme section 40(2) was being introduced to catch, because the Chief Secretary to the Treasury gave an example of the kind of scheme the section was designed

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142. (1982) 54 TC 200 at pp214-5. Compare Lord Diplock's words from IRC v Joiner cited, supra!
143. Now section 85 CGTA 1979

to stop to the Commons Standing Committee.[144] The facts were similar to those found in the Dawson case. It is clear that, by agreeing to bring in section 40(2) to catch Dawson-type schemes, Parliament was accepting that the original legislation (namely, that applying in 1971) did not catch the Dawsons.

It is not open to the Law Lords in their judicial capacity to take House of Commons debates into account, of course; but Parliament's intention was clear from the words of the legislation which amended the law prospectively only.

The ethics of the Inland Revenue can be called into question here. The Revenue will have advised the relevant ministers on the clause that became section 40, and they would have been fully aware that Parliament had no intention of making it retrospective; quite the opposite. At the same time they were challenging the Dawsons in the courts (the Special Commissioners had already given their decision by this time) using arguments which were aimed at running counter to Parliament's intention.

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144. H.C Deb. Standing Committee C, 21 June 1977, cols 913-4

CHAPTER 14

CONCLUSIONS

Introduction

In this final Chapter some conclusions from the analysis in the previous Chapters are set out and a number of suggestions are made as to the way forward based on the lessons of the past and the experiences of other countries. Some of these suggestions have been made, in one form or another, by other commentators, some are fresh recommendations. A few of the suggestions are rather radical but tough problems call for tough solutions and they are, therefore, put forward for further consideration as a means of curing a number of grave defects in the present system.

The conclusions are here dealt with under six headings:

1. The problems of anti-avoidance legislation, and suggested solutions.
2. The rejection of a general anti-avoidance provision.
3. The way forward for the "Ramsay" principle.
4. Conclusions on judge-made law.
5. Conclusions on the substance doctrine.
6. The structure of the courts and the hearing of tax cases.

The Problems of Anti-Avoidance Legislation and Suggested Solutions

A. The Problems.

It has been seen that the present code of tax legislation in the UK has been built up piecemeal, over the last 70 years in some cases, as with the income tax settlement provisions.[1] What has been produced is a confusing and, to many, bewildering mass of highly detailed and complicated legislation, spread over many different Acts and supplemented by Inland Revenue Extra Statutory Concessions, Statements of Practice, press releases etc.; not to mention case law, complicated by the inconsistent attitudes of the judges.

This concoction of finely detailed legislation usually enacted after scant, or little consultation and cursory examination in Parliament is bound to given rise to loopholes and unintended problems for the innocent.

Even in 1960, when tax legislation was not nearly as complicated as it is now, Lord Evershed MR told the American Bar Association:

> "To an ever increasing extent my own Court finds itself occupied in the interpretation of Parliamentary language so highly involved that the process is more comparable to that of the solution of a highly difficult crossword puzzle, and the final result, I have sometimes thought, might have been more speedily - and certainly more cheaply - obtained by the spinning of a coin."[2]

The complicated legislative picture is getting worse every year. Finance Acts are becoming longer and more

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1. See Chapter 2
2. Quoted in "Taxation" 17 September 1960

detailed. The 1989 Act is a good example. For the layman, the Budget "had nothing in it", and yet the Act eventually contained 188 sections and 17 Schedules, covering 275 A4 size pages. This is partly due to the undoubted fact that, when major changes are not being enacted, the opportunity is taken to tinker with the law, with many small changes being made. However, it is also true that the legislation itself is becoming more complicated. Such a system cannot avoid giving rise to unfairness, uncertainty and confusion. One of the unfortunate consequences of this is that "innocent taxpayers" often get caught unwittingly; whereas the taxpayer who wants to find a way to avoid paying tax can often find a loophole he can exploit.

Taxpayers are having to rely on expensive experts for advice on even straightforward and normal transactions. It is reasonable that those who indulge in complicated manoeuvres to avoid tax should have to seek the guidance of those who are well-versed in the intricacies of the law; but the ordinary taxpayer should only have to do so when he has some major or unusually complicated deal in hand. It is the naive or innocent taxpayer who often falls into a trap set for a more sophisticated person who may already have found his way to safety.

However, it has reached the stage that even professional advisers, let alone the ordinary taxpayer, simply cannot understand the tax laws of this country. Large firms of solicitors and accountants have teams of experts specialising in particular areas of tax law, such as trust taxation, transfer pricing, Schedule E etc. Even these experts cannot say with any degree of confidence that they fully understand all aspects of their particular area.

The notion that a taxpayer is entitled to know the tax laws that regulate his business and personal activities so that he can plan his life accordingly is, unfortunately, now an unreal concept in this country. Taxpayers are at the mercy of ever-changing, ever more complex laws, administered by increasingly aggressive tax authorities. The most disgraceful manifestation of this is outside the ambit of this study, value added tax, with its bewildering mass of delegated legislation, practice notes, tribunal decisions etc, made much worse by the uncomprising attitude of the officers of Customs and Excise who are armed with powers that the man in the street finds unbelievable. At least the situation regarding those taxes administered by the Inland Revenue is not as bad as this; but there are worrying signs that matters are heading down the same road.

This is intolerable. The trouble is that taxpayers, and those who represent them, have grown used to the situation, and there is a grudging acceptance of the position. But, looking at the matter objectively, it is clear that taxpayers should not be placed in this invidious position of not knowing the law. After all, the penalties for falling foul of this incomprehensible law can be severe. Tax is not a voluntary impost: it is not something individuals, companies, etc become involved with only if they choose to do so; it cannot be said to them "you have chosen to become involved, so you must take the consequences". Caveat emptor should have no application to ordinary taxpayers, although those who indulge in tax avoidance, of course, must beware of getting their fingers burnt.

It must not be forgotten that it is not just the complex arrangements and transactions that can give rise to difficult tax problems; even the simplest business or family activity can have complicated tax consequences. What appears to be the almost paranoid fear of the Government and the Revenue of leaving loopholes has lead them to introduce legislation of such prolixity as to make most taxpayers, many professionals and some judges' heads swim.

It has been seen that, over the years, Parliament has become more sophisticated in drafting anti-avoidance legislation. There are two opposite trends.

1. There is much more very detailed, difficult and wordy legislation.
2. There are more of the broader, widely drafted provisions which are perhaps aimed at specific abuses, but which are much wider in their scope than the particular schemes in question.

The categories identified by the Carter Commission[3] as the "sniper" and the "shotgun" approaches are being developed in a big way in the tax law of the UK.

This is not to say that the two categories cannot live side-by-side, they can do. What is more they should do so. Different problems call for different solutions. The problem is finding the right balance.

Although a general anti-avoidance provision in the UK must be avoided at all cost,[4] that is not to saying that there is not place for wide, sweeping provisions. Take dividend stripping, for instance.[5] This subject shows some of the worst aspects of the UK system, but eventually, rather by luck than by judgment, the present system is fairly satisfactory.

It has been seen in Chapter 1 that the terms "dividend stripping", "bond washing" and "stock stripping" encompassed schemes of great artificiality, with which the normal taxpayer would have little sympathy. It proved very difficult to stamp these schemes out by specific, narrowly targeted legislation, particularly with the courts generally sticking to the traditional

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3. See Chapter 9
4. Infra
5. See Chapter 1

literal construction of the statutes. In the end, Parliament was, in 1960, persuaded to introduce wide, sweeping legislation of great complexity. It has been seen that the House of Commons was mislead about the ambit and consequences of this legislation and that what is now section 703 et seq ICTA 1988 covers a very wide area, much more extensive than the purported target of the original legislation. Despite this, the legislation has worked well, although inevitably some innocent taxpayers have been caught, especially initially. These days, considering its width and complexity and the wide interpretation given to it by the courts, this legislation gives rise to surprisingly few problems in practice. Paradoxically, it is probably the width of the provisions that is accountable for this. Even professional advisers who know very little about tax generally know that, if their clients are doing virtually anything regarding shares or securities, section 703 probably applies in one way or another and it is now common practice to make an application for clearance under section 707, even if it is not readily apparent that section 703 applies at all and, if so, how. This clearance procedure is the key. It is often the case that it is very difficult to say with any certainty whether the Revenue would seek to apply section 703 and, if they did, what the consequences would be, It is the clearance procedure that provides the necessary element of certainty. What is more, it is not merely the existence of the clearance procedure that is important, but it has on the whole, been used sensibly, reasonably and commercially by the Revenue.

This phenomenon, that the width of a provision actually helps taxpayers and their advisers because they are constantly on their guard, can be seen in other areas. To take just three examples:

1. The income tax settlement provisions examined in Chapter 2 are very wide, but they have been around a long time with comparatively little

amendment. It is accepted among most advisers that any transaction involving, say, transfers to infant unmarried children, or where the settlor or this spouse retains a benefit etc, will necessitate an examination of the relevant provisions. The exception to this is section 677 ICTA 1988, as to which, see below.

2. It is accepted that most ways of extracting value from a company are covered by the comprehensive distribution provisions[6] to which reference will almost invariably be made in relevant cases.

3. Section 765 ICTA 1988[7], before its partial repeal *in 1988* was, *potentially the* most draconian anti-avoidance provision in the UK tax system, but it was never actually used, because every adviser knew about it and could act accordingly, normally by seeking Treasury consent for their clients' proposals.

Wide provisions give rise to problems when their ambit is obscure. Probably the best example of this is section 677 ICTA 1988. This section, as has been seen in Chapter 2, has come in for severe criticism from the House of Lords. It is a scandel that this section has not been repealed or substantially amended since criticism started to mount with the case of Potts' Executors v IRC[8] in 1951. It is rare for a well-advised taxpayer to be caught by it, and yet it remains a trap for the unwary. Few can claim to understand it fully.

One ancillary point to be made here is that it is unsatisfactory to use cases taken from other jurisdictions, even if they are only employed to give a judge inspiration or comfort. The best example of this

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6. See Chapter 1
7. See Chapter 9
8. (1951) 32 TC 211; see Chapter 2

was Lord Wilberforce's use of the Knetsch and Gilbert cases in Ramsay. The two cases in question are examined in Chapter 11. Lord Bridge in Furniss v Dawson also drew inspiration from across the Atlantic and the case of Gregory v Helvering.[9] It has been shown in Chapter 10 that, even in the USA, there is no unanimity in how the various judicial doctrines are used and, in one of the cases cited by Lord Wilberforce, Gilbert, there was a strong dissenting judgment. If such cases have given rise to uncertainty and inconsistency in their own country, they are of very dubious authority when transported into an alien jurisdiction which had been treading a very different judicial course since at least 1935, when the Gregory v Helvering and Duke of Westminster cases were heard.[10]

B. *Solutions*

It is absolutely essential that we get away from the situation in which it is impossible for taxpayers to know the tax law with which they must comply. What is more, the situation must not be made worse each year with at least one Finance Act of increasing length and complexity which has had little real consideration in Parliament.

It would be naive to think that there is a panacea for all of the ills that beset the present system, but that is not a valid reason to do nothing. There are a number of steps that would, it is submitted, help to a greater of lessor extent. These include:

1. The setting up of a committee to examine existing and future tax legislation.
2. Increased use of consultation before legislation is enacted.
3. Separating technical tax changes from the

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9. See Chapter 10 for an analysis of this case and its impact on anti-avoidance principles in the USA.
10. See Chapters 10 and 11

annual Budget.

4. Introducing a system of Revenue rulings.
5. A codification of UK tax legislation.
6. A simplification of existing UK tax legislation.

Just an important are the steps that are not needed. There should be no place in the UK system for:

1. A general anti-avoidance provision.
2. A statutory "Ramsay principle"
3. Judicial anti-avoidance rules.

Each of these points is dealt with in turn.

1. A Tax Legislation Committee

It is suggested that there should be a Committee set up to examine existing and future tax legislation on a formal basis. This would not be along the lines of a Royal Commission; rather it would be similar, but not identical to he US Advisory Group or the Canadian Taxation Advisory Committee. It is, of course, absolutely essential that legislation is actually made only by Parliament. This must not change. However, at the moment, the main, and normally the sole impetus for new legislation comes from the Executive, principally through the Inland Revenue. Taxpayers rarely have any real imput. Even where there is consultation, the comments of taxpayers and interested bodies are made to the Inland Revenue who generally decide whether, and to what extent, notice is to be taken of those representations. There are some issolated exceptions where the sheer vehemence and volume of protest forces changes to be made. The withdrawal of the original close investment companies legislation and the U-turn on the withdrawal of the inheritance tax relief for Deed of Variation in the Finance Bill 1979 are two recent examples. But this is far too remote and informal.

What is required is that the recommendation made to Parliament must represent all shades of opinion and benefit from the best expertise available and, furthermore, that Parliament is given the time and resources to consider the recommendations and debate the ensuing legislation properly.

The point to keep in mind is that this would not be detracting from the principle that laws must be made by the Legislature, but enhancing it. Can it truly be said that, at present, most members of the House of Commons really understand the full implications of what they are enacting? The answer is obviously "no". Very few tax experts fully understand the bulk of the Finance Act 1989, for example: a non-tax expert, sitting in the House of Commons, however intelligent and sincere he may be, could not accurately claim to understand any significant part of the Finance Act he had a hand in enacting in 1989. In reality, this is not legislation by the Legislature, but by the Executive. it is even worse in an area like VAT, where delegated legislation plays such a large part in the lawmaking process. The increasing influence of the EEC in taxation matters can only make matters worse.

The Committee should have a membership drawn from all relevant areas; the Law Society, the Bar, the Institute of Chartered Accounts, the Institute of Taxation, the Universities and so on. The Committee would also have a strong representation from the tax authorities and other relevant governmental bodies. It is, of course, essential that, if the Committee is to have the proper influence, membership must be restricted to those of the highest calibre.

Rather than Members of Parliament being given, as at present, recommendations and explanatory information from within the Executive, this function would be fulfilled by the Committee.

Among the Committees functions would be the following;

(1) To examine deficiencies in existing tax legislation. This would include the filling of loopholes to prevent unwarrented exploitation of the law, and the alleviation of injustice in the system.

(2) To seek the views of taxpayers and interested bodies through an expanded and more formal consultation process.

(3) To prepare, with the help of the Parliamentary draftsmen and other experts, draft legislation for consideration by Parliament. They would not, of course, have any say in matters related to the running of the economy, which would remain the province of the Chancellor, through the present system of annual Budgets and Finance Acts.

(4) To act as a channel through which taxpayers, the professionals and the tax authorities can liaise. This would reverse the present trend towards confrontation between taxpayers and their advisers, on the one hand, and the Inland Revenue, on the other, in which it seems that each side is perpetually trying to score points off the other. It is a question of attitude. It is submitted that increasing cooperation would breed a new level of responsibility on each side.

Of these roles, one of the most important would be to examine and make recommendations on the whole mass of uncoordinated and complex anti-avoidance legislation that has built up throughout this century, and to keep the picture under constant review.

Obviously this review would have to be considered by Parliament in the light of wider policy issues which should remain the province of Parliament. For example, the raison d'etre of many anti-avoidance provisions is that income has been taxed more heavily than capital, and taxpayers must be prevented from artificially converting income receipts into capital to reduce or eliminate their tax liabilities. With the parity in rates between income and corporation taxes, on the one hand, and CGT, on the other, many of these anti-avoidance provisions have lost much of their point. Indeed, some bizarre situations can arise. For example, as explained in Chapter 1, when a company purchases it own shares the proceeds are usually treated as a distribution unless certain conditions are fulfilled, in which case CGT treatment is granted. There are anti-avoidance provisions to prevent taxpayers obtaining this relief artificially. Because of the parity in tax rates, it can often arise that it is better for the vendor/shareholder not to be granted CGT treatment, and so in some situations taxpayers deliberately try to be caught by the anti-avoidance provisions so that they do not qualify for CGT treatment.

A fair number of anti-avoidance provisions could be either repealed, severely restricted or simplified if the parity is to stay. However, if, as a political or economic issue, capital gains revert to being less heavily taxed that income, similar provisions would be required. Even under the present system it can often be better to be taxed under the CGT rules because of the reliefs and exemptions available under the CGT code, so some provisions are necessary to prevent income being concerted into capital, but the vast present array of anti-avoidance provisions is not required.

B. Increased Consultation

This is something to be encouraged and expanded. Admittedly, more use is being made of the consultation process than in the past, and the results, where it has been used, have been fairly satisfactory.

Some legislation has been substantially amended prior to its introduction due to submissions received. A good example of this is the "controlled foreign companies" legislation examined in Chapter 9. Other proposals have been withdrawn completely, in their original form at least, following the consultation process. A recent instance of this concerned the proposals for altering the residence and domicile rules for individuals.[11]

As the experience of this process has been so encouraging, it makes clear sense to put it on a more formal basis and to expand the use of consulation. It is suggested that it would also be a distinct improvement if the process was coordinated by an independent body such as the Committee which is recommended above.

3. Separating Technical Tax Changes from the Budget

Lumping major tax changes and detailed amendments together with annual budgetary changes is traditional in this country and so some people accept it as a sensible phenomenon. In fact, looking at the matter objectively, it is absurd. The need for secrecy over such things as tax rates is obvious, and there is clearly a need to tie what might be called economic tax measures (rates, allowances etc) to a Budget delivered just prior to the start of the tax year.

There is little reason for restricting nearly all major technical tax changes to such a time table; in fact, an annual technical tax Bill in the autumn, for example, would give Parliament much more time to consider the proposed legislation. Admittedly, Parliamentary time is tight, but if the legislators were handed a Bill with comprehensive explanatory notes on the draft clauses which are the result of detailed examination by the Committee suggested above, representing the Revenue, the professions, academic institutions etc, after full consulation with interested parties, those legislators can act on the knowledge that they are starting off with a balanced and carefully considered proposal which they can then debate, free from the potential jostling that inevitably surrounds a Budget.

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11. See Chapter 9

Compare this proposal to the present procedure. Most technical tax changes receive no more than a passing mention in the Budget Speech, many are not mentioned at all. Normally, the first anyone knows about the details is through the Inland Revenue Press Releases issued when the Chancellor sits down, although a few changes might be foreshadowed by a Ministerial statement. Sometimes important changes do not even come to light at his stage, they are introduced at the Committee or Report Stages.

With the political parties arguing over the contents of the Budget within the restraints of a very strict time-table, many important technical changes receive no more than a cursory examination in Committee and so the will of the Revenue often prevails by default.

The mess this can lead to was amply illustrated by the fiasco described in Chapter 1 surrounding the abolition of close company apportionment and the abortive introduction of the close investment company regime in 1989.

4. Revenue Rulings

The value of formal rulings can be seen in the USA and Canada and also, in one particular area in the UK, namely, the obtaining of advance clearances in relation to some of the anti-avoidance provisions.

To take the USA, that country's system, with its wide range of judicial anti-avoidance principles and complex and wide ranging legislation would be beset by enormous uncertainty were it not for the extensive system of rulings explained in Chapter 10. The efficacy of this system is helped by the attitude of the Internal Revenue Scheme. Although they are aggressive towards tax avoidance, they adopt a helpful and sensible attitude towards rulings requested by the ordinary taxpayer. There it is recognised, as it should be here, that co-operating with taxpayers helps everyone in the long run because lengthy disputes can be avoided.

This can be seen in a smaller way in the UK. An increasing number of anti-avoidance provisions now contain advance clearance procedures; such as section 267(3A) ICTA 1970, section 88 CGTA 1979, sections 707 and 765 ICTA 1988. These procedures generally work very well, allowing taxpayers to proceed with a proposed course of action in safety, in the knowledge that the complicated or widely drafted anti-avoidance legislation in question will not be applied to them.

There a few failures. The clearance procedure in section 776 ICTA 1988[12] is virtually useless, but that is because the section itself is badly flawed, and also because the clearance procedure is handled by inspectors of taxes, few of whom really understand the section. This is an exception, however, and normally clearance procedures work well in practice.

It is suggested that the UK system could be greatly improved in two ways:

(1) by the introduction of a comprehensive system of rulings under which taxpayers can obtain the guidance of the Revenue on their interpretation of tax legislation;

(2) by the introduction of an across-the-board clearance system.

The Revenue Law Committee of the Law Society made a study of the questions of the dissemination of Revenue information and of a system of advance rulings as part of their examination of the Ramsay principle. Their recommendations, to be found in "Tax Law in the Melting Pot", which it is not necessary to repeat here, are a

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12. See Chapter 3
13. pp42-5

clear and sensible way forward and should be supported. It is, however, submitted that the Law Society were not positive enough in two areas.

1. Although they mentioned the possibility of reporting Special Commissioners' decisions, they were more interested in the publication of an abstract of decisions of the Commissioners on the Ramsay principle, their main area of concern in their report. It appears that there is a strong case for all important Special Commissioners' decisions to be reported, with appropriate safeguards to ensure taxpayer anonymity if necessary.[14] It is not uncommon when a taxpayer is in dispute with the Revenue, that the taxpayers' advisers to hear on the grapevine of a relevant Commissioners' decision on a similar point. The taxpayer can rarely obtain details of such a decisions, the Revenue always can.

2. Certain reservations were expressed about a general advanced rulings system. The four "obstacles" specified were:
   (1) Expenses and delay in obtaining rulings. This is surely not the obstacle the Revenue Law Committee thought it to be. Compare the cost and delay of obtaining a rulings with the additional cost and delay of having to ask professional advisers to "cover all the angles" because the taxpayer cannot be sure of the Revenue's probable response when faced with a difficult question of fact or law. Not infrequently, this entails taking Counsel's opinion, further adding to cost and delay.

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14. Infra

(2) The second objection mentioned, which the Committee itself rightly did not consider to be valid, was that some practitioners fear that Revenue will too easily become aware of tax avoidance techniques. But practitioners would not have to use the rulings system if they wanted to keep a particular scheme quiet. In any case, these days it does not take the Revenue long to hear about a scheme. For example, one often finds that seminars at which schemes are discussed are attended by delegates from the Revenue, and often schemes very quickly appear in the professional press, to which the Revenue have access, of course.

(3) It was felt that the additional precedent material would render the practice of tax law even more complicated than at present. It is difficult to see the real force behind this objection; any additional complication would be outweighed by the increased certainty the system would generate.

(4) Cost effectiveness. Obviously the authorities would have to ensure that the relevant department was manned by personnel of sufficient expertise and in sufficient numbers to deal with the requests for rulings. The Revenue are under considerable pressure as it is, with many of their best men being poached by the professions. However, there is no need to think that the system could not be self-financing. The additional expensive professional time now expended in checking complicated transactions for possible areas of Revenue attack would largely be avoided. For instance, all or

part of the £1,000 or so spent on obtaining Counsel's opinion could be paid instead as a fee for a ruling from the Revenue. The present cost to taxpayers in professional fees caused by the uncertainty generated by the current situation should not be underestimated; it is greater than most people think.

5. Codification

One of the problems in finding one's way through the mass of legislation is that it is spread over so many different Acts with many cross-references and amendments being made to other Acts. The Legislation is not presented in any logical or coherent way and there is often a real problem in tracing the relevant provisions. There are consolidations, of course, but it is impossible for them to be frequent enough. Income (and later corporation) tax has recently been consolidated after 16 years (1952 to 1970) and 18 years (1970 to 1988). What is more, the consolidation is very quickly out of date. The ICTA 1988 has been quickly followed by two massive Finance Acts, 1988 and 1989, and the situation will get worse every year. Every Finance Act since the CGTA 1979, to take another example, has made some changes to it, and it will presumably be some time before a fresh CGT consolidation is undertaken. At the time of writing, a much needed consolidation of the capital allowances legislation is ready for introduction. The process of consolidation does help, but it does not and cannot be the complete answer.

It is submitted that a much better system is to have a unified code as in the USA or Canada; a single Act which is amended each year or as frequently as is found necessary. In other words, there would be permanent consolidation in which legislation can be kept in a logical and clear order, with a much simpler system of cross-references.

6. Simplification

This is one of the most intractable problems of all. As submitted below, a general anti-avoidance provision must be avoided at all cost: simplification at the expense of boundless uncertainty and confusion is not solution at all; it would make matters worse.

Codification of the legislation would help, but that cannot strike at the heart of the problem. Something must be done to prevent Parliament churning out increasing volumes of wordy and obscure legislation.

It is fashionable to blame the Parliamentary draftsmen for the prolixity of the language and the practice of amending earlier legislation time and time again. But, the draftsmen are only doing what they are told and, at the end of the day, the standard of drafting is actually high in the UK. The problem, it seems, lies deeper than this. Those who complain most about the obscurity of the legislation, the taxpayers and their professional advisers, are the ones who comb the legislation for the slightest crack through which they can slip, aided, particularly in the past, by the literal interpretation given to the legislation by the courts. All of these cracks, unless they are too minor to be worth bothering about, have to be filled. The way this has been done in this country has been by legislation.[15] It is difficult to criticise the taxpayers for this, particularly in times of high, or even penal tax rates. Furthermore, there is little moral censure attaching to legal avoidance in the UK, although the man in the street tended to take a rather more critical view of the antics of the participators in the highly artificial schemes that existed prior to 1981.

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15. Sometimes with help from the judges: consider for example, their actions against dividend stripping (Chapter 1), remittance schemes (Chapter 9) and avoidance in general (Chapter 11).

It is too idealistic to hope that if professionals, without whom would-be avoiders could not operate except on a very basic level, become involved in the consultation and examination process through the committee mentioned above, that a more responsible attitude would be engendered? It probably is foolish to expect too much, but it cannot do any harm, and there may well be benefits, in bringing together the protagonists in the perpetual battle of wits that has been waged for most of this century. If everyone is working towards a simpler tax system, it must be better than if everyone is apply pressure the other way.

The problem, however, must not be underestimated. It would no doubt be difficult to draft simple tax legislation given the legislative and drafting traditions in the UK. The Departmental Committee on Income Tax Codification[16] said that:

> "to expect from us a codification of the law of income tax which the layman could easily read and understand was a vain hope, which only the uninstructed could cherish.... Income tax legislation must, by its very nature, be abstract and technical, and can never be easy reading. It is concerned with principles and methods of calculation which it is difficult to express in words without an appearance of complication."[17]

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16. Cmd 5131 (1936)
17. Para 26

The Rejection of a General Anti-Avoidance Provision

It is hoped that the examination of those common law countries that have general anti-avoidance legislation such as Australia, New Zealand and now Canada[18] shows clearly that a general anti-avoidance would be totally inappropriate for the UK. Experience has shown that such legislation breeds enormous uncertainty for taxpayers.

Another problem is that the such provisions are at the mercy of the judges who can literally either make the legislation a feared and powerful tool in the hands of the tax authorities, or a virtually useless weapon in the taxman's armoury. The Australian experience with section 260, and the courts' treatment of Article 31 GAT in the Netherlands shows this: for many years these provisions were thought to be moribund, but a change of attitude of the courts (in Australia, caused by a change in personnel) suddenly brought them back to life in a big way. The UK experience with the Ramsay principle suggests that such a provision would be just as susceptible to the vagaries of judiciary prejudice as was section 260 in Australia and Article 31 in the Netherlands. Taxpayers have the right to much greater certainty than is conceivably possible with a general anti-avoidance provision.

What little experience the UK has with wide general anti-avoidance provisions is not in the least encouraging. The general profits tax and excess profits tax provisions considered in Chapter 1 show how inequitable and harsh such legislation can be. Admittedly, those provisions were subject to a particularly fierce "purpose" and "main benefit" test, but in whatever form, such legislation should have no place in the UK tax code.

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18. See Chapter 10

It is not an answer to say that those sections were drafted many years ago at times of either national emergency of national austerity and, these days, with a more stable climate and legislators and draftsmen used to preparing anti-avoidance legislation, a clearer, fairer and more equitable provision could be drafted. This simply will not do. Canada has a tax and judicial system not dissimilar from the UK. Its Parliament and draftsmen were well used to constructing legislation to combat sophisticated manoeuvres; and yet, when they came to introduce a general anti-avoidance provision, they enacted one of such width and imprecision that it seems that it cannot fail to create enormous uncertainty and confusion.

Another problem that would have to be faced if a general anti-avoidance provision were to be introduced in the UK, would be its interaction with the many specific anti-avoidance provisions. The type of problem that can arise is illustrated by the Challenge Corporation case heard by the Privy Council and discussed in Chapter 11. It will be recalled that the point over which the majority and the minority disagreed was how the New Zealand general anti-avoidance provision interacted with a specific relief which had its own anti-avoidance rules attached to it. The judgment of the majority was not, it is suggested, such as to inspire confidence that many similar problems would not arise with a general provision in the UK.

The Way Forward for the Ramsay Principle

This is a topic that causes a lot of debate. Some experts argue that the Ramsay principle should be done away with altogether, others think it should be retained but enshrined in legislation, either in accordance with Lord Brightman's formula in Furniss v Dawson, or in the form of a general business purpose test.

The first point to make is that the principle should stay in some form or another. For all its faults, it has succeeded in stamping out the worst excesses of the tax avoidance industry. A return to a climate in which highly artificial, circular and self-cancelling schemes could flourish would be to no-one's benefit (apart from the scheme merchants themselves and the relatively few taxpayers who are actually lucky enough to get such a scheme past the Revenue and the courts). Such schemes are disliked by the general public, most of whom have no choice but to pay their taxes (it is usually paid for them under PAYE), and the antics of the few advisers who become involved reflect badly on the public image of the professions. Such a climate breeds complex legislation, clogs up the Commissioners' and court system and leads to bad relationships between the Revenue and taxpayers in general. It also tends to lower the moral standards of the taxpaying public: if the man in the street reads of a wealthy taxpayer avoiding hundreds of thousands of pounds through what he sees as legal chicanery, he well might ask himself. "He got away with it, why not me?"

The two questions to be answered are:

1. How wide should such a principle be?
2. In what form should it take?

As to the width of the principle, this is, of course, a difficult question. It is not necessary to repeat here the analysis set out in Chapter 11 of the various forms the Ramsay principle took, from the relatively narrow submissions of Peter Millett QC, for the Crown, before the House of Lords in Ramsay, through the wide formulations of the Law Lords in Ramsay and Burmah Oil, to the delineation of the boundaries in Furniss v Dawson and the retrenchment of the principle to one of mere statutory interpretation by the majority of the Law Lords in Craven v White. Some would even argue that the lower courts are even swinging too far back the other way. The success (so far) of, for instance, the VAT "pre-payment" cases and the capital transfer tax scheme in the Countess Fitzwilliam case,[19] *both outside the ambit of the present* study, show how difficult is it becoming for the Revenue to apply the principle.

No formulation can work fairly in every case but it is suggested that the formula that has worked best in practice is that of Lord Brightman in Furniss v Dawson as interpretation by Lord Oliver in Craven v White. Pressures from people like the Revenue and Lord Templeman to expand the principle again, and by some commentators to restrict it still further, should be resisted.

Specifically, the principle should not:

(i) be a general judicial anti-avoidance or fiscal nullity principle;

(ii) allow recharacterisation of transactions.

The present state of the principle, as interpreted by the House of Lords is, it is submitted, as close to being a workable, clear and sensible rule is can be achieved. The one major problem appears to be in working out the ambit of preordination in relation to such situations as auction sales.

As to the form in which the Ramsay principle should be embodied, many people argue that it should be embodied in

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19. Supra

statutory form; the Revenue Law Committee of the Law Society in "Tax Law in the Melting Pot" thought so, for example.[20] There is indeed a great deal to be said in support of this view and, if the courts were to go back to the wide Ramsay/Burmah Oil formulation favoured by Lord Templeman, such arguments would be hard to counter. However, if the principle is to remain one of statutory interpretation in accordance with Lord Oliver's perception of it, it is submitted that it should be left in non-statutory form. As soon as it is embodied in legislation, the possibility of exploitation increases; get round the words of the statute and you have a chance, unless the legislation is worded in general terms, in which case it would not be precise enough to give the necessary element of certainty. With a judicial rule of construction, taxpayers are aware that this does not apply.

The one area in this statutory action would be helpful would be in laying down a clearance procedure. It should be noted that, during the passage of the 1984 Finance Bill through Parliament, a Conservative backbencher put forward a clause providing for just such a statutory clearance procedure, but the Government did not select the clause for debate. However, there is now a place for a clearance procedure, particularly with the Law Lords still unable to decide on a unified approach.

On 17 May 1984, at a conference on Furniss v Dawson, Peter Whiteman QC put forward the following wording, which, it is submitted, is the type of clause required:

> "(1) Where a person considers that a transaction or transactions to be effected by him may be regarded by the Board

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20. p41

(a) as consisting of a pre-ordained series of transactions (hereinafter called 'a 'composite transaction'), which may or may not include the achievement of a commercial or business end and

(b) as including steps which have no commercial or business purpose apart from the avoidance of a liability to tax,

and in reliance upon the judgment of any Court made given or delivered on a specified date the Board may accordingly disregard the composite transaction or any one or more of the steps inserted therein for tax purposes, that person may make an application to the Board in accordance with the provisions of this section.

(2) Where the Board are satisfied that in the circumstances as described in such application as is referred to in sub-section (1) the composite transaction or any steps inserted therein should not be disregarded for tax purposes, they shall notify the applicant and accordingly thereafter the Board shall be precluded from so regarding the composite transaction or any such steps for any tax purpose.

(3) Any application under subsection (1) above shall be in writing and shall contain particulars of the composite transactions that is to be effected and the Board may, within 30 days of the receipt of the application or of any further particulars previously required under this subsection, by notice require the applicant to furnish further particulars for the purpose of enabling the Board to make their decision; and if any such notice is not complied with within 30 days or such longer period as the Board may allow, the Board may not proceed further on the application.

(4) The Board shall notify their decision to the applicant within 30 days of receiving the application or, if they give a notice under subsection (3) above, within 30 days of the notice being complied with.

(5) If the Board notify the applicant that they are not satisfied as mentioned in subsection (2) above or do not notify their decision to the applicant within the time required by subsection (4) above, the applicant may within 30 days of the notification or of that time require the Board to transmit the application, together with any notice given and further particulars furnished under subsection (3) above, to the Special Commissioners; and in that even any notification by the Special Commissioners shall have effect for the purpose of subsection (2) above as if it were a notification by the Board.

(6) If any particulars furnished under this section do not fully and accurately disclose all facts and considerations material for the decision of the Board or the Special Commissioners, any resulting notification that the Board or Commissioners are satisfied as mentioned in subsection (2) above shall be void.

(7) For the purposes of this section

(a) 'tax' means income tax, corporation tax, capital gains tax and [inheritance] tax;

(b) 'specified date' means 12th March 1981, 3rd December 1981 and 9th February 1984."

Conclusions on Judge-Made Law

It is not necessary here to repeat the arguments set out in Chapter 13, but a number of particular points can usefully be stressed.

The first is a general one. It is hoped that the examination of the position in Chapter 13 demonstrated that judicial lawmaking in the field of tax avoidance is most definitely not the way forward. Various euphemism can be used, such as adopting a "new approach" or "developing" the law but it is clear that, in reality, the law has been changed, although certain of the judges in the House of Lords have now pared the Ramsay principle down to being no more than a principle of statutory interpretation.[21] Other judges, such as Lord Templeman have no intention of so restricting the principle.

It has been seen that among the major problems of arising out of judicial pioneering are:

(i) the retroactive effect of their judgments; and

(ii) the great uncertainty caused.

The retroactive effect of the judges' decisions can cause great problems at the moment. Transactions can be carried out in accordance with the law as it stands at the time and then, many years later, the judges change their mind and say, for example, that:

(a) the arrangement was a perfectly reasonable one for the taxpayer to take;

(b) the arrangement was perfectly legal when it was carried out;

(c) it is still technically correct according to the legislation; but

(d) the judges have decided that they do not like it so they will not allow it to work.

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21. See Chapter 11

A layman might say this was fiction; the Burmah Oil Co Ltd, amongst others, would tell him otherwise.

One way around this way pointed out by John Avery Jones.[22] He pointed out that the traditional view is that the judges merely declare the law as it always was. However, the Law Lords who heard the initial Ramsay cases clearly announced that they were changing their approach and "developing the law". The traditional view was therefore being at least partially set aside by the Law Lords themselves. Avery Jones pointed out that, in the USA, the courts gave up the "pretence" that they declare the law over a century ago and the decisions of the courts do not necessarily have retroactive effect; but sometimes have prospective effect only.

The Supreme Court have set out the factors which might persuade them to declare a decision to have only prospective effect. In Chevron Oil v Huson,[23] the Supreme Court stated:

> "In our cases dealing with the nonretroactivity question, we have generally considered three separate factors. First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied.... or by deciding an issue of first impression whose resolution was not clearly foreshadowed...... Second, it has been stressed that 'we must..... weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation'..... Finally, we have weighed the inequity imposed by retroactive application, for where a decision of this Court could produce substantial inequitable results if

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22. [1984] BTR 203
23. 404 US 97 (1971)

applied retroactivity, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of nonretroactivity....."

It is submitted that such a rule should be introduced in the UK to alleviate the hardship caused in such cases as Burmah Oil and Furniss v Dawson. It should not be forgotten that in relation to both schemes, Parliament legislated to stop avoidance in those areas but did not do so retrospectively. In the circumstances, Avery Jones' conclusion must be correct. He said:

> "If Parliament had enacted the [Ramsay] principle it would certainty not have been retrospectively; in applying the same rule to the court, it would merely be recognising the reality that the courts were legislating. And, recognising that the law in this area is in an early stage of development, why not at the same time, give the courts power to make prospective decisions in the future?"

There is not good reason why they should not be given this power. Otherwise, the notion that a taxpayer is entitled to be taxed under the law as it stood at the time he carried out his transactions is in danger of becoming a meaningless incantation.

Another problem shown by Chapter 11 is that the direction of judicial advances are too much influenced by the prejudices of the judges. Compare, for example, the current conflict in the House of Lords between Lord Templeman and Lord Oliver and the rebellion of the Chancery Division and, to a certain extent, the Court of Appeal against the worst excesses of the Ramsay principle. It is becoming very difficult indeed for the Revenue to win a "Ramsay" case at first instance, and success in the House of Lords can depend on which Law Lords hear the case. This is clearly not an acceptable situation.

Another unfortunate trend that is occurring is the tendency, found in some civil law jurisdications and also in common law jurisdictions such as the USA, of judges being less analytical in their approach to tax avoidance schemes. Tax barrister David Mile QC, who has very extensive experience in presenting tax cases in court - he was in Ramsay itself - recently told the writer that he has noticed a trend with some judges who tend to reach a decision that a particular tax avoidance technique will not work, and then find a principle to produce that result.

Finally, an important reason why judges should not be seen to making law is one pointed out in Chapter 13, but it deserves to be stressed here. The judges, on the whole, have retained their valuable independence from the political arena and generally are rightly held in high regard by the public. If they are seen to be entering into the lawmaking apparatus, they lose their essential detachment from the Legislature. If a taxpayer has a grievance because he has fallen victim to what he considers to be a harsh, or unfair or anomalous law, his ire should be directed towards Parliament, in which the public's elected representatives are, at least in theory, responsible for that state of affairs. If he can also point a finger at the judges as being wholly or partly responsible for the law in question, the judges would lose their position of impartiality; and they would only have themselves to blame.

Conclusions on the Substance Doctrine

It can be seen from Chapter 11 that the picture regarding the substance doctrine is a very complex one. The first problem to face is that there are no universally accepted meanings of "form" and "substance". There terms have been used to mean different things, at different times, to different judges. Too often the terms have been used loosely without close analysis of the way they have been used in the past. In truth some judges have intended to mould the substance principle to fit their own aims and objectives.

The words of Lord Atkin in Liversidge v Anderson[24] come to mind in this respect:

> "'When I use a word', Humpty Dumpty said in rather a scornful tone, 'it means just what I choose it to mean, neither more nor less.' 'The question is', said Alice, 'whether you can make words mean so many different things.' 'The question is,' said Humpty Dumpty, 'which is to be master - that's all'".

It is difficult to suggest what can be done to prevent this; if indeed it should be prevented. There are arguments for saying that it is inevitable and, indeed desirable, that judges should have the flexibility to do what they feel is right in any particular case. Variations, reflecting both the judges' own prejudices and prevailing external circumstances are bound to occur. Within the framework of a code containing specific and detailed provisions, which have to be applied to a multiplicity of situations, this flexibility is essential. In this respect, inconsistency in some cases is really an acceptable price to pay. It is better than trying to place judges in a legislative straightjacket as to extent to which they must respect or ignore the form

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24. [1942] AC 206 at p245

of the transaction and documentation before them. No such legislation could possibly cover the almost limitless combinations of circumstances that can come before the courts.

There are two areas, however, in which it is suggested that changes could be made.

1. It seems that the UK concept of the sham as applied in tax cases is too narrow. It has been seen in Chapter 11 that the doctrine was hardly ever used, even in the face of extremely artificial, circular and self-cancelling arrangements. Judges began to talk about the application of the sham doctrine in cases such as Garvin but by that time it was too late. It seems that if the courts had traditionally adopted a more robust view of a sham, more akin to the US concept, the worst excesses of the tax avoidance industry in the 1970's, plus earlier schemes such as the dividend stripping arrangements, might have been prevented, or at least mitigated.
2. Another area in which a UK concept has perhaps been too narrow is in the courts reluctance to look through entities, particularly companies, which are used in tax avoidance schemes. This has been considered in Chapter 12 in connection with piercing the corporate veil, and Chapter 1 as regards personal service companies, with certain international aspects being considered in Chapter 9. It has generally been too easy to manipulate entities, especially companies, in tax avoidance arrangements. The problem is, if the courts are to be given greater powers to

disregard entities used in tax avoidance arrangements, how can it be done without introducing unacceptable areas of uncertainty into the law? It is suggested that one way would be to adopt the "business activity" test found in the USA.[25] Some UK judgments came somewhere near this, but there iss no consistency and UK judges still seem to be too conservative in this respect; some of the companies used in the artificial schemes of the kind marketed by, for example, the Rossminter organisation and Godfrey Bradman were no more than puppets dancing to the tune of the scheme director, and yet it has been seen in Chapters 11 and 12 how reluctant most of the judges were to look through those companies.

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25. See Chapter 10

The Structure of the Courts and the Hearing of Tax Cases

Experience has shown that the present system of deciding tax disputes in the courts is not satisfactory. The prospect of fighting a case through the courts is in most cases prohibitive in time and money. Most taxpayers simply cannot afford to dispute matters with the Revenue, and many arguable claims of taxpayers fail by default.

The Inland Revenue, on the other hand, have virtually unlimited resources to fight against cases right up to the House of Lords if necessary. They also have more say than taxpayers in the timing and conduct of cases through the courts. Sometimes there is evidence that the Revenue are not using their position properly. One example of this was the war of attribution they fought in their campaign against artificial tax avoidance by refusing to take test cases and determining to spin the proceedings out for as long as possible. There is also the manipulation of the conduct of tax appeals. The long delays in bringing the Burmah Oil case to court, for example, undeniably worked in the Revenue's favour; then there was the manipulation suggested by the Craven v White case being heard in the High Court before Baylis v Gregory, which was heard by the Special Commissioners a year before Craven v White.[26]

The actual structure of the courts which deal with tax cases calls for reorganisation.

Starting with the Commissioners, this system works well and there appears to be no valid reason to change it except in two respects.

1. There is a sensible division between the General and Special Commissioners. There have, however, been occasions on which very different tax avoidance arrangements have been

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26. See Chapter 11

heard by the General Commissioners. This is clearly inappropriate given the importance of the Commissioners' findings of fact. A good example of this was Reed v Nova Securities Ltd. It can be seen in Chapter 8 that possibly inappropriate findings by General Commissioners effectively tied the hands of the House of Lords, forcing them to come to a decision in favour of the taxpayer company which clearly did not please all of the Law Lords. Other difficult avoidance cases heard by General Commissioners have included Westcott v Woolcombers Ltd, Coates v Arndale Properties Ltd, Page v Lowther, Yuill v Wilson, Newstead v Frost, and no less a case than Eilbeck v Rawling. It seems little more than plain common sense that such cases should be heard by Special Commissioners who have a detailed knowledge of tax law.

2. The decisions of the Special Commissioners should be published on a selective basis. The present system is unfair. The Revenue know about important Special Commissioners decisions; taxpayers and their advisers do not. Information about some decisions circulates on the "grapevine", particularly amongst practising members of the tax Bar but, on the whole, taxpayers are in the dark about the Commissioners' attitudes to particular points which are often of great interest in other cases.

In the courts themselves there are arguments for saying that tax law is now so complicated that tax cases need to heard, not necessarily by judges who specialise solely in taxation, but at least judges who have some background in taxation matters. Most judges of the Chancery Division, even if they are not from the tax Bar, have at least some experience of handling tax cases at the very highest level. Indeed, some of the present contingent have had extensive dealings in tax matters; judges such as Vinelott, Warner and Peter Gibson JJ, for example. The late Walton J had even more experience in taxation, being at one time a leading member of the tax Bar.

It would not be appropriate to have judges who deal only with taxation because that would give them too narrow an outlook. Most cases demand knowledge of other areas of the law such as trust law, company law, partnership law and so on. However, a judge should have a good working knowledge of taxation. Nearly all judges in the Chancery Division have this, but many judges who hear tax cases in the Court of Appeal and, even more so, the House of Lords have had not exposure to taxation at all, either at the Bar or on the Bench.

On the other hand, leading members of the tax Bar, when elevated to the Bench, can find themselves restricted to hearing non-tax cases, as has happened recently with two leading members of top tax chambers in the Temple.

This is obviously a complex area, but consideration should be given to the establishment of a Tax Court as a division of the High Court. The judges who sat in this court would be drawn from judges of the other divisions, but particularly the Chancery Division, who have extensive experience of taxation matters.

As far as the Court of Appeal and House of Lords are concerned, it should be possible to ensure that at least one judge who was previously on the panel qualified to sit in the Tax Court, heard an appeal in a tax case.

The problems of judges who are used to other areas - often not statute based law like taxation - can be seen in the formulation and development of the Ramsay principle. It is admitted that this point should not be taken too far because the two main engineers of the new approach, Lords Templeman and Wilberforce both did have extensive experience of taxation either at the Bar or on the Bench. Nevertheless, it makes sense that, if a leading member of the tax Bar is elevated to the bench, he should hear tax cases, not exclusively, but regularly; but it seems a particularly English thing to do to send him off to, say, the Western Circuit to handle cases in areas of the law he may not have come across since law school.

This would mean breaking down traditional ideas, but the fact has to be faced that tax law is now staggeringly complex and, even if the judges in the UK are the best in the world - some people argue with considerable justification that they are - the time has come to bring some specialisation to the Bench, as there is, out of necessity, at the Bar.

It would be interesting to know to what extent the judges in the House of Lords who introduced and "developed" the Ramsay principle appreciated the havoc that their pioneering attitude caused to normal, commercial business life. It can be seen in Chapter 13 that those Law Lords who made pronouncements on the subject, either in court or outside, were aware of the uncertainty they were creating, and were unrepentant; but can they have been aware of he sheer scale of the disruption caused to "innocent" taxpayers? It is possible that those judges who had spent their careers in the common law may not have appreciated this.

Very few people regret the demise of the tax avoidance industry which peddled highly artificial, highly complicated tax avoidance schemes to anyone who could afford the fees. That industry gave tax planning in general a very bad name; the man in the street perhaps getting the (normally) mistaken impression of shady deals involving, say, trusts set up in exotic locations, bogus companies, and millions of pounds passing round a table in a matter of minutes. These dealings also had an attraction that few professional adviser could resist. If a client badly needed, say, a capital loss to shelter a large gain he had made, and the adviser knew of an organisation selling a product which leading experts confirmed would do the trick, he had to ask himself whether it was right not to alert his client to the possibility, regardless of his own feelings on the moral legitimacy of such arrangements.

However, as has been pointed out in Chapter 13, judicial action was not the appropriate method of dealing with this situation.

Another point is that serious consideration should be given to ways of cutting the cost of taking tax matters before the courts, particularly if cases progress beyond the High Court level.

The present system of each side bearing its costs before the Commissioners is a fair one which should continue. Similarly, there appears to be no real objection to the losing side paying the costs, on the present basis, in the High Court. It is undeniable that the taxpayer's "day in court" (although it is often more) is expensive, but that is a problem faced by litigants in all areas of the civil law. It is not unreasonable to expect taxpayers to take a gamble in the High Court. However, beyond the High Court there is a case for changing the present rules, particularly in the light of two factors:

1. Often cases taken further than the High Court can properly be regarded as "test" cases establishing a point of general interest to many taxpayers. The Revenue not infrequently take a case on appeal even though the tax at stake in that case is relatively insignificant because of the effect on the general body of taxpayers. It seems harsh that the individual

taxpayer should have to risk footing the bill for this exercise if he has won his case in the High Court. It is suggested that it should be possible for a taxpayer to make an application to the judge for classification of the case as a "test" case, namely one of significance to the general body of taxpayers. The judge's power to classify a case in this way would be an extension of the court's present discretion over costs. If a case is so certified, the costs of the appeal would in any event be borne out of the public purse. The judge would be able to guage the legitimacy of an application, so frivolous appeals at the public's expense could not be mounted. This would also partially get over any problem of the Revenue refusing to take test cases, as they have done in some instances.

2. As mentioned above, the Revenue have virtually unlimited resources. This is often gives them a significant advantage in disputes with taxpayers. In practice, many small arguments are barely worth taking before the Commissioners, and certainly not worth taking to the High Court. Even in more substantial cases, taxpayers have to think carefully before exerting their rights to seek redress. The Revenue are not subject to the same restrictions, they can carry on protracted disputes over relatively insignificant matters. Although they are busy, and so often concentrate on the important issues, it is not uncommon for an inspector to stick out for his view on a matter which hardly seems worthwhile. At the other end of the scale there are the big avoidance cases. Where they are so minded, they can wage a war of

attrition. There have been instances when they have announced to taxpayers that they would refuse to take test cases and would fight each one, to the House of Lords, if necessary, knowing that time and money are on their side. A system of classification of "test" cases might help to remove some of the present inequality in the respective positions of the Revenue and the taxpayer.

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Aldwarke Co Ltd v IRC (1933) 18 TC 125
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Campbell v IRC (1968) 45 TC 427
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Chamberlain v IRC (1943) 25 TC 318
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Clark v IRC (1978) 52 TC 482
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Himley Estates Ltd v IRC (1932) 17 TC 367
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IRC v Horrocks (1968) 44 TC 645
IRC v Joiner (1975) 50 TC 449
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IRC v Morton (1941) 24 TC 259
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IRC v Oswald (1945) 26 TC 435
IRC v Paget (1938) 21 TC 677
IRC v Parker (1966) 43 TC 396
IRC v Paterson (1924) 9 TC 163
IRC v Pay (1955) 36 TC 109
IRC v Payne (1940) 23 TC 610
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IRC v Pratt (1982) 57 TC 1
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IRC v Warden (1938) 22 TC 416
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Lee v IRC (1943) 26 TC 485
Leedale v Lewis (1982) 56 TC 501
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Lionel Sutcliffe Ltd v IRC (1928) 14 TC 171
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MacDonaldv IRC (1940) 23 TC 449
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Pilkington Brothers Ltd v IRC (1982) 55 TC 705
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St Louis Breweries Ltd v Apthorpe (1898) 4 TC 111
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Thompson v The Trust & Loan Company of Canada (1932) 16 TC 394
Thomson v Gurneville Securities Ltd (1971) 47 TC 633
Thomson v Moyse (1960) 39 TC 291
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Tobago Income Tax Commissioners [1945] AC 1
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Vestey v IRC (1961) 40 TC 112
Vestey v IRC (1979) 54 TC 503
Vestey's Executors v IRC (1949) 31 TC 1
Waller and Hartley Ltd v IRC (1972) 48 TC 515
Wallersteiner v Moir [1974] 1 WLR 991
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Wilkinson v IRC (1931) 16 TC 52
Wild v King Smith (1941) 24 TC 86
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Wilsons (Dunblane) Ltd v IRC (1954) 35 TC 107
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Wolfson v IRC (1949) 31 TC 141
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J.H Young & Co v IRC (1926) 12 TC 827
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AUSTRALIA

Bell v FCT [1953] 87 CLR 308
Cecil Bros Pty Ltd v FCT (1964) 111 CLR 430
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Dobinson v FCT (1935) 3 ATD 150
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Jacques v FCT (1924) 34 CLR 328
Lau v FCT 84 ATC 4929
Mayfield v FCT (No1) (1961) 108 CLR 323
Molloy v FCT (1925) R & McG 113
Mullens v FCT 76 ATC 4288
Oakey Abattoir Pty Ltd v FCT 84 ATC 4718
Patcorp v FCT (1977) 140 CLR 330
Pincus v FCT 85 ATC 4765
Rowdell Pty Ltd v FCT (1963) 111 CLR 106
Slutzkin v FCT 76 ACT 4019
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BELGIUM

Brepol's case Cour de Cassation, 6 juin 1961, Pas 1961.1.1082 Cour de Cassation, 11 juin 1957, Rep fisc p750

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Front & Simcoe Ltd v MNR [1960] Ex CR 350
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Indalex Ltd v The Queen 88 DTC 6053
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ISRAEL

C.A 265/67, Piskei Din, Vol 21 (part 2), p593
C.A 450/75, Piskei Din, Vol 28 (part 2), p287
C.A 11/74, Piskei Din, Vol 29 (part 1), p297
C.A 634/73, Piskei Din, Vol 29 (part 1), p517
C.A 734/74, Piskei Din, Vol 30 (part 1), p27
I.T App. Tel-Aviv 6/50, Pessakim Mehoziyim, Vol 7, p347

ITALY

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no 2115 of 5 May 1978
no 2658 of 9 May 1979
no 5563 of 6 October 1980
no 5264 of 7 October 1981

THE NETHERLANDS

HR 27 November 1918 B 2102
HR 26 May 1926, NJ 1926, p723, PW no 12157
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BNB 1969, No 217
BNB 1978, No 299
BNB 1979, No 87
BNB 1979, No 188
BNB 1979, No 223
BNB 1982, No 242
BNB 1985, No 32

NEW ZEALAND

Elmiger v IRC [1967] NZLR 161
Wisheart v IRC [1971] ATC 6001
3 New Zealand Board of Review Decisions 49 (Case 5)

UNITED STATES OF AMERICA

A.F of L v American Sash Co 335 US 538 (1948)
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Baron (Estate of) v Commissioner 83 TC 28 (1984)
Barnett v Commissioner 385 US 1005 (1967)
Bass v Commissioner 50 TC 595 (1968)
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Britt v US 431 F.2d 227 (5th Cir 1970)
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Cole (Estate of) 73,074 P-H Memo TC (1973)
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Commissioner v Newman 159 F.2d 848 (2d Cir 1942)
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WEST GERMANY

Decision of 10 November 1983, BStBl 1984, II, p605 The Lower Tax Court of Dusselfdorf (1982) No 12 p604

TABLE OF STATUTES

UNITED KINGDOM

INTERPRETATION ACT 1889	Section 1
FINANCE ACT 1914	Section 5
FINANCE (No2) ACT 1915	Section 44
INCOME TAX ACT 1918	Section 27 General Rules 7, 23 Case IV, Rule 2 Case V, Rule 2
FINANCE ACT 1922	Sections 20, 21 Schedule 1
LAW OF PROPERTY ACT 1925	Section 53
TRUSTEE ACT 1925	Sections 31, 32, 41
FINANCE ACT 1927	Sections 12, 31, 32, 33
FINANCE ACT 1935	Section 20
FINANCE ACT 1936	Sections 18, 19, 20, 21
FINANCE ACT 1937	Sections 14, 19, 22
FINANCE ACT 1938	Sections 13, 24, 28, 38, 39, 40, 41, 42 Schedule 3
FINANCE ACT 1939	Sections 14, 15, 19
FINANCE (No2) ACT 1939	Sections 12, 13 Schedule 7
FINANCE ACT 1940	Sections 19, 26, 28

FINANCE ACT 1941	Sections 19, 35, 43
FINANCE ACT 1943	Sections 20, 24
FINANCE ACT 1944	Section 33
INCOME TAX ACT 1945	Sections 58, 59
FINANCE (No2) ACT 1945	Section 58 Schedule 8
FINANCE ACT 1946	Section 28, 34, 44 Schedules 9, 11
FINANCE ACT 1947	Sections 30, 31, 33, 35, 36, 38
FINANCE ACT 1948	Sections 38, 39, 40, 41, 42, 43, 44, 45, 46, 49
FINANCE ACT 1949	Sections 20, 28
FINANCE ACT 1950	Section 26
FINANCE ACT 1951	Sections 31, 32, 36, 37
FINANCE ACT 1952	Sections 68, 69
INCOME TAX ACT 1952	Sections 5, 58, 124, 128, 137, 142, 175, 184, 245, 246, 249, 253, 257, 258, 259, 260, 262, 329, 333, 341, 359, 392, 397, 398, 399, 401, 404, 405, 407, 508, 411, 412, 415, 469
FINANCE ACT 1953	Section 24
FINANCE ACT 1954	Section 17, 23

FINANCE (No2) ACT 1955	Section 4 Schedule 3
FINANCE ACT 1956	Sections 29, 30, 31 Schedules 4, 7
FINANCE ACT 1958	Sections 18, 19, 20, 21, 22 Schedule 7
VARIATION OF TRUSTS ACT 1958	Section 1
FINANCE ACT 1959	Sections 23, 24, 25, 26, 29
FINANCE ACT 1960	Sections 20, 21, 22, 23, 24, 25, 26, 27, 28, 37, 38, 43 Schedule 4
FINANCE ACT 1962	Sections 12, 14, 23, 24, 25 Schedule 9
FINANCE ACT 1963	Sections 22, 23, 24, 47
FINANCE ACT 1964	Sections 17, 18, 19 Schedule 7
FINANCE ACT 1965	Sections 12, 15, 18, 22, 25, 30, 42, 45, 46, 47, 48, 63, 65, 74, 75, 77, 78, 83, 97 Schedules 7, 10, 11, 15, 17, 18, 22
PRICES AND INCOMES ACT 1966	Schedule 2
FINANCE ACT 1966	Sections 23, 25, 39 Schedule 4

FINANCE ACT 1967	Section 22
CAPITAL ALLOWANCES ACT 1968	Sections 3, 77, 78, 87, 95 Schedule 7
FINANCE ACT 1968	Section 23 Schedules 12, 19
FINANCE ACT 1969	Sections 28, 30, 32, 33 Schedules 14, 19
INCOME AND CORPORATION TAXES ACT 1970	Sections 30, 34, 80, 81, 82, 83, 84, 108, 114, 153, 168, 186, 187, 188, 233, 234, 235, 236, 237, 252, 256, 258, 259, 262, 267, 272, 274, 278, 278A, 279, 280, 281, 284, 285, 287A, 289, 296, 297, 375, 387, 437, 438, 439, 440, 441, 442, 443, 444, 450, 451, 451A, 452, 454, 457, 458, 460, 461, 463, 466, 467, 469, 470, 471, 472, 473, 474, 475, 476, 477, 480, 482, 485, 486, 487, 488, 489, 491, 497, 513, 526, 532 Schedules 8,14
TAXES MANAGEMENT ACT 1970	Sections 1, 6, 20, 20A, 20B, 20C, 20D, 33, 49, 50 Schedule 1
FINANCE ACT 1970	Section 27

FINANCE ACT 1971	Sections 32, 41, 44, 56 Schedule 8
FINANCE ACT 1972	Sections 68, 69, 77, 79, 80, 81, 94, 119 Schedules 12, 22
FINANCE ACT 1973	Sections 16, 19, 22, 23, 26, 28, 29, 30, 31, 33 Schedules 8, 11, 12
FINANCE ACT 1974	Sections 29, 30, 41, 42 Schedule 2
OIL TAXATION ACT 1975	Section 20 Schedule 9
FINANCE ACT 1975	Section 17
FINANCE (No2) ACT 1975	Sections 34, 35, 36, 36A, 37, 58, 60 Schedule 8
FINANCE ACT 1976	Sections 41, 44, 60, 61, 62, 62A, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72 Schedule 5
DEVELOPMENT LAND TAX ACT 1976	Sections 2, 5, 8, 12, 18, 20, 21, 39, 40, 44
FINANCE ACT 1977	Sections 33, 33A, 40, 41, 43, 48
FINANCE ACT 1978	Sections 23, 24, 31, 32, 46, 53, 54, 55, 56, 57, 58, 59, 60, 61, 77

CAPITAL GAINS TAX ACT 1979	Sections 1, 2, 4, 10, 12, 14, 15, 17, 19, 25, 26, 26A, 26B, 26C, 26D, 29A, 31, 32, 44, 46, 48, 49, 51, 52, 53, 54, 55, 56A, 58, 61, 62, 63, 65, 75, 77, 78, 79, 80, 81, 85, 86, 87, 88, 93, 115, 116, 117, 118, 119, 120, 121, 122, 126, 126A, 126B, 126C, 128, 134, 146, 147A, 147B, 150, 151, 155, 209
FINANCE ACT 1980	Sections 44, 45, 47, 49, 55, 64, 66, 70, 74, 79, 116, 117 Schedules 9, 10, 18
FINANCE ACT 1981	Sections 30, 31, 42, 45, 46, 71, 72, 74, 74, 75, 76, 78, 79, 80, 81, 82, 83, 84, 85, 86, 88, 90, 91
FINANCE ACT 1982	Sections 43, 44, 53, 59, 60, 70, 71, 72, 82, 84 Schedule 9
INSURANCE COMPANIES ACT 1982	Section 1
FINANCE ACT 1983	Sections 20, 21
INHERITANCE TAX ACT 1984	Sections 49,158

FINANCE ACT 1984	Sections 38, 47, 58, 62, 66, 70, 82, 83, 84, 85, 86, 87, 88, 89, 90, 91, 121 Schedules 10, 12, 14, 16, 17, 18
COMPANIES ACT 1985	Sections 425, 427
FINANCE ACT 1984	Sections 56, 71, 73, 74, 75, 76, 77 Schedules 9, 21, 22, 23
INSOLVENCY ACT 1986	Section 110
FINANCE ACT 1986	Sections 26, 42, 45, 57, 58 Schedules 6, 13, 18
FINANCE ACT 1987	Section 70
FINANCE (No2) ACT 1987	Sections 62, 63, 64, 65 Schedules 4
INCOME AND CORPORATION TAXES	Sections 6, 11, 18, 19, 20, 34, 35, 36, 37, 38, 53, 56, 59, 61, 65, 74, 75, 76, 87, 98, 100, 109, 114, 116, 118, 125, 131, 132, 135, 135, 138, 139, 141, 142, 143, 144, 145, 146, 148, 149, 153, 154, 155, 156, 157, 158, 159, 160, 161, 162, 163, 164, 165, 166, 167, 168, 188, 192, 198, 209, 210, 211, 213, 214, 215, 216, 217, 218, 219, 220, 221, 222, 223, 224, 225, 226,

ICTA 1988 (Continued)

227, 228, 229, 230, 231, 235, 236, 237, 240, 242, 243, 245, 247, 249, 251, 254, 285, 313, 331, 343, 346, 347A, 348, 349, 353, 380, 381, 384, 393, 395, 397, 399, 402, 403, 404, 409, 410, 411, 413, 414, 416, 417, 418, 419, 420, 421, 422, 532, 577, 660, 663, 664, 665, 668, 670, 671, 672, 673, 674, 674A, 676, 677, 678, 679, 681, 684, 685, 686, 703, 704, 705, 706, 707, 708, 709, 710, 711, 712, 713, 714, 715, 716, 717, 718, 719, 720, 721, 722, 723, 724, 725, 726, 727, 728, 729, 730, 731, 732, 733, 734, 735, 736, 737, 739, 740, 741, 742, 743, 744, 747, 748, 749, 750, 751, 752, 753, 754, 755, 756, 757, 758, 759, 760, 761, 762, 763, 764, 765, 767, 768, 769, 770, 771, 772, 773, 774, 775, 776, 777, 778, 779, 780, 781, 782, 783, 784, 785, 787, 788, 790, 832, 837, 838, 839, 840

Schedules 10, 11, 17, 18, 24, 25, 26, 30

FINANCE ACT 1988	Sections 36, 50, 65, 66, 72, 73, 74, 77, 78, 79, 80, 81, 82, 83, 84, 85, 86, 87, 88, 89, 105, 106, 107, 110, 112, 130, 131, 132 Schedules 4, 6, 14
FINANCE ACT 1989	Sections 36, 53, 103, 104, 105, 106, 107, 108, 109, 124, 126, 127, 128, 129, 132, 135, 136, 137, 138, 182 Schedules 12, 14

AUSTRALIA

Land Tax Act 1877	section 55
Income Tax Act 1895	section 44
New South Wales Land and Income Tax Assessment Act	section 63
Land Tax Assessment Act 1915	section 63
Income Tax Assessment Act 1936	sections 51, 260
Income Tax Assessment Act Part IV A	sections 177A-G

BELGIUM

CIR Art 24, 44, 46, 187, 250
CIT Art 24

BERMUDA

Exempted Undertakings Tax Protection Act 1966

CANADA

Income War Tax Act	section 6
Income Tax Act	sections 8, 15, 18, 21, 40, 48, 53, 54, 55, 56, 63, 67, 69, 74, 75, 78, 85, 87, 88, 91, 95, 245(137), 246(138), 247(138A)

CAYMAN ISLANDS

Tax Concessions Law 1962	
The Cayman Islands Trust Law 1967	section 79

DENMARK

Company Tax Act	section 12

FINLAND

Taxation Act	section 56

FRANCE

Book of Fiscal Procedures	Art L64
CGI	Arts 57, 155A, 209B, 221, 238A, 1732

REP. OF IRELAND

Income Tax Act 1967	section 61
Corporation Tax Act 1976	sections 58, 62
Finance Act 1980	section 40

ISRAEL

Income Tax (Taxation in Periods of Inflation) Act 1982
Income Tax Ordinance section 86

ITALY

Civil Code	Art 1414
Constitution	Art 23
Provisions of the Law in General	Art 12

JAPAN

Constitution of Japan	Art 12, 84
Corporation Tax Law	Art 11, 22-2
Income Tax Law	Art 12
Special Taxation Measures Law	Art 66-5

THE NETHERLANDS

GAT	Art 31
Income Tax Act 1964	Art 35
CITA	Art 7

NEW ZEALAND

Income Tax Act 1878	section 62
Land and Income Tax Assessment Act 1900	section 82
Land and Income Tax Assessment Act 1916	section 162
Land and Income Tax Act 1954	sections 108, 111, 138
Income Tax Act 1976	sections 22, 99, 191

SWEDEN

Lag 1980:865

SWITZERLAND

Civil Code Art 2

Decree of the Federal Council of 14 December 1962

UNITED STATES OF AMERICA

Internal Revenue Code	sections 162, 316, 337, 482, 551, 951, 1503
Tax Reform Act 1986	section 1249

WEST GERMANY

AstG 1972	sections 1, 2-5, 7-14
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