TRANSFER OF ASSETS

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I TA 1988 s.741 motive defence after the Pre Budget Statement of 5th December 2005 (PBR) – the New Regime by Stephen Brandon QC ("Stephen")

II Transfer of Assets Provisions after the PBR by James Kessler QC ("James")

Reported by Ralph Ray[1]

A Brief Introduction

TA ss.739 and 740 apply income tax liabilities on transferring assets abroad by persons ordinarily resident in the UK. S.739 applies to transferors and s.740 to other persons, e.g. beneficiaries. S.741 contains exemption from these sections (see below).

I **TA 1988 s.741** (see above)

Stephen set out the statute as currently in force for transactions before 5th December 2005: "Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either –

(a) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or

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(b) that the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation."

In particular, this has focused on **the Revenue's approach** that:

(1) the test is objective, not subjective – a policy decision of the Board, although evidence of the transferor's purpose may be highly relevant.

(2) creating an offshore structure avoids tax;

(3) the client must therefore have intended to avoid tax and s.741 cannot apply;

(4) *Beneficiary* and *Carvill* (see below) are not binding on it;

(5) this objective test is supported by *dicta* of Lord Nolan in Willoughby;

(6) s.741 can apply only if the taxpayer can point to a specific statutory relief which he/she intended to fall within.

HMRC claim that the test is **objective**, so that one looks to see if the tax liability has been lowered and, if it has, HMRC's position is that tax avoidance must have been one of the main purposes of the transfer so that s.741 cannot apply.

In Stephen's view, HMRC's **objective** test is untenable and he referred to some leading decisions supporting the **subjective** test including: *Philippi v IRC* 47 TC 75; *MacDonald v IRC* 23 TC 449; *Corbett's Executors v IRC* 25 TC 305; *IRC v Willoughby* [1997] STC 995; *Beneficiary v IRC* [1999] STC 134; *Carvill v IRC* [2000] STC SCD) 143; *Crown Bedding v IRC* 34 TC 107.

Conclusion

Stephen concluded on this aspect: "In my opinion, there cannot, on any reasonable analysis, be any doubt that the test, under s.741, is subjective, not objective. In my opinion, the correct test to apply is to establish first what was the (subjective) purpose of the transfer/associated operations. Then, it is not a question of whether the person who carried them out *thought* that they amounted to "tax avoidance": the question is whether a tax saving which that person intended (if any) amounts, in law, to "tax avoidance". (This may well be all that Counsel for the Revenue meant in *Willoughby*.)

What is an objective, or subjective, test has been laid down in the common law for hundreds of years. The difference is that, with a subjective test, the Court is searching to know what was in the mind of the particular individual concerned. An objective test, on the other hand, is one applied by the Courts through the eyes of what used to be known as a hypothetical "reasonable man"."

Meaning of Tax Avoidance

In dealing with s.741, Stephen emphasised that it is equally important to appreciate what constitutes "tax avoidance" after *Willoughby*. HMRC has contended that unless a taxpayer can point to a particular provision which grants a relief Parliament intended to give, he/she cannot satisfy s.741. The meaning of "tax avoidance", however, took on a new importance with the development of the *Ramsay* principle. Following the decision in *Ensign Tankers*, the Courts developed a new, more precise, meaning of "tax avoidance". This meaning, of course, is now relevant for s.741 purposes. The case of *IRC v Brebner* 43 TC 705 contains the famous quote from Lord Upjohn, at p.718-719, that where there are two ways of carrying out a transaction, it would be wrong necessarily to conclude that in choosing the tax efficient one, he/she intended to avoid tax. One point at the heart of HMRC's argument is their confusion over "purpose" and "effect".

As regards the post 5th December 2005 rules, Stephen referred to draft sections 741A to 741C.

(1) After s.741 insert: "**741A Exemption from ss 739 and 740 (transactions after 5th December 2005).**

(i) The individual is not liable to income tax by virtue of s.739 or 740 for a year of assessment if he satisfies an officer of the Board -

(a) that Condition A is met, or

(b) in the case where Condition A is not met, that Condition B is met.

(ii) Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

(iii) Condition B is that –

(a) all the relevant transactions were genuine commercial transactions, and

(b) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

Satisfaction of Condition A

Conditions A and B are alternatives, broadly reflecting s.741(a) and (b). The taxpayer must prove a negative in that it would "not be reasonable to draw the conclusion … that the purpose of avoiding liability to taxation was one purpose … for which the relevant transactions, or any of them, were effected". This test is clearly objective: see *Crown Bedding*

Condition B

Condition B first requires proof that the transactions were genuine commercial ones: presumably a modern "*bona fide* commercial" test. Section 741A, subsection (5) sets out a very narrow definition of when a "relevant transaction" is a "commercial transaction". It is limited to:

- those effected in the course of a trade or business; or

- those effected with a view to setting up a trade or business.

In either case, however, the transaction must be effected for the purposes of the trade or business.

Both Conditions A and B, however, lay down objective tests, i.e. what reasonable conclusion can be drawn from all the circumstances. Subsection (4) is intended to bring the law into line with what HMRC has argued in correspondence: an objective test which could, if they wanted it to be, subjective. Stephen contends that this is, of course, nonsense. How is a Court likely to deal with such conceptually unsound nonsense?

II **James** covered further aspects involving transfer of assets abroad; motive defence; transitional rules and planning implications.

Meaning of "avoidance" in motive defence

The House of Lords in *IRC v Willoughby* decided that "avoidance" in the motive defence meant tax avoidance in the strict sense and not mitigation:

> "*… it was essential to understand what was meant by "tax avoidance" for the purposes of s.741. Tax avoidance was to be distinguished from tax mitigation … My Lords, I am content for my part to adopt these propositions*".

Meaning of "taxation" in motive defence

Taxation in s.741 means any form of UK taxation, and not only income tax: *Sassoon v IRC* 25 TC 154. This is the HMRC view: International Manual provides at INTM600040: "In this context 'taxation' includes the avoidance of any UK tax liability including for example Inheritance Tax and CGT as well as Income Tax." Foreign tax is not "taxation" for this purpose. The House of Lords assumed that this was so without argument in *Herdman v IRC* 45 TC 394. This must be right since (1) it is illogical that the purpose of avoiding foreign taxes should have UK tax consequences and (2) it would be almost impossible to apply an avoidance/mitigation distinction to foreign taxes (where the distinction would depend on the foreign tax culture and attitudes).

Purpose of advisers and agents of transferor

If a person relies wholly on advisers, and executes documents without more than a vague idea of approving proposals put to him and not properly understood, he has adopted the purpose of his advisers or (which comes to the same thing) that the purpose of his advisers is to be attributed to him. In *IRC v Pratt*, Mr Lucas (the taxpayer) "did not understand the scheme: it was masterminded by his own professional advisers". Nevertheless, "he, *through his advisers*, was fully acquainted with the fact that what was to follow was a tax avoidance scheme, he must fall fairly within the section".

Avoidance/mitigation distinction

James set out the most important judicial and other statements on the avoidance/mitigation distinction.

Intention of Parliament – Lord Nolan said:

> "*Tax avoidance within the meaning of s.741 is a course of action designed to conflict with or defeat the evident intention of Parliament.*" [*IRC v Willoughby* 70 TC 57 at p.117].

This is now the authoritative general statement on the subject. The Tax Law Review Committee used a similar definition of "avoidance":

> "*We have regarded tax avoidance as action taken to reduce or defer tax liabilities in ways that Parliament plainly did not intend or could not possibly have intended had the matter been put to it*".

HMRC have also adopted this approach:

> "*Tax avoidance is any action taken to obtain a tax advantage in a way that Parliament did not intend or would not have intended had the matter been put before it. This definition is based upon the report on tax avoidance produced by the Tax Law Review Committee in 1997.*"

There have been some attempts to be more specific:-

Special tax regime – Morritt LJ said:

> "*The genuine application of the taxpayer's money in the acquisition of a species of property for which Parliament has determined a special regime does not amount to tax avoidance merely on the ground that the taxpayer might have chosen a different application which would have subjected him to less favourable tax treatment*".

This repeats the test of the intention of Parliament. Professor Willoughby's offshore bonds seem reasonably clear examples of a "species of property for which Parliament had determined a special tax regime".

Economic consequences – Lord Nolan said in *Willoughby*:

> "*The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that*

> *Parliament intended to be suffered by those taking advantage of the option.*"

This repeats the test of the intention of Parliament with the added refinement of identifying the intended "economic consequences".

Other indicia of tax avoidance – It is suggested that "economic consequences" and "special tax regime" are categories of tax saving steps which do accord with the intention of Parliament but are not an exhaustive categorisation of mitigation. They should be regarded as indicia or "badges" of mitigation (like the badges of trade). One can think of others. The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regs 2004 are an interesting attempt to identify indicia of tax avoidance for the purposes of disclosure obligations. The indicia are:

(1) confidentiality from other promoters; and

(2) premium fees (typically linked to tax savings).

The OECD also identified secrecy as a common characteristic of avoidance.

Associated operation: definition

Section 742(1) ICTA provides just about the widest definition the drafter could devise: "For the purposes of this chapter "an associated operation" means, in relation to any transfer, an operation of any kind effected by any person in relation to

[1] any of the assets transferred or

[2] any assets representing, whether directly or indirectly, any of the assets transferred, or

[3] to the income arising from any such assets, or

[4] to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets. (Paragraphing added)

James stated that this must be right. An associated operation does not exist in isolation, it exists in relation to a transfer. There are two requirements: (1) It must be an "operation"; (2) It must be "effected in relation to" items [1] to [4] above; James describes this as being "associated" with a transfer.

"Operation" – "Operation" is (understandably) not defined but is clearly a word of wide import. It includes a company becoming non-resident. It does not include

death, but that does not much matter because it does include the act of making a will. In *Herdman v IRC* 45 TC 394 there was a sale (i.e. transfer) of assets to an Irish company. The company then "accumulated" income and "managed" its assets so as to be able to repay a loan to the transferor. These were held to be "operations" by most of the judges but this is obiter and extremely difficult to accept.

Significance of associated operations

It is never enough to establish that there is an associated operation in relation to a transfer. This is just the first step. One must then go on to ask what (if anything) follows. The term "associated operations" is used in many places in the transfer of asset provisions. (See also the New Conditions in s.741C.)

Planning implications – Trustees must ensure that from *5th December 2005* any acts by them (or of companies owned by the trustees) do meet the new Condition A (or Condition B if relevant). In short, they must ensure that they do no act which might be regarded as having a tax avoidance purpose. As the law now stands, there are many transactions which could in the past have been safely carried out, but which might now be regarded as risky, at least until the position becomes clearer. Ordinary management of trust investments, and retention or distribution of trust income, will involve associated operations but those operations will fall within Condition A. Examples of transactions which may cause difficulties are dealings with UK situate property intended to save IHT or income tax.

Suppose a discretionary trust is within the motive defence. The settlor is deceased. The beneficiary comes to the UK. The trustees pay capital (not income) to that beneficiary. It is tentatively suggested that this is mitigation, rather than avoidance, so that Condition A is satisfied.

Suppose a trust is within the motive defence, and later the settlor comes to the UK. The trustees retain trust income abroad (if it was remitted to the UK there would be a tax charge under the s.648 clawback). Is this tax avoidance? It is tentatively suggested that the answer is, no. Suppose the trustees also make capital payments to the settlor. Is this tax avoidance? It is very tentatively submitted that the answer is, no.

Suppose a trust, all of whose beneficiaries are abroad, wishes to invest in UK land. The trustees invest via a trust company in order to avoid inheritance tax and the additional rate of income tax on the rent. It is suggested that this is mitigation rather than avoidance. If this is not the case, then the effect on the UK economy could be quite remarkable. No sensible trustees would choose to invest in UK land at the cost of losing the motive defence.

Suppose the trustees wish to invest in UK equities, but choose to do so via a unit trust or OEIC which is not UK situate. In these circumstances it is considered that the transaction is not tax avoidance, and Condition A is satisfied.

Dealing with HMRC enquiries

Section 741(1) provides that ss.739 and 740 shall not apply: if the individual shows in writing or otherwise to the satisfaction of the Board that [old Condition A or B apply].

Likewise under the New Conditions, the individual must "satisfy an officer of the Board" that Condition A or B is met. This imposes the burden of proof on the taxpayer. That makes no practical difference as the burden of proof generally rests on the taxpayer, and in any event, disputes are rarely decided by the burden of proof. Contemporary correspondence and background documentation may be relevant to the factual issue of whether the transferor had the purpose of reducing tax. It will not shed much light on the issue of whether the purpose should be classified as avoidance or mitigation. Some factors such as confidentiality or tax related agreements may shed light on this, or at least, on whether the parties regarded the matter as tax avoidance. In *IRC v Willoughby* 70 TC 57 for instance, the Special Commissioner reviewed sales literature relating to the offshore bonds. In practice, expect HMRC to ask for contemporary documentation. The advisers should review it before making a claim. In the case of a transfer to a trust, this includes:

(1) Trust documentation and letters of wishes.

(2) If not evident from the above, details of intended beneficiaries.

(3) Details of assets transferred.

(4) Contemporary correspondence between trustees, accountants and settlor. (Legal advice may be privileged.)

Often the issue arises many years after the transfer of assets, and the contemporary records have been lost. That should not matter, as secondary material and inferences from common sense should suffice, but efforts should be made to recover original documentation, if only to avoid the suspicion that damaging documents may have been suppressed.