

INHERITANCE TAX AND TRANSFER PRICING: A NEW PROBLEM?

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As a general rule, a non-UK domiciliary is liable to a tax charge under IHTA 1984 only on transfers of his UK situated assets. Transfers of non-UK situated assets, such as shares in an offshore company, will not trigger an IHT charge. In the light of this, such an individual may be advised to arrange for a transfer of his UK assets to an offshore company.

A common application of this idea has been to reduce the inheritance tax liability of foreign domiciliaries owning or needing a UK residence. The foreign domiciled individual would own shares in the offshore company which owns the house in which he is allowed to live rent free. Previously the main concern was not whether this worked for inheritance tax purposes, but whether it gave rise to a Schedule E income tax charge by virtue of section 145 Income and Corporation Taxes Act 1988 ("ICTA").² This article discusses the emergence of a new possible income tax problem which arises from an unexpected source: the transfer pricing legislation introduced by the Finance Act 1998. This is to be found in section 770A and Schedule 28AA ICTA.

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² This was on the basis that the non-domiciled individual was a shadow director of the non-resident company and as such was subject to a Schedule E charge on the deemed emolument of the living accommodation. The Revenue's argument that section 145 applies has been rejected in an obiter dictum of a Special Commissioner (see *The Tax Journal*, 12th May 1994, pp12-13)

Paragraph 1 of Schedule 28AA sets out the 'Basic rule on transfer pricing':

"(1) This Schedule applies where:

- (a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions, and
- (b) at the time of the making or imposition of the actual provision:
 - (i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or
 - (ii) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

(2) Subject to paragraphs 8, 10, and 13 below, if the actual provision:

- (a) differs from the provision ("the arm's length provision") which would have been made as between independent enterprises, and
- (b) confers a potential advantage in relation to United Kingdom taxation on one of the affected persons, or (whether or not the same advantage) on each of them,

the profits and losses of the potentially advantaged person or, as the case may be, of each of the potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision."

By paragraph 2, the Schedule is to be construed in accordance with the Model Tax Convention on Income and on Capital published by the Organisation for Economic Co-operation and Development. However, some of the expressions used in the 'basic rule' are defined elsewhere in the Schedule: 'transaction' or 'series of transactions' (paragraph 3), 'participation in the management, control or capital of a person' (paragraph 4), and 'advantage in relation to United Kingdom taxation' (paragraph 5).

In the author's view, the wording used in the new legislation is wide enough to catch the provision of UK accommodation to a non-UK domiciliary by an offshore

company. This is for the following reasons:

- There is a 'provision' to the non-domiciliary by the offshore company of a rent-free UK house within the meaning of paragraph 1 (1)(a) to Schedule 28AA.
- The provision is "made or imposed between two persons by means of a transaction or series of transactions". 'Transaction' is defined by Schedule 28AA paragraph 3 to include: '... arrangements, understandings and mutual practices (whether or not they are, or are intended to be legally enforceable)'. In the present context there is clearly an arrangement under which the individual is allowed to occupy the house rent-free.
- The non-domiciled individual is 'directly or indirectly participating in the management, control or capital of' the offshore company. This will certainly be true where the shares in the offshore company are owned directly by the non-domiciled individual. Further, even if an offshore trust were interposed, it is, in the author's view, likely that the individual would be found to be indirectly participating. Paragraph 4 to Schedule 28AA defines 'indirect participation' very broadly, and it will be difficult to create a structure in which the individual was sufficiently distanced from the offshore company so as not to be indirectly participating in that company.
- The difference between the value of the actual provision (which, if the individual is allowed to live in the house rent free, will be nothing) and the arm's length provision (market rent for the house) confers a potential advantage in relation to UK taxation on the offshore company within paragraph 5 of Schedule 28AA. This is in terms of the income tax it would have had to pay if it had been receiving market rent.

Accordingly, the profits and losses of the offshore company must be computed as if it had charged an arm's length rent for allowing the non-domiciled individual to occupy the house.

What are the consequences of this? Firstly, the offshore company will be liable to basic rate tax under Schedule A on the deemed income. Secondly, sections 739 and 740 ICTA may apply to catch the non-domiciled individual. Sections 739 and 740 apply in circumstances where, following a transfer of assets (namely the transfer of the house to the offshore company), income becomes payable to a person resident or domiciled outside the UK. Section 739 charges any individual who has, by virtue of the transfer or any associated operations, the power to enjoy income which in consequence of the transfer becomes that of a person (the offshore company)

resident or domiciled outside the UK. Such income is deemed to be that of the person with the power to enjoy and is taxed under Schedule D, Case VI. Section 740 is designed to charge a person not charged under section 739 who receives a benefit as a result of the transfer of assets and charges by reference to the benefit received.

For these provisions to apply, the income becoming payable to persons resident or domiciled outside the UK within both sections 739(1) and 740(1)(a) would have to include the income which is *deemed* to have been paid to the offshore company by virtue of the transfer pricing legislation. There is nothing to suggest that this cannot be the case.

However, in terms of section 739, it seems improbable that the non-domiciled individual could be said to have 'power to enjoy' the income which the transfer pricing legislation deems the offshore company to have received within the meaning of section 739(2) (see the definition of 'power to enjoy' in section 742(2) which appears to envisage the existence of income that can give actual enjoyment). As for section 740, assuming the non-domiciled individual is resident in the UK, it would be difficult to argue that he was not receiving a benefit by being allowed to stay in the house rent-free within the meaning of section 740(1)(b). However, in the author's view, section 740 will not apply since there is no relevant income within the meaning of section 740(3). The reason for this is that it is not possible to provide a benefit out of deemed income which is not actually in existence.

In conclusion, despite the fact that sections 739 and 740 do not seem to apply, under the above structure the transfer pricing legislation nevertheless has the effect that the inheritance tax saved comes at the cost of potentially serious income tax problems for the offshore company. In terms of remedial action, it is possible that recourse could be had to the methods which have previously been employed to avoid the section 145 income tax problem.³ However, discussion of this is outside the scope of the present article.

³ For instance, the offshore company could borrow money to purchase the property and offset interest payments on the loan against the market rent paid by the non-domiciled individual. Alternatively, it might be worth considering the reversionary lease scheme.