LOANS FROM TRUSTS AFTER *BILLINGHAM v COOPER*

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1 Scope of the Article

The Court of Appeal in *Billingham (Inspector of Taxes) v Cooper* [2] decided that a loan made by trustees to a beneficiary on favourable terms but repayable on demand can result in a tax charge on the latter under the capital gains tax Offshore Beneficiary Provisions.[3] The Court held that it made no difference that the loan was made to the beneficiary entitled for an interest in possession, even though he would have been entitled to any interest paid.

In this article, I canvass the possibility that there will be no imputing of gains under the Provisions if a loan is made on arm's length terms to a beneficiary entitled for an interest in possession, even if the interest is never in fact paid.

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2 [2001] EWCA Civ 1041 [2001] STC 1177, upholding the decision of Lloyd J, reported at [2000] STC 122. An identical case heard with it was *Edwards (Inspector of Taxes) v Fisher*.

3 Taxation of Chargeable Gains Act 1992 sections 87 - 97 and Schedule 5. See my *Non-Resident Trusts* 8th Edition Chapter 14.

2 Non-Resident Trusts 8th Edition

2.1 Interest-Free Loans in General

In the 8th edition of my Non-Resident Trusts, which stated the law in force on 1st September 2000, after the decision of Lloyd J but before the decision of the Court of Appeal, I first recollected that in earlier editions of the work, I had expressed the view, which I had admitted was a minority one, that, provided the loan was repayable on demand, there should be no gain imputed to the beneficiary as a result of making the loan. That view has been decisively rejected by the Court of Appeal. It decided that it was not the making of the loan but the failing to call it in which conferred the benefit.

2.2 Interest-Free Loans to Beneficiaries Entitled in Possession

I secondly noted that the taxpayer's other main argument depended on the fact that he had an interest in possession in the settled property: "no benefit is received from the trustees or ... the value of the benefit is nil because the benefit, if any, is the non-charging of interest, whereas if interest had been charged it would have gone to the borrower in his capacity as the beneficiary entitled to income and thus he was no better off than he would otherwise have been and in that sense got no benefit from the transaction, or in a different sense any benefit he received was from himself". I suggested that Lloyd J's rejection of this argument was "superficial", as he made no attempt to construe the statute purposively or to understand the precise nature and extent of the fiction, which operates for capital gains tax purposes, that the trustees are deemed to own the settled property. His decision was nevertheless endorsed by the Court of Appeal, very briefly, at paragraph 37:

> "The construction adopted by the judge is in my view a permissible (though awkward) construction which gives effect to the manifest purpose of the legislation.
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> "The taxpayers' construction does not do so, either on the wider part of the argument or on the narrower point which relies on Mr Cooper and Mr Fisher having been life tenants. The whole scheme of the legislation requires the court to see what benefit a beneficiary actually receives, in cash or in kind, otherwise than as income or under an arm's length transaction. Any pre-existing beneficial interest belonging to the beneficiary is irrelevant. The judge dealt with this point shortly ([2000] STC 122 at 135) but there was no need for him to say more."

What Lloyd J had said was:

> "Mr Ewart's[4] other contention is that no benefit is received from the trustees or that the value of the benefit is nil because the benefit, if any, is the non-charging of interest whereas if interest had been charged it would have gone to the borrower in his capacity as the beneficiary entitled to income and thus he was no better off than he would otherwise have been and in that sense got no benefit from the transaction, or in a different sense any benefit he received was from himself.
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> "Again, I prefer Mr Tidmarsh's[5] submissions. It seems to me that the legislation does not call for or permit a comparison of the position that the recipient might have been in if a different transaction had been undertaken by the trustees. There are too many different possible comparisons for that to be a tenable approach. The proper comparison is with the position of the recipient if the actual loan had not been made rather than if some other transaction had been entered into. The recipient of the actual loan, if it had not been made, would not have had the use of the money lent.
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> "It seems to me that this is particularly clear from the fact that the sections are directed to attributing gains not only to beneficiaries but also among beneficiaries in circumstances in which more than one beneficiary has received a capital payment, which of course is not true of either of these cases.
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> "I accept Mr Tidmarsh's point that in that context it is not sensible to suppose that the person entitled to income has a special status which exempts him from this treatment or requires him to be treated more favourably than other beneficiaries.
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> "Mr Ewart expressly disavowed the contention that, if the benefit which the income beneficiary received was by way of capital advance, an outright transfer of an asset, say a holding of gilts, the benefit conferred was to be valued by reference to the reversionary interest only because he was already entitled to the income interest of that same asset. That being so, and I am sure he is right, it seems to me to confirm that the recipient's existing interest under the trust has to be left out of the calculation for the purpose

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4 David Ewart was counsel for the taxpayers.

5 Christopher Tidmarsh was counsel for the Inland Revenue.

of valuing the benefit conferred under s.97(4).

"Nor can I accept Mr Ewart's contention that the benefit, and so the payment, was not received from the trustees. Plainly the trustees conferred that benefit since it was they who refrained from calling in the loan. Plainly that omission was of benefit to the borrower."

2.3 Loans on Commercial Terms to Beneficiaries Entitled in Possession

Thirdly, I expressed the opinion that, in the case of an interest in possession trust, it is much easier to ensure that a loan can be made to the beneficiary entitled in possession without his paying any interest or receiving any capital payment. I suggested that the safest method was probably to ensure that the loan is made on commercial terms but that the beneficiary does not in fact pay interest for any period during which he would be entitled in equity to receive the interest back from the trustees. There is no question of any liability to income tax arising unless and until interest is actually paid. See *Parkside Leasing v Smith*.[6] I pointed out that while this strategy might be useful for the loan of chattels, it would probably not be appropriate for the loan of land, on account of possible income tax charges which it might generate. Neither Lloyd J nor the Court considered the situation where the loan is made on commercial terms so that interest is due at law but the beneficiary does not in fact pay it on the grounds that he would be entitled in equity to receive it back from the trustees.

3 Loans on Commercial Terms post *Billingham v Cooper* in the Court of Appeal

3.1 Loans to Beneficiaries not Entitled in Possession

If a loan is made at a commercial rate of interest to a beneficiary where no beneficiary is entitled for an interest in possession, he will owe a debt to the trustees. At that point he has received no capital payment or, if you like, a capital payment of a nil value. Suppose that the trustees forgive the payment of interest which is already due or has accrued. That is very clearly a capital payment. It is just as if the trustees had assigned to another beneficiary the right to be paid interest which had already fallen due.

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6 [1985] STC 63.

3.2 Loans to Beneficiaries Entitled in Possession

3.2.1 The Position in Principle

If a loan is made at a commercial rate of interest to a beneficiary who is entitled for an interest in possession to the creditors' (i.e. the trustees') rights under the loan, is a capital payment made by the trustees failing to call in the loan? Let us firstly approach the matter on first principles and then see what, if any, difference the decision in *Billingham v Cooper* makes.

The position is that the loan is a genuine loan at Law. The trustees can, in a court of Law, sue on it and recover the entire amount of interest due from the borrower. The loan is a genuine loan in Equity too. The only difference is that, in Equity, the borrower has a good defence to the claim for interest accruing during periods when he continues to be entitled for an interest in possession provided the trustees do not require the interest in order to discharge trust expenses chargeable to income or to satisfy their lien. In my view, the trustees have conferred no benefit on the beneficiary by making the loan or by failing to call it in. If the beneficiary neglects to pay the interest and they take steps to enforce payment, then if and to the extent that the beneficiary can plead the Equitable defence that he is the sole beneficial owner of the right to the interest and directs the trustees not to collect it, it is he, not they, who confers the benefit (if such it can be described) on himself of avoiding paying himself the interest.

Suppose the beneficiary assigns to, say, his wife the right to receive the interest on the loan which has accrued but not yet been paid and suppose that she directs the trustees not to sue her husband, it is quite clear that it is she and not the trustees who are conferring the benefit on him.

3.2.2 Effect of *Billingham v Cooper*

Does anything in the judgments in *Billingham v Cooper* conflict with this? The Court of Appeal judgment refers to the judgment of Lloyd J. Now the argument presented to Lloyd J was apparently that "the value of the benefit is nil because the benefit, if any, is the non-charging of interest whereas if interest had been charged it would have gone to the borrower in his capacity as the beneficiary entitled to income and thus he was no better off than he would otherwise have been and in that sense got no benefit from the transaction, or in a different sense any benefit he received was from himself". Note that the two ways of putting the point are not the same. Lloyd J dealt only with the first point when he said:

> "... the legislation does not call for or permit a comparison of the position that the recipient might have been in if a different transaction had been undertaken by the trustees. There are too many different possible comparisons for that to be a tenable approach. The proper comparison is with the position of the recipient if the actual loan had not been made rather than if some other transaction had been entered into. The recipient of the actual loan, if it had not been made, would not have had the use of the money lent."

Pausing there, that does not impinge at all on the case of a loan at a full rate of interest. It is not in that case the making of the loan which confers the benefit, nor the failure to call it in. The benefit to the beneficiary comes from the fact that he is entitled to the income of the trust fund, no matter how it is invested. That was the case before the loan was made and will still in principle be the case once the loan is repaid. It is purely incidental that the trust fund happens to be invested for the time being in a loan at interest to him.

Lloyd J then goes on to say:

> "Mr Ewart expressly disavowed the contention that, if the benefit which the income beneficiary received was by way of capital advance, an outright transfer of an asset, say a holding of gilts, the benefit conferred was to be valued by reference to the reversionary interest only because he was already entitled to the income interest of that same asset. That being so, and I am sure he is right, it seems to me to confirm that the recipient's existing interest under the trust has to be left out of the calculation for the purpose of valuing the benefit conferred under s.97(4)."

This has to be read in the context of a benefit *prima facie* conferred by the trustees in that they have failed to stipulate for payment of interest which they could have done had the transaction been on commercial terms. In the instant case, there is no such benefit. Any benefit the beneficiary receives accrues to him by virtue of his "existing interest under the trust" and that, we are told by Lloyd J, has "to be left out of the calculation for the purpose of valuing the benefit conferred under s.97(4)."

The matter was put a little differently in the Court of Appeal:

> "The whole scheme of the legislation requires the court to see what benefit a beneficiary actually receives, in cash or in kind, otherwise than as income or under an arm's length transaction. Any pre-existing beneficial interest belonging to the beneficiary is irrelevant."

While remembering that the context was rather different from that envisaged, these words too are extremely helpful to the beneficiary. His right to the interest payable *is* in the nature of income. And that right is part and parcel of the "pre-existing beneficial interest belonging to the beneficiary" which, we are told, is irrelevant.

Lloyd J also said:

> "Nor can I accept Mr Ewart's contention that the benefit, and so the payment, was not received from the trustees. Plainly the trustees conferred that benefit since it was they who refrained from calling in the loan. Plainly that omission was of benefit to the borrower."

In the present case, the benefit will plainly not be received from the trustees.

4 Conclusion

I therefore conclude that neither the making by trustees of a loan on arm's length terms to a beneficiary entitled for an interest in possession, nor their failure to call it in, can amount to the conferring of a capital payment by them on the beneficiary, even if the interest is not in fact paid because the beneficiary would have a good Equitable defence if sued.

At the same time, courts which were capable of deciding that in calculating the value of an interest-free loan to a beneficiary entitled for an interest in possession one has regard only to the gross, not net, benefit to him, are clearly not incapable of deciding the contrary, for reasons good, bad or non-existent.