SECTION 787 ICTA 1988 - ARTIFICIAL PAYMENTS OF INTEREST

Philip Ridgway and Adam Francis[1]

During the late 1970s the tax avoidance industry started to sell schemes whereby relief for interest paid was obtained either as a deduction in computing income or as a charge on income set against total profits without any real payment being made by the taxpayer. Section 38 Finance Act 1976, now section 787 Income and Corporation Taxes Act 1988, was introduced by the Treasury in order to attack what was becoming a wholesale trade in such schemes, by disallowing relief for interest paid where the sole or main benefit that would be expected to accrue to the payer of the interest was the obtaining of a reduction in tax liability. Although the reason for the introduction of the provision was to legislate against a series of specific avoidance schemes, in recent years the Inland Revenue appear to be taking a more aggressive stance and are seeking to apply section 787 in far wider circumstances than those originally envisaged by Parliament. The reason for this is probably that it is easier to use an existing anti-avoidance section than it is to argue from first principles, as was done in *Cairns v MacDiarmid*[2], that the payments being made by the taxpayer are not actually interest at all. Or, if they are interest, that they are short interest and not annual interest.[3]

The intention for legislating

Section 38 Finance Act 1976 was introduced during the Report Stage of the Bill, which clearly restricts the time available for debate upon both the policy behind the provision and the technical details. The reason for its introduction was to combat specific tax avoidance schemes which were being sold at that time. The

---

[1] Philip Ridgway & Adam Francis, Coopers & Lybrand, 1 Embankment Place, London WC2N 6NN. Tel: (071) 583 5000 Fax: (071) 213 0481

[2] [1983] STC 170.

[3] S.787 applies to all interest not just annual interest. However, most sections give relief only for annual interest. Relief for short interest is given, if at all, as a trading expense under s.74(a), ICTA 1988 for which it is necessary for the expense to be incurred wholly and exclusively for the purposes of the trade profession or vocation.

purpose of the clause was explained in a Parliamentary answer given by the then Treasury Minister, Mr Denzil Davies.[4]

> "The Inland Revenue is aware of recent attempts at tax avoidance by what purport to be payments of interest in advance on large artificial borrowings.
>
> The Inland Revenue is challenging these schemes under the existing law. But assuming that the matter goes to appeal, it could be some years before a final ruling is obtained. It appears that there are a considerable number of these schemes, and in view of their wholly artificial nature, it is unacceptable that substantial amounts of tax should remain at risk. To put the matter beyond doubt, therefore, legislation will be introduced at the Report Stage of the Finance Bill to counter artificial devices for exploiting the provisions which allow tax relief for interest paid."

There are two points to note in this statement. First that the Minister had in mind specific anti-avoidance schemes which would, if successful, deny the Inland Revenue substantial amounts of tax because of their widespread use. Secondly, the apparent confidence of the Minister that the existing law would, in any event, deny relief in the cases that were then pending. The problem from the Minister's point of view was the length of time that would elapse before those cases would come to court.[5] Unfortunately, the Minister did not indicate precisely what schemes he had in mind and this may, of course, restrict the scope for seeking to apply *Pepper v Hart*[6] although it may be possible to argue that the application of section 38 should be limited to schemes that were in existence at that time.

The Nature of the Scheme in *Cairns v MacDiarmid*

The essence of the schemes being sold, and presumably those being litigated against, was that a loan would be obtained and the first year's interest would be paid in advance. This interest payment would be available as a deduction either

---

4 Hansard vol. 912 No. 118 col. 665.

5 In the event the Minister's fears were well founded. In *Cairns v MacDiarmid* the interest payment was made on 1st March 1974. The matter did not come before the Commissioners until May 1979, the High Court until December 1981 and the Court of Appeal finally gave judgment on 17th December 1982.

6 [1992] STC 898.

against the total income of an individual[7] or against the profits of a company.[8] This was so notwithstanding that part of the interest payment related to a future accounting period or that the ownership of the capital borrowed had been transferred, and the taxpayer/borrower was effectively reimbursed for the interest paid by the calculation of the consideration involved in the transfer of the debt.

The case of *Cairns v MacDiarmid* itself illustrates the concerns of the Minister. This case involved a scheme that had been entered into prior to 1976 and was in the course of correspondence with the Revenue at the time of the ministerial statement. The scheme was devised and sold in large numbers by Mr Tucker of Rossminster. Mr Cairns worked as an employee of Mr Tucker who wished to pay him a bonus of £5,000 for his services. As stated by Donaldson MR, "Mr Cairns would naturally have preferred this to be free of income tax and no doubt it was a matter of professional pride ... that it should be".[9] This was to be achieved by providing a deduction for interest of that amount in the overall computation of Mr Cairns' income. An arrangement was therefore devised whereby Mr Tucker made an interest free loan of £5,000 for 7 days to Mr Cairns. This was advanced on the 28th February.[10] On 1st March Rossminster Acceptances Ltd loaned Mr Cairns £37,740 for two years at 13.25% per annum interest, which incidentally amounted to £5,000 per annum, therefore the funds available to Mr Cairns totalled £42,740. The interest payable upon the loan from Rossminster Acceptances was payable

---

7 Under s.75 Finance Act 1972 an individual was allowed a deduction from or set off against his income if he paid interest which was chargeable to tax under Schedule D Case III or it was interest payable in the United Kingdom on an advance from a bank carrying on a bona fide banking business in the United Kingdom. Relief was not allowed for the first £35 of interest unless the loan was a protected loan (i.e., a loan to purchase an interest in land or a loan to purchase plant and machinery - see Sched 1 FA 1972). The Finance Act 1974 reintroduced the regime which was in force prior to the Finance Act 1972 and which is now contained (with some amendments) in ss.353-368 ICTA 1988. The 1974 Finance Act provisions took effect from Budget Day, 26th March. If Mr. Cairns had succeeded in his argument that the payment was annual interest he would have succeeded by a mere 25 days. Although, despite the restriction of relief, it was still felt necessary to deal with artificial payments in the 1976 Finance Act.

8 Section 248(1) ICTA 1970; now s.338(1) ICTA 1988 and s.259(6) ICTA 1970, now s.403(7) ICTA 1988.

9 [1983] STC 178 at 180 a-b.

10 Presumably this was done to enable cash to move to support the argument that cash was actually "paid" - a mere set-off or roll up arrangement may not have been sufficient for this purpose. See *Minsham Properties v Price* [1990] STC 718 and *Parkside Leasing v Smith* [1985] STC 63.

annually in advance. Mr Cairns received a cheque from Rossminster for £37,740. At the same time he handed over a cheque for £5,000.[11] In the following few days Mr Cairns entered into a contract whereby for a payment of £32,740, another Rossminster company agreed to a novation of the loan which would discharge the repayment obligation of Mr Cairns. With the remaining sum at his disposal Mr Cairns repaid Mr Tucker the £5,000 interest free loan. Mr Cairns therefore received £5,000 plus £37,740, i.e., £42,740. He paid £5,000 interest, £32,740 to transfer the debt and £5,000 to repay the interest free loan (i.e., £42,740). His net position was therefore nil. The whole arrangement lasted 4 days. Mr Cairns sought to deduct the £5,000 interest payment incurred on the loan from Rossminster as a charge on income under what is now section 353 ICTA 1988, thus effectively eliminating the corresponding liability to tax upon the £5,000 bonus paid by Mr Tucker.

Section 38 came into force on 9th June 1976. Parliament did not seek to make the provision retrospective; therefore, the Inland Revenue were forced to rely upon the law in force at the time of the transaction. The Court of Appeal acknowledged that the scheme "received its quietus in the Finance Act 1976". However, without the benefit of section 38 it was necessary to attack the artificial nature of the transaction, which arose in one of three ways. First, no interest was actually paid. This was the basis of the decision at first instance.[12] The benefit of the loan was "sold" the following day. It could be argued that the taxpayer did not pay the initial £5,000, which was stated to be annual interest in advance, as a payment by time for the use of money. As the taxpayer was effectively reimbursed for his entire outlay the following day it could be said that he incurred no expense at all. Secondly, the right to the capital was sold, and hence the intention of the parties was that, as between themselves, the loan was only intended to last a few days with the result that the interest was short interest and did not fall within the relieving provisions. This was the basis of the decision in the Court of Appeal which characterised the interest payment as one of short interest. The label or method of calculation of the interest was held not to be conclusive. For example, an overnight deposit may pay interest at an annual rate but this will not alter the

11 There was some confusion on the facts whether or not he received a net £32,740 with the first payment of interest being set-off. If this was the case there would appear to have been no need for the interest free loan advanced a few days earlier. Nothing appears to have turned on this point in the Court of Appeal but the Inland Revenue seem to have advanced the argument that because it was a net payment it was not interest "paid".

12 "It was a payment made in discharge of a purely artificial liability which was created in order to achieve a tax advantage" per Nourse J [1982] STC 226 at page 243 f-g.

intention of the parties that the interest was to be short.[13] There was never any doubt that the loan from Rossminster to Mr Cairns was to last only a few days. Thirdly, the advance payment of interest was for no other purpose than the avoidance of taxation.[14]

It is probably essential that the Court of Appeal did not conclude, as Nourse J did, that the payment was not a payment of interest at all, for if this was the case section 38 Finance Act 1976 would have missed its mark. It applies to "any payment of interest". If the Court of Appeal had followed Nourse J[15] there would have been no payment of interest and nothing to disallow. It follows from this finding that the payment was still taxable as interest in the hands of the payee. Therefore, if the Inland Revenue invoke s.787, the payee still remains potentially liable to tax on the receipt.

The Restriction

Section 787 provides that "relief shall not be given to any person[16] ... in respect of any payment of interest if a scheme has been effected or arrangements have been made ... such that the *sole or main benefit that might be expected to accrue* to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief."

The reliefs at which the section is aiming are therefore:

(a) Companies

(i) relief for short interest (but see footnote 3) under section 74(a) ICTA 1988;

(ii) group relief for excess charges on income under section 403(7) ICTA 1988;

---

13 Per Donaldson MR at page 181 j.

14 *Cairns v MacDiarmid* was an early application of the *Ramsay* principle. Sir John Donaldson MR noted how the spectre of *Ramsay* had grown as the case progressed. In front of the Commissioners it had been "...but a cloud the size of a man's hand." At first instance it had "...achieved the status of a major depression." In the Court of Appeal Mr Cairns' case was, "...wholly unprotected from the icy blast of *Ramsay's* case".

15 See footnote 12 above.

16 It therefore applies to individuals as well as companies.

(iii) relief for annual interest under section 337(3) and 338(1) ICTA 1988.

(b) Individuals

relief for interest under sections 353 to 368 ICTA 1988.

The section applies whether the scheme or arrangement was made before or after the interest payment is made. Besides the illustration of *Cairns v MacDiarmid* above, the section may also catch the following types of transaction:

(a) a person obtains a loan to pay for improvements on property that is let which are to be carried out by a connected person at an inflated price;

(b) a company borrows money from a bank in order to subscribe for share capital in a subsidiary where the dividend stream expected from the subsidiary is less than the interest payments **and** there is no realistic expectation of an increase in the value of the investment, particularly where the subsidiary is resident overseas;

(c) an overseas investor borrows money from a UK lender in order to acquire property and set off the interest against rental income.

When introduced the section was clearly intended to deter taxpayers from entering into circular transactions which had no commercial motive apart from the obtaining of a reduction in the tax liability. Of course there is a risk with a circular transaction that the taxpayer may argue that no "payment" has been made and that no interest was received. But the wording of the section enables the Inland Revenue to go far beyond the circular transaction.

The motive test, namely "the sole or main benefit that might be expected to accrue" (section 787(1)) is to be applied at the beginning of the transaction. It is an objective test as to whether any commercial benefit is likely to result. If an overall commercial benefit is likely to be obtained, there is scope for arguing that the main benefit was not the obtaining of a reduction in the tax liability, albeit that a reduction in tax happens to be an ancillary benefit.[17]

[17] The mere fact that a transaction is tax driven does not necessarily militate against it being a trading transaction; *Ensign Tankers (Leasing) Ltd v Stokes* [1992] STC 226.

Commercial v Artificial

The section is designed to counter arrangements that are designed only to reduce a liability to tax; it is understood that the Inland Revenue will not seek to deny relief where a genuine borrowing has been obtained. For instance, it is understood that the Inland Revenue will not apply the section to "Swiss roundabout" transactions. This is an arrangement which is designed to combat the problems of section 338(4) ICTA 1988. In order to get relief for interest paid to a person not resident in the UK it is necessary for:

(a) the payment to be made under deduction of tax which is then accounted for under Schedule 16 ICTA 1988;[18] or

(b) the payment to be a payment of interest under s.340 ICTA 1988; or

(c) the payment to be a payment out of income brought into charge under either Schedule D Case IV or D Case V.

A company can create Schedule D IV or V income by placing the proceeds of the original loan on deposit with a Swiss bank. The company would then borrow a like amount from the Swiss bank, probably giving a charge over the original deposit as security. The interest paid on the second loan will, by virtue of the UK/Switzerland Double Taxation Agreement, be paid without the deduction of basic rate income tax, consequently section 338(4)(a) will be satisfied. The interest charged upon the first loan will be paid out of the interest accruing to the company upon the deposit and the interest on the second loan may be set against the company's total profits. The purpose of the arrangement is not to avoid tax, but to obtain finance at a commercial rate.

Absence of Clearance Procedure

As stated previously, the application of section 787 is wholly dependent upon the motive for the transaction. There is no clearance procedure by which the taxpayer may obtain any comfort from the Inland Revenue. The motive is to be viewed objectively at the beginning of the transaction. In the case of *Crown Bedding Company Ltd v IRC*[19] the Court of Appeal had to address the meaning of the words "the main benefit which might have been expected to accrue" as applied to

---

18 Where the payment is made overseas and the relevant tax treaty provides for payment to be made gross it is to be treated as if tax had been deducted (Reg. 6 Double Taxation Relief (Taxes on Income) (General) Regulations 1970).

19 (1946) 34 TC 107.

Excess Profits Tax. Lord Greene MR stated that the main benefit which might have been expected does not mean the main benefit which was in fact expected by those carrying out the transaction but rather the main benefit which might have been expected by a person surveying all the facts and knowing all the law on the subject at the time of the transaction.[20] In other words a very informed man on the Clapham Omnibus. However, it should be remembered that the existence of a tax motive does not necessarily negate the fact that a company has entered into a commercial transaction.[21]

Claims for Group Relief

Under section 787(3) it is specifically enacted that the relief for interest paid is not restricted to the person paying the interest. Where the benefit of the interest deduction is passed to a group company in accordance with section 403(7) ICTA 1988 (as a transfer of charges on income to a company which is the holder of not less than 75% of the ordinary share capital of the company incurring the interest payment), in determining what benefit might be expected to accrue from the transaction the question "shall be determined by reference to the claimant company and surrendering company taken together". The use of the word "shall" mandates a joint rather than an individual consideration of the two group companies' taxation burden. It is therefore necessary to compare the benefits arising to each company as obviously the tax benefit will accrue to the claimant company; however, there may be a commercial benefit to the surrendering company.

Current Inland Revenue Attack

In recent years the Inland Revenue have changed tack on section 787 and used the restriction as a method of attacking many transactions that would otherwise obtain the benefit of interest relief. The dividing line between what is commercial and

20 "... the question of probability or possibility is a matter 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 at which you can say a thing is probable rather than possible and the precise point at which you say that a probability falls to a 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." per Lord Greene MR at page 119.

21 *Ensign Tankers (Leasing) v Stokes* [1992] STC 226.

what is not is very fine. For instance, the following have been known to be the subject of Revenue scrutiny:

- in deciding how to fund a group company the decision was taken to borrow from a bank instead of using non-deductible intra-group funding;

- a prepayment scheme whereby interest rates were fixed in advance or payments of interest made in advance during a period of volatile base rates in order to secure the underlying finance, and to provide certainty;

- a loan arranged and interest paid in order to repurchase share capital of the company. The Inland Revenue have questioned the commercial rationale of the purchase;[22]

- stripped bonds transactions where the right to the interest on the bond and the capital sum are separated and the bond is then reacquired by the borrower's group.

Although the Inland Revenue appear to be widening their net, it should be remembered that 787 is an anti-avoidance provision and therefore the onus should be upon the Inland Revenue to show the lack of motive in the first instance. Of course, once such evidence has been adduced it will be for the taxpayer to rebut it.

Legislative Purpose

Although the expressed intention of Parliament was to counter immediately schemes which could eventually be struck down by the courts, there is no real ambiguity about section 787. It is a very widely drawn section which, on its face, simply denies relief for payment of interest. Consequently, despite the fact that it is known in tax circles that it was intended to attack certain schemes, there is little chance of invoking *Pepper v Hart*. Perhaps this is a model for legislative draftsmen.

---

[22] Where clearance is refused for CGT treatment it will be difficult to argue that the interest was for the benefit of the trade.

The Interest Question

The statement made by the Minister in 1976 indicated there is a line of attack that the Inland Revenue have at their disposal other than section 787. This was demonstrated in the case of *Cairns v MacDiarmid* in which relief was denied on the grounds that the interest was not "annual interest" (see the facts of the case above). It is therefore necessary to examine the intention of the parties to ascertain what is the real nature of the payment. However, the categorisation of interest as short or annual is a secondary step. The first question is whether the payment is "interest" at all.

The meaning of interest is succinctly put by Rowlatt J in *Bennett v Ogston*[23] in which he stated that interest "is payment by time for use of money". When money is borrowed from a bank on terms that interest is paid in advance, so that a net payment is made by the bank, or that the immediate prepayment of interest means that in effect only a net sum is received followed by a real borrower purchasing the loan from the initial borrower, there must be some doubt as to whether the intermediary is paying a sum to the bank by way of "interest" because there is little or no use of the money on his own account. This may be especially so where the payer of the interest has no intention to "use" the principal but instead it is merely "parked" in an account until such time as the next stage of the scheme takes place. The advantage that the Inland Revenue have in categorising it as interest is that they do not need to decide how the payment should be charged to tax in the hands of the payee.[24]

A further question concerning the deduction of interest is raised by section 75(3) ICTA 1988 which provides that if, in an accounting period of an investment company, the expenses of management, together with any charges on income paid in an accounting period **wholly and exclusively** for the purposes of the company's business, exceed the amount of profits from which they are deductible then that excess shall be carried forward into future accounting periods. There will be a question as to whether the interest paid was wholly and exclusively for the company's business where the scheme is broked by persons seeking to assist companies in minimising their tax liabilities. It may be argued by the Inland Revenue that there is a dual motive in the borrowing and so it is not made "wholly and exclusively", i.e., the "interest" comprises both a payment for interest **and** a

23 (1930) 15 TC 374.

24 There is also a substantial body of anti-avoidance legislation designed to restrict interest deductions. S.209 ICTA 1988.

payment to the broker of the scheme for fees and commission. Such an argument was advanced in *Eilbeck v Rawling*.[25]

Conclusion

The problem with any anti-avoidance legislation is that it must be wide enough to catch the true avoidance scheme and yet not stifle true commercial transactions so as to put UK companies at a competitive disadvantage. With the arrival of the decision in *Pepper v Hart* there may be tendency to consult Hansard to see if the scope of any particular section can be narrowed. However, where there is no ambiguity reference to Hansard is not permitted. If the ambit of 787 were to be restricted by the Courts it would be a simple matter to re-enact it with a statement that it was now aimed at interest schemes in general. Such an approach was taken when introducing the recent equity note legislation[26] when it was stated that the legislation was drawn deliberately widely to save having to legislate in the future. The problem with such wide legislation is that it does produce uncertainty. In the absence of any clear policy from the Inland Revenue as to when s.787 is to be invoked, a clearance procedure would enable taxpayers to know in advance whether transactions are likely to be attacked.

---

[25] [1981] STC 174.

[26] S.31, F(No.2) A 1992.