FIELD COURT TAX CHAMBERS

FCTC DIGEST

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Producer: Stephanie Talbot

MEMBERS OF CHAMBERS

Patrick C Soares

Patrick Way KC

Philip Baker KC

Imran S Afzal

Peter Vaines

Dilpreet K Dhanoa

David Southern KC

Riya Bhatt

Rita da Cunha

David Tipping

Alex Spencer

Door Tenants

David Bloom KC

Porus F Kaka

Philip Goeth

Dr Richard Collier

CONTENTS

EDITORIAL

Patrick Soares

Welcome to the Christmas 2024 Edition of the FCTC Digest, and a merry Christmas to all our readers from FCTC.

Unmissable FCTC conference on 3 March 2025 – THE DOMICLE CHANGES

Chambers have had so many enquiries about the Draft Finance Bill/Budget 30 October 2024 changes in the domicile and remittance basis rules and the 4-year tax-free holiday and the demise of Protected Trusts and the 5 April 2025 deadline that we are running a virtual conference on the changes on **Monday, 3 March 2025 and we have plenty of ideas to share and traps to be avoided.** We will also be preparing for the conference **full notes** which will be your medicine kit to deal with the changes.

We dare you to miss this conference!

Back to the FCTC Digest.

The first article by the editor looks at the **Temporary Repatriation Facility (TRF)** which is essential for those who have decided to remain in the UK and have overseas funds taxable on a remittance basis or funds in a protected settlement which are taxable on a benefits basis. These monies can be brought to the UK or paid out from a protected settlement at low tax rates.

The second article is by **Patrick Way KC,** and deals with the special (the word is not used in a good way) provisions in the draft Finance Bill which apply to **footballers and the like** who want to make use of the **new 4-year tax holiday** available to people coming to the UK and who have not been resident in the UK in the prior 10 years. The article deals with their special treatment and what steps they must take.

The third article is by **Peter Vaines** and it brings readers up to date on **carried interest** and the government's proposals and the case law and the new HMRC approach. This is an essential update for those having to advise on carried interest.

The fourth article is by **Dilpreet Dhanoa** and deals with the **Treasures of Bazil v HMRC case and the situations where public law issues can be raised at the First-tier Tribunal level.** This area of the law needs to be settled at some stage perhaps by legislation.

The fifth article by **David Southern KC** is on the corporation tax **unallowable purpose rule**: the HMRC success rate on this rule is high and in the one case where they lost on the rule they won on other grounds. Make sure this rule is on your checklist, especially since corporation tax is payable on UK rents rather than income tax (where the anti-avoidance provisions are "milder").

The sixth article is by **David Tipping** and deals with the proposed abolition of domicile as a tax connecting factor from 6 April 2025 and how this affects **double death duty tax treaties.** There are surprises to be found. Common law domicile is to remain untouched as far as treaties are concerned. This can prove **very attractive to taxpayers who have an Indian Domicile.**

The seventh and final article is by **Lachlan JS Molesworth**, who will be joining the chambers, and he looks at the position where a **UK parent sets up a trust for a son or daughter resident in Australia**. There is a clash between the jurisdictions and Lachlan will help you navigate a way to safety.

Patrick C Soares

FCTC

SO YOUR NON-UK DOM CLIENT HAS DECIDED TO STAY – MAKING USE OF THE TEMPORARY REPATRIATION FACILITY (TRF)

Patrick C Soares

This facility is aimed at taxpayers who may have created a protected offshore settlement often with an underlying offshore company (this article deals principally with settlements and their underlying companies but the TRF also covers individuals who have a fund of offshore pre-6 April 2025 income and gains (taxable on a remittance basis) in their own names). The settlor will have retained his or her overseas domicile under common law but will be deemed domiciled in the UK. He or she will have created the settlement prior to becoming deemed domiciled in the UK. The settlement and company will be full of income and gains taxable only when payments come out of the settlement to a UK resident person. From 6 April 2025 any *future* income and gains in the settlement will be taxed on the settlor as it arises if the settlor is a beneficiary

under the settlement and remains resident in the UK. The TRF is concerned with the pre-6 April 2025 income and gains which are taxable only when paid out to a beneficiary who is resident in the UK. The aim of the TRF is to encourage settlements to advance those pre-6 April 2025 funds to the settlor and other beneficiaries within 3 years from 6 April 2025 paying only the TRF charge which can be as low as 12%. In the editor's experience the inducement seems to be working.

The initial question to ask is: what income and gains in a settlement benefit from the TRF treatment?

The settlement may have the following types of income and gains.

Type 1

Pre-6 April 2025 income which arose in the settlement (ITA 2007 s720/731 income or ITTOIA 2005 s625 etc income) or an underlying offshore company (ITA 2007 s720/731: assuming the motive defence is not available).

Type 2

Income which arose to the taxpayer prior to him or her settling the same (taxable on a remittance basis) (ITA 2007 s809B et seq): he or she will have transferred it to a relevant person (the trustee of the settlement) (ITA 2007 S809M(2)(g)).

Type 3

There may be trust gains within TCGA 1992 s87. Some of these may have been made by an underlying company which may have been apportioned to the settlement under TCGA 1992 s3 if the motive defence in s3A was not available.

Type 4

There may also be gains realised by the taxpayer in his or her own name (taxable on a remittance basis) with the funds then being settled. Those gains will be taxed on a remittance basis (s809B). The taxpayer will have transferred the same to a relevant person (s809M(2)(g)).

Type 5

There will have been gains crystalised on the transfer

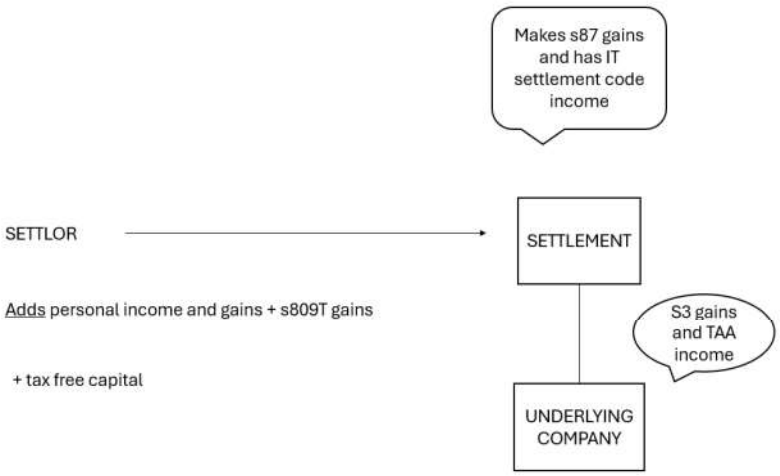
of assets into the settlement under ITA 2007 s809T (Foreign chargeable gains accruing on disposal made otherwise than for full consideration).

The effect of ITA 2007 s809T is to treat the gain as having been realised by the taxpayer so that if sums are remitted to the UK by the settlement they can be assessed on the taxpayer as a remittance of the taxpayer's gains under ITA 2007 s809L via a relevant person.

Fund Type 6

Finally there may be tax free capital.

DIAGRAM SHOWING DIFFERENT PARTS OF THE FUND



PROPOSAL

Funds will be advanced by the trustees to the settlor in the 3 years after 5 April 2025 to the taxpayer to make use of the TRF (which charges tax at rates of 12% or 15%).

ANALYSIS OF THE DRAFT LEGISLATION (DRAFT BILL SCHEDULE 6)

INTRODUCTION

Schedule 6 sets out a charge on amounts of qualifying overseas capital (QOC) of individuals.

Note, the word capital is used even if the payment derived from an income source.

The charge is to be known as the temporary repatriation facility charge: the "TRF charge".

Note to bear the TRF charge is attractive as the rates are low and other tax charges are excluded. This charge is *sui generis*.

Amounts of qualifying overseas capital of an individual are subject to the TRF charge only if the individual designates them as such: a designation

(called a “designation election”) is a prerequisite to the TRF charge.

An individual may only make a designation election if the individual was subject to the remittance basis for at least one tax year (being a tax year before the tax year 2025-26).

KEY REQUIREMENTS

Thus the key requirements are:

a. it is necessary to determine the qualifying overseas capital (The QOC),

b. a designation election must be made,

c. the taxpayer must have been a former remittance basis user and

d. the taxpayer must be resident in the UK in the years (maximum 3) for which the TRF charge is imposed.

ASCERTAINING THE AMOUNT OF THE QUALIFYING OVERSEAS CAPITAL (QOC) (SCHEDULE 3 PARA 2) – INDIVIDUALS

It is important to determine the amount of the QOC

as the amount of the QOC which has been designated falls within the TRF charge and is *ipso facto* exempt from other tax charges.

An amount is within the QOC if it falls within any of the following three heads:

Head One (normal head)

An amount falls under this head if—

(a) it is an amount that arose in the tax year 2024-25 or an earlier tax year as income or as a gain,

(b) the amount has not been remitted to the United Kingdom, and

(c) the amount, if remitted to the United Kingdom, would have had the following tax consequences:

(i) the individual becomes chargeable to income tax by reference to the amount remitted in accordance with section 22, 26, 41F or 554Z9 of ITEPA 2003 or section 832 of

ITTOIA 2005 (income charged on remittance basis), or

(ii) a gain is treated as accruing to the individual by reference to the amount remitted in accordance with paragraph 1(2) of Schedule 1 to TCGA 1992 (gains charged on remittance basis).

This head would cover the normal overseas gains and income of a remittance basis user who has not remitted the same to the UK.

Example

Ms X has always been non-UK dom under common law. She became deemed dom on 6 April 2017 and has been UK resident for many years and has paid tax on her personal income on an arising basis on and from that date and she is also taxed on her capital gains realised on and from that date. The gains and income which arose prior to 6 April 2017 (£1m) are taxable on a remittance basis (Ms X had been a remittance basis user prior to becoming a deemed dom). The £1m is the qualifying overseas capital

(QOC). She is UK tax resident in 2025/26 and she has made a designation election (in her return) on that £1m for that year: she pays tax on it of £120,000 (12% rate).

Head Two (later elections)

An amount falls within Head Two if:

(a) it is an amount that arose in the tax year 2024-25 or an earlier tax year as income or as a gain,

(b) the amount is remitted to the United Kingdom in the tax year 2025-26, 2026-27 or 2027-28, and

(c) that remittance would be a taxable remittance.

In this situation an amount that is qualifying overseas capital falling within Head Two (and that has not previously been designated) may only be designated in a designation election for the tax year in which it was remitted.

Head Three (sweeper-upper)

An amount of capital falls within Head Three if—

(a) it does not fall within Head One or Head Two

(b) it was held by the individual immediately before 6 April 2025,

(c) it was situated outside the United Kingdom—

(i) immediately before it was most recently acquired by the individual before that date, and

(ii) throughout the period beginning with the time referred to in sub-paragraph (i) and ending with that date.

AMOUNTS OF CAPITAL PAYMENTS (UNDER TCGA 1992 S87) MADE BY TRUSTEES OF A SETTLEMENT (SCHED 3 PARA 3) – THESE PAYMENTS ARE QOC

The TRF is adapted to apply to settlements where

capital payments are made within TCGA 1992 s87.

The capital payment from the settlement comes within the TRF regime where—

a) an individual is the beneficiary of a settlement, and

b) that individual receives a capital payment from the trustees in the tax year 2025-26, 2026-27 or 2027-28 (the golden years) and

c) section 87 of TCGA 1992 applies to the settlement for that tax year, and

d) under section 87A of that Act (if it applied also for this purpose) the capital payment would be matched (in whole or in part) with the section 1(3) amount for the tax year 2024-25 or any earlier tax year if the section 1(3) amount for each tax year after the tax year 2024-25 were nil.

So much of the capital payment as would be matched with the section 1(3) amount for the tax year 2024-25 or an earlier tax year is an amount of qualifying

overseas capital (QOC) of the individual (Sch 3 para 3(2)).

Example

The Y overseas settlement has made gains *at the trust level* (or in an underlying company where the gains are apportioned up to the settlement under TCGA 1992 s3) (the "s1(3) amounts") of £1m over the years up to 2024/25. These will be taxed on a benefits basis under the protected trust regime. The settlor is UK resident and became deemed domiciled in 2017. That £1m is QOC.

AMOUNTS OF INCOME WHICH AROSE TO THE TRUSTEES AND UNDERLYING COMPANIES CAUGHT BY THE IT SETTLEMENT CODE OR THE TRANSFER OF ASSETS ABROAD CODE – THESE ARE DEEMED TO BE QOC (SCH 3 PARA 4)

If one or more of the following conditions are satisfied the income referred to arising in a settlement and its underlying company will be QOC (see Sch 3 para 4(1)) -

(a) an individual is treated as having an amount of income as a result of section 643A of ITTOIA 2005 (benefits paid out of protected foreign-source income or transitional trust income) for any of the tax years 2025-26, 2026-27 or 2027-28 or

(b) an individual would have been treated as having an amount of income as a result of any other provision of Chapter 5 of Part 5 of ITTOIA 2005 (settlements: amounts treated as income of settlor or family) in the tax year 2024-25 or an earlier tax year but was not only as a result of the application of section 648(3) of that Act (relevant foreign income treated as arising under settlement only if and when remitted), or

(c) (i) an individual is treated as having an amount of income for any of the tax years 2025-26, 2026-27 or 2027-28 as a result of section 732 of ITA 2007 (individuals receiving

a benefit as a result of relevant transactions) and

(ii) under section 735A of that Act (if it applied also for this purpose) that amount would be matched with relevant income that arose in the tax year 2024-25 or an earlier tax year, and

(iii) that amount would have been treated as relevant foreign income of the individual if it had been treated as accruing in the tax year 2024-25 and the individual had been subject to the remittance basis for that tax year.

Comment

This provision found in Sched 3 para 4 ensures that settlement code income and transfer of assets abroad income comprise QOC.

Example

The Z overseas protected settlement has settlement

code income at the trust level and transfer of assets code income at the underlying company level totalling £1m. These will be taxed on a benefits basis under the protected trust regime. The settlor is UK resident and became deemed domiciled in 2017. That £1m is QOC.

THE CONCOMITANT EXEMPTIONS – SCHED 3 PART 2

The exemptions from income tax and capital gains tax are found in paras 7-8 of the Bill.

No reference is made to IHT.

INCOME TAX NATURE OF THE QOC TO THE EXTENT IT DERIVES FROM SETTLEMENT CODE INCOME OR TRANSFER OF ASSETS ABROAD INCOME

In the normal case when such monies are paid to the settlor from the protected settlement they are taxed as the income of the recipient.

Para 7 (2) of Sched 3 states no liability to income tax arises *on the amount of the income* treated as QOC.

The amounts of the TRF charge are to be charged as if they were amounts of income tax (Sched 3 para 6 (2)).

It is arguable that no interim IHT charges should arise on such payments by virtue of IHTA 1984 s65(5)(b) which applies to a payment which "is (or will be) the income of any person for the purposes of income tax." The question is whether the payments is still income for the purposes of income tax if no liability to income tax attaches to it in the particular circumstances.

INTERACTION OF DESIGNATION WHEN AMOUNTS ARE REMITTED FROM MIXED FUNDS – SCHED 3 PART 3

The general rules is if monies come out of a mixed fund the income is deemed to come out first and there is a strict ordering process set out in ITA 2007 s809Q.

The technical Note summarises these provisions thus:

"Changes to the mixed fund ordering rules

121. Where a TRF election is made, the mixed fund ordering rules (section 809Q ITA 2007) will be modified in two ways.

(1) Designated amounts will automatically rise to the top of the mixed fund ordering and will always be treated as remitted to the UK in priority to any other amounts, regardless as to which year these amounts relate.

(2) Rather than a transaction-by-transaction approach, when analysing accounts containing designated amounts, it will be possible to use an annualised approach for the TRF period. Individuals will be able to review their overseas accounts at the end of the year and accumulate their total remittances and overseas transfers which are deemed to take place on 5 April (including for accounts which closed before the end of the tax year).

Nominated Income Rules

127. Nominated Income ordering rules (section 809J ITA 2007) will be switched off where an individual has made a designation under the TRF. They will, however, be brought back into force from 6 April 2028, when the TRF period ends.

128. As a consequence, individuals will be able to remit any nominated income to the UK both free of any tax charge and also without engaging the nominated income ordering rules (RDRM35110)."

CONCLUSION

All the five sources of income and gains qualify for the TRF charge in the editor's opinion which means the tax charge on the same can be as low as 12%; Type 1 comes within Sch 3 para 4, Type 2 within Sch 3 para 2(2), Types 3 and 4 within Sch 3 para 3(2), and Type 5 within Sch 3 para 2(2).

FCTC Comments

NO FIG LEAF FOR ENTERTAINERS AND SPORTSPERSONS

Patrick Way KC

Speed read

The Budget of 30th October 2024 confirmed that, broadly speaking, domicile as a factor in taxation, together with the remittance basis, would disappear with effect from 6th April 2025. However, a new FIG regime was announced which allows newly qualified residents, within a four-year window, to not only receive foreign income and make overseas gains tax free but to "remit" those amounts into the United Kingdom tax free. Chapeau to Rachel Reeves except that the FIG regime does not apply to entertainers or sportspersons after all: Chapeau withdrawn.

The new rule for performance income

The relevant provisions are found within the draft Finance Bill 2025 at clauses 37 to 39.

The writer imagines that these are well known to readers but very broadly, clause 37 provides that

within a four-year window an individual coming to the United Kingdom for the first time, after ten years away from the United Kingdom, can enjoy foreign income, foreign gains and a certain amount of foreign earnings entirely tax-free even if those amounts are remitted.

However, the good news does not extend to sportspersons and entertainers because new provisions of Part 8 of ITTOIA 2005 (*foreign income: special rules*) now include legislation relating to *performance income* which is now fully taxable and falls outside the FIG regime. (See the Finance Bill 2025, clause 37)

More specifically, ITTOIA 2005 s.845F provides (with effect from 6th April 2025) that certain income is disqualified under s.845G. This includes (s.845G(d)) *performance income* as defined in the new s.845H.

The schedule to this article sets out the wording of the new s.845H in full.

Consequently, this will mean that, for example, a footballer who is non-domiciled (under the current rules) who has transferred overseas image rights into an overseas arrangement (and who is otherwise

entitled to the FIG regime) will now find that the future performance income which is produced (the royalty income) with effect from 6th April 2025 will automatically be taxed in that player's hands whether they receive the income or not. In other words, the four-year "FIG window" does not apply to performance income.

Equally, for the purposes of the transfer of assets abroad ("TOAA") rules (found in Income Tax Act 2007, Part 13, Chapter 2) performance income will not be capable of benefiting from the FIG regime, even though other foreign income within a TOAA structure does so benefit (ITTOIA 2005 s.845F, Item No.19, inserted by Finance Bill 2025 clause 37(1)). The motive test, however, will still be available in relevant circumstances – ITA 2007 s.737.

Further, whilst there will be a relief for foreign employment income (see the new provisions of Part 2 of ITEPA 2005 particularly the new s.41M) there is a limit on the amount of foreign employment income where relief is obtainable and this is found by reference to the new s.41R(2). Specifically, therefore, the relief for foreign employment income is limited to the lesser of:-

(a) 30% of relevant qualifying employment income; and

(b) £300,000.

HMRC's current stance

In order to consider any planning to take effect before 6th April 2025 in relation to performance income we need, first, to understand HMRC's current thinking in respect of overseas image rights income which arises before 6th April 2025. Such income would definitely fall within the new definition of 'performance income' which expression is relevant from 6th April 2025 onwards.

HMRC's present thought processes go along the following lines:-

(a) income from image rights is not royalty income (the writer disagrees and see EIM00736 – "*some of the intellectual property rights that make up the "image rights" … are likely to meet the definition of intellectual property"*);

(b) income from image rights is not employment income (the writer disagrees); and

(c) the income is trading income where the source is playing of football principally in England (the writer disagrees).

Taking a jaundiced view, one can guess that the reason that HMRC have plumped for this definition of image rights income (*it's trading income*) without any authority in the view of the writer is to take account of ITTOIA 2005 ss.5 and 6. For example, the wording of s.6 is as follows:-

> "(1) Profits of a trade arising to a UK resident are chargeable to tax under this Chapter wherever the trade is carried on."

And also HMRC's view takes advantage of s.7(5) since relevant foreign income can arise only if a trade is carried on *wholly* outside the United Kingdom.

In other words, on HMRC's analysis, all image rights income is taxed in the United Kingdom and overseas image rights income cannot be segregated into foreign overseas income.

So, under the present rules (where domicile remains relevant of course) HMRC will always argue that image rights income has a UK source. This means that if there is a current structure which, for the sake

of argument, is susceptible to the transfer of assets abroad rules, HMRC will say that the remittance basis cannot apply to protect against a charge whilst the image rights income remains abroad. This is on the basis that image rights income is effectively trading income with a UK source: so its "in the UK" immediately. HMRC will also seek to deny the availability of the motive test although in the writer's experience some footballers have been successful in demonstrating a lack of tax avoidance so that the motive test can be available as a defence after all.

What to do before 6th April 2025 – first step

The difficulty with the current position is that HMRC will say, for the reasons mentioned above, that the income in question is already subject to UK tax because it is UK-source trading income.

This is where use of the temporary repatriation facility ("TRF") may help. Where it applies the amount of tax on foreign income and gains remitted after 5th April 2025 will be 12% only. So payments of foreign image rights income should be made abroad – into the player's overseas bank account – before 6th April 2025. This should at least preserve the current argument (with which HMRC do not agree) that

image rights income is foreign source and can benefit from the remittance basis taking account of the footballer's non-domiciled status. And the income would be "remittable" foreign income.

Next step – use temporary repatriation facility

This would then bring us to the next step which is to take advantage of the new TRF. This affords (see clause 41 and Schedule 10 of the new Finance Bill) a useful facility for individuals who had been subject to the remittance basis before 6th April 2025 to pay sums into the United Kingdom at a rate of 12% tax only.

The draft legislation repays, of course, detailed reading because the wording is by no means clear but, broadly speaking, on the basis that the overseas image rights income would have been chargeable to income tax by reference to the remittance basis when received before 6th April 2025 (as will be the case in this proposal), and given that the footballer in question would, by definition, have been non-domiciled before 6th April 2025, it follows that the income in question will from 6th April 2025 amount to "qualifying overseas capital" for the purposes of

the TRF. This is by reference to the particular provisions of the current Finance Bill Schedule 10 paragraph 2.

Pursuant to the TRF the relevant amounts of overseas image rights income would then be designated as TRF capital.

Finally, the designated amounts of overseas image rights income paid into the footballer's foreign bank account before 6th April 2025 and then designated for the TRF regime could then be paid into the United Kingdom during the tax years 2025-26, 2026-27 or 2027-28. Provided, as mentioned, that a relevant designation election had indeed been made then the amounts "remitted" would be subject to a rate of tax of 12% only.

Please read the legislation very carefully as it is tortuous and please be aware that HMRC are likely to argue that the overseas image rights income is not protected by the remittance basis in the first place: so income tax would arise on the pre-6th April 2025 payment anyway.

Conclusion

Prior to the introduction of the wording which has

found its way into the Finance Bill it had seemed that there would be a golden opportunity for entertainers and sportspersons to come to the United Kingdom for up to four years on a very tax-efficient basis.

As it turns out, the reality is that those individuals will find that they are subject to an income tax charge on all their overseas activities that produce performance income.

Any steps now to ameliorate the position may result in a reduced charge of 12% within the TRF window but readers should be aware – as already warned in this article – that HMRC will argue (almost certainly) that any sums that are image rights income and are paid abroad before 6th April 2025 will be regarded as UK-source income anyway.

SCHEDULE

Section 845H – performance income

(1) Performance income is any income chargeable to income tax (however that charge arises) that results, directly or indirectly, from the performance of a relevant activity by a performer (whether performed in the United Kingdom or not).

(2) “Performer” means any individual who gives performances of entertainment or sport.

(3) For the purposes of this section “performances of entertainment or sport” includes any activity of a physical kind performed by an individual (alone or with others) which is or may be made available to the public or any section of the public, whether for payment or not.

(4) The following are “relevant activities” –

(a) the giving of a performance of entertainment or sport;

(b) the participation of the performer in any sound or video recording;

(c) any activity in connection with a commercial occasion or event (including the appearance of the performer in connection with the occasion or event).

(5) The reference to a commercial occasion or event includes any description of occasion or event –

(a) for which any person might receive or become entitled, as a result of anything done by the performer, to receive

anything by way of cash or any form of property; or

(b) which is designed to promote commercial sales or activity by advertising, the endorsement of goods or services, sponsorship, or other promotional means of any kind.

DELAWARE LLCs AND CARRIED INTERESTS

Peter Vaines

The Budget highlighted the new government's dissatisfaction with the tax treatment of carried interests. It may be thought that the subject of carried interests is bit obscure to be the focus of such attention when there are one or two other matters arguably more important for them to grapple with – but you never can tell.

There is already a special rate of 28% capital gains tax applicable to carried interests and this will go up to 32% on 6th April 2025. The Budget also included an announcement that the government intends to bring all carried interest realisations into charge to income tax from April 2026.

The Supreme Court judgment in *Anson v HMRC [2015] UKSC 44* has a relevance to this issue when it comes to interests in Delaware LLCs. The case concerned a claim for relief for US tax against Mr Anson's UK tax liability, under the UK/US Double

Taxation Agreement. An important requirement for the relief is for the income on which the US tax has been paid, to be the same income (or at least the same source) as that chargeable to tax in the UK. In other words "the source of the profits or income in each jurisdiction is the same.

I am not concerned here with the tax credit issues – but with the UK tax treatment of the interest of a member in the assets of a Delaware LLC such as a carried interest – and how the judgment of the Supreme Court affects that issue.

Carried interests are subject to a plethora of special anti-avoidance rules in the ITA 2007, but I am assuming for this purpose that these various rules are not in point. I am focusing simply on the basic entitlement of the member of the LLC .

I have no knowledge of Delaware law, but I understand that for US tax purposes a Delaware LLC is treated as transparent and the profits and gains of the LLC are treated as the profits and gains of the members. However the UK tax treatment is also important.

It is necessary to identify whether for UK tax purposes the LLC should be regarded as equivalent to a partnership of which the member is a partner. The

crucial test is whether the profits of the business belong to the LLC which are subsequently paid out to the members (in the manner of a company), or whether the profits of the LLC belong to the members as they arise (in the manner of a partnership).

The Supreme Court in *Anson* held that the members of a Delaware LLC were automatically entitled to their share of the profits generated by the business carried on by the LLC as they arose. The profits did not belong to the LLC which only became the income of the members when they were distributed; the profits belonged to the members as they arose in exactly the manner of a partnership.

However, despite the Supreme Court judgment being the ultimate authority on the matter, HMRC have refused to follow it on the grounds that the decision was specific to the facts of the case and was not of wider application: see HMRC Brief 15 (2015). Their published position relates to the application of the judgment to the interpretation of the UK/US Double Taxation Agreement and the relief for US tax under the DTA; however, it is clear that they seek to apply their reasoning more widely.

The views of HMRC have been supplemented by a

guidance statement on 12th December 2023 which contains fresh views about the Supreme Court's decision in *Anson*.

This new guidance expresses in clear terms that HMRC disagree with the decision of the FTT in *Anson* on the interpretation of Delaware law. The FTT found specifically that the profits did not belong to LLC but that the members had an interest in the profits as they arose.

HMRC say at paragraph 180050 of their International Manual that despite the decision in *Anson*:

> "HMRC continue to believe that the profits of an LLC will generally belong to the LLC in the first instance and that members will not be treated as receiving or entitled to the profits."

This statement is wholly contrary to the decision of the Supreme Court in *Anson*. Essentially, what HMRC are saying is that the FTT was wrong in *Anson*, and that is what they will argue in any future case. As far as the FTT is concerned, HMRC are quite entitled to do so; the FTT is not a court of record, and its decisions are not binding. In any event, a decision on foreign law is a finding of fact, not law, and HMRC would seek a

different finding of fact in a future case.

However, the matter is not straightforward because HMRC also argue that the decision of the Supreme Court was wrong. This is a difficult stance to adopt because the Supreme Court is the highest legal authority in the UK, and its decisions represent the law of England and Wales – so it is not open to citizens, taxpayers or indeed any organ of government, to assert that they were wrong. HMRC seek to circumvent this difficulty by saying that the decision of the Supreme Court was based on the facts found by the FTT and because those facts were wrong, this means that the Supreme Court's decision was also wrong – and is therefore not binding on the lower courts.

I would suggest that this overlooks the ultimate legal authority of the Supreme Court and (philosophically perhaps) that a decision of the Supreme Court is right even if the decision is in some sense wrong. (A parallel can be drawn here with a batsman who is given out "caught" by the umpire even though he did not hit the ball. He is still out.) A person dissatisfied with a decision of the Supreme Court could take another case on the same facts and hope that a differently constituted Supreme Court will come to a different

conclusion. Although decisions of the Supreme Court are binding on all lower courts, since the *Practice Statement (Judicial Precedent) [1966] 1 WLR 1234* the Supreme Court has the power not to follow its earlier decisions – although this power is rarely exercised.

However, there is no automatic right of appeal to the Supreme Court. It is necessary for the Supreme Court to grant leave to appeal, and leave will only be granted for matters involving an arguable point of law of general public importance which they consider ought to be considered by the Supreme Court. This is a very high hurdle – and even more difficult where the matter has previously been the subject of a decision of the Supreme Court.

Accordingly, it can be said that whether HMRC or anybody else disagrees with a decision of the Supreme Court, it is the law, and will continue to be the law until it is overturned one way or another – for example by a subsequent decision or by legislation. However, it must be recognised that HMRC have taken a firm view on the subject and their statement makes it clear that they will reject any claim for double taxation relief in respect of tax paid by the LLC. Their statement focuses

almost entirely on double taxation relief, but their challenge is of general application. Their position is that the profits of the LLC belong to the LLC and not to the members as they arise. The members are not entitled to the profit, unless and until they are distributed to them – necessarily in income form:

> "This guidance is to provide further clarification of HMRC's view of LLCs following Anson with regards to who the profits belong to and the availability of DTR".

It is the reference to "who the profits belong to" which is important in this context. It is clear that in the view of HMRC, a member of a Delaware LLC cannot not be treated as a partner in the manner described by the Supreme Court and the proceeds of his carried interest must be treated as income chargeable to income tax.

HMRC might ultimately be shown to be correct in their analysis, but the law is not simply what HMRC say they it should be. They have to win the argument in the courts first. In the meantime, taxpayers are entitled to prepare their tax returns (and be taxed) on the existing law, based on established Supreme Court authority, and not in a different fashion just because

HMRC would prefer the law to be something else. It cannot be right for the taxpayer to prepare their tax returns in a manner directly contrary to the law, just to appease HMRC.

However, it is necessary to have regard to the practical realities. Where a transaction is reflected in a person's tax return in a manner that is believed to be correct (on sound legal grounds) but is contrary to the published HMRC view, what are his obligations? There is no obligation on a taxpayer to notify HMRC that their published views have not been followed (except in the case of very large companies with a turnover over £200m of a balance sheet value of £2billion who adopt a tax treatment that is contrary to HMRC's known position), but many would regard it as prudent to do so. It is not unknown for HMRC to allege carelessness where views expressed in their Manuals are disregarded. Furthermore, and possibly more important, full disclosure of the gain and the tax treatment could limit the HMRC enquiry window to only 12 months under section 9A TMA 1970 rather than the four years (or possibly 6 years) which would apply to a discovery assessment. The extent of that disclosure will be a matter of debate and examination in each case.

It seems inevitable that there will be further litigation (or a change in the law) on this subject as HMRC clearly are not prepared to accept the present legal position. This is likely to mean that HMRC will challenge the treatment of carried interests held by Delaware LLCs and seek to charge them to income tax. How this challenge will be manifested and articulated remains to be seen.

It will be interesting to see how the courts react to this new HMRC approach (when they come to consider it) and whether a court will be prepared to accept that the Supreme Court decision in *Anson* can be disregarded.

FAIRNESS, REASONABLENESS & LEGITIMATE EXPECTATIONS?

Some lessons learnt from *Treasures of Brazil* and a few other cases in-between…

Dilpreet K. Dhanoa

"…I start with a further sombre reflection: notwithstanding those many judgments and the acres of scholarly writing, we have made little progress. There is a real danger that the concept of legitimate expectation will collapse into an oncohate justification for judicial intervention. It sounds so benign – who could be against the protection of legitimate expectations? – but, it seems to me, as sometimes interpreted, the concept often gives little guidance and plays at best a rhetorical role."[1]

Introduction

The sentiment expressed by Professor Forsyth above, remains a practical issue in the world where

[1] Prof. C. Forsyth, 'Legitimate Expectations Revisited' (ALBA/BEG Paper) (2011).

tax and constitutional and administrative law overlap.

This article considers the very recent case of *Treasures of Brazil v HMRC* [2024] UKFTT 929, and the question of legitimate expectation as raised in a tax context before the First-tier Tribunal ("FTT"), which traditionally has been considered a forum which does not have the jurisdiction to hear such matters.

The doctrine of 'legitimate expectation'

Typically, cases brought on the grounds of legitimate expectation are founded on the basis that the taxpayer had a legitimate expectation that it would be treated in accordance with HMRC's published guidance. It has been made clear by the courts that *"If a public authority so conducts itself as to create a legitimate expectation that a certain course would be followed it would often be unfair if the authority were permitted to follow a different course to the detriment of one who entertained the expectation, particularly if he acted on it"* (*R v Board of Inland Revenue, ex parte MFK Underwriting Agencies Ltd and others* [1990] 1 All ER 91, DC).

Whether a particular statement gives rise to legitimate expectation will depend on: i) the quality of the guidance; and, b) the circumstances in which it is made and context in which it has been relied on. The starting point is that HMRC are not bound to give effect to representations (purportedly made) where to do so would require the relevant department to act ultra vires and outside the scope of its powers and functions.

As noted in *MKF Underwriting:*

(i) the taxpayer must "put all his cards face upwards on the table";

(ii) the ruling or statement relied upon must "be clear, unambiguous and devoid of relevant qualification' and given by the relevant/correct department/team (that is, an appropriate person who is clearly the right person to give the statement (see: Matrix Securities); and,

(iii) the "doctrine of legitimate expectation is rooted in fairness", but "fairness is not a one-way street. It imports the notion of equitableness, of fair and open dealing, to

> which the authority is as much entitled as the citizen." In other words, it is also fair for a public authority to change its mind and/or develop its position or thinking.

Judicial Review as a remedy

Judicial review is a remedy of last resort. Accordingly, the Administrative Court cannot typically entertain a claim for judicial review in circumstances where there is a 'suitable alternative remedy' available to a claimant. This principle was made clear by the House of Lords in *Kay v Lambeth LBC* [2006] UKHL 10:

> "…[respect should be given to] the principle that if other means of redress are conveniently and effectively available to a party they ought ordinarily to be used before resort to judicial review…"

The case of *Glencore Energy UK Limited v HMRC* [2017] EWHC 1476 (Admin), held that permission to apply for judicial review should be refused where there are alternative remedies available to a claimant which are in substance adequate and appropriate.

The Court of Appeal upheld the High Court's decision noting:

> "...the principle is based on the fact that judicial review in the High Court is ordinarily a remedy of last resort, to ensure that the rule of law is respected where no other procedure is suitable to achieve that objective. However, since it is a matter of discretion for the court, where it is clear that a public authority is acting in defiance of the rule of law the High Court will be prepared to exercise its jurisdiction then and there without waiting for some other remedial process to take its course. Also, in considering what should be taken to qualify as a suitable alternative remedy, the court should have regard to the provision which Parliament has made to cater for the usual sort of case in terms of the procedures and remedies which have been established to deal with it. <u>If Parliament has made it clear by its legislation that a particular sort of procedure or remedy is in its view appropriate to deal with a standard case,</u>

> the court should be slow to conclude in its discretion that the public interest is so pressing that it ought to intervene to exercise its judicial review function along with or instead of that statutory procedure. But of course it is possible that instances of unlawfulness will arise which are not of that standard description, in which case the availability of such a statutory procedure will be less significant as a factor." [Emphasis added]

The Court of Appeal went on to note:

> "Treating judicial review in ordinary circumstances as a remedy of last resort fulfils a number of objectives. It ensures the courts give priority to statutory procedures as laid down by Parliament, respecting Parliament's judgment about what procedures are appropriate for particular contexts. It avoids expensive duplication of the effort which may be required if two sets of procedures are followed in relation to the same underlying subject matter. It minimises

> the potential for judicial review to be used to disrupt the smooth operation of statutory procedures which may be adequate to meet the justice of the case. It promotes proportionate allocation of judicial resources for dispute resolution and saves the High Court from undue pressure of work so that it remains available to provide speedy relief in other judicial review cases in fulfilment of its role as protector of the rule of law, where its intervention really is required." [Emphasis added]

The basic objective of the tax regime is to ensure the correct amount of tax is collected from the right taxpayer at the right time. There is an appeals regime in place which is more appropriate to deal with tax appeals, and those are before the First-tier Tribunal. As noted by the Court of Appeal: *"To allow judicial review to intrude alongside the appeal regime risks disrupting the smooth collection of tax and the efficient functioning of the appeal procedures in a way which is not warranted by the need to protect the fundamental interests of the taxpayer. Those*

interests are ordinarily sufficiently and appropriately protected by the appeal regime."

The case of *Treasures of Brazil*

It is unusual when a taxpayer succeeds in a legitimate expectation case, in the context of tax. The requirements are strict and exacting, and the judicial review doctrine sets a high bar for the test to be met with respect to: (a) whether a legitimate expectation was created; and, (b) whether the public authority (in the tax context, HMRC) resiled from it.

The brief facts are as follows. Treasures of Brazil Limited ("TOBL") is a business trading in the sale of jewellery and bags, having been incorporated in March 2022. In September 2022, the Director of TOBL, Ms Brambila, was of the view that the VAT registration threshold would be met in the relatively near future. She instructed her accountant (Ms McCormick) to apply for voluntary VAT registration, on behalf of TOBL.

The VAT registration application sought an effective registration date of 1 October 2022, and it was submitted on 21 September 2022. The same day of submission, an email response was received from HMRC in the following terms:

> "We've received your application. So we can process it, you need to email us copies of your identity documents. For information on how to do this, sign in to 'Register for VAT' online and view your existing applications.
>
> What happens next.
>
> After we get copies of your documents, we'll write to you with a decision on your application. This usually takes us about 30 days.
>
> You should wait until your VAT registration is confirmed before you:
>
> - get any software
> - charge customers for VAT
>
> From HMRC VAT team"

The reason for setting out the email on which the taxpayer relied, is because of the test as set out in *MFK*. This will be addressed shortly.

Given HMRC's email and the contents of it, Ms McCormick advised Ms Brambila that TOBL should only start to collect VAT *once VAT registration had*

been confirmed. Throughout October and November 2022, HMRC was chased for updates. The VAT registration was eventually confirmed in a letter dated 10 October 2022, with an effective VAT registration date of 1 October 2022. However, there are two significant points of note in the factual matrix:

(i) *First*, HMRC's systems indicated that the letter was issued on 17 December 2022.

(ii) *Secondly*, TOBL did not receive the letter until 28 December 2022. It was only at that point that TOBL then immediately began to charge VAT on its sales.

TOBL submitted its first VAT return for December 2022, reporting £4,502 of input VAT. The return declared no VAT on sales, on the basis that Ms Brambila considered it unfair that TOBL would be penalised for HMRC's poor communication which had resulted in TOBL not charging VAT on its sales for the period.

Following correspondence between the parties, HMRC raised a 'Best judgement assessment', with an adjusted output VAT figure for the period (of

£15,257), and an adjusted input figure (of £6,512). TOBL appealed to the FTT.

The general legal framework as regards to the collection of VAT was not in dispute between the parties. The prime focus of contention was: whether or not the FTT had jurisdiction to consider matters of legitimate expectation in respect of TOBL's appeal. Then flowing from that: whether TOBL had a legitimate expectation, and if so, what would the effect be on the assessment.

Traditionally, it is broadly accepted that the starting point is that the FTT does *not* have jurisdiction to hear claims of legitimate expectation. HMRC ran this argument, relying on the case of *HMRC v Noor* [2013] UKUT 071 (TCC), in which the Upper Tribunal held:

> "…in our view, the F-t T does not have jurisdiction to give effect to any legitimate expectation which Mr Noor may be able to establish in relation to any credit for input tax… legitimate expectation is a matter for remedy for judicial review in the Administrative Court; the FtT has no jurisdiction to determine the disputed

> idea in the context of an appeal under section 83."

The FTT in TOBL considered that the position had evolved since the formulation of the position in *Noor*. In particular, considering the more recent Upper Tribunal case of *KSM Henryk Zeman SP z oo c HMRC* [2021] UKUT 182 (TCC), the FTT in *Treasures of Brazil* noted that whilst:

> "…it was clear from the list of appealable items in s 83 VATA that the FTT did not have a general supervisory jurisdiction. However, that was not the same thing as saying that a taxpayer may not in at least certain of the cases described in s 83(1) defend themselves by challenging the validity of a decision on public law grounds. The starting point was that they should be able to. The question which arose was whether the statutory scheme expressly or by implication excluded the ability to raise a public law defence."

Applying the Upper Tribunal's rationale in *Zeman*, the FTT noted that first, a consideration of the relevant provision was required, then the relevant

policy considerations, with the conclusion in respect of section 83 being (*Zeman* at [84]):

> "[84] Coming back then to where we started our analysis, the critical question in this case (see *Beadle* at [44]) is whether the relevant statutory scheme expressly or by implication excludes the ability to raise a public law defence of legitimate expectation (again, see *Beadle* at [44]). For all the reasons given above, we do not consider that s 83(1)(p) does exclude that ability. On the contrary, on the facts of this case and given the broad subject-matter of s 83(1)(p), we see strong reasons for thinking that it would be artificial and unworkable to exclude a defence based on the public law principle of legitimate expectation from the tribunal's appellate jurisdiction. We therefore consider that the FTT did have jurisdiction to determine that question in this case."

Applying the test in *MFK*: namely, that:

(i) the taxpayer should "put all their cards face up on the table"; and,

(ii) the statement relied upon should be clear, unambiguous and devoid of relevant qualification,

the FTT was of the view that the first limb was met as TOBL had done all it was required to and had not concealed anything. As regards to the second limb, despite HMRC drawing the FTT's attention to various parts of HMRC's own guidance and manuals, the FTT concluded that any general guidance would be superseded by specific guidance – such as the contents of an acknowledgment email. Furthermore, the FTT made clear that the taxpayer should not be expected to check specific instructions it received from HMRC to ascertain if it matched general guidance. Finally, the FTT noted that the email from HMRC had said specifically that TOBL should not charge customers for VAT, and to wait for the registration to be confirmed *before* taking further action such as acquiring software, and had not instructed TOBL to consult any other general guidance.

Accordingly, it was held by the FTT that the email from HMRC was clear, unambiguous and unqualified advice, and TOBL (as the taxpayer) had

a legitimate expectation that they should therefore not collect VAT prior to confirmation of its registration.

Effect of the appeal in *Treasures of Brazil*

Once the FTT had established that legitimate expectation existed, it considered the effect of the appeal.

In the context of tax and unfairness, the FTT looked to the Court of Appeal in *HMRC v Hely Hutchinson* [2017] EWCA Civ 107, which noted two points in particular. First, that part of the context to be taken into account is that the law imposes on HMRC a duty to collect tax and that taxpayers must expect to pay the right amount of tax. Secondly, the Court of Appeal had referenced *Samarkand Film Partnership No 3 v HMRC* [2017] STC 926 at [115] which stated:

> "Experience shows that the cases where such a claim has succeeded, at any rate in the field of taxation, are relatively few and far between. This is in my view hardly surprising. There is a strong public interest in the imposition of taxation in accordance with the law, and so that no individual taxpayer, or group of

> taxpayers, is unfairly advantaged at the expense of other taxpayers"

Accordingly, the FTT noted there is *"a high level of unfairness needed to displace the presumption that HMRC should not be impeded in collecting the tax that Parliament has decided ought to be paid."*

In order to answer the question as to whether the appropriate threshold has been reached, the FTT looked once again to the Court of Appeal for guidance, but this time to the case of *R v Northern East Devon Health Authority, ex parte Coughlan* [2001] QB 213 at [57] (approved by the Supreme Court in *Finucane* [2019] UKSC 7):

> "Where the court considers that a lawful promise or practice has induced a legitimate expectation of a benefit which is substantive, not simply procedural, authority now establishes that here too the court will in a proper case decide whether to frustrate the expectation is so unfair that to take a new and different course will amount to an abuse of power. Here, once the legitimacy of the expectation is established, the court will

> have the task of weighing the requirements of fairness against any overriding interest relied upon for the change of policy."

The balancing exercise therefore being: as between the requirements of fairness and the overriding public interest in HMRC being able to collect tax due by law. In the circumstances, the FTT considered it was right to overturn the general assumption that HMRC were entitled to collect the tax legally due. This was because of the *"legitimate expectation they had created"*, and that in the circumstances HMRC's assessment was *"conspicuously unfair"*.

Conclusion

The circumstances in which a taxpayer can raise a public law argument, certainly in a tax context and before the FTT, continues to be a matter of much contention. For the purposes of section 83 of the Value Added Tax Act 1994, it appears to be the case that there is clearly some scope. The detailed analysis and commentary of the FTT in the case of *Treasures of Brazil* will certainly provide some helpful guidance in this context.

A CHRISTMAS TURKEY-SHOOT – THE UNALLOWABLE PURPOSE RULE

David Southern KC

A Christmas turkey-shoot

A 'turkey-shoot' is defined in the Shorter Oxford English Dictionary as: *'a shooting match in which the mark is a live turkey, or its head only*.'

The point is that the turkey is tethered, so that the shooting skills of the participant are not greatly tested and the turkey's chances of survival are correspondingly limited.

It is not like pig-sticking in India in the days of the British Raj, where – according to that long-forgotten minor classic by F. Yeats-Brown, *Bengal Lancer* – the wild boar frequently gave as good as it got.

Cases involving the unallowable purpose rule appear to have become a turkey-shoot. On my calculation of cases which have got to court the score at present is: HMRC 7.5*;* turkeys 0.5 (counting cases which have gone through more than one level of court as a single

case). The 0.5 case is *Iliffe News and Media Ltd v R & C Comrs* [2013] SFTD 309. However, while the taxpayer won on the unallowable purpose argument, he lost on another ground, so this case does not really count.

A larger number of cases have been settled without getting to court.

The unallowable purpose rule

The unallowable purpose rule says that finance costs of debt are not deductible in computing taxable profits, if the loan has an unallowable purpose. In effect, where the rule applies for tax purposes the debt is treated as equity, to the extent that the interest deduction is disallowed.

Corporation Tax Act 2009 ('CTA 2009'), s 441(3) provides that a loan relationship debit cannot be brought into account to the extent that the loan is attributable to an unallowable purpose:

> *"(3) The company may not bring into account for that period for the purposes of this Part so much of any debit in respect of that relationship as on a just*

and reasonable apportionment is attributable to the unallowable purpose."

Unallowable purpose is defined in s 442(1). A loan relationship has an unallowable purpose if,

"the purposes for which the company

(a) is a party to the loan relationship, or

(b) enters into transactions which are related transactions by reference to it

include a purpose ('the unallowable purpose') which is not amongst the business or commercial purposes of the company."

A tax avoidance purpose is "*any purpose which consists of securing a tax advantage for the company or any other person*": s 442(5).

"Tax advantage" has the meaning of securing a relief from tax, a repayment of tax or simply paying less tax than would otherwise be due: CTA 2010, s 1139.

Section 442(4) contains an escape clause. It says that having a tax avoidance purpose is not an unallowable purpose if the tax avoidance purpose is not a main purpose or one of the main purposes for which the company entered into the loan relationship.

The idea is that if a tax advantage (typically a saving of corporation tax) is an effect rather than a purpose of the loan relationship, the restriction does not bite.

'Unallowable purpose', while a novel concept in 1996 when the loan relationships legislation was introduced, has been reproductive, so now may be encountered in other contexts, e.g. CTA 2009, s 521E.

The main purpose rule

The unallowable purpose rule is twinned with the main purpose rule, so that two rules of uncertain extent work in combination.

The main purpose rule was originally introduced in Finance Act 1960 as part of the transactions in securities rules. It has been since adopted as a regular feature of anti-avoidance rules, including *ex multis* unallowable purpose as defined in CTA 2009, s 441(2).

There are four characteristics of the main purpose test, in its various manifestations:

(i) The test is concerned with ends not means. The test is concerned with the purpose of the transaction, not its effect; the goal pursued, not the means by which it is implemented.

(ii) The test is subjective. It is necessary to establish by a close analysis of the evidence, what the decision-makers planned to achieve.

(iii) The purpose will only be invalid, if it is the main purpose or one of the main purposes of the transaction.

(iv) A purpose is a main purpose if it is a significant purpose.

The question of burden of proof in main purpose tests has never been satisfactorily established. While the burden of proof should in theory be on HMRC, who have to prove that this was not a normal commercial transaction, in practice it has been placed on the taxpayer, because if he simply asserts

the bona fides of the transaction, and HMRC argue that the taxpayer was up to no good, HMRC are likely to prevail.

The reason for the appearance of this test in the loan relationships rules is that, when introduced in 1996, they were intended to introduce an accounts-based system, following FA 1993 (for foreign exchange gains) and FA 1994 (for financial instruments). Accounting rules do not distinguish between trading and non-trading transactions. The principles of double entry bookkeeping know nothing of these distinctions. The reason for their purpose in the tax rules is to establish a distinction between trading and non-trading losses, which are treated separately.

For the purpose of calculating trading profits for tax purposes, it has been the case since 1806 that no expenses are allowed as taxable deductions unless they are incurred *'wholly and exclusively for the purposes of the trade'*: CTA 2009, s 54(1)(a). This rule did not fit in with the new accounts-based system. Hence the unallowable purpose rule.

Debt is inherently tax-advantaged

It is the constant gripe of tax administrators, not least the OECD, that debt is inherently tax-advantaged, because the normal rule is that debt expenses are deductible in computing taxable profits. So every debt transaction for the borrower has the result if not the intention of securing a tax advantage. Companies do not incur debt in order to secure a tax advantage. They secure a tax advantage because they have incurred debt.

Situations where a company incurs debt for some non-commercial reason will be an obvious case for the unallowable purpose rule to be invoked, e.g. the construction company which lends money to a football club of which the company chairman is also the club chairman.

A.H. Field (Holdings) Ltd v R & C Comrs [2012] UKFTT 104 (TC) may perhaps be regarded as a non-commercial case. This involved an asset-rich but illiquid company, which borrowed money to pay dividends. On the other hand, it is normal commercial practice for companies which wish to preserve working capital, or have illiquid assets

which they cannot or do not wish to sell, to borrow money for the purpose of paying dividends, which recognise the financial underpinning which the shareholders provide to the business.

In general the fact that debt secures a tax advantage cannot justify the application of the unallowable purpose rule. Cross J explain why this is so in a different context in *IRC v Kleinwort Benson Ltd* 45 TC 369:

> *'When a trader buys goods for £20 and sells them for £30, he intends to bring in the £20 as a deduction in computing his gross profits for tax purposes …it would be ridiculous to say that his object in entering into the transaction was to obtain this tax advantage.'*

As Cross J continued, this will only be the case if this was the main object of an otherwise ordinary commercial transaction. It if is an ordinary commercial transaction, this is unlikely to be the case.

The Upper Tribunal in *JTI Acquisition Company (2011) Limited v R & C Comrs* [2023] STC 1459 somewhat lamely observes, that the use of debt is normally an ordinary commercial transaction, but the unallowable purpose rule can sometimes be applied:

> *'That in no way means the countless situations where commercial assets bought with borrowing and where a deduction is sought for the interest on the borrowing, fall foul of the rules.'*

To establish where the line is crossed, all the facts and circumstances of the transaction have to be considered.

The problem for the tax adviser

The problem for the tax adviser is that corporate transactions necessarily, not adventitiously, produce tax relief, either in terms of reliefs or charges. The tax adviser responsible for organising a transaction will and must seek to arrange it in the most tax efficient way. That is self-evident. However, he is faced with the dilemma of the 18th century soldier, ordered to

fire on rioters. If he disobeys the order, he will be shot for mutiny. If he obeys the order, he will be hanged for murder. The tax adviser will get his P45 or be accused of tax avoidance.

Overlapping main purposes

In many cases, the acquisition of a subsidiary may involve a company reconstruction within TCGA 1992, ss 135-139: *Syngenta Holdings Ltd v R & C Comrs* [2024] UKFTT 00998 (TC). The main purpose test is also used in deciding whether a company reconstruction can be carried out on a tax neutral basis. TCGA 1992, s 137 says that (emphasis supplied) the beneficial tax treatment cannot be obtained:

> *'unless the exchange or scheme of reconstruction in question is affected for bona fide commercial reasons and does not form part of a scheme or arrangement of which the main purpose or one of the main purposes is avoidance of liability to capital gains tax or corporation tax'.*

One may ask rhetorically: if a scheme of reconstruction of a group, and the finance of an acquisition by a member of the group of a target company, are part of one overall transaction, how can one part of the transaction (company reconstruction) have an allowable purpose and another part (the loan transaction) an unallowable purpose?

The same problem occurs in an international context.

The UK arbitrage rules apply where a "deduction scheme" involving a hybrid entity generated a deduction for a loan relationship debit in the UK, if one of the main purposes of the scheme was to achieve a UK tax advantage of more than minimal amount: Finance (No 2) Act 2005, ss 24-25. The rules allowed HMRC to serve a deductions notice disallowing amounts otherwise deductible for corporation tax: TIOOPS 2010, s 243.

In such cases, HMRC may agree to an advance thin capitalisation agreement (ATCA): TIOPA 2010, ss 218(1), (2)(e), 213.

This was agreed in *JTI Acquisition Company*. So how can one part of a large transaction be innocent of tax

avoidance and another part be denatured by a tax avoidance purpose?

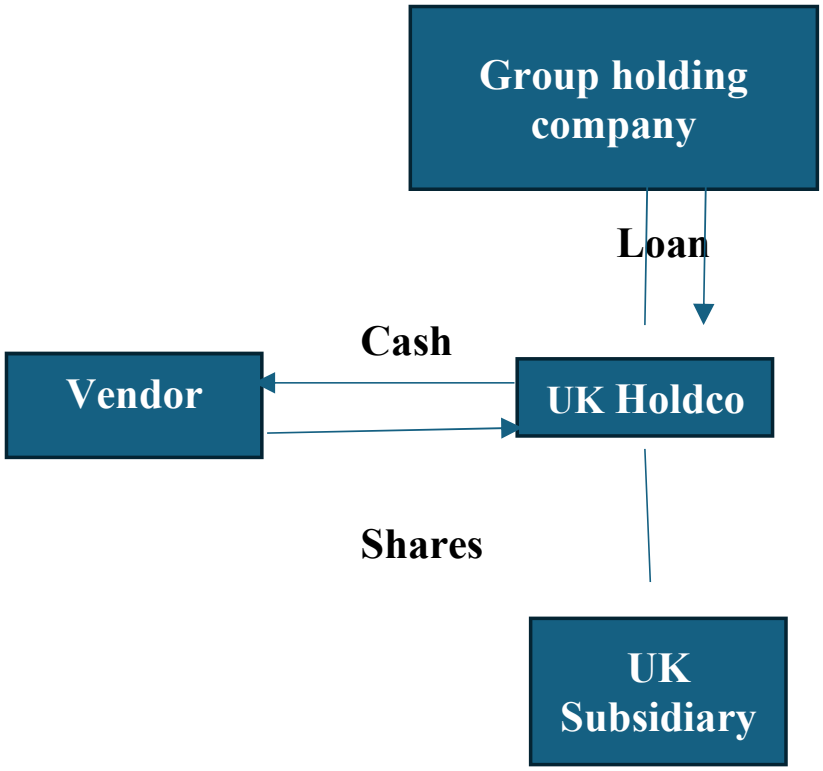
What is, one may ask, an ordinary commercial transaction? If the main purpose rule is concerned with ends not means, there must be some means of scoping out as a self-contained end, the part categorised as tax avoidance from the transaction as a whole.

Typical scenario

The unallowable purpose rule is liable to be invoked in cases where there is a debit for UK tax purposes but no corresponding credit. The unallowable purpose rule is applied, if it is not designed, to remove tax asymmetries.

The typical scenario is found where a UK holding company, a special purpose vehicle (SPV) is set up to acquire a UK target company, and the acquirer co purchases the target with borrowed funds. The UK company incurs loan relationship debits, producing a non-trading loan relationship deficit ("NTLRD"): CTA 2009, s 457(2)(a). This it surrenders to UK group companies, which claim group relief. The

companies claim the relief by way of deduction from 'taxable total profits' for corporation tax purposes.



If both borrower and lender are UK resident, the tax result is likely to be neutral. If, however, the lender is non-resident, there will be deduction for UK tax purposes but no corresponding UK tax credit. It is this asymmetry to which HMRC object.

The law says nowhere that interest paid by a UK borrower to a UK lender is deductible, but that interest paid to a non-resident lender is non-

deductible. In view of the international nature of finance, the multiple levels of lenders which it encompasses and the application of international tax agreements, such a contention would be – to borrow from Cross J – 'ridiculous'.

The fact that the film producer in *Godfather 1* regarded as situation as 'ridiculous' did not prevent his finding a horse's head on his pillow in the morning. Similarly, the fact that a company may regard a non-deduction of a finance cost as ridiculous will not prevent the application of the unallowable purpose rule.

An alternative structure

The point which HMRC will make is that it was not necessary to borrow funds to pay for an acquisition: it could have been financed out of equity, or using a non-UK SPV to effect the acquisition.

As the Upper Tribunal pointed out at [32], it is necessary to postulate a comparator transaction, not vitiated by an unallowable purpose.

The problem about equity is that it involves increasing the number of shares in issue, which exercise is often subsidised by existing shareholders.

Companies are concerned about issues such as return on equity and earnings per share, which may be favoured by use of debt and depressed by the use of equity.

This is because, depressingly, shareholders are concerned about dividends. As a famous German banker of the 1920s observed: 'All my customers are very stupid: first they buy my shares, then they expect dividends.'

Assume two companies, one wholly financed by equity, the other financed 20% by equity and 80% by debt.

	Company A	Company B
Equity £1 shares	1000	200
Debt (5% interest)	0	800

Capital employed	1000	1000
Pre-tax profits	200	160
Tax	(50)	(40)
Post-tax profits	150	120
EPS	0.15	0.6

An acquisition of a company is proposed for 500, using the same sources of finance, and giving the same return. The result will be:

	Company A	Company B
Equity £1 shares	1500	300
Debt (5% interest)	0	1200
Capital employed	1500	1500
Pre-tax profits	300	240

Tax	(75)	(60)
Post-tax profits	225	180
EPS	0.15	0.6

An investor, looking at EPS, will want to invest in company B, rather than company A.

Evidence

As noted earlier, the test of unallowable purpose is subjective. It is not possible to put a company in the darkest dungeon in the kingdom, and beat it with rubber truncheons until the correct answer is obtained.

It is necessary therefore to find what the board of directors of the borrower thought that they were up to. As the Upper Tribunal observed at [63], n *'a wider-ranging and fact-sensitive enquiry of all circumstances is called for …'* .

The problem is that the board of a subsidiary must necessarily be concerned with the commercial and financial policies of other companies in the group, in

particular its ultimate parent. Companies are artificial creations. The fact-finding tribunal may conclude that the borrower company is simply the puppet of its parent, has no autonomous rule, and its commercial objective (acquiring a UK subsidiary) is insignificant compared with the overall group purpose of securing a UK tax advantage.

In *JTI Acquisition Company* the central finding of the FTT was that the decision to raise the loan and buy the target (LTT) shares was taken not in the UK by JTIAC in the UK but by the ultimate parent (JGI) in the United States. There was "*no genuine decision-making at the UK level*". The judge concluded: at [2022] STFD 1089 at [153]

> *"From the above findings of fact, I conclude that there was no genuine decision-making at the UK level as regards the decision to issue the $550m loan notes to JTI. The decision-makers were at the JGI level, and their object in implementing the Deloitte scheme was to bring into existence the loan relationship of which the Appellant would be a party,*

thereby securing a UK tax advantage by generating the free-standing loan relationship debits to the UK members of the JGI group. Pursuant to s 442(5) that object was a 'tax avoidance purpose' and an 'unallowable purpose' in terms of s 441."

What, one may ask, is a 'free-standing' loan relationship debit? 'Free-standing' presumably means a borrowing which stands outside the main commercial transaction. A loan has an unallowable purpose, if its primary role or a primary role is not to fund the purchase (a commercial purpose), but to produce interest deductible from UK taxable profits. In other words, the purpose is to finance the acquisition is the most tax efficient manner, which may involve locating the acquirer company in the UK. The suggestion is that the acquisition was made to obtain a tax deduction, rather than to maintain or enhance the return on capital employed. Alternatively, the suggestion may be that the financial means were so distorted by tax

considerations as to constitute the aim of a separate transaction.

The classic economic theory of the firm is that groups are formed to achieve internal economies and efficiencies superior to those obtainable in an open market between separate suppliers. In this economic context of the group, equity and debt have abandoned the pretence of differentiation and become a double act, exchanging their masks so rapidly that the effort of distinguishing one from the other becomes at best a pedantic exercise.

However, for legal and so for tax purposes the distinction is fundamental. Likewise the separate existence of each company is not something which can be brushed away for tax purposes as an artificial device.

Corporate interest restriction

The uncertainty of interest restriction tests such as the unallowable purpose/main purpose rules has been recognised by the OECD. In devising the corporate interest restriction, now incorporated into UK law in TIOPA 2010, the OECD recognised the

unsatisfactory nature of subjective tests of excessive interest deductions, and sought to substitute a purely arithmetic restriction, based on the consolidated group accounts. The UK rules impose as a general rule a 30% restriction of EBITDA (as measured for the purpose of the special tax rules) on the finance cost which can be claimed as an annual deduction by the UK group. In most cases, this would apply in cases to impose a proportionate restriction, in place of the outright restriction imposed by the unallowable purpose rule.

HMRC, however, have shown no enthusiasm for invoking the CIR rules in place of the unallowable purpose rule. It may be because its effects are less severe than the unallowable purpose rule. It may be because they find the rules too tedious and too difficult. In that case I would earnestly recommend to them to study my book on the subject.

Conclusion

The unallowable purpose rule is a drastic rule, because it enables HMRC to directly intervene in group financing arrangements.

There needs to be a degree of pragmatism in deciding when HMRC should be allowed to intervene in the commercial decision-making process of companies, in situations where motives will necessarily, not adventitiously, conflict.

The courts and tribunals have confused ends and means. This is putting the cart before the horse.

The bar of the unallowable purpose test has been set so low as to introduce a turkey-shoot mentality on the part of all sides. This is bad for turkeys. But it also reinforces an anti-business climate which is bad for everyone.

INHERITANCE TAX TREATIES: THE LAST STAND FOR DOMICILE

David Tipping

Introduction

Readers will likely be aware of the fundamental reforms announced by the government at the Budget on 30 October 2024. The details of those reforms can be found elsewhere in the pages of this Digest, and in many other tax publications in recent weeks. Those changes include a whole-sale reform to the basis of inheritance taxation and the abolition of domicile as a connecting factor for tax purposes.

Domicile will, however, continue to live on in an unlikely place. The United Kingdom's relatively small network of estate duty and inheritance tax treaties explicitly refer to domicile as a concept and the government's proposals appear to have left their operation unchanged. Therefore, this piece will examine the status of the UK's IHT treaties and their relationship with the new long-term residence regime. It concludes on a note of caution for readers by highlighting possible measures that the

government may take in light of the issues raised below.

The UK's IHT Treaty Network

The United Kingdom is a party to 10 IHT treaties. It is common to distinguish between the 'old' and 'new' treaties, although the latter is a relative term, given most of them were entered at a time when the United Kingdom still imposed capital transfer tax rather than IHT.

The four old treaties are those entered into when estate duty was still in-force. Those are the treaties with:

- India (1956);
- Pakistan (1957);
- France (1963); and
- Italy (1968).

The so-called new treaties are those with:

- Ireland (1978);
- the United States of America (1978);
- South Africa (1979);
- the Netherlands (1980; amended in 1996);

- Sweden (1981; amended in 1989); and
- Switzerland (1994).

Of these treaty partners, three no longer impose any form of IHT or estate duty: India, Pakistan and Sweden. Nevertheless, the treaties remain in force, although it should be noted that the new treaties typically contain a subject-to-tax rule. For example, Article 5(5) of the UK-Sweden treaty states:

> "If by reason of any of the preceding paragraphs of this Article any property would be taxable only in one Contracting State and tax, though chargeable, is not paid (otherwise than as a result of a specific exemption, deduction, credit or allowance) in that Contracting State, tax may be imposed by reference to that property in the other Contracting State notwithstanding that paragraph."

The new treaties are given effect for the purposes of domestic law, notwithstanding anything contained in the IHTA 1984, by virtue of section 158(1) IHTA 1984. The old treaties were originally incorporated into domestic law by section 54 Finance (No 2) Act 1945 and their implementation is preserved in

relation to IHT on death only by section 158(6) IHTA 1984. Note, therefore, that the old treaties do not apply to chargeable transfers during the lifetime of the individual taxpayer.

Unlike the UK's vast network of double tax treaties in relation to income tax and CGT, with which readers may be familiar, the IHT treaties do not follow a single model with only minor variations. Instead, there are more significant differences between them and in the way that they allocate taxing rights between the Contracting States. Nevertheless, there are common features and an overall similarity in structure.

First, the treaty must identify when an individual is "domiciled" in a particular Contracting State. Much like residence, the test for domicile varies between countries and the treaties specify how that is to be determined. For example, Article II(3)(a) of the UK-France treaty states that:

> "For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties

> shall be determined in accordance with the law in force in that territory."

In the newer treaties, the test is very similar, but subtly different. For example, Article 4(1) of the UK-USA treaty provides that:

> "For the purposes of this Convention an individual was domiciled:
>
> (a) in the United States: if he was a resident (domiciliary) thereof or if he was a national thereof and had been a resident (domiciliary) thereof at any time during the preceding three years; and
>
> (b) in the United Kingdom: if he was domiciled in the United Kingdom in accordance with the law of the United Kingdom or is treated as so domiciled for the purposes of a tax which is the subject of this Convention."

These wordings are representative of the UK's treaty practice in relation to the old and new treaties respectively. The most notable difference between

them is the addition of the words "…or is treated as so domiciled…" in the new treaties. This incorporates the deemed domiciled rules found in section 267 IHTA 1984, which are explicitly disapplied for the purposes of the old treaties by section 267(2) IHTA 1984. The treaties provide tie-breakers to ensure that an individual is not domiciled in both Contracting States for the purposes of the treaty.

Once the treaty-domicile of the individual is identified, the treaty provides relief from double-taxation by either explicitly restricting the right of one Contracting State to tax, or by providing situs rules which ensure that certain assets are taxed in only one Contracting State.

An example of the former type of rule is article 3(3) of the UK-India treaty, which states that:

> "Duty shall not be imposed in Great Britain on the death of a person who was not domiciled at the time of his death in any part of Great Britain but was domiciled in some part of India on any property situate outside Great Britain:
>
> Provided that nothing in this paragraph shall prevent the imposition of duty in

> Great Britain on any property which passes under a disposition or devolution regulated by the law of some part of Great Britain."

Meanwhile, typical situs rules are contained in article IV of the UK-Italy treaty:

> "(1) Land shall be deemed to be situated at the place where it is located; rights or interests (otherwise than by way of security) which constitute immovable property shall be deemed to be situated at the place where the land which they relate is located; the question whether rights or interests constitute immovable property shall be determined in accordance with the law of the place where the land to which they relate is located.
>
> (2) Tangible movable property (other than such property for which specific provision is hereinafter made) and rights or interests (otherwise than by way of security) therein shall be deemed to be situated at the place where it is located at

> the time of the deceased person's death[…]
>
> (3) Debts, secured or unsecured, excluding the forms of indebtedness for which specific provision is made elsewhere in this Article, shall be deemed to be situated at the place where the debtor was residing at the time of death of the deceased person.
>
> (4) Bank accounts shall be deemed to be situated at the branch at which the account was kept."

As can be seen from the above, the typical regime limits the taxing right of the other Contracting State to assets situated in that country if the individual is not domiciled there for the purposes of the treaty.

The New Regime

Two reforms announced on 30 October will play a significant role in the operation of the UK's IHT treaties. These are (1) the abolition of domicile as a connecting factor, being replaced by the concept of long-term residence; and (2) the new regime for settlements, the tax status for which shifts according

to the corresponding status of the settlor. The key features of these changes are set out below, although this discussion is by no means comprehensive and merely highlights the issues.

Abolition of Domicile

With effect from 6 April 2025, a person will be subject to IHT on their worldwide estate if that person is a "long-term resident" of the United Kingdom. This new term is defined in the new section 6A IHTA 1984[1] as follows:

> "(1) For the purposes of this Act, an individual is a "long-term UK resident" at all times in a tax year if they were UK resident for at least 10 of the previous 20 tax years.
>
> (2) But an individual is not a long-term UK resident at any time in a tax year ("the current tax year") if they were non-UK resident—

[1] References to legislation will operate on the assumption that the draft legislation published alongside the 30 October Budget will be enacted as drafted. Draft legislation is always subject to change.

(a) for any 10 consecutive tax years during the 19 tax years before the current tax year, or

(b) for at least the required number of consecutive tax years ending with the tax year before the current tax year."

The "required number of consecutive tax years" in subsection (2)(b) is set out in a table in section 6A(3), according to the number of years that the individual has been UK-resident:

Number of resident years	**Required number**
13 or less	3
14	4
15	5
16	6
17	7
18	8
19	9
20	10

This change is accompanied by numerous minor reforms across the IHTA to replace any reference to "being domiciled in the United Kingdom" with the equivalent phrase "long-term resident in the United Kingdom". For example, section 6(1) IHTA 1984 will read as follows from 6 April 2025 (with the old wording struck-through in red and the new wording underlined in blue):

> "Property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual ~~domiciled outside the United Kingdom~~ who is not a long-term UK resident."

These reforms also include the repeal of section 267 IHTA 1984, which contains the rules relating to deemed domicile. The effect of those rules is that a person who was resident in the UK for a specified number of years is treated as domiciled for the purposes of IHT. At first glance, the removal of these rules is sensible: in a system moving away from domicile to a pure residence-basis, there is no apparent rationale for maintaining a deemed domicile, which is also based upon residence. This

does raise a problem for the application of the UK's IHT treaties.

As described above, an individual will be treaty-domiciled in the United Kingdom if they are domiciled under common law in a constituent part of the UK, or are deemed to be UK domiciled for the purposes of IHT. The domestic changes introducing long-term residence will not change this treaty position. HMRC confirm as much in its technical note accompanying the 30 October Budget, in which it states that:

> "*IHT Double Tax Conventions*
>
> 158. The UK has 10 IHT Double Tax Conventions (DTCs) and there are no changes to the treaties or how these operate."

Significantly, this means that the common law test for domicile will be preserved for the purposes of determining whether an individual is treaty-domiciled in the United Kingdom and therefore whether the UK has the right to tax that individual's worldwide estate. Furthermore, the repeal of section 267 IHTA 1984 will actually narrow the UK's right to tax under the new treaties, because the concept of

deemed domicile is being abolished. Individuals that previously would have been treaty-domiciled in the United Kingdom by reason of the deemed domicile rules may find that, from 6 April, they are entitled to relief under a treaty by reason of being domiciled elsewhere at common law.

Reform to IHT Taxation of Trusts

The second major reform which is likely to be affected by the IHT treaties is the new system for the taxation of trusts.

Under the current law, the question of whether a trust is subject to IHT is determined at the time of its creation. Broadly, property situated outside the UK will be excluded from IHT if it is put into a settlement and, at that time, the settlor is not domiciled in the United Kingdom (section 48(3) IHTA 1984).

Under the draft proposals, section 48(3) IHTA 1984 is to be repealed and replaced with a wholly-new section 48ZA IHTA 1984. The effect of this section is that, if property is comprised in a settlement and situated outside the United Kingdom, its status as excluded property is dependent on the settlor's contemporaneous status as a long-term resident.

If the settlor died before 6 April 2025, the property will be excluded property if he was not domiciled in the UK when the property became comprised in the settlement. If the settlor dies after 5 April 2025, the property is only excluded if the settlor was not a LTR-individual immediately before his death. If, however, the settlor is still alive, the property is only excluded at any time that the settlor is not a long-term resident. Therefore, if a settlor is alive, the tax status of a trust is subject to change according to his movements and residence status in the United Kingdom. This is likely to create difficulties for many trustees and is almost certainly incompatible with the protections for settlements contained in some of the United Kingdom's treaties. Note different rules may apply if there is a qualifying interest in possession in the trust fund e.g. an interest in possession created before 22 March 2006 (see IHTA 1984 s49(1) & (1A)).

Article 11(2) of the UK-Netherlands treaty provides that:

> "The United Kingdom may impose tax by reference to property comprised in a

settlement unless at the time when the settlement was made the settlor was:

(a) domiciled in the Netherlands; and

(b) not a national of the United Kingdom who had been domiciled in the United Kingdom at any time within the immediately preceding ten years."

A similar provision can also be found in the UK's treaties with South Africa (article 5(2)) and the USA (article 5(4)).

Notably, this restriction is tested at the time when the settlement was made. There is no provision which allows for the settlement to be taxed later because the settlor has subsequently become connected to the United Kingdom (such as later becoming long-term resident). Suppose that an individual (Ms. X) is domiciled for the purposes of the treaty in the Netherlands on 6 April 2025 when she creates a new discretionary settlement. Assume that Ms. X is not a UK national and has never been domiciled (or deemed domiciled) in the United Kingdom. Even if Ms. X becomes long-term resident on that date (for example, because she has been resident in the UK for

more than 10 but fewer than 15 of the last 20 years), the settlement she has created will not be taxable in the United Kingdom.

Similarly, this exemption will protect settlements whose taxable status would otherwise be subject to change with the long-term residence status of the settlor. Suppose that Mr. Y has always been resident in South Africa. He creates a discretionary settlement in 2016. He later moves to the United Kingdom on 6 April 2025, where he remains. Under the proposed changes, the settlement would become taxable once Mr. Y becomes long-term resident on 6 April 2035 and the first 10-year charge would be imposed in 2036. However, the UK-South Africa treaty makes no provision for altering the tax status of a settlement. Therefore, the trust would retain its tax exemption under the treaty, even after Mr. Y becomes long-term resident.

In summary, the UK's treaty network appears to undermine the new section 48ZA trust regime entirely by fixing the taxable status of a trust at the time of its creation.

Possible changes to come

If this all sounds too good to be true, it might be. It is

hard to know what thought has been put into this by the government, but one must assume that this (particularly the on-going protection for trusts) cannot be the intended outcome. The treaties are making certain assumptions about the tax system that, from 6 April 2025, will no longer be true. What might the government do between now and then?

First, it is entirely possible that the government chooses to terminate some of the treaties unilaterally. This would be particularly unsurprising in relation to those countries which no longer impose an equivalent of IHT. In those cases, the treaty is providing a blanket exemption when its purpose is merely to prevent double-taxation. That outcome is difficult to justify, and it would not be surprising if the government decided that unilateral termination would be appropriate.

Secondly, it is possible that the government may come alive to the mismatch between the old language of the treaties referring to domicile and the new concept of long-term residence. This could also be addressed unilaterally by creating a new deemed domicile for the purposes of IHT treaties. It could be a single line of legislation that provides that an

individual is to be treated as domiciled for the purposes of an arrangement given effect by section 158 IHTA if that individual is long-term resident in the UK. This would at least bring all of the new treaties into line with the domestic law from 6 April 2025 and it is somewhat surprising that this was not already included in the draft legislation.

Thirdly, it is plausible that the government may seek to renegotiate the existing treaties. This is less likely than taking some form of unilateral action, but it must be recognised that three of the current treaties have been amended in the past. This would also provide an opportunity to amend the tax treatment of settlements under the treaties so as to align them with the new regime.

Finally, we may see increasing use of treaty overrides in future IHT legislation. For example, Schedule A1 IHTA 1984 treats certain assets as taxable if their value is attributable to UK residential property or loans which are used to purchase UK residential property. Paragraph 7 of that Schedule specifically provides that nothing in any double tax treaty should be read as preventing a person from being liable for any amount of IHT under paragraphs 1–5 of the

Schedule, unless the property is taxed in that other country. It is possible, although it seems unlikely, that a wider override may be introduced to accompany section 48ZA IHTA 1984 and prevent settlements with living settlors from benefitting from an otherwise generous treaty protection.

Conclusion

One can only conclude that the impact of IHT treaties does not appear to have been sufficient thought. As presently drafted, the legislation which was announced on 30 October 2024 appears entirely inconsistent with the UK's treaty network. Perhaps someone thought that the number of treaties was so small that it was unlikely to be of significant impact.

However, as explained above, those treaties could have a major effect on an individual's IHT liability and, in the right circumstances, afford a large amount of protection for the fortunate individual. In particular, the protections for settlements will be particularly important if a settlor becomes long-term resident in the United Kingdom.

Given the potential benefits on offer, one must assume that the government will take some action to address what could easily be perceived as 'loopholes'

under the new regime. Advisers will want to exercise caution before promising the clients the world based on the IHT treaty network. Nevertheless, for the right individual, treaty protection deserves serious consideration as one adjusts to the new system.

TRUSTS WITHOUT BORDERS: UK TRUSTS AND FOREIGN AUSTRALIAN BENEFICIARIES

Lachlan J S Molesworth

More British expats live in Australia than any other foreign jurisdiction: around 1.2 million UK citizens currently live Down Under, coming in well ahead of the USA and Canada at second and third place with 720 thousand and 530 thousand respectively.

It is hardly surprising therefore the prevalence of tax issues that arise involving UK trusts with Australian beneficiaries. The interplay of the UK and Australian rules governing the taxation of trusts and their beneficiaries is a minefield seemingly intended to trip up even the most assiduous tax adviser. Without careful planning in establishing UK trusts involving individuals with an Australian connection, punitive tax consequences can arise.

This article looks to the essential considerations in establishing and managing UK trusts with potential Australian beneficiaries and Australian residency issues.

Tax residency of beneficiaries

The starting consideration in establishing or managing a UK trust with a potential foreign Australian beneficiary is the application of the respective tax residency rules to individual beneficiaries. This is important as it has a bearing on the tax impost applying to distributions of both income and capital of the trust in both the UK and Australia.

Broadly, a beneficiary that is a UK tax resident and UK domiciled is liable to UK tax on their worldwide income. If the trustee of the trust is not a UK resident, the UK beneficiary is taxed only on UK sourced income and UK capital gains within the non-resident capital gains tax regime, although section 86 and 87 of the Taxation of Chargeable Gains Act 1992 can attribute the capital gains of non-resident trustees to a UK settlor or beneficiary in certain circumstances.

Under the UK rules, whether a beneficiary is a UK resident is determined by the Statutory Residence Test found in Schedule 45 of the Finance Act 2013, and includes the automatic overseas resident and UK resident tests; and the UK sufficient ties test. This includes the well-known 183 days test most commonly relied on to determine individual UK tax residence.

By comparison, the Australian residency test is found in section 6(a) of the Income Tax Assessment Act 1936, and provides that a resident of Australia means:

(a) a person, other than a company, who resides in Australia and includes a person:

(i) whose domicile is in Australia, unless the Commissioner is satisfied that the person's permanent place of abode is outside Australia;

(ii) who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that the person's usual place of abode is outside Australia and that the person does not intend to take up residence in Australia; or

(iii) who is:

(A) a member of the superannuation scheme established by deed under the Superannuation Act 1990; or

(B) an eligible employee for the purposes of the Superannuation Act 1976; or

(C) the spouse, or a child under 16, of a person covered by sub-subparagraph (A) or (B); …

Australian residents are taxed on their worldwide income, unless they fit within the definition of a temporary resident.

A temporary resident is defined in section 995-1 of the Income Tax Assessment Act 1997 as an individual who (a) holds a temporary visa granted under the Migration Act 1958; and (b) is not an Australian resident within the meaning of the Social Security Act 1991; and (c) whose spouse is not an Australian resident within the meaning of the Social Security Act 1991.

Where an individual meets the tax residency test of both the UK and Australia, Article 4 of the 2003 Australia-UK Double Taxation Convention determines residency and therefore which country has taxing rights over the individual's income and capital gains. That article generally operates to deem an individual a resident of the country where they have a permanent home; or if they have a permanent home in both States, or in neither of them, then the individual shall be deemed to be a resident only of the State with which

the individual's personal and economic relations are closer (or has their "centre of vital interests").

Tax residency of trusts

When establishing a trust with an Australian connection it is also essential to consider the tax residency of the trust itself.

Under UK law, sections 475 and 476 of the Income Tax Act 2007 broadly provide that a trust will be a UK resident if:

(a) all of the trustees are UK tax residents; or

(b) at least one trustee is UK tax resident and at least one trustee is non-UK tax resident; and

(i) the settlement arose as a consequence of the death of the settlor and the settlor was a UK tax resident or UK domiciled for UK tax purposes at the time of their death; or

(ii) the settlor was UK tax resident or UK domiciled at the time of the settlement.

By contrast, the Australian position is that a trust will be an Australian tax resident pursuant to section 95(2) of the Income Tax Assessment Act 1936 if:

(a) a trustee of the trust estate was a tax resident of Australia at any time during the year of income; or

(b) the central management and control of the trust estate was in Australia at any time during the income year.

Administratively the Australian Taxation Office has published guidance on how the Commissioner of Taxation applies the law that, for double taxation purposes, the residence of a trust is determined by reference to a person who is a trustee as if the trust is an entity, not by reference to the trustee in their own capacity: see TR 2005/14.

If a trust meets the definitions of a resident under both UK and Australian law, the 2003 Australia-UK Double Taxation Convention is again consulted which broadly determines the question of residency based on where the "place of effective management is situated" (Art 4(4)). The issue of trust dual-residency under a UK double taxation agreement was examined in *HM Revenue and Customs v Smallwood & Anor* [2010] EWCA Civ 778; [2010] STC 2045. The court confirmed that under Article 4 of the UK/Mauritius double taxation agreement a trust that is a dual tax resident is

deemed resident in the jurisdiction where its effective management and control is located and discussed the relevant factors that inform the meaning of that term. The wording of Article 4 in the UK/Mauritius agreement is the same as that in the equivalent article in the 2003 Australia-UK Double Taxation Convention, making the case relevant precedent for determining the residency of trusts in the UK-Australia context.

Taxation of Australian resident beneficiaries

Turning to the taxation of UK trust income and capital distributed to beneficiaries that meet the Australian residency tests, the relevant provisions are found in sections 97 and 99B of the Income Tax Assessment Act 1936 which operate to tax beneficiaries on trust receipts.

Under section 97, income to which a beneficiary is "presently entitled" during an Australian income tax year is included in their assessable income for that year. The term "presently entitled" is a statutory defined term that refers to situations where the trustee has allocated income to the beneficiary during the tax year, effectively making it available to them. In a UK trust context this is particularly relevant for interest in

possession trusts or trusts that fully distribute their income annually. In such cases, the beneficiary's share of the trust income is taxed in Australia at their personal marginal income tax rate.

Where trusts do not entitle beneficiaries to income in a particular year, and the trustee exercises the discretion to retain income or capital gains within the trust, section 97 does not apply, and the income of the trust is not attributed to the Australian beneficiary in that particular income year.

If income has been accumulated in the trust and is distributed to an Australian resident beneficiary at a later date, it falls outside the scope of section 97. Instead, such distributions are taxed under section 99B, which applies to previously retained income and capital gains. This provision ensures that any accumulated trust income or gains distributed to an Australian tax resident beneficiary are included in their taxable income for the year of receipt.

Under section 99B, any amounts received by, or applied for the benefit of, an Australian tax resident beneficiary during the Australian tax year must be included in the beneficiary's taxable income for that year. However, this amount can be reduced in two

limited circumstances: (1) if the distribution comes from the corpus of the trust, which refers to the original settled capital; or (2) if the amounts have already been subject to tax in Australia.

Importantly, distributions received by an Australian resident beneficiary are taxable under section 99B(1) if the individual has been an Australian tax resident (but are not a temporary resident) at any point during the tax year.

In practice, distributions from UK discretionary trusts to Australian beneficiaries are often taxed in Australia under section 99B. If a trust distribution is received in an income year when the individual becomes an Australian resident, it will typically be taxed at the beneficiary's marginal tax rate unless the temporary resident exemption applies.

Although Australian tax law provides a 50 percent capital gains tax discount for individual taxpayers on capital gains if the relevant asset disposed of was held for at least 12 months and the taxpayer was an Australian resident during the ownership period, the concession does not apply to capital gains derived from non-Australian property that is distributed by a non-Australian trust. This can be quite punitive in tax

outcome. If a UK trust sells a capital asset, such as a share or an equitable instrument, and distributes the proceeds to an Australian beneficiary, the gains in the UK will be taxed under the CGT regime at 20 percent (after deducting the annual exemption); and then will be subject to tax in the Australian beneficiary's hands at their marginal tax rate of up to 47 percent, without any capital gains tax concessions being available.

However, if the UK capital gains tax liability arises in the hands of the beneficiary such that both UK and Australian tax is payable *by the beneficiary*, double tax relief may be available in Australia as a foreign income tax offset to mitigate double taxation. That is the 20 percent tax in the UK may be available to offset Australian tax at the relevant marginal rate (up to 47 percent) on the distribution of the capital gain. Nevertheless, the overall gain is still ultimately subject to a total tax impost applying at the taxpayer's highest marginal tax rate in Australia.

UK trusts ceasing to be UK resident

It is worth briefly touching on the possible (serious) consequence of a UK trust ceasing to be a UK resident – for instance because its trustee becomes an Australian resident resulting in the trust assuming

Australian residence.

UK capital gains tax arises under section 80 of the Taxation of Chargeable Gains Act 1992 when a UK-resident trust ceases to maintain its UK tax residency. This event triggers a deemed disposal of all the trust's assets at their market value as of the start of the UK tax year in which the residency change occurs. Needless to say, this can be a serious tax matter.

Several additional provisions of UK tax law may also become relevant. Sections 720 and 731 of the Income Tax Act 2007 (dealing with the transfer of assets aboard) may impose tax if a beneficiary remains UK tax resident and does not utilise the remittance basis. However, these rules do not apply if the trust's settlor is already taxed on the trust's income under section 624 of the Income Tax (Trading and Other Income) Act 2005.

A charge under section 731 of Income Tax Act 2007 (dealing with benefits charges) may also arise when a UK settlor, excluded from the trust, benefits from a transfer of assets abroad. This charge applies to non-transferors and beneficiaries of non-UK resident trusts who receive benefits or capital payments from the trustees. Additionally, a benefit charge under section

732 of Income Tax Act 2007 applies if a relevant transfer occurs, a UK tax-resident individual receives a benefit during the tax year, the benefit is provided from assets transferred; and the amount is not otherwise taxable under sections 720, 727, or 731 of Income Tax Act 2007, or sections 643A, 643J, or 643L of Income Tax (Trading and Other Income) Act 2005.

This benefit charge is calculated based on the lesser of the benefit received or the related income, with section 733 of Income Tax Act 2007 providing the formula for calculation. If the benefit exceeds the relevant income for the year, the excess is carried forward and taxed in future years when additional income arises. Unlike the section 720 charge, benefits taxed under these provisions are treated as non-savings income, disqualifying them from the personal savings allowance and dividend allowance.

Conclusion and planning considerations

Navigating the taxation of UK trusts with Australian beneficiaries or trustees that become Australian is a complex endeavour, fraught with the potential for unexpected liabilities to arise. Differences in tax systems and residency rules necessitate careful planning to avoid costly surprises. Obtaining advice in

both jurisdictions is often essential, particularly before potential beneficiaries (or trustees) locate to Australia and ideally before the start of the Australian tax year on 1 July; and also before the realisation of UK capital assets. Additionally, claiming double taxation relief requires appropriate documentation to substantiate items such as initial trust corpus, sources of income and quantum of taxes paid. Disparities between UK and Australian tax liabilities can be substantial and taxpayers generally require documentary evidence to avail themselves of available exemptions or concessions. By taking proactive steps and seeking tailored advice, it is possible to mitigate risks and ensure compliance with both overlapping tax legal frameworks.