The Offshore Taxation Review

# TAXABLE REMITTANCES (1): A PLAIN PERSON'S GUIDE TO LAW, FACT AND MYTH

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## 1. Introduction

1.1 The purpose of this article is to provide a straightforward guide to the taxation of income remitted to the United Kingdom, an area where published Revenue practice and decisions of the Courts seem to bear little resemblance to each other.

1.2 Everyone concerned with tax planning for non-UK domiciliaries knows that if the client is UK resident, income tax is avoided by retaining foreign source income abroad and not remitting it. Again, most advisers know, broadly speaking, what is a taxable remittance and how to avoid one. There is, however, a significant body of English and Scottish case law on what constitutes the remittance of income and on drawings from a mixed fund, although the bulk of it is often not understood in depth. Understanding it, however, is the key to securing planning opportunities, avoiding pitfalls and (where necessary) explaining to the Revenue why its view is wrong.

1.3 In these two articles, I attempt to outline many of the (often) accepted "rules" and put them to the test. In this article I deal with the Schedule D, Cases IV and V charges generally and in the following article, with ICTA 1988, sections 739 to 743 in particular.

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## 2 Some Basic Preliminaries

*Cases IV and V but not VI*

2.1 The remittance basis applies to investment income chargeable under Schedule D, Cases IV and V, trading income (provided it has a foreign source) and employment income. It does not apply to casual income chargeable under Schedule D, Case VI and, consequently, where the foreign domiciliary earns profits abroad (say, from a consultancy) it must be secured that the income will not fall under Schedule D Case VI.

2.2 Also, it does not apply to foreign income *deemed* to be chargeable under Case VI unless there is a specific relieving provision. Hence the need, with ICTA 1988 section 739, for section 743(3) and with section 740, for section 740(5). In applying these provisions, it is therefore necessary to read in ICTA 1988, sections 65(5) to (9) (see the following article).

### The Remittance Rule

2.3 The remittance rule[2] is given by subsection (5) (as amended):

"Where subsection (4) above applies the tax shall ... be computed -

(a) in the case of tax chargeable under Case IV, on the full amount so far as the same can be computed, of the sums received in the United Kingdom in the year of assessment without any deduction or abatement; and

(b) in the case of tax chargeable under the Case V, on the full amount of the actual sums received in the United Kingdom in the year of assessment from remittances payable in the United Kingdom, or from property imported or from money or value arising from property not imported, or from money or value so received on credit or on account or in respect of such remittances, property, money or value brought or to be brought into the United Kingdom, without any deduction or abatement other than is allowed under the provisions of the Income Tax Acts in respect of [profits] charged under Case I of Schedule D."

2 Where section 65(4) excludes the arising basis, in relation to, typically, foreign domiciliaries.

### *Thomson v Moyse*

2.4 Surprisingly, perhaps, the "extending" words following a charge to tax under Case V are merely instances of what constitutes a remittance, so that it is not the case that Case V is wider than Case IV: *Thomson* v *Moyse* 39 TC 291. In a nutshell, a "remittance" for these purposes occurs where economic value is transferred into the United Kingdom ("by whatever means the agencies of commerce or finance may make available ...") and income situated abroad is depleted. It is *not* a requirement of the legislation that property be physically brought into the United Kingdom.

### *Harmel v Wright*

2.5 It must always be appreciated that the Revenue can effectively "trace" any income through any number of bank accounts or purchases and sales of investments, if, at the end of the day, it ends up being received by the taxpayer (or so that he/she is entitled to it[3]) in the United Kingdom in one form or another: see *Harmel v Wright* [1974] STC 88. (The potential width of this decision, however, has, in my view, been overtaken by *Ramsay*.)

### The Propositions

2.6 I continue my Plain Person's Guide by setting up propositions for attack.

## 3 Proposition 1

3.1 The "rule"

It is possible to separate income from capital as it arises, and remit capital only.

3.2 Conclusion

True.

3.3 Theory and Practice

3.3.1 The clear authority for this is *Kneen v Martin* 19 TC 33 (although

3 See *Walsh v Randall* 23 TC 55, Wrottesley J at 60.

*dicta* in *Roxburghe* (see below) suggests that it may not even be necessary to operate separate accounts: this is very much a"bold" view).

3.3.2 The difficulty here is not with the law (which is simple) but with the practice. In theory, the client opens two accounts, one deposit and one income, and interest is transferred from the income account to deposit, as it arises. Remittances are made only from the deposit account. (Remember, when closing accounts, to close the income account, so that income arising *there* is remittable).

3.3.3 Difficulties often arise where interest is transferred between a number of accounts, and where professionals invest monies through their client accounts. As regards client accounts, great care is needed where a single client account is kept, which is then sub-divided between a number of clients. In principle, there should at least be a separate capital, and a separate income, account, with separate numbers. Ideally, of course, separate bank accounts should be kept in relation to each client. Care is especially needed with the use of "sub-accounts". It is not, however, unknown for banks to make mistakes and remit from the wrong account. It is not (necessarily) fatal that a drawing is made from the wrong account (see Proposition 3).

## 4 Proposition 2

4.1 The "rule"

4.1.1 If an account is mixed (deliberately or inadvertently) it is always "income" which is remitted from the account before capital, as a matter of law.

4.2 Conclusion

Rubbish.

4.3 Theory and Practice

4.3.1 This is the traditional (and apparently unshakeable) printed view of the Inland Revenue: see IM 1566. It is nonsense. The leading authority on the point is *Scottish Provident Institution v Allen* 4 TC

409; 591. In that case, the Court of Session approved the decision of the Commissioners that sums remitted from a mixed account did consist of interest alone. The House of Lords upheld that decision. There a life assurance society invested various sums in Australia at interest. From time to time, Scottish Provident took sums from mixed capital and income accounts in Australia, and remitted them to the United Kingdom. The interest earned in Australia was included in Scottish Provident's revenue and, so far as received or accrued up to 31st December, 1894 (the period in question) was taken into account in arriving at the surplus divisible among the members by way of bonus or otherwise: (see Case Stated at page 413).

4.3.2 The decision was, however, not surprising, since the taxpayer had led no evidence to show that the sums were remittances of capital. Rather, each side maintained that, as a matter of law, the remittance was of income, or of capital. Further, the Case Stated shows that the sums remitted were used for the payment of bonuses which, by law, had to come from income.

4.3.3 What is crystal clear, is that whether or not a remittance is of income or capital is a question of fact. This was stated by the Lord Chancellor at page 592, Lord Shand at page 593, and Lord Davey at page 594. The Lord Chancellor stated, at page 593:

> "I think it is for the company to show, if the fact be so, ... a good deal of it was repayment of that which was in truth the capital and not profit at all. No attempt has been made to do that, ... it is obvious that the mere nicknaming of the sum received and ascribing to it, because it is so named, the character of capital and not of income, cannot defeat the right of the Crown to have the tax levied upon that which in substance and truth is profit ..."

4.3.4 Note how the Revenue Manuals focus on the "nicknaming" point. It will hardly ever apply! According to the Lord Chancellor, all that Scottish Provident did was direct its local agent to tell the Revenue that the money came from capital. This was the "nicknaming". It is a question of fact whether income or capital has been remitted. If, for example, the client needs £500,000 to buy a principal residence, and asks for a return of his or her capital in that sum, albeit from a mixed account, I find it difficult to see how it is, as a question of fact, "income" which is being remitted. In *Scottish Provident*, however, the court was well able to draw the inference that the taxpayer company had reinvested its capital, and remitted its profit, since it *had* to pay the bonuses, from the remittance, out of income.[4]

4.3.5 To propound another "bold view", it is certainly arguable that, unless he/she has, on the evidence, elected to take income, the taxpayer is entitled to say that capital, or income not taxable on remittance, has been remitted from a mixed fund (see below).

## 5 Proposition 3

5.1 The "rule"

If a remittance is (wrongly) taken by a bank from an income account, instead of a capital account, this is always a remittance of taxable income.

5.2 Conclusion

False.

5.3 Theory

5.3.1 Again, the question is one of fact. The leading authority is *Duke of Roxburghe's Executors v IRC* 20 TC 771. In that case the Duchess asked her bankers to remit sums from an account containing capital, or income which would not be taxable on the remittance basis. By mistake, the bank extracted funds from an account containing sums which would be taxable if remitted to the UK. In fact, there was a mutual mistake: the Duchess's advisers thought the remittable funds were in the "Special Custodian Account": the bank kept a "Custodian Special Account" but this differed from what the advisers meant. On appeal, it was held that the remitted funds should be treated as taken from capital or non-taxable income.[5] Lord Normand stated, at pages 725/726:

4 While there are references to sums being "presumed" to be income in the Court of Session, this must be because, *on the evidence*, that presumption was raised. Scottish Provident gave no evidence to rebut this obvious inference from the evidence given.

5 I.e., income already taxed on the arising basis.

> "... nothing but misunderstandings prevented the bank from carrying out these instructions ... money was available in account "B" ... the whole transaction, so far as the bank is concerned, can be made to confirm with the Duchess' instructions ... I think that all that is required is the making of cross entries ..."

5.3.2 Lord Fleming, at page 732, held that the book entries of the bank could not be conclusive evidence against the Duchess, since she gave the bank instructions which it had not complied with. The speech of Lord Moncrieff is interesting in that he states, at page 733:

> "... I regard it as wholly without significance in this connection that the customer may have instructed his banker, in place of keeping a single currency account on his behalf, to place sums paid in by him from time to time to the credit of separate accounts. Such distributions of his resources ... can, in my opinion, have no influence upon his resulting liability to income tax."

5.3.3 The Revenue is, apparently, not fond of *Roxburghe*. The decision, however, accords with common sense. The position (at least in English law) is that bank accounts are merely *prima facie* evidence of the position[6]: the bank does not "remit" from a pot marked "income". It is crucial to remember that statements of account are merely internal records, by one side of a business relationship with another party. They do not record a physical extraction of funds. They can be wrong: if so, there is no reason why they should bind the customer.

5.4 Practice

5.4.1 The essence of this decision is that the bank's internal procedures, if against the instructions of their client, do not govern the tax position. Had the Duchess complained, the bank would have had to rectify its books, and the Revenue is in no better position than the bank. It is important to note that there is nothing in the speeches which requires a retrospective writing to have taken place. The

6 On the banker/customer relationship in Scottish law, note particularly Lord Fleming at page 732.

crux of the matter is that the Duchess was entitled to ask for this to be done. It should, of course, help to facilitate any argument with the Revenue if the bank admitted its errors and amended its records.[7]

## 6 Proposition 4

### 6.1 The rule

A taxable remittance of income can be avoided, by securing that its source "ceases" in the year of assessment before remittance, and the abolition of the preceding year basis does not affect this.

### 6.2 The conclusion

True.

### 6.3 Theory

6.3.1 The source ceasing rule is of ancient lineage, stretching back to *Brown v National Provident Institution* 8 TC 57: the Revenue accepts it (see IM 1563). It is the third point which was considered in *Brown* which is relevant. It is often thought that this relates to discounts physically received in the year of assessment after the bonds were disposed of but the case actually turns on the preceding year basis rules. The discounts, physically earned in 1916/17, when the Treasury bill business was carried on, were taxable in 1917/18, by which time the activities had ceased. Lord Haldane observed, at page 85, that since there was no source in 1917/18, "... we have to assume that there was no income on which to base the tax". Thus, the income of the preceding year was the *measure* by which tax was charged, but if the source was not held when that "measure" became relevant, there was nothing to which that "measure" could relate.

6.3.2 Does the abolition of the preceding year basis, together with the repeal of ICTA 1988, section 66, change matters? No. If *Brown* is examined, there, Lord Atkinson highlights the two ways in which tax could be charged, either by deeming the income of one year to

7 Astonishingly, I have even known Swiss banks do this!

be earned in a later year (just as the old "super tax" did, or as, by analogy, TCGA 1992, section 13 deems a gain of one person to accrue to another) or by using the income of the earlier year as a *measure* for the later year. In the former case, it would be irrelevant whether the source existed in the later year; in the latter case, it would be crucial.

6.3.3 ICTA 1988, section 65, subsection (5) works by charging to tax the amount of foreign income (already arisen) which is remitted. Thus the *measurement* of the taxable sum depends on two factors: the income which has arisen and the amount of it remitted. It is *not* the case that income is deemed to arise in the year of remittance. Thus, *Brown* in fact applies by analogy: the fact that, until recently, the preceding year basis also applied to Cases IV and V was merely coincidental, not determinative of why remittances after source ceasing were not taxable. Understanding this helps in isolating some of the anomalies, e.g., how income "drops out of charge" when a foreign domiciliary acquires a domicile in the United Kingdom.[8]

6.4 Practice

It must however be secured that each investment is a separate "source". It is preferable to close a bank account and transfer the funds to a new account with a different branch if possible. The banking evidence should very clearly show the closure of the "old" account and transfer of funds: as always, it is wise to assemble the documents as if they were a "bundle" to be put before the Special Commissioners and ask: do they prove the point? An account may, however, in English law, be "closed" even without formalities: *Berry v Halifax Commercial Banking* [1901] 1 Ch 188. It must also be remembered that there is clear authority that the remittance must *not* be made until after the end of the year of assessment in which the source ceases: *Joffee v Thain* 36 TC 199.

## 7 Proposition 5

7.1 The "rule"

In determining if a remittance from a mixed account is "income", income from a source which has ceased (which is not taxable on remittance) has to

8 Although, then, great care is needed to avoid arguments that income from foreign companies might constitute "capital distributions": see TCGA 1992, section 122, subsections (5), (6).

be treated as capital (so that, the Revenue may argue, it "comes out last").

7.2 Conclusion

Wrong.

7.3 Theory and practice

7.3.1 In my experience, advisers sometimes assume, on an "income out first" computation, that "source-ceased" income falls to be treated as capital. It does not. Even trust law requires a formal capitalisation: see *Re Berkeley* [1968] Ch 744 and it is nonsense to speak of "capitalisation" where a single person has outright ownership (cf also *Re Bates* ([1928] 1 Ch 682).

7.3.2 Where monies move between accounts some of which have "source-ceased", it is necessary to make a running total of income taxable, and not taxable, on remittance. In such circumstances, computations need to be more complex than is often assumed. (Programmes such as Excel cope well.) This leads on to Proposition 6.

## 8 Proposition 6

8.1 The "rule"

Where income taxable on remittance is mixed with income not so taxable, the taxpayer can designate from which "source" the income comes. (Many advisers may become acquainted with this "rule" for the first time.)

8.2 Conclusion

In my opinion, on the existing authorities, correct.

8.3 Theory

8.3.1 There is abundant authority to support this.[9] In *Edinburgh Life*, the company mixed income both subject and not subject to tax in a

9 See particularly *Edinburgh Life v Lord Advocate* 5 TC 472: *Sterling Trust* 12 TC 868; *IRC v McNaught's Executors* 42 TC 71.

single account but needed to show that drawings were from profits charged to tax.[10] The Court of Session held that the drawings should be treated as taken rateably from each "source" of income but the House of Lords held that the taxpayer company was entitled to treat those drawings as made from taxed income. Lord Atkinson notes that no formal appropriation was made: the crucial point was that the taxpayer had sufficient taxed income in the mixed account (see pp. 482/483). It was therefore able to say that it *had* made the drawings from taxed income, i.e., from the most favourable component in the mixed fund. Lord Gorell, at page 490, thought the position to be no different than if the company had kept separate accounts. In *Sterling Trust*, the Court of Appeal held that drawings from a mixed fund and, alternatively, from separate funds, in each case were made (or, with the mixed fund, treated as made) from the most favourable component.[11]

8.3.2 The Revenue accepts that (on the *ratio* of *Sterling Trust*) this applies where income taxable on a remittance basis is mixed with income taxed on an arising basis but the speeches/judgments in these cases are wider. There seems no reason, logically, why the taxpayer cannot say (for example) that the remittance comes from "source-ceased" income, rather than current year's income, even accepting the (misconceived) view that we must take income out before capital.[12]

8.4 Practice

This, obviously, can make an enormous difference when computing remitted income from a mixed source. In my experience, computations are sometimes put to the Revenue which over-estimate the tax due, because the vital importance of "source-ceased" income in a mixed account has been missed.

10 If the Case Stated is examined, at page 473, it will be seen that they included consideration for the grant of annuities which, arguably, are capital in nature.

11 The judgment of Atkin L J from p.887 onwards, is especially illuminating. His view is that there is nothing to prevent the taxpayer from paying out of any fund it pleases: the only question is whether there is sufficient income from the required source in the mixed fund.

12 The Revenue would not be correct in arguing that the decision in *Sterling Trust* was merely to prevent double taxation, so that income taxed on an arising basis was not taxed again: it could not be.

## 9 Proposition 7

9.1 A suggested "rule"

Where income and capital are held in a mixed account by a bank, unless the taxpayer has, on the evidence, elected otherwise, he or she can treat remittances matched with capital held by the bank.

9.2 This is the principle, which can conveniently be thought of as the "*wider ratio*" in *Roxburghe*. Obviously, it draws on the analogy with *Edinburgh*, *Sterling Trust* and other cases. If, admittedly, outside the remittance context, it is possible for the taxpayer to be able to state that he/she has drawn from a particular component in a mixed account, why should this not apply in the context of remittances? If (contrary to what the Revenue will say) *Scottish Provident* does *not* lay down the "income out first rule", does *dicta* in it support the argument? I would say not: Scottish Provident *had* to pay bonuses from income. Thus, it had elected to withdraw taxable income. The taxpayer who has not so elected may, however, argue, even if a mixed income/capital fund, that he/she has drawn from the capital component.

## 10 Proposition 8

10.1 The "rule"

A taxable remittance can be avoided by giving the unremitted income away abroad, and allowing the donee to remit.

10.2 Conclusion

True.

10.3 Theory

This, of course, stems from *Carter v Sharon* 20 TC 229, and the advice of Wrottesley J in *Walsh v Randall* 23 TC 55 to an unsuccessful taxpayer, that he should have alienated the sums in question before they reached the UK. It is worth noting that what was effectively given abroad was a banker's draft. The reason this constituted payment abroad (and not when received by the drawer in the United Kingdom) was because it constituted unconditional payment when issued, since the taxpayer could not countermand the payment. This can often be of significance. It is wise, in seeking to take advantage of it, to bear in mind the distinctions, on what is "conditional payment" made between the speeches in *Thomson v Moyse* (*infra*) and the approach of Scott J in *Parkside Leasing* [1985] STC 63.

10.4 Practice

There must of course be a genuine gift, and not an arrangement under which the donee returns the money, or sums representing it, to the donor once it has reached the UK. Simply settling a sum, with capital appointed back after remittance, is likely to be met with a *Harmel v Wright* attack.