

MOTIVE DEFENCE TO SECTIONS 739 AND 740

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1 The Statute

Section 741 ICTA 1988 provides that ss.739 and 740 (the transfer of asset provisions):

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
- (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.

This defence to the transfer of asset provisions is the subject of this article. It is here called "the motive defence."

There are two tests, and the taxpayer need only satisfy one of them. They are here called test (a) and test (b).

2 Enactment History

The motive defence was originally a proviso to s.18 FA 1936, in the following terms:

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Provided that this subsection shall not apply if the individual shows in writing or otherwise to the satisfaction of the Special Commissioners that the transfer and any associated operations were effected *mainly* for some purpose other than the purpose of avoiding liability to taxation.
(Emphasis added.)

Section 28 FA 1938 substituted the present text. The reason is given by the Solicitor-General in a Parliamentary Debate (Hansard 27th June 1938, col 1610):-

Again it is an actual case. A taxpayer transferred a large amount – he was not one of the small people for whom my hon. and learned Friend was pleading – of foreign securities to a trust company abroad on certain trusts under which the income was to be accumulated until the death of the taxpayer. There was a discretion to the trustees to pay certain portions of the income to the taxpayer or to his son. The deed gives to the taxpayer and his son power, with the consent of the trustees, to revoke the trust, or, alternatively, they can withdraw all or any part of the trust property for their own benefit. The trust income has been accumulated, and none of it has been distributed. The vigilant Revenue authorities pursued this taxpayer, and he contended, successfully, as it transpired, on appeal, that the foreign trust was born because of his fears as to the financial position of this country and the dangers of the situation on the Continent —

Mr Lees Smith: When was this – in 1931?

The Solicitor-General: No, in 1936. He stated that he wanted to find a stable country where he could make safe provision for his family. The Special Commissioners decided that the main purpose of the transaction was occasioned by A's pessimistic view of the European situation at the time; that, arising out of that, his main intention was to make provision for his family in a safer country; and that, if there was any intention of avoidance of taxation, it was incidental to the main purpose. They therefore decided that there was no liability under Section 18 of the Act of 1936. That instance has only to be cited to the Committee for the Committee to realise that on this particular matter the hon. Member for Chesterfield (Mr. Benson) was a true prophet in 1936, when he said that the word "mainly" would be too wide.

A case on similar facts may well succeed today, but the test is slightly stiffer, as the word "mainly" (whatever it meant) no longer appears.

3 Test (a)

Test (a) depends on a single condition:

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.

A transfer may have several purposes. If one of those purposes is the avoidance of taxation, the taxpayer fails test (a). It does not matter what the other purposes are.²

4 Test (b)

Test (b) depends on two conditions; both must be satisfied:

that the transfer and any associated operations were:

- (1) bona fide commercial transactions and
- (2) were not designed for the purpose of avoiding liability to taxation.

4.1 “Bona fide commercial”

What is meant by “commercial”?

In the Revenue view:-

The expression “bona fide commercial” in Section 741(b) is taken to apply only to the furtherance of trade or business, and not to the making or managing of investments.
(Tax Bulletin 40)

But what can be more “commercial” than the management to maximise the return from investments? Moreover one cannot draw a distinction between “trade or business” and “making or managing investments” because “making or managing of investments” may be a “business”. The Revenue view if it is coherent at all is unduly narrow.

² The point is stated in *Ex p. Phillipi* 44 TC 31, but it is plain from the terms of s.741.

There are some useful explanations of the word “commercial” which can be gleaned from different sources. Ambrose Bierce (as so often) hits the mark:

A commercial pursuit is one in which the thing pursued is the dollar.³

The Special Commissioners adopted the same approach in *Lewis v IRC* [1999] STC (SCD) 349:-

It is trite law that in exercising their duties trustees must use as much diligence as a prudent man of business would exercise in dealing with his own private affairs ... Faced with the self-investment problem their duty was to act in a business-like manner: this they did. Put another way, they acted commercially as was their duty. In our view it would be construing the statute too narrowly to hold that they did not carry out the transactions for bona fide commercial reasons, unless an investment decision cannot be for commercial reasons.

In *IRC v Goodwin* 50 TC 583 at p.607, Russell LJ said:

Bulmer v Inland Revenue Commissioners [1967] Ch. 145 was a case indicating that the expression ‘bona fide commercial transaction’ was used judicially to describe something lacking an element of a bounty, in determining whether there was a ‘settlement’ ...

This takes us to the heart of the meaning of “commercial”. A transaction with an element of bounty is uncommercial. For instance, a gift to a settlement for the benefit of a settlor’s family is not commercial. The same applies if the class of beneficiaries includes the settlor as well as others. By contrast a loan or transfer of assets to a company wholly owned by oneself is quite capable of being a “commercial transaction” even if the loan is interest free. This is supported by cases on s.660A such as *IRC v Levy* 56 TC 68.

The “bona fide commercial” condition is not required to satisfy test (a).

4.2 “Designed for the purpose of avoiding taxation”.

What happens if a transaction is designed for two purposes? The Revenue say:

The Revenue’s view is that one of the essential conditions of s.741(b) would not be satisfied where there was a significant element of tax avoidance

³ The Devils Dictionary (from the definition of “Merchant”).

purpose in the design of the transfer and any associated operations.
RI 101.

But this paraphrase is obviously too generous to the Revenue. One must identify the main purpose and a subsidiary tax avoidance purpose does not matter. The Special Commissioner correctly stated the law in *Carvill v IRC* [2000] STC (SCD) 143:

One must ask in para (b) whether the transfer was designed for the purpose of avoiding tax or not. This seems to me to require that the main purpose was not tax avoidance because if one has to categorise a transaction as being either designed for the purpose of tax avoidance or not, when it is clearly accepted that a transaction may be designed for more than one purpose, the only way to categorise the design into one purpose is to look at the main purpose of the design. I think, therefore, that the taxpayer's contention of sole purpose is too loose a test and the Revenue's contention of significant purpose is too stringent a test although it will in practice be difficult to determine the difference between a significant and a main purpose.

This is easier to satisfy than under test (a).

Is there a difference implied by the use of the word "designed", in test (b); and "effected", in test (a)? In the context, this is more than ordinary English usage will allow. Those words must be synonymous.⁴

In practice one will often argue that tests (a) and (b) are both satisfied. Test (a) is the more likely candidate in the context of transfers to normal family trusts but test (b) will be relevant for transfers to companies.

5 Meaning of "Taxation"

It has been held that *taxation* means any form of UK taxation, and not only income tax: see *Sassoon v IRC* 25 TC 154. This is the Revenue view: Inspector's Manual 4620:

In this context 'taxation' includes Inheritance Tax and Capital Gains Tax as well as Income Tax.

⁴ Contrast the robust comments of Lord Simonds when pressed with the distinction between the expressions "by means of" and "by virtue or in consequence of" in (what is now) section 739: "This is altogether too fine a distinction. The difference of language is sufficiently explained by the wish of the draftsman not to use the same expression twice." *Congreve v IRC* 30 TC at 204.

Sassoon, though criticised, is a decision of the Court of Appeal and must be taken to represent the law at present. It is submitted that it would be upheld if challenged in the House of Lords.

So "tax avoidance" here means avoidance of Income Tax, CGT or Inheritance Tax. One must ask of any transfer:

- (1) Is the purpose to avoid Income Tax?
- (2) Is the purpose to avoid CGT?
- (3) Is the purpose to avoid Inheritance Tax?

5.1 Does "Taxation" Include Foreign Taxes?

"Taxation" in a UK taxing statute means UK taxation. 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.

6 Time to Ascertain Purpose and Change of Purpose

The purpose must be ascertained at the time of the transfer.⁵ This causes problems for the Revenue. Harold Lever made the point graphically in Parliament in 1969:

If we are to have a section [739], it has to bite on all settlements abroad which at any time are used for avoidance of tax even though originally started for innocent purpose. Supposing a man has transferred money to set-up a Bible society in Bulawayo and his heir being more sophisticated and perhaps more materialistic, finds himself with a settlement set up for unimpeachable purposes and decides that it would make a useful vehicle for the avoidance of all income tax and surtax.⁶

There are three possibilities.

- (1) The change of purpose may be accompanied by a new transfer of assets carried out for a tainted purpose. In that case the transfer of asset

⁵ The point was made in *Herdman v IRC*; but it is plain from the terms of s.741.

⁶ Hansard 17th July 1969 column 955-5. At the time Harold Lever was Financial Secretary to the Treasury.

provisions may apply in relation to the second transfer of assets.

- (2) There may be no further transfer of assets but there may be associated operations carried out for a tainted purpose. The question as to whether or not this brings the transfer of asset rules into operation is discussed below (Associated operations and the Motive Defence).
- (3) There may be a change of purpose without any new transfer or any associated operations. In that case the motive defence remains available and transfer of assets provisions do not bite at all.

7 Purpose of Transfer v Purpose of Transferor

In *IRC v Pratt* [1982] STC at p 795, Walton J observed:

It is not 'the transferor's purpose in effecting the transfer' but 'the purpose for which the transfer was effected'.

But surely one cannot say:-

- (1) "the purpose for which the transfer was effected"

could be different from

- (2) the transferor's purpose in effecting the transfer?

(1) is at best a shorthand expression for (2). Indeed a transfer itself cannot have a purpose: only a human being (or at least, a sentient mind) can have a purpose. "Purpose", if it means anything, is a mental state. If one says that an inanimate but man-made object such as a book has a purpose, one is only attributing to the book the purpose in the mind of the author/publisher/user of the book. If one says that a statute or a transfer has a purpose, one is attributing to the statute or transfer the purpose of those who make it.

8 Who's Purpose?

It is suggested that the section must be looking at the purpose of the transferor or quasi transferor.

In the case where:

- (1) a company makes a transfer
- (2) there is no quasi transferor⁷

usual company law principles must be applied to attribute to the company the views of the individuals acting on its behalf.

In a case where a transferor is acting by agent or attorney, the author suggests that the purpose of the agent or attorney should, on normal agency principles, be attributed to the transferor.

If a taxpayer is relying wholly on advisors, and executes documents without more than a vague idea of approving proposals put to him and not fully understood, it is suggested that one may fairly say that he has adopted the purpose of his advisors.

9 Who's Tax?

A settlor does not normally "avoid" his own CGT or Income Tax when making a settlement from which he is excluded. As far as the settlor's tax liabilities are concerned, any tax saving is tax mitigation.⁸ However, the Revenue rightly say that the position of the Trustees and beneficiaries needs to be considered and the motive defence fails if the purpose of the transferor is that their tax liabilities are avoided.

10 Meaning of "Purpose": Objective or Subjective

The Motive Defence refers to "purpose". In the Revenue's view:

'Purpose' is taken to be the end it is sought to achieve by the transaction.

⁷ In such a case of course there would be no *individual* "transferor" who is within s.739: see the author's *Taxation of Foreign Domiciliaries* 10.4.2 (transfers by companies). The purpose of the company which makes the transfer is still relevant for the application of the motive defence to a charge under s.740.

⁸ See Lord Templeman's dictum cited below.

This is a fair paraphrase,⁹ but it does not take us very far.

A choice has to be made between:

- (1) An objective test of “purpose”.
- (2) A subjective test.
- (3) A mixture of objective and subjective.¹⁰

There is no guidance in the section.¹¹

The Revenue took up arms for an objective test:

If a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes even if the transferor did not form the subjective intention of avoiding tax.

The advantage to the Revenue in this view was that it allows them to say to a taxpayer in an appropriate case (such as Professor Willoughby) “perhaps you did not *think* what you were doing involved the avoidance or even the mitigation of tax; but it was, nonetheless; it was unwitting tax avoidance”. However, the ink had hardly dried on the Revenue statement when the Special Commissioners held that the test is subjective; *Beneficiary v IRC* [1999] STC (SCD) 134 at 143, *Carvill v IRC* [2000]

⁹ It is based on *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450.

¹⁰ This mixture may take many different forms, such as *Mallalieu v Drummond* 57 TC 330 applies to s.74(1)(a) ICTA 1988 or *R v Ghosh* [1982] QB 1053 applies to “dishonesty” in criminal law. This apparently simple dichotomy objective/subjective is inadequate to cover the various permutations of circumstances which can arise.

¹¹ It may be said that “purpose” is at least normally a subjective concept. “Objective purpose” is a difficult concept. It means, presumably, the purpose which an ordinary reasonable person would have if he stood in the circumstances of the transferor. But how practical is it to identify purpose in this way?

More generally, an analysis of the concept of purpose would draw much support from Lord Hoffmann’s analysis of the concept of “causation”; like identifying “causation”, the identification of “purpose” depends on the purposes of the enquiry which is made.

However, the motive defence is not the best place to begin the analysis because “tax avoidance” carries hazy and subjective elements.

STC (SCD) 143. That is where the law now rests, and will probably remain.¹²

In practice (depending perhaps on one's understanding of objective/subjective) it will rarely, if ever, matter which view one forms.

11 "Avoidance" Distinguished From "Mitigation"

A full discussion of the concept of tax avoidance requires a book to itself.¹³ The following does not say all that could be said.

The term "tax avoidance" has a variety of meanings and the particular meaning depends on the context.

The starting point is to distinguish:

- (1) An *etymological* sense of "tax avoidance" which may be taken to mean any act done whose effect (or purpose) is to escape or save tax or reduce tax liabilities. Contrast an advertisement for PEPs: "Be a tax avoider"!
- (2) Of course the word is not usually used by anyone in this etymological sense: much done purely to escape tax is not considered "tax avoidance". For instances, investments in PEPs, ISAs, TESSAs and venture capital trusts are *only* chosen to save income tax or CGT; likewise covenants to charity (before 2000/01); simple gifts which are PETs are often made primarily to save IHT.

So we need to distinguish between two classes of things all of which are done to save tax but some of which are and others are not tax avoidance. They are conventionally labelled tax avoidance and tax mitigation.¹⁴ The crucial question is how to draw the distinction between the two. The labels do not go far to explain how to do so.

In this article the expression "saving tax" is used as a neutral term to describe both avoidance and mitigation (or what is described above as an etymological sense of "tax avoidance"). Two issues must therefore be distinguished in relation to any

¹² The subjective approach is supported by *IRC v Goodwin* 50 TC 583.

¹³ For further reading, see Nabil Orow, *General Anti Avoidance Rules* (Jordans, 2000). This has an extensive bibliography.

¹⁴ This terminology goes back only to 1986 though the concept is older.

transfer:

- (1) Is the purpose to save tax (to use the neutral expression)?
- (2) If so, is the purpose to be characterised as tax avoidance or mitigation?

The avoidance/mitigation line is very murky. Or as the Courts have put it, "What constitutes tax avoidance is very much a matter of opinion."¹⁵ In the fog of uncertainty, two broad approaches can be distinguished:

- (1) "Tax avoidance" as politicians, civil servants (and perhaps most non-tax lawyers) use the term.¹⁶ This means no more or less than any tax practice which politicians and civil servants judge undesirable and want to stop (or which it is assumed that politicians and civil servants would judge undesirable and want to stop if they considered the matter). For an example of this usage see the National Audit Office Report (Countering VAT Avoidance, 1992):

"Avoidance involves complex issues and the position is constantly changing. A policy change in the UK, or a ruling from the European Commission or European Court of Justice, can easily result in today's unacceptable avoidance becoming tomorrow's acceptable tax mitigation, and vice versa."

- (2) "Tax avoidance" in the sense used by tax lawyers. As we will see, the Courts impose a stiffer test of what is "tax avoidance". It is right, indeed necessary, for them to do so because if the position were "constantly changing" as a result of a mere "policy change in the UK or ruling from the European Commission" then the concept is unworkable for tax. The law can cope with a concept of "tax avoidance" which changes over time; is there anything which does not change over time? But relative stability is essential.

¹⁵ Per Lord Wilberforce in *Mangin v IRC* [1971] AC 735 at 739 in a passage often cited since. Cf John Avery Jones in *Carvill v IRC* [2000] STC (SCD) 143 "an extremely elusive concept".

¹⁶ A purist may say any other usage is incorrect or debased; that takes us to the debate as to whether or not there is such a thing as "correct" English usage (where different groups use English differently) and how one determines it if there is. We forbear to enter that territory here. Nothing will stop the word being used in this wide sense.

In either case the concept involves a value judgment, not different in kind from the concepts “good” or “bad”, “honest” or “dishonest”, “negligent” or “reckless”. In other words: “tax avoidance” is not self explanatory, it is not a given. It is a construct (like “love”) defined and determined by reference to values and culture in which we live. The difference between the approaches (1) and (2) is largely: *whose* values and culture does one apply.

In what follows “tax avoidance” is used in the strict legal sense. Nevertheless, it is worth bearing in mind how easy the loose sense can be adopted, leading to error or confusion.

Relevant approaches in distinguishing tax avoidance (in the s.741 sense) and tax mitigation are to seek to identify:

- (1) “the spirit of the provision”; “misusing” a provision;
- (2) the “evident intention of Parliament” (which probably mean the same thing as (1));
- (3) “artificiality;”

and many more. The usefulness of these approaches will vary according to the context.

One way that the Courts may deal with the intractable conceptual problems of “tax avoidance” and “bona fide commercial” (as with others) is to classify the issue as one of fact, on which they can therefore refuse to adjudicate on appeal.¹⁷

12 Judicial Guidance

This section sets out the most helpful judicial statements on the avoidance/mitigation distinction.

Lord Nolan said:

Tax avoidance within the meaning of section 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.116.

¹⁷

For an example of this approach see *IRC v Goodwin* 50 TC 583.

Lord Nolan has used his words carefully. He may have had in mind Frege's perceptive observation¹⁸ that an expression may have a "sense" (abstract meaning) but no "reference" (the object to which that abstract meaning refers). Frege gave the example of "the will of the people". Another such is "the intention of Parliament". But Lord Nolan refers to the *evident* intention of Parliament. Unless there is an "evident" intention, there is no tax avoidance. This approach does not remove a penumbra of uncertainty, but it helps to reduce it.

Lord Templeman said:

The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax.

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 reduction in his tax liability. ...

Thus when a taxpayer executes a covenant and makes a payment under the covenant he reduces his income. If the covenant exceeds six years and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the payment under the covenant.¹⁹

When a taxpayer makes a settlement, he deprives himself of the capital which is a source of income and thereby reduces his income. If the settlement is irrevocable and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the reduction of income.

Challenge v IRC [1986] STC at p. 554-5.

This approach focuses on whether the taxpayer has reduced his income or capital in a way appropriate to a tax saving.

Wrottesley J said:

The legislature has clearly in mind an individual who is evading liability to income tax, and not a person who is, through no effort of his own, not in the

¹⁸ "On Sense and Reference". This is available in English in *Translations from the Philosophical Writings of Gottlob Frege*, Blackwell, 2nd ed., 1960.

¹⁹ That the income tax rules on covenants have changed does not alter the force of the example.

road and so not likely to be affected by a tax.
Congreve v IRC 30 TC 163 at p.184

This approach focuses on the tax position of the individual before the transfer.

Lord Justice Morritt 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.
IRC v Willoughby [1995] STC at 183.

This focuses on the taxation provisions which apply to the transaction carried out.

Lord Upjohn said:

My Lords, I would only conclude my speech by saying, when the question of carrying out a genuine commercial transaction, as this was, is reviewed, 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 *necessary* consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of this section, avoidance of tax. No commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can. 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.
IRC v Brebner (1967) 43 TC at 718.

This "celebrated"²⁰ passage may be summarised by saying that a taxpayer has no duty to maximise his tax liability and failure to maximise tax liability is not tax avoidance.

²⁰

Willoughby v IRC [1995] STC at p.167

13 Danger of Generalisations and of Old Cases

In 1964 Harman LJ threw off the comment (in the course of argument):

I think a discretionary trust is no more than a fiscal dodge.
Re Londonderry [1965] Ch 918 at 927.

Behind this vague but pejorative comment there may have been an accurate perception of the role of discretionary trusts at a time when (by oversight) they were almost entirely outside the scope of estate duty; that is before the FA 1968 imposed an estate duty regime targeted at these trusts.

Nowadays it could not fairly be said that discretionary trusts have lacked attention from Parliament, and they can no longer be regarded as general tax avoidance vehicles. Of course, specific artificial arrangements which involve discretionary trusts may constitute tax avoidance. An example may be nil rate band trust arrangements combined with interest free loans.²¹ Two points emerge:

- (1) In this area one cannot generalise: so much depends on the specific facts in every case.
- (2) The concept of tax avoidance has been re-examined in recent cases (and the terminology of mitigation/avoidance dates back only to 1986). Older cases do still have some role to play here, but they must be reviewed carefully and critically and in the light of changes in statutory tax law as well as changes in attitude reflected in the more recent cases.

14 Is Tax Deferral “Avoidance”?

It is suggested that arrangements to defer tax may be regarded as “avoidance” and indeed many classic cases, such as *Furniss v Dawson* itself, might be characterised as involving mere “deferral” of tax. However, the fact that tax is merely deferred, not avoided, may be a factor which supports the conclusion that the arrangement is to be characterised as tax mitigation and not avoidance.

²¹ On these arrangements, see *Drafting Trusts and Will Trusts*, James Kessler, 5th Edition, paragraph 17.5.

15 When is A Transfer From An Individual to A Settlement Made for the Purpose of Avoiding CGT Or It?

We can now turn to some practical application of these general principles. It is helpful to consider two extreme cases:

Extreme Case 1: Foreign Domiciled and Resident Settlor

Suppose a foreigner (not UK resident or domiciled) wishes to provide for his UK resident and domiciled family.

Plainly, if sums are large, and he is well advised, he should make a settlement, rather than making absolute gifts. The advantages may include : (1) Beneficiaries may not be equipped with the financial acumen or expertise to handle funds. (2) Wish to benefit future generations. (3) Wish to protect trust fund against creditors of beneficiaries and their divorcing spouses. (4) Foreign Exchange Control.

The settlor then has a choice: to make the settlement in the UK, in his own jurisdiction, or in an offshore centre. He will often reject his own jurisdiction, for reasons of domestic law and tax. So the choice falls between the UK and the offshore centre. In the absence of tax, there may be no reason to prefer the one to the other.

The choice of UK Trustees (rather than foreign Trustees) will not in principle yield any greater CGT.²²

The choice of exclusively UK Trustees will produce a greater amount of income tax than the other. Trustees where only one is resident outside the UK are not subject to income tax: s.110 FA 1989. Does that mean that the choice of the offshore jurisdiction is tax avoidance? It is submitted that the answer is, no. To hold otherwise would be to suggest that one has a duty to maximise one's UK tax liability.

The position is even plainer if there is a significant²³ non-resident or domiciled beneficiary, as well as UK beneficiaries.

Section 62(2) TCGA 1992 confirms that it is not the intention of Parliament that the choice of foreign Trustees by a non-resident or domiciled settlor should be regarded

²² As long as the trustees are professionals: see s.69(2) TCGA 1992.

²³ "Significant" in the sense that the Trustees genuinely wish to benefit that beneficiary.

as tax avoidance.

Extreme Case 2: United Kingdom Settlor

Contrast now a settlor who is UK resident and domiciled, making provision for his family. Again, he will make a settlement, and the choice is UK or offshore. If he chooses the latter (or if non-resident trustees are appointed), the inference or intention to save UK CGT or Income Tax is a very strong one and this purpose will be tax avoidance rather than mitigation.

Case 3: Immigrant Settlor

Consider now a settlor who makes a settlement:-

- (1) shortly before becoming resident or
- (2) after becoming resident or
- (3) shortly before becoming UK domiciled.

Assume the motive was to save tax (as it generally will be) the inference that this is avoidance (not mitigation) of UK Income Tax or CGT becomes progressively stronger in cases (1), (2) and (3).

16 When is A Transfer From An Individual to A Settlement Made for the Purpose of Avoiding IHT?

The residence of trustees is almost wholly irrelevant for IHT.

The transfer of money by a foreign domiciled person from a UK bank to a foreign bank in order to make the funds excluded property is an act of tax mitigation, not avoidance. See *Beneficiary v IRC* [1999] STC (SCD) 134.

The same would apply if the transfer is made by trustees of a settlement whose settlor was not domiciled when the settlement was made.

The same would apply to a sale of UK situate shares and re-investment in non UK situate shares.

A gift by a settlor to a settlement from which he is excluded is IHT mitigation and not "tax avoidance". This applies if the settlor is not UK domiciled and the settlor

chooses to give, and the trustees choose to invest, in non-UK property.

The same applies if the beneficiaries are UK domiciled so an absolute gift to them would have given rise to IHT.

Section 48 IHTA 1984 provides that property in a settlement made by a person not domiciled in the UK is, if not situate in the UK, excluded property. Any inheritance tax advantage conferred by the settlement, so far from being contrary to the evident intention of Parliament, would appear to be in accordance with Parliament's evident intention. Once again, the argument to the contrary amounts to an argument that the settlor has a duty to maximise his inheritance tax liability.

A gift by a settlor to a settlement from which he is not excluded, in circumstances where the settlor is anticipating becoming UK domiciled, is more borderline. Section 48 IHTA 1984 makes it very plain that such a gift carries substantial tax advantages. But is it "contrary to the evident intention of Parliament" to enjoy these advantages? As the authorities now stand, no definitive answer can be given to this question but the author prefers the answer that such a gift is not "tax avoidance" should be regarded as mitigation not avoidance.

17 Transfer by Trustees to Trust Subsidiary

17.1 Transfer of UK Assets to Trust Subsidiaries.

By "trust subsidiary" is meant a company wholly owned by trustees, which holds beneficially what might in substance be regarded as trust assets.

Transfer of UK situate assets from trustees to a trust subsidiary may offer significant tax advantages in cases where the settlor was not domiciled in the UK:

- (1) Obtaining IHT excluded property status.
- (2) Avoiding:-
 - (a) additional rate income tax (discretionary settlement) or
 - (b) (in some cases) higher rate income tax (interest in possession settlements)

where the life tenant is not UK domiciled.

Even if the only purpose of the transfer is to save tax, it is arguable that the purpose is tax mitigation not tax avoidance. The transfer to a company also has a possible CGT disadvantage, so any tax saving may be regarded as part of a “package deal”, with advantages and disadvantages. This does not savour of tax “avoidance”.

Transfers to companies also give significant advantages which have nothing to do with tax:

- (1) In the case of UK land, avoiding personal liabilities of trustees arising from direct ownership.
- (2) In the case of interest in possession trusts, avoiding distributing excessive amounts of income to life tenant.
- (3) Advantages of trust administration:-
 - (a) Segregation of trust funds of trustees; or sometimes combining trust funds for ease of management.
 - (b) Avoiding possible problems of trusts investing in civil law countries.

It is a question of fact in each case whether the purpose of a transfer to a company is to obtain these non-tax advantages. But where it is the policy of trustees that all its trust funds should be held in separate wholly owned companies, the argument that the motive defence applies is especially strong.

It is significant to note that the Edwards report suggests that 80-90% of Jersey trusts hold their assets through underlying companies.²⁴ Trusts managed in Switzerland always use underlying companies for Swiss law reasons.

17.2 Transfer of non-UK assets to Trust Subsidiaries

When non UK assets are transferred to a trust subsidiary, the UK tax advantage may be less or nil.

²⁴ Review of Financial Regulation in the Crown Dependencies Cm 4109 (Andrew Edwards, 1998) para. 12.5.2.

18 Transfer by Non Resident Foreign Domiciled Individual to Foreign Company

A foreign domiciled individual who transfers his UK assets to a company incorporated abroad may also enjoy comparable tax advantages:

- (1) Obtaining IHT excluded property status.
- (2) Avoiding higher rate income tax.

Such transfers also give significant advantages which have nothing to do with tax. In particular, in the case of UK land, avoiding personal liabilities arising from direct ownership. In such cases, the motive defence may well apply.

If the purpose of the transfer is to save IHT, there is a reasonable argument that the transfer is tax mitigation, not tax avoidance.

If the purpose was to save income tax at the higher rate, the point is more debatable. In many circumstances, however, non-residents do not pay income tax at the higher rate. See s.128, FA 1995.

19 Transfer From One Trust to Another Trust

There are so many reasons why funds may be transferred between trusts that it is impossible to generalise as to whether such transfers are made for tax avoidance. One reason such transfers are made is where a single trust holds several sub-funds for different branches of a family. The transfer avoids the unfairness which arises under a single trust, that gains accruing to one share are taxable on a beneficiary of another share who receives a capital payment. It is considered that a transfer for this reason does not have the motive of CGT "avoidance".

20 Associated Operations and the Motive Defence

Applying the motive test is relatively straightforward when there is a single transfer. It is more complicated if there are a transfer and a number of associated operations to consider.

In the following discussion:

- (1) An "innocent" transfer or associated operation is one which satisfies the motive test (in short, which is not made for tax avoidance purposes).

- (2) A “tainted” transfer or associated operation is one which does not satisfy the motive test (in short, which is made for tax avoidance purposes).

Test (a) provides:

- (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.

Test (b) provides:

- (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.

(Emphasis added)

The transfer and any relevant associated operations must each separately satisfy the motive test. One does not group the transfer and the associated operations together, and look for a single main purpose. Thus there are as many tests to pass as there are transfers and relevant associated operations.

21 Which Associated Operations are Relevant for the Motive Defence?

The motive test refers to “*any* associated operations”.

However, it cannot mean any associated operations whatsoever. If in 1096 a crusader transfers land to trustees to avoid feudal duties, and in 2000 the land is again transferred to trustees, the two operations are associated. See s.268 IHTA 1984. It cannot be that the crusader’s (arguable)²⁵ tax avoidance motive would prevent the transfer in 2000 from qualifying for relief!

In context the reference is to the associated operations referred to in s.739 or s.740. That is, the associated operations relevant to the operation of those sections. That is, the transfer and operations by virtue of which income accrues to the non-resident. There may and generally will be other associated operations, but those are irrelevant and must be ignored.

²⁵ Feudal duties would plainly be “taxation”. I forbear to consider the question whether the transfer should be regarded as avoidance or mitigation of feudal duties, which would depend on attitudes to taxation in the middle ages.

The House of Lords so held in *Herdman v IRC* 45 TC 394 where:

- (1) Assets were sold to an Irish company in consideration of shares and a loan. This was an innocent transfer (the motive was to avoid Irish tax.)
- (2) The company accumulated income and used it to repay the loan. This was an associated operation, and the motive was to avoid UK tax.

The motive defence applied. No income arose to the non resident by virtue of the associated operation. The Special Commissioners held in an unreported decision that this is still the law²⁶ and the Revenue now accept this. RI 201 provides:

The law was amended in 1969 following a decision of the Courts (in *IRC v Herdman* 45 TC 394) that only the transfer and any associated operations giving a power to enjoy at the outset were relevant for determining whether the terms of s.741 were satisfied. The amendment to the legislation sought to bring all associated operations into consideration when s.741 was

²⁶ The Revenue argued that the law was altered by FA 1969, s. 33. This was supported by a statement by Harold Lever in Hansard 17th July 1969 column 955-6. At the time Harold Lever was Financial Secretary to the Treasury.

“The *Herdman* decision in the House of Lords was to the effect that section [739] did not apply in cases where a change of circumstances enabled arrangements which were originally innocent of the purpose of avoiding tax to be used later on for the purpose of tax avoidance. If anyone had the good fortune to find himself connected with a settlement abroad originally of the most innocent intent he was free, without the impact of section [739], to exploit it without limit because section [739] would not bite on it, according to the *Herdman* decision.

It therefore became necessary to put back the teeth in section [739] which had been knocked out by the *Herdman* case. If we are to have a section [739], it has to bite on all settlements abroad which at any time are used for avoidance of tax even though originally started for innocent purpose. Supposing a man has transferred money to set-up a Bible society in Bulowayo and his heir being more sophisticated and perhaps more materialistic, finds himself with a settlement set up for unimpeachable purposes and decides that it would make a useful vehicle for the avoidance of all income tax and surtax. The *Herdman* decision meant that section [739] would not prevent this. Clause 27 therefore knocks out the *Herdman* decision and I think that the hon. and learned Gentleman would be fair enough to say that that is reasonable”.

See also the obiter dictum of Morritt LJ in *IRC v Willoughby* 70 TC at p.97:

“In the FA 1969, legislation was enacted, s.33, to nullify the decision of the House of Lords on the point.”

However, the law is plain and there is no ambiguity which might justify recourse to Hansard on *Pepper v Hart* principles.

invoked. Because of doubts expressed as to the effectiveness of this amendment, it has been the Revenue's practice in considering whether a defence under s.741 is available to consider only the transfer and any associated operations which directly establish a power to enjoy the income of the overseas person under any particular sub-head in s.742(2).

Suppose:

- (1) A transfers assets to a non resident company in return for shares in that company ("the first transfer"). Suppose the first transfer is innocent, there being no tax avoidance motive. Income accruing to the company is not caught by s.739 or 740 as the motive defence applies.
- (2) A transfers the shares in that non resident company to an offshore settlement ("the second transfer").

The second transfer is an operation associated with the first. (Associated operations: definition).

Suppose the second transfer has a tax avoidance motive.

Can the Revenue argue that the first transfer fails to qualify for the motive defence?

The argument would be that one cannot say that:

the transfer and *any* associated operations

are innocent of tax avoidance. For there is an associated operation and it is not innocent. But that associated operation is not relevant for the purposes of s.739. Income accrues to the non-resident company in consequence of the first transfer. It does not accrue in consequence of the first transfer in conjunction with associated operations.

Take the same transactions, but assume that the first transfer had a tax avoidance motive, and the second transfer was innocent. The motive defence plainly does not apply. It is not enough to find an innocent associated operation. So income of the company is within s.739 or 740. Dividends from the company to the trustees are caught by s.739 or 740 since the income arises by virtue of the tainted taxpayer to the company and an associated operation (the dividends).

Conclusion

The motive defence is a much wider defence to s.739 and s.740 than is commonly realised. This is especially the case in matters concerning foreign domiciliaries.