

SECTION 739: ISOLATING THE CAUSAL RELATIONSHIPS

Stephen Brandon¹

- 1 Despite all the light and heat generated by and as a result of the decision of the Court of Appeal in *Willoughby*, many aspects of ICTA 1988 section 739 have still received insufficient critical attention. In particular, it is well worth considering:
 - 1.1 Who, after the last *Vestey*² case, is a "transferor" and how might assets be spirited abroad without there being a transferor?
 - 1.2 What, after the last *Vestey* case, is the nature and quantum of income in respect of which a transferor might be taxable — how misguided is the common view of *de Walden*?³
 - 1.3 What is the nature and extent of the causal relationships which must exist before there can be a liability under section 739?

Given the requirements of space, I deal here with the last question (although each is dealt with fully in my forthcoming book *The Taxation of Non-UK Resident Companies and Their Shareholders*⁴). In a nutshell, the requirements of the section are often not fully understood by those advising on it and, particularly in complex cases, I believe that a far greater quantum of liability is sometimes agreed by advisers than is strictly due. This may be due, partly, to a failure to check if the necessary "connections" exist between the transfer the "entitlement" (whether to a capital sum or of "power to enjoy"), and the income which became payable.

¹ Stephen Brandon, Barrister, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ Tel: (0171) 242 2744 Fax: (0171) 831 8095.

² *Vestey v IRC* [1980] STC 10.

³ 30 TC 345.

⁴ Key Haven Publications PLC, to be published Spring 1996.

The First Causal Relationship

- 2 The first set of causal relationships is set out in section 739 subsection (1). The sections exists:

"... for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets *by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable* to persons resident or domiciled outside the United Kingdom."

Thus, in a simple case with no associated operations, the income must become payable by virtue or in consequence of the transfer. If, despite the transfer, it remains payable to the same person it had been payable to before it, the section does not apply. Thus, if the individual purchases shares in A Ltd (a Jersey company) with the purchase price paid to the Jersey ordinarily resident vendor, the company's income is not subject to the section⁵.

- 3 The vast majority of situations where section 739 is in point will, however, concern associated operations. The definition of "associated operations" is therefore worth noting. Section 742 subsection (1) provides that:

"... an associated operation" means, in relation to any transfer, *an operation* of any kind *effected* by any person in *relation to any of the assets transferred or any assets representing*, whether directly or indirectly, *any of the assets transferred*, or to the income arising from any such assets, or to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets."

- 4 Thus, the income must become payable by virtue or in consequence of the transfer (with or without associated operations). If it only becomes payable by virtue of an operation other than the transfer, that operation must have been effected in relation to (in a wide sense) the original transfer.
- 5 The third set of causal relationships occurs when one comes to the "entitlement" of the transferor (whether of a power to enjoy or to a capital sum). These relationships differ according to the type of entitlement. As regards capital sums, the position is set out in section 739 subsection (3):

⁵ See Robert Venables QC, OTPR Vol. 2, Issue 2, p 43.

"Where, before or after any such transfer, such an individual receives or is entitled to receive any capital sum *the payment of which is in any way connected with the transfer or any associated operation, any income which, by virtue or in consequence of the transfer, either alone or in conjunction with associated operations,* has become the income of a person resident or domiciled outside the United Kingdom shall, ... be deemed to be income of that individual..."

The position as regards "power to enjoy" is set out in subsection (2):

"Where *by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has ... power to enjoy,* whether forthwith or in the future, any income of a person resident or domiciled outside the United Kingdom which ..."

- 6 Again, the role of the associated operation is likely to prove crucial: in many cases it will be because of operations other than the transfer itself that the "entitlement" will arise. It is thus first necessary to consider the width of "associated operations". Since such "operations" have effect by reference to a particular transfer, it will always be necessary to ascertain if an associated operation might *itself* be a transfer of assets. This will depend, primarily, on whether there is a "transferor". While the meaning of that term strays beyond the confines of this article, it may generally be assumed that operations effected by foreign companies owned by offshore trustees should not normally have a UK ordinarily resident individual as the "transferor" (cf. *that* operation).

The Associated Operation and the Representation of Assets

- 7 Generally, the "associated operation" will concern either the original transfer of assets, or (in the wide sense set out in section 742(1)), property representing the assets so transferred. The "associated" operation is not, of course, the asset itself, or property representing it, or its income. It is the event (such as a sale, exchange or gift) which *relates* to the asset, or property representing it, or its income. Thus, if the asset originally transferred is exchanged by the foreign transferee for shares in Newco the "associated operation" is the exchange, and the Newco shares "represent" the originally transferred property after the exchange.
- 8 Ascertaining if an "operation" is "associated" with a transfer will usually depend on the answers to two questions:

- 8.1 What is the property which, at the relevant times, "represents" the transferred assets, income or accumulations of income from it?
- 8.2 Does the operation *relate* to the originally transferred asset or, if appropriate, an asset representing it, its income or accumulations of its income?
- 9 In a simple case, establishing "representation" will not cause problems. If shares are transferred to offshore trustees and income arises which is used to purchase other shares, the original shares, and the additional shares, will both be potentially subject to associated operations. This must be so when it is income from an asset which is applied in, say, purchasing another asset. If rented land is transferred to an offshore company, in exchange for an issue of its shares to offshore trustees, those shares will "represent" the land. Thus, any later transfer of those shares would be an associated operation. This is clear from *MacDonald* 23 TC 449, where MacNaughton J held that the Bema stock (exchanged for the originally transferred stock) represented that stock and thus it was the Bema stock which was subject to an associated operation: see page 459.
- 10 In a complex situation, however, there may be several transfers of assets, followed by further transfers of those assets, purchases of underlying assets and transfers of shares in companies to which the originally transferred assets have themselves been transferred. The question then is, which assets "represent" the ones originally transferred? (I am, now, leaving aside applications of income in the acquisition of further assets.) I believe at least the following possible answers present themselves:
 - 10.1 Let us assume the originally transferred assets are shares in company A. Where shares in company A are then transferred to Company B, for an issue of shares in Company B (say, to foreign trustees), the shares in Company B "represent" the originally transferred assets. Similarly, if the shares in Company B are sold for (say) £1,000,000, the £1,000,000 "represents" those shares; or
 - 10.2 Alternatively, it is still the shares in Company A, not those in Company B, nor the £1,000,000, which are the subject of the section so that no other assets "represent" the originally transferred assets; or
 - 10.3 Let us further assume that the shares in Company A, exchanged for shares in Company B, are themselves exchanged by Company B, for shares in Company C. Further, that the shares in Company C are sold for £1,000,000 which is used to purchase shares in Company D. A further possibility is that the shares in Company A, Company B, Company C and Company D are all within the subsection; or

- 10.4 On the facts of answer 3, a further possibility is that the Revenue has a right of election to *choose* which asset or assets represent the originally transferred assets;
- 10.5 In the event of underlying assets being acquired:
- 10.5.1 If an underlying asset is bought, say, by Company A, that cannot represent the shares in Company A so transferred;
- 10.5.2 If, however, cash is transferred, say, to trustees, the assets it purchases will represent the originally transferred asset (the cash); or
- 10.6 The answers to all these questions set out above are not correct, or not wholly correct, since it is a question of fact at each stage which asset actually "represents" the originally transferred assets.
- 11 At first glance answer 1 seems correct, and may well be right in many circumstances. There will, however, be exceptions. If the shares in Company B were gifted on, say, to an associated entity, they must surely still be within the section as the originally transferred assets. This should also be the case if, instead of being sold for £1,000,000, the shares in Company B were sold for a totally illusory consideration of £1. That £1 could not be the only asset both "representing" those shares and within the subsection. This points to the background facts to the sale or transfer being relevant.
- 12 As regards answer 4, it is only necessary to say that, after the decision of the House of Lords in the last *Vestey* case, the idea that there is a Revenue "election" inherent in section 739, but not expressly set out in that section, is bizarre. I cannot conceive of a court accepting that such extra-statutory power exists.
- 13 It seems to me that the only wholly correct (subject to one point below) answer is answer 6. While, *prima facie*, 1 seems correct, the circumstances may show otherwise. It must, therefore, be a question of fact at each stage which asset truly "represents" what was transferred. This is consistent with the approach of MacNaughton J in *MacDonald*. Again, with answer 5, the question will be one of fact, but it is difficult to see how an underlying asset (purchased by Company A) could "represent" the originally transferred asset.
- 14 This leaves one further question: Can a Court hold that both the asset transferred and property coming to represent it (*not* income from it), as a question of fact, are *both* within the section? An obvious instance could be where our shares in Company A were transferred to trustees who formed Company B and exchanged the shares in Company A for them.

Neither asset has left the "structure". While the question of whether an asset "represents" another is one of fact, whether both are capable of being within the section is properly one of law. It is possible that a Court might hold that both *can* be within the section.

Causal Relationship And The Associated Operation: The Second Causal Relationship

- 15 Having established which asset it is relevant to consider at a particular point, that is, whether it is the originally transferred asset or one representing it on the one hand, or accumulations of income, or an asset representing that income, on the other, I turn to the second branch of the definition of "associated operation", that is, the requisite "relationship" test.
- 16 As I have noted, an "associated operation" is an "operation" concerning property. Assuming that we now know what the asset is, we must apply the "relationship" test, which is that the operation must be "in relation to" the asset. Here, there are two possible *scenarios*. First, the operation may itself be a transfer of the asset in question (that is, the originally transferred asset or ones "representing" it or its income). In that case, while the question is one of fact, one would expect the "relationship" to be virtually axiomatic. Secondly, where the operation does not consist of a transfer of that asset, it is then a straightforward question of fact whether, on all the evidence, the "relationship" exists.
- 17 The case most directly concerned with what is an "associated operation", and which offers most guidance, is *Fynn* 37 TC 629. The case is important because what is an associated operation is a question of fact. Whereas, in many authorities, the courts merely hold that the Commissioners hearing the case *could* properly have found, as a question of fact, that operations were associated, in *Fynn*, the then Upjohn J overturned the decision of the Commissioners, and held, as a matter of law, that, on the facts of the case, they were not entitled to find that the operation complained of was "associated" with the tainted transfer.
- 18 In *Fynn*, the taxpayer sold certain investments to a company (Crescent) incorporated in Eire. The purchase price was left outstanding. A year later, the investments were converted into an issue of shares to the taxpayer, which shares he settled in favour of his children. Subsequently, Crescent borrowed funds to purchase investments in the market, and secured this borrowing by a charge on the securities sold to it by the taxpayer. Three years later, the taxpayer lent £12,000 to Crescent by way of interest-free loan, but there was no evidence that this was for the purpose of removing the charge on the assets originally transferred. There

was no dispute that, on the making of the interest-free loan, the taxpayer became entitled to a capital sum (its repayment) and, therefore, while such loan was outstanding, he was *prima facie* within the terms of the then s.412(2) ICTA 1952.

19 Upjohn J had to consider first, whether, within what is now section 739, subsection (3), the entitlement to that capital sum was in any way connected with the transfer or the associated operation (the charging of the transferred assets). He held, at page 636, that "connected" must be given its ordinary meaning, and held that there was no such "connection".

20 The Inland Revenue then argued that the loan itself was an associated operation, in which case, of course, it must necessarily have had a "connection" with the capital sum entitlement, being the right to repayment of that same loan. His lordship, however, rejected the argument that the loan was an associated operation with the transfer (the sale of the shares) or the (admitted) associated operation (the charging of the shares sold). He stated, at page 637:

"Now is it [an associated operation] in relation to any of the transferred assets? And it is said that it is because the loan reduced the overdraft ... Speaking for myself, I cannot see that the making of the unsecured loan can be said in any ordinary use of language to have any relation to the previously created charge. It was an unsecured loan made, on the facts of the case, not for the purpose of reducing the overdraft because the bank were pressing for payment nor for the purpose of freeing the assets from the charge. It was made to the company as an interest-free unsecured loan and the company could have used it in any way that it pleased. I cannot see that it bears any relation to any of the transferred assets or to the charge. It seems to me that the Special Commissioners have misdirected themselves as to the true meaning of the section."

21 This is important, because it shows that, even if a later act results in funds being transferred to the foreign entity which received the originally transferred asset, even if it is a loan free of interest, and even if the two "operations" are effected by the same transferor, the later operation is not *necessarily* an operation "associated" with the previous transfer. (It must, of course, be kept in mind that such a transfer might, in itself, constitute a "transfer of assets" by virtue of which some income becomes payable to that entity.) The Inland Revenue had argued that the loan "related" to the transferred assets, through the charge over the transferred securities, because, as a question of fact, ultimately the overdraft was reduced. As, however, it was not made *for the purpose of* reducing the overdraft, and of releasing the charge, the loan did not relate to those securities and thus

was not an operation associated with the original transfer of those securities.

How Reliable is *Fynn*?

- 22 The binding nature of an authority concerns the principles it lays down, not its facts: one need only refer to the decision of the Court of Appeal in *Le Rififi*⁶ to see this in its naked glory. Anyone relying on the precise facts of *Fynn* as a guide may be disappointed, but the principle remains: there must be a *real* connection between these two matters.
- 23 The fact that operations take the form of subsequent transfers to entities *themselves* established with transfers within the section, including subsequent transfers made by way of interest-free loan, does not *in itself* mean that they comprise operations associated with the original transfers. The words "in relation to" in section 742 subsection (1) show that the later step must have a genuine *connection* with it. It is not enough that it merely "affects" it, or that it follows on, chronologically, from it. Where, therefore, the operation does not take the form of a gift, sale or exchange of assets directly or indirectly representing those received in the original transfer (or of accumulations of income) there must be some other real factual relationship before the subsequent step can be an associated operation.
- 24 To summarise matters so far, the income which it is sought to tax must become payable by virtue or in consequence of the transfer (and associated operations). Secondly, in all but the simplest cases, the link between the transfer and the income, on the one hand, and the "entitlement" on the other, will depend on steps being shown to be associated operations. That requires it to be shown that such steps display the requisite "relationship" to the transfer.

The Third Causal Relationship

- 25 This brings me to the third relationship which must be shown. Once the associated operations have been established, do they (or, of course, the original transfer) have the requisite "connection" to the entitlement? The requirement differs slightly, depending upon which head of "entitlement" is being considered. In either case, the causal relationship is likely to be with the last associated operation, that is, the last active step. The

⁶ *Customs & Excise Commissioners v Le Rififi* [1995] STC 103.

relationship to be established is not, of course, merely with the property subjected to the last operation.

- 26 I turn first to the requisite "connection" with a capital sum entitlement. Under section 739 subsection (3), tax is leviable where the transferor receives "a capital sum" (as defined in subsection (4)), the payment of which is in any way *connected* with any transfer or any associated operation. The test can be summarised in the following way:

An individual (including a spouse) is taxable on the income of a foreign entity where:

- (1) the income has become payable to it by virtue or in consequence of the transfer, by him, either alone or in conjunction with associated operations (the First and Second Causal Relationships); and
- (2) he has a capital sum entitlement, and the payment of the capital sum is connected with the transfer or *any* operation associated with it (the Second and Third Causal Relationships).

- 27 Thus, there must be a *transfer* (by him) and associated operations (by anyone), and first, by virtue or in consequence of that transfer (with any associated operations), the foreign entity receives income, and secondly, in connection with *that same* transfer, or *any* operations associated with it, he received, or was entitled to receive, the capital sum entitlement, whether before or after *that* transfer.⁷

- 28 I have already considered *Fynn* in connection with the meaning of "associated operation". Of equal importance is the other part of the *ratio* in that decision, dealing with the requisite "connection" between the transfer (or any such associated operation) and the capital sum entitlement, which was the primary *ratio*. The question was, was the later interest-free loan of £12,000 "in any way connected" with the original sale of investments to Crescent or the operation associated with it (the charging of those investments by Crescent to secure further borrowings)?

- 29 Upjohn J held, at page 636, that "connected" must be given its ordinary meaning, and he went on:

⁷ It follows, of course, that the consideration of the Second Causal Relationship (what are the associated operations?) may produce two separate chains of operations, since we are looking at operations probably producing separate results: income and "entitlement".

"Every case must be dependent upon its facts, but I look to those facts and ask myself whether it can be said that the right to receive repayment of the sum of £12,000 is in any way connected with the original transfer or with the charging of the transferred assets by the company. It is said that it is so connected because the payment of the £12,000 reduced the overdraft secured on the transferred assets. Speaking for myself, I can only express my view in one sentence. I can see no connection whatever between the charge of transferred assets on the one hand and either the lending of the money or the right to receive payment on the other. They just do not seem to me to have any connection at all one with the other upon the facts of this case."

30 Again, the question is one of fact, and the Special Commissioners had found that there was indeed a connection between the transfer, the associated operation of charging the securities transferred and the making of the interest-free loan. Upjohn J therefore overturned that finding as being one which could not possibly be made on the evidence. The principle thus is that later steps, which "affect" the property originally transferred, cannot result in liability under section 739 subsection (3) unless there is a *real connection* between the tainted transfer and any such step.

31 As regards "power to enjoy", the causal relationship test differs, in that power to enjoy the income of the foreign entity has to arise:

"by virtue or in consequence of [the original transfer] either alone or in conjunction with associated operations ..."

It would seem very likely that a court would adopt the same approach as in *Fynn* in relation to subsection (2), that is to say, the question is one of fact on all the evidence, and, secondly, the power to enjoy must come about because of a real relationship between it and the original transfer, or an associated operation (again, likely to be the last active step), if appropriate. It is not correct to say that the test will necessarily be satisfied merely because the power to enjoy subsists in the income of the same entity to which an associated operation was made, or simply because there is a chronological link. Thus, for example, if an alleged "operation" associated with the transfer was not in any way causally linked with the power to enjoy, it could not be relevant. This must follow from the use of the words "by virtue or in consequence of".

Conclusion

32 The upshot of all this is that, particularly in complex cases involving a number of post-original transaction operations and different entities, it is vital that it is first established whether and where the three requisite causal relationships exist. All too often it has been assumed that because X made the original transfers to Offshore Co. and subsequently was entitled to a capital sum from it, or an associated company (often because a loan has carelessly been made from or to one of the entities), he is taxable on all the underlying income in the structure. Leaving aside the issue of *quantum*, he may not be taxable at all! The plan in a complex case must be:

- (1) Isolate each step.
- (2) Determine which are the "transfers" themselves (i.e., where there is a "transferor").
- (3) Isolate the income which has become payable to any entity.
- (4) Isolate any "entitlement" in any entity.
- (5) Determine which operations show the requisite causal relationship to each income stream. Ascertain if any are operations which are ultimately associated with a section 739 transfer.
- (6) Take that transfer and ascertain all operations which are associated with it. Ascertain if any show the necessary relationship to an entitlement.
- (7) If so, determine what income became payable by virtue or in consequence of that transfer and its associated operations.
- (8) Next comes the quantum of charge. Not all **that** income (ascertained in 7) may be taxable, but that is beyond the scope of this article.

33 Only the income, ascertained in 7 above, is subject to the section. Practitioners who follow this method in relation to complex transactions, happening over a number of years, are in for many hours of enthralling entertainment: but they might save a client millions!