THE INCOME TAX "SETTLEMENT" PROVISIONS POST *JONES V GARNETT*[1]

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1 Overview of The Income Tax "Settlement" Provisions

1.1 The Purpose of the Provisions

The Income Tax Settlement Provisions (to which I shall refer in this Article simply as "the Provisions") are now contained in Income Tax (Trading and Other Income) Act 2005 Part 5 Chapter 5, "Settlements: Amounts Treated As Income of Settlor", being sections 619 to 648. The Provisions use the term "settlement" in a very special sense,[3] which is both wider and narrower than (a) the classic meaning of "settlement" and (b) "trust". In this Article, I shall henceforth use the term "settlement" in inverted commas to indicate that I mean a settlement within the meaning of the Provisions. I have not, however, altered quotations from legislation or judicial authorities.

Lord Hoffmann succinctly described the Provisions in *Jones v. Garnett* [2007] UKHL 35:

> "1. Chapter IA[4] of Part XV of the Income and Corporation Taxes Act 1988 contains anti-avoidance provisions intended in principle to prevent people from reducing their tax liabilities by settlements, gifts or similar

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3 See 8.

4 In force from 1995/96 to 2004/05.

arrangements which transfer income or income-producing assets to their minor children or under which they or their spouses retained an interest.

"These provisions go back many years."

Where the Provisions bite, they in most cases do so by deeming income which "arises under a settlement" to be for income tax purposes the income of the settlor (and of the settlor alone). In certain cases, however, they deem the settlor to be in receipt of notional income, the quantum of which is calculated by reference to, *inter alia*, income which has arisen to the "trustees" of the "settlement".

1.2 Legitimacy of the Provisions

The effect of the Provisions goes way beyond any legitimate purpose which they might serve. They can catch innocent, not to say saintly, taxpayers. The most notorious example is *Vandervell v Commissioners of Inland Revenue* (1966) 43 TC 519 in which the House of Lords held that Mr Vandervell was taxable on income which he had genuinely given away to a bona fide charity (the Royal College of Surgeons).

In a fair and civilised society, the Provisions would bite only on income which the settlor could enjoy, directly or indirectly,[5] and not on income which he had effectively alienated.[6]

1.3 History of the Provisions

The Provisions originated in 1922 and were originally relatively modest. Over the years they were tightened up, the most intense tightening of the screw being effected by Finance Act 1965, passed under the Old Labour government of Harold Wilson. They were consolidated in Taxes Act 1970 Part XVI and then in Income and Corporation Tax Act 1988 Part XV. The latter provisions were substantially re-cast by Finance Act 1995. While this was presented merely as a re-write, the House of Lords held in the rogue case of *West v Trennery* [2005] UKHL 5 [2005] STC 214 that even the so-called "consequential amendments" had effected unexpected and substantial changes in the law.

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5 This is the, much more logical, basis of the "power to enjoy" charge under the Transfer of Assets Abroad Provisions, now contained in Income Tax Act 2007 Part 13 Chapter 2.

6 There would, of course, be scope for argument as to when precisely he could enjoy income indirectly and in particular whether the use of trust funds so as to confer a benefit on a third party, such as the settlor's spouse or child, whom the settlor was under a legal obligation to maintain, might be regarded as an indirect benefit to himself.

1.4 Interpretation of the Case Law

The Provisions have spawned a wealth of case law and have been considered by the House of Lords on many occasions, most recently in *Jones v. Garnett* [2007] UKHL 35. When reading the case law, it is important to bear in mind that the statute law on which they are based has been constantly evolving.

It is also vital to remember that judicial attitudes to tax planning have varied from time to time. As with other complex areas of tax law, the judicial decisions are not always easy to reconcile with each other. As a general rule, a more recent decision is probably a better guide than an older decision as to which way the Courts would be likely to jump tomorrow.[7] Hence, *Jones v Garnett* is particularly important. However, it is also important to work out not only *how* the judges decided a particular case but *why* they did so. That will give the best indication of how they are likely to decide a different case. *Jones v Garnett* is an excellent illustration of this.[8]

1.5 Present Importance of the Provisions

The Provisions are, of course, important in determining when income arising under a "settlement" is deemed to be that of the settlor for income tax purposes.

The unusual definition of "settlement" which they contain, and which has been the subject of many reported cases, the latest of which is *Jones v. Garnett* [2007] UKHL 35, is imported into other contexts. The most important by far is the capital gains tax Offshore Beneficiary Provisions, contained in Taxation of Chargeable Gains Act 1992 sections 87 to 98A.

The definition of "settlement" contained in the Provisions is also important in other contexts, such as determining when persons are "connected persons" for the purposes of income tax,[9] capital gains tax[10] or inheritance tax.[11] There are a number of other miscellaneous contexts where this definition is imported, for

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7 Or in five years time, when today's planning is likely to be tested before them.

8 In their eagerness to ensure that the exemption for outright gifts between spouses applied, they may well have taken a very narrow view of what the "settlement" in that case consisted of. It is possible that they might not take so narrow a view in a subsequent case where the exemption was not in point.

9 Income Tax Act 2007 sections 993 and 994.

10 Taxation of Chargeable Gains Act 1992 section 286.

11 Inheritance Tax Act 1984 section 270.

example, Taxes Management Act 1970 section 27 (Revenue information powers.)

1.6 Tax Avoidance Motive

Although the Provisions are often described as anti-avoidance provisions,[12] I had always assumed that there was no need whatsoever, in order for them to come into play, for there to be any tax avoidance motive or even a tax planning motive. Contrast the Transfer of Assets Abroad Provisions and Income Tax Act 2007, which contain, in sections 736–742, a motive defence.

Lord Walker in *Jones v. Garnett* [2007] UKHL 35 at paragraph 48 has, however, raised a question mark over whether my assumption was correct. Lord Walker just might be suggesting that the presence of a tax avoidance motive may be relevant in determining whether there is a "settlement" in the first place. In my opinion, it would be unwise to read too much into this statement. Certainly, where there is clearly a "settlement" (because there is bounty), I do not read his speech as indicating that it is in any way necessary to discern a tax avoidance motive. He *might* be suggesting that where it is not so clear that there is a "settlement", then a tax avoidance motive is a factor which may be taken into account. Yet given that their Lordships endorsed the view that the hallmark of a "settlement" is "bounty" or, in language that they preferred, gratuitous intent,[13] I would not myself so read his remarks.

1.7 Interaction with Other Provisions

As often happens with tax legislation, the Provisions were enacted and extended virtually in isolation and with little regard to other anti-avoidance provisions. They overlap and sit sometimes uneasily with, for example, Income Tax Act 2007 Part 13 (Tax Avoidance) Chapter 2 Transfer of Assets Abroad, Chapter 3 Transactions in Land and Chapter 4 Sales of Occupation Income.

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12 See the speech of Lord Hoffmann in *Jones* v *Garnett* paragraph 1 and passim.

13 See 8.2.

2 The Main Provisions

2.1 Summary

2.1.1 Summary of the Main Charging Provisions and Their Effect

Income Tax Act 2007 lists the main charging provisions:

> "619 Charge to tax under Chapter 5
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> (1) Income tax is charged on-
>
> (a) income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest),
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> (b) income which is treated as income of a settlor as a result of section 629 (income paid[14] to relevant children of settlor),
>
> (c) capital sums which are treated as income of a settlor as a result of section 633 (capital sums paid to settlor by trustees of settlement), and
>
> (d) capital sums which are treated as income of a settlor as a result of section 641 (capital sums paid to settlor by body connected with settlement).

In very broad, untechnical, terms,[15] the Provisions deem income arising under a settlement to be that of the settlor if:

- he or his spouse / civil partner can benefit from the settled property in any way
- a minor unmarried child of the settlor in fact benefits from the settled property
- the trustees directly or indirectly make loans to, or confer gratuitous benefits on, the settlor or his spouse / civil partner, but only to the extent

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14 This is misleading, as section 629 also applies to income which is not so paid but is deemed by section 631 to be so paid. See 2A.4.4.

15 This summary sacrifices accuracy to brevity in order that the reader may have a very rough guide to how the Provisions operate.

that there is undistributed income

However, the technique used is different, depending on the precise charging provision. Section 624 catches income as it arises and thus deems it to be income of the settlor (and of the settlor alone). That section is very easy to operate. Any income tax paid by the trustees is treated as paid by them in a representative capacity on behalf of the settlor.[16] If the trustees pay the income in the exercise of a discretion to a beneficiary other than the settlor, it is in my view[17] deemed not to be the income of that beneficiary.

Section 629 purports to apply the same principle. However, that gives rise to difficulties where income which arises under a settlement is paid to, or for the benefit of, a relevant child of the settlor in a year of assessment other than that in which it arises. See 4.3. The difficulty is compounded if section 631 (Retained and accumulated income) applies where the trustees retain or accumulate income arising under the settlement and a payment is subsequently made in connection with the settlement to, or for the benefit of, a child of the settlor who is unmarried or not in a civil partnership, so that the payment is treated for the purposes of section 629(1) as a payment of income. See further 4.4.

In the case of the charge under sections 633 and 641, it is not the case that the income which is deemed to be that of the settlor is the same income as that which arose under the settlement. It is theoretically different income. However, there is

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16 The *rate* at which the trustees are liable to tax is controversial. The Revenue appear to take the view that that will depend on the real trusts so that, for example, if a beneficiary is entitled for an interest in possession, the trustees will be liable at only the normal rate whereas if there is a discretionary trust of income, they will be liable at the (higher) trust rate or trust dividend rate. Before the amendment of Income and Corporation Taxes Act 1988 section 686 and Income Tax Act 2007 section 480 by Finance Act 2006 section 89 that view would have been untenable (as the Revenue accepted). As a result of the amendment, income is no longer in terms not caught by the section in question simply because it is, in the words of the unamended Income and Corporation Taxes Act 1988 section 686(2)(b) "before being distributed treated for any of the purposes of the Income Tax Acts as the income of a settlor". However, in my view, the omission of those words makes no difference. For if income which arises under the settlement is treated by Income Tax (Trading and other Income) Act 2005 section 624 "for income tax purposes as the income of the settlor and of the settlor alone", then it cannot be income which "arises to the trustees of a settlement" within Income Tax Act 2007 section 479(1)(1); nor can it be "accumulated or discretionary income" within the meaning of section 480(1). While it is true that section 464(8) provides: "Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received", so that the trustees cannot claim not to be liable at all in a representative capacity, that does not mean that they are liable at the trust rate or the trust dividend rate.

17 The view of the Revenue is not altogether both clear and coherent. It may be that in practice, there is no difference between our views.

a relationship between income arising under the settlement and the income the settlor is deemed to receive in that:

(a) there is a cap on the settlor's liability which takes into account, *inter alia*, the quantum of income arising under the settlement and

(b) in taxing the settlor, he obtains a credit for income tax paid by the trustees.

Section 621 (Income charged) provides:

> "Tax is charged under this Chapter on all income and capital sums to which section 619(1) applies."

Section 622 (Person liable) provides: "The person liable for any tax charged under this Chapter is the settlor." The trustees of the settlement may, however, still be liable to tax in a representative capacity. See section 646(8), which provides:

> "Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received."[18]

2.1.2 Provisions Relevant in Taxing the Settlor

2.1.2.1 Fiscal Alchemy?

Section 619(2) provides:

> "(2) For the purposes of Chapter 2 of Part 2 of ITA 2007 (rates at which income tax is charged), where income of another person is treated as income of the settlor and is charged to tax under subsection (1)(a) or (b) above, it shall be charged in accordance with whichever provisions of the Income Tax Acts would have been applied in charging it if it had arisen directly to the settlor."

The former rule was that income which was deemed by the Provisions to arise to a settlor was, by a species of fiscal alchemy, converted into Schedule D Case VI income. The present rule is more logical.

Where it is section 624 which applies to deem income arising under a settlement to

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18 It is a moot point whether, as the Revenue seem to consider, trustees can ever be liable at the (higher) trust rate or dividend trust rate in respect of income which arises to them which is deemed to be the settlor's or whether, as I consider, they cannot. See the second previous footnote to this section 2.1.1.

be that of the settlor as it arises, there is no difficulty in applying this section. In the context of the section 629 charge, however, the position is again not so clear, especially where it is brought into play by section 631. See 4.4.

Why does section 619(2) in terms apply only to the situations described in section 619(1)(a) and (b) and not (c) and (d)? That is because in the situations described in (c) and (d), the settlor is deemed to receive non-existent income. Hence, section 619(2) would not be appropriate. To that extent, therefore, the Provisions can still work a limited form of fiscal alchemy by converting one type of income into another type of income.

2.1.2.2 Income Treated As Highest Part of Settlor's Total Income

Section 619A (Income treated as highest part of settlor's total income) provides:

> "(1) This section applies to income which is treated as income of a settlor as a result of section 624 (income where settlor retains an interest) or 629 (income paid to unmarried minor children of settlor).
>
> "(2) The income is treated as the highest part of the settlor's total income for the purposes of section 619 (so far as it relates to the income).
>
> "(3) See section 1012 of ITA 2007 (relationship between highest part rules) for the relationship between-
>
> > (a) the rule in subsection (2), and
> >
> > (b) other rules requiring particular income to be treated as the highest part of a person's total income."

Section 619A is important in determining the quantum of tax the settlor can recover from the trustees or other persons: see section 646, cited at 9. It ensures, broadly speaking, that it is the difference between the amount of tax he would have paid if there had been no income arising under the settlement and the amount of tax he in fact has to pay in consequence of section 624 and section 629.

Section 619A has no application where sections 633 and 641 apply. That is because it is not the case that the income of another person is in terms deemed to be the income of the settlor and so he is given no right of indemnity against any other person. Instead, he is given a credit for tax paid by the trustees.[19]

2.1.2.3 Deductions and Reliefs Available to the Settlor

Section 623 (Calculation of income) provides:

> "For the purpose of calculating liability to tax under this Chapter (but for no other purpose), a settlor shall be allowed the same deductions and reliefs as if any amount treated under this Chapter as income of the settlor had actually been received by the settlor."

I am myself unable to see what this section adds to the Chapter. However, it does no harm. It is curiously worded in two respects. First, it is difficult to see what scope the words in brackets have or could have. The fact that they are in brackets may indicate that they are inserted for the avoidance of doubt. Second, it is difficult to see how actual receipt of income by the settlor could be relevant. What matters is whether or not income belongs to him, not whether or not he receives it.

3 Settlor Retains an Interest

3.1 The Basic Rules

Income Tax (Trading and other Income) Act 2005 section 624 (Income where settlor retains an interest) provides:

> "(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises-
>
> (a) during the life of the settlor, and
>
> (b) from property in which the settlor has an interest.

In order for income to be caught by the section, it must be "income which arises under a settlement".

Thus, one must first determine whether there is a "settlement": see 8. That is no simple matter.

19 See Income Tax (Trading and other Income) Act 2005 section 640, set out at 5.9.

Secondly, one must determine whether any income arises under that settlement: see 11. Again, that is no simple matter. It depends in part in ascertaining of what the "settlement" consists.

Thirdly the income must arise "from property in which the settlor has an interest": see 3.3. This, too, is quite a complicated concept. Under earlier law, all income arising under a settlement was caught unless the settlor could show that it arose "from property of which the settlor has divested himself absolutely by the settlement". See, for example, Income and Corporation Taxes Act 1988 section 683(1)(d) (which was repealed by Finance Act 1995 with effect from April 6th 1995). Now, however, the onus is effectively on the Revenue to show that the income does arise "from property in which the settlor has an interest". If it does not arise from "property" at all, then the present section cannot apply. If it does indeed arise from "property" but the settlor does not have an interest in that property, it does not matter whether the property is property of which the settlor has divested himself absolutely by the settlement.

3.2 Trustee Expenses

Income Tax (Trading and other Income) Act 2005 section 624(2) provides:

> "(1A) If the settlement is a trust, expenses of the trustees are not to be used to reduce the income of the settlor."

In my view, the subsection has no effect whatsoever.

3.3 Property in which the Settlor has an Interest

3.3.1 The Statute

Income Tax (Trading and other Income) Act 2005 section 625 (Settlor's retained interest) provides:

> "(1) A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related property-
>
> (a) is payable to the settlor or the settlor's spouse or civil partner,
>
> (b) is applicable for the benefit of the settlor or the settlor's spouse or civil partner, or

(c) will, or may, become so payable or applicable."

There are several minor exceptions to this rule, discussed below at 3.3.5.

I shall refer compendiously in this Article to the property in question and any property which in relation to it is "related property" as **"Relevant Property"**.

3.3.2 "Property"

I have not been able to find any relevant definition of "property". It is a Protean word, the meaning of which can differ according to the context. In the context of a taxing statute, however, which talks of an "interest" in property, one would expect it to bear a technical meaning. Thus, to the man in the street, Whiteacre is a piece of property. Yet to the lawyer, "property" would convey the meaning of a proprietary interest. Thus, a freehold reversion in Whiteacre would be a different property from the leasehold interest to which it is subject. The distinction is very clearly made in the context of the Inheritance Tax Gifts with Reservation of Benefit Provisions. See *Ingram v IRC* [1999] STC 37.

The decision of the House of Lords in *Lord Vestey's Executor v Commissioners of Inland Revenue* (1949) 31 TC 1 is most instructive in this respect. Lord Simonds described what the settlors had done.

> "*I do not doubt that the two deeds of 29th December and 30th December, 1921 …. were parts of a single design. By the former document, which I call "the lease", the Vestey brothers demised or agreed to procure the demise to the Union Cold Storage Co., Ltd., a company of their own creation, of properties, cattle lands, freezing works and other assets situate in divers parts of the world. The term was for 21 years from 10th April, 1921, determinable by either party upon six months' notice. The rent was £960,000 per annum reducible in certain events, and it was payable not to the lessors but to three gentlemen residing in Paris whom I will call "the Paris trustees". ….*
>
> *"By the second document, which I call "the deed of trust", the Vestey brothers as settlors declared the trusts upon which the Paris trustees were to hold the rent payable under the lease as and when received by them. These trusts are of a curiously elaborate character, but in general outline they follow the usual form of a family trust in conformity with the premise that the settlement is made in consideration of the natural love and affection of the settlors for the beneficiaries. It is sufficient at this stage to say that no beneficial interest in the ordinary sense of that expression is reserved to the settlors …*"

He then set out the argument for the Crown:

> "*The first question arises under [Finance Act 1938 section 38(2)] and the argument for the Crown is as follows. The lease and the deed of trust … together form the settlement for the purpose of the Section. They point to the wide definition of "settlement" in Section 41(4) (b): "The expression 'settlement' includes any disposition, trust, covenant, agreement or arrangement". The whole thing, they say, is an arrangement; therefore it is a settlement. Next, they say, the lease is part of the arrangement, therefore it is "a provision of the settlement*".

Lord Simonds does not deny any of this. But he then went on to consider the precise way in which it was claimed the settlement provisions applied:

> "*Therefore the power, vested in lessors or lessee, to determine the lease is a power to determine a provision of the settlement. And finally, when this has been done, the settlors will or may become beneficially entitled to the whole or part of the property then comprised in the settlement.*[20]
>
> *"This view … is not in my view tenable in face of the decision of this House in Chamberlain's case, 25 TC 317. True it is, that as was there observed, each case must be judged on its own facts, but I think that the principle of that decision clearly is that the steps which are taken towards a settlement are not to be confused with the settlement itself and (what is all-important to the present case) that the property comprised in the settlement is that property alone in respect of which some beneficial interest is created. Applying this principle, which, apart from authority that constrains me, commends itself to my reason, I find that the only property comprised in the settlement is the rent payable under the lease to the Paris trustees with the investments and accumulations of income arising from it*."

He thus rejected the argument that any person had "power to determine the settlement or any provision thereof in such manner that the settlors will become entitled to the property comprised in the settlement or any part of it". The property comprised in the settlement, i.e. the lease would clearly have ceased to exist.

Even more interestingly in the context of the Provisions in their present state, he went on to consider Finance Act 1938 section 38(3) and (4):

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20 RV note: this particular charging provision was repealed by Finance Act 1995.

> "*Here the question is whether [the settlor] had during any year of assessment "an interest in any income arising under or property comprised in a settlement". He must be deemed to have had such an interest "if any income or property which may at any time arise under or be comprised in that settlement is, or will or may become, payable to or applicable for the benefit of the settlor or the wife or husband of the settlor in any circumstances whatsoever". Here are very wide words. But … Counsel for the Crown do not, I think, suggest that Lord Vestey had any interest within the meaning of the Sub-section except that to which I now refer.*"[21]

Finance Act 1938 section 38(3) and (4) were in terms very similar to the Provisions in their present form.

Lords Simonds' speech strongly suggests that if a settlor were nowadays to grant to the trustees of a classic settlement created by him a beneficial lease, determinable by the settlor on short notice, then, provided he had no interest in the lease or the income arising under it, he would not have any interest in the property comprised in the settlement simply because of his retained interest in the freehold.

It will be apprehended that this principle can be applied to types of property other than leases and reversions. It is even arguable that it applies to equitable interests under classic settlements. The strategy would be first to create a classic settlement which was not a "settlement" within the meaning of the Provisions and then to gift an interest arising under that classic settlement to the trustees of a "settlement" within the meaning of the Provisions.

If my view is correct, it means that an enormous amount can be achieved by careful planning and drafting.

3.3.3 "Payable or Applicable"

In practice, the crucial test is likely to be whether Relevant Property may become payable or applicable for the settlor or the settlor's spouse or civil partner so that section 625(1)(c) is satisfied.

What do the words "payable or applicable" mean? If a settlor makes an outright gift of property to another it is always possible that the other may in future choose to give the settlor part of the property or income from it. The words "may become payable or applicable for the benefit of" the settlor cannot be so wide as to include that possibility, as otherwise there would be no property in which the

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21 The alleged interest was the power of the settlor to direct investment. That argument was rejected by the House of Lords.

settlor did not have an interest. The key to my mind is that the expression is not "may be paid or applied" but "may become payable or applicable". The words "payable or applicable" suggest something more than the possibility of payment or application. The concept of possibility is already present in the word "may". Rather they suggest that someone, for example a trustee or a director, may have a power or discretion to pay or apply.

If the view I have set out in the previous paragraph is correct, it would follow that there could be circumstances where Relevant Property was in fact paid or applied for the benefit of the settlor without ever having been "payable or applicable" for his benefit. A simple case would be where a father has given his son most of his wealth and then unexpectedly falls on hard times. If the son chooses to maintain his father out of the father's donation, that will not in my view bring section 624 into play.

I am fortified in my conclusion in that Taxation of Chargeable Gains Act 1992 section 77(2) draws the distinction very clearly. If my view on the meaning of the words "payable to or applicable for the benefit of" were not correct, section 77(2)(b) would be redundant.

3.3.4 What is Related Property?

Section 625(5) provides:

> (5) In this section "related property", in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income from it."

For a modern re-write, this is succinctly expressed, even to the point of ambiguity. In fairness to the drafter of the Income Tax (Trading and other Income) Act 2005, this is possibly because, given that the corresponding provision it replaced was also ambiguous, he was deliberately trying to preserve the ambiguity, taking the view that it was not part of his task to bring clarity to the law. It is possible to read the subsection in many ways.[22]

The difficulties arise, I suspect, because the drafter was trying to deal in, for once, too few words with several distinct concepts, namely:

> (a) income derived, directly or indirectly from the original property

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22 Compare the decision of the House of Lords on corresponding (but not identical) capital gains tax provisions in *West v Trennery* [2003] EWHC 676 (Ch) [2003] STC 580.

(b) property representing the original property

(c) property representing income derived directly or indirectly from the original property.

3.3.5 Property in Which the Settlor Does Not Have an Interest

Income Tax (Trading and other Income) Act 2005 section 625 contains a number of minor exceptions to the basic rule as to when property is property in which the settlor has an interest.

The drafting of section 625(2) and (2A) is to some extent defective, from the Revenue's point of view, and clearly allows some scope for sophisticated planning.

Subsection (4) provides:

> "In subsection (1) "the settlor's spouse or civil partner" does not include-
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> (a) a spouse or civil partner from whom the settlor is separated under an order of a court or a separation agreement,
>
> (b) a spouse or civil partner from whom the settlor is separated where the separation is likely to be permanent,
>
> (c) the widow or widower or surviving civil partner of the settlor, or
>
> (d) a person to whom the settlor is not married but may later marry or a person of whom the settlor is not a civil partner but of whom the settlor may later be a civil partner.

Subsection 4(c) endorses the interpretation of the House of Lords of earlier provisions in *Lord Vestey's Executor v Commissioners of Inland Revenue* (1949) 31 TC 1.

Subsection 4(d) might well have been implied by the courts, even if not expressly contained. Most settlements are drafted on the basis that it does not exist, as the settlor and *any* spouse[23] of his are excluded from benefit. However, if the settlor

23 Nowadays, "spouse" would be defined as including a civil partner.

is currently unmarried,[24] that is not strictly necessary, if one is concerned merely with avoiding the application of the Provisions.

3.4 Exception for Outright Gifts Between Spouses or Civil Partners

Income Tax (Trading and other Income) Act 2005 section 626 (Exception for outright gifts between spouses or civil partners) provides:

> "(1) The rule in section 624(1) does not apply in respect of an outright gift-
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> (a) of property from which income arises,
>
> (b) made by one spouse to the other or one civil partner to the other, and
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> (c) meeting conditions A and B.
>
> (2) Condition A is that the gift carries a right to the whole of the income.
>
> (3) Condition B is that the property is not wholly or substantially a right to income.
>
> (4) A gift is not an outright gift for the purposes of this section if-
>
> (a) it is subject to conditions, or
>
> (b) there are any circumstances in which the property, or any related property-
>
> (i) is payable to the giver,
>
> (ii) is applicable for the benefit of the giver, or
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> (iii) will, or may become, so payable or applicable.
>
> (5) "Related property" has the same meaning in this section as in section 625.

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24 Again nowadays, references to marriage and related terms would normally be defined to include a civil partnership and related terms.

I do not see subsections (2) and (4) as problematic. They do no more than set out what would have been implied by "outright gift" in subsection (1).

The difficulty of interpretation arises from subsection (3): when does property which is otherwise given outright constitute "wholly or substantially a right to income"?

An obvious example of property which consists wholly of a right to income is an annuity or an interest in possession in a trust fund consisting of investments.

What of a life interest in settled property which confers on the spouse the right to occupy the property during her life? While the benefit conferred is of an income nature, it is not in my view a "right to income".

Suppose that the spouse has the right, at her election, either to occupy property to or rent it and receive the proceeds? While this is not so clear, it is again in my view not a "right to income".

The decided cases have been concerned with shares in limited liability companies. *Jones v Garnett* was such a case. Mr Jones allowed his wife to subscribe at par for one of the two issued shares in a newly acquired company. This was treated by the House of Lords as in the circumstances the equivalent of his transferring the share to her for its nominal value. Thus, there was a "transfer of assets". The House of Lords also decided that, whether or not he conferred any benefit on her at that stage, he nevertheless had the requisite element of "bounty" so that the transaction amounted to a settlement. Mr Jones then provided services to the company at an undervalue, thus enabling the company to make profits which were distributed, in part, to Mrs Jones by way of dividend. It seems to have been accepted by both parties to the litigation that, on the basis that Mr Jones had made a settlement when Mrs Jones acquired her one share, the income arising under that settlement was the dividends paid on the share. The Revenue appears – I am not altogether able to understand quite why – not to have argued that Mr Jones entered into any other settlement (e.g. in providing services at an undervalue) or that there was any income arising, particularly the income which arose to the company, which could be characterised as income arising under the settlement. Thus, the only point remaining to be decided was whether Mr Jones could bring himself within the section 626 exception.

It seems to me that, on this point at least, given the Revenue's position, the decision of the House of Lords that his settlement was within section 626 was impeccable, not to say inevitable.

As Lord Hoffmann remarked, at paragraph 26:

> "Thus a gratuitous transfer of quoted shares from husband to wife, although obviously a settlement for the purposes of [Income and Corporation Taxes Act 1988] section 660A, is excluded from the section and the income is taxed as the wife's income".

He then went on to consider the three points of distinction the Revenue tried to make in *Jones v Garnett*:

> "27. Does this apply equally to the transfer to Mrs Jones of her share in Arctic Systems Ltd, from which her dividend income arose? The Revenue say no for three reasons. First, they say there was no gift of the share by Mr Jones to Mrs Jones. He never owned the share which she took. It belonged to the formation agents and Mrs Jones bought it from them for £1.
>
> 28. In my opinion this narrow analysis of the transaction would be inconsistent with the reasoning by which I think that the transfer comes within section 660A in the first place. It was Mr Jones's consent to the transfer of a share with expectations of dividend to Mrs Jones for £1 which gave the transfer the "element of bounty" for the purposes of section 660A. By the same token, I think it made the transfer a "gift" for the purposes of subsection (6). And there is no dispute that, if it was a gift, it was outright."

One's only difficult is in seeing how the Revenue thought they could get away with this argument.

It is interesting that Lord Neuberger interpreted the Revenue's argument rather differently:

> "91. The Revenue's first argument was that Mrs Jones paid £1 for her share, and that therefore there was no "outright gift", merely a purchase at an undervalue. In my opinion, that point will not do, and it was not strongly pressed by Mr Furness. A purchase at an undervalue involves, as a matter of ordinary language, an element of gift. There was a "settlement" in the present case because there was an "arrangement", and there was an "arrangement" because, for the reasons already explained, there was a substantial element of "bounty" when Mrs Jones acquired her share. It seems to me very difficult to contend that there was a substantial element of bounty without there having been a gift, albeit that the value of the

> gift must be diminished by £1 to take into account what Mrs Jones paid for her share. To describe the element of gift in the arrangement as substantial is, in my judgment, a positive understatement in the light of the virtually nominal payment of £1. Once one accepts that there is a gift, it seems to me that the word "outright" is of no assistance in connection with this point."

Again, one wonders why the Revenue adduced this argument when they apparently failed to adduce much more telling arguments.

Lord Hoffmann continued:

> "29. The second argument is that the transfer of the share was not the whole of the arrangement, which included the provision of services by Mr Jones, the dividend policy and so forth. Again, I think that would be inconsistent with the argument by which the revenue have, in my opinion, succeeded on the first point. The transfer of the share was in my opinion the essence of the arrangement. The expectation of other future events gave that transfer the necessary element of bounty but the events themselves did not form part of the arrangement."

This point very much depended on the, to my mind, rather odd way, in which the Revenue were represented as having argued their case in the Lords.

The third point was the only point of general interest:

> "30. Finally, the revenue say that the property given, i.e. the share, was "wholly or substantially a right to income". It is true that the value in the share arose from the expectation that it would generate income. But that is true of many shares, even in quoted companies. The share was not wholly or even substantially a right to income. It was an ordinary share conferring a right to vote, to participate in the distribution of assets on a winding up, to block a special resolution, to complain under section 459 of the Companies Act 1985. These are all rights over and above the right to income. The ordinary share is different from the preference shares in Young v Pearce (1996) 70 TC 331, which conferred nothing except the right to 30% of the net profits before distribution of any other dividend and repayment on winding up of the nominal amount subscribed for their shares. Those shares were substantially a right to share in the income of the company.

> "31. In my opinion, this arrangement falls within the exception in section 660A(6)."

It is interesting to speculate whether the answer would have been the same if the Revenue had argued either or both that (a) the settlement on which they relied was not the transfer of the share and that (b) the income arising under the settlement was 50% of the income arising to the company. For reasons best known to them, they chose not to.

Lord Neuberger added remarks which make it even easier for the taxpayer to bring himself within the exception:

> "It may be the case that the main, possibly the sole, reason Mrs Jones acquired a share in the company was to enable her to receive a substantial dividend each year, but section 660A(6)(b) is concerned with the objective character of the property involved, not the subjective reason for which it was acquired."

Lord Walker's dicta, if anything, go even further in favour of the taxpayer:

> "56. I have found the condition in [Income and Corporation Taxes Act 1988] section 660A(6) (b) "the property given is wholly or substantially a right to income" rather more difficult. The property given was an ordinary share—in fact, half the issued ordinary share capital of Arctic—and so it was certainly not "wholly . . . a right to income." If the plan worked it could be expected to produce a healthy dividend income but not to attain any significant market value (it would hardly be marketable at all on the basis that Arctic was a going concern, since Mr Jones could not be expected to continue to work under an arrangement which channelled nearly half his earnings to a stranger). But at the outset there was at least the possibility that Arctic would build up a reserve of undistributed income, and the agreed statement of facts and issues suggests that this occurred (because of IR35) during 2000-1 and 2001-2. The decision of Sir John Vinelott in Young v Pearce (1990) 70 TC 331 is distinguishable because of the very unusual rights conferred on the preference shares (under new articles of association which were part of the arrangement) in that case."

One suspects that their Lordships felt just as strongly as did the Court of Appeal that Parliament should have taken the principle of independent taxation – of not regarding a wife as an appendage of her husband – to its logical conclusion and treated a settlor as not having an interest under a settlement simply because his wife could benefit.[25] They preferred to do so, however, not by narrowing down the definition of "settlement" but by given a generous interpretation of the section 626 exemption.

The decision in *Young v Pearce* is well summarised in the speech of Lord Hope:

> "36. In *Young v Pearce* (1996) 70 TC 331 the share capital was divided into two classes: 50 preference shares of £1 each, of which 25 were allotted at par to the wives of each of the two taxpayers, and 50 ordinary shares of £1 each which divided equally between the taxpayers themselves. The preference shareholders were entitled to 30% of the net profits for any year in which the profits of the company were to be distributed, the balance of the distributed profits to be paid to the ordinary shareholders. The articles provided that in the event of liquidation the preference shareholders were to be entitled to repayment of the sums subscribed for their shares, but no more. They were entitled to attend and to speak but not to vote at general meetings of the company.
>
> "37. In the light of those facts Sir John Vinelott said, at p 346, that the property given in the form of the preference shares was wholly or substantially a right to income. This was because the preference shares entitled the holders to a preferential dividend if the directors decided that the whole or part of the profits arising in any given year were to be distributed and because, apart from that right to income, the only rights were to repayment of the nominal sum paid on the allotment of the shares and the right to attend but not to vote at general meetings of the company. It would not have been accurate to say that the rights attached to the preference shares were wholly a right to income, because of the right to repayment of capital. But there is no doubt that, on the facts of that case, the rights were "substantially" a right to income. That is because there was no right under the articles, after repayment of capital, to participate in any other assets of the company.
>
> "38. The position would have been different if the shares in question in

25 It is interesting that for inheritance tax purposes, spouses are by and large treated as different persons, even though there exists the concept of "related property" and inter-spouse transfers benefit from favourable treatment, so that, for example, a gift by a husband under which his wife takes a benefit is not on that account a gift with reservation of benefit. The various capital gains tax rules are more akin to the income tax rules.

> *Young v Pearce* had been ordinary shares. The rights which an ordinary shareholder enjoys are not confined wholly, or even substantially, to a right to income. The residue of the assets of the company belongs to the ordinary shareholders, after the rights of creditors and of any preference shareholders have been satisfied. So property given which consists of ordinary shares in a company will always attract the exception in section 660A(6)."

Thus, it should be easy in practice for spouses (and civil partners) to ensure that their arrangement fall the *Jones v Garnett* rather than the *Young v Pearce* side of the line. The only caveat is that, given that the Revenue are notoriously bad losers, they intend to seek to change the law – we know not yet how – as from April 2008.

3.5 Matrimonial Disputes

Income Tax (Trading and other Income) Act 2005 section 627 (Exceptions for certain types of income) provides

> "(1) The rule in section 624(1) does not apply to income which-
>
> (a) arises under a settlement made by one party to a marriage or civil partnership by way of provision for the other-
>
> (i) after the dissolution or annulment of the marriage or civil partnership, or
>
> (ii) while they are separated under an order of a court, or under a separation agreement, or where the separation is likely to be permanent, and
>
> (b) is payable to, or applicable for the benefit of, the other party."

This section will often not be needed where matrimonial difficulties have arisen, in that there will be no "settlement", as there will be no bounty.

It is a moot point whether (i) and (ii) qualify (a) the time of making of the settlement or (b) the time at which the relevant provision is to take effect. If the latter, which would be the natural construction, then, oddly enough, even a settlement made on marriage under which the spouse is given an interest in possession, would not be caught by the Provisions if it made the appropriate provision.

3.6 Exception for Income Belonging to Charities

Income Tax (Trading and other Income) Act 2005 section 628 (Exception for gifts to charities) provides:

> "(1) The rule in section 624(1) does not apply to any qualifying income which arises under a UK settlement if-
>
> (a) it is given by the trustees to a charity in the tax year in which it arises, or
>
> (b) it is income to which a charity is entitled under the terms of the trust."

"Charity" is defined, by subsection (6) to include:

> (a) the Trustees of the National Heritage Memorial Fund,
>
> (b) the Historic Buildings and Monuments Commission for England, and
>
> (c) the National Endowment for Science, Technology and the Arts"

"UK settlement" is defined, by section 628(6), to mean a settlement the trustees of which are resident and ordinarily resident in the United Kingdom. It is difficult to see why the requirement that the trustees should be United Kingdom resident is imposed.

Who are the "trustees"? It is likely that they must be the trustees of a classic trust. See 9. While this narrower interpretation will normally work in favour of the taxpayer, in the context of this exception it can work in favour of the Revenue,

"Qualifying income" is defined by subsections (2) and (2A), which provide:

> "(2) In this section "qualifying income" means-
>
> (a) income which must be accumulated,
>
> (b) income which is payable at the discretion of the trustees or any other person, or
>
> (c) income which (before being distributed) is income of any person other than the trustees.

(2A) The cases covered by subsection (2)(b) include cases where the trustees have, or any other person has, any discretion over one or more of the following matters—

(a) whether, or the extent to which, the income is to be accumulated,

(b) the persons to whom the income is to be paid, and

(c) how much of the income is to be paid to any person."

The language of these subsections largely mirrors that of Income Tax Act 2007 section 480, which contains the definition of "accumulated or discretionary income" for the purpose of imposing the higher rate of charge to income tax on the income of trustees.

One clearly has to apply the test in subsection (2)(c) on the assumption that the Provisions do not apply.

The interpretation of section 628 is highly problematic. Where a payment to charity is desired but it is difficult to bring the payment within section 628, consideration should be given to making the payment to the settlor, if the trustees are so empowered, and allowing him, if he thinks fit, to make the payment to the charity and obtain a gift aid deduction for income tax purposes. This should not normally in my view constitute a fraud on the power of payment. National Insurance Contributions should be borne in mind.

See also section 627(2)(b) (gift aid payments), discussed in the next section.

3.7 Other Exceptions

Income Tax (Trading and other Income) Act 2005 section 627 (Exceptions for certain types of income) also provides

"(2) The rule in section 624(1) does not apply to income which consists of-

(a) annual payments made by an individual for commercial reasons in connection with the individual's trade, profession or vocation,

(b) qualifying donations for the purposes of Chapter 2 of Part 8 of ITA 2007 (gift aid), or

(c) a benefit under a relevant pension scheme."

It is difficult to see how (a) could be point as there would be no "settlement".

It should be recalled that the gift aid rules have their own strict provisions to ensure that a donation does not qualify for favourable tax treatment if the donor or a person connected with him receives in consequence of the gift a benefit which is not permitted.

4 Income Treated As Income of Settlor: Relevant Children

For these complicated provisions, which are beyond the scope of this Article, the reader is referred to my The Taxation of Trusts 2007 Chapter 22A.4

5 Capital Sums Treated As Income of Settlor: Trustees' Payments

For these complicated provisions, which are beyond the scope of this Article, the reader is referred to my The Taxation of Trusts 2007 Chapter 22A.5

6. Capital Sums Treated as Income of Settlor: Connected Bodies

For these complicated provisions, which are beyond the scope of this Article, the reader is referred to my The Taxation of Trusts 2007 Chapter 22A.6.

7 Capital Sums Legislation: A Critique

I have always been highly sceptical as to whether the capital sums legislation was justified. It was no doubt originally aimed at the simple situation where the settlor lent trustees money, probably interest-free, which the trustees then invested so as to produce an income. The income was then accumulated, the trustees paying the standard rate of tax only. Sums equal to the net annual income could then be paid to the settlor year by year in discharge of the trustees' loan. I do not myself see any mischief in this. The settlor has genuinely alienated the income. All that he gets back is the amount he has lent and does so as creditor, not as beneficiary.

The capital sums legislation is in any case particularly inept as this result can be achieved by rather more sophisticated strategies.

It is significant that the Revenue proposed abolishing the legislation, as from 6th April 1995. This, however, was part of a totally unacceptable package under which it was proposed that a settlor who made a beneficial loan to the trust should be taxed on non-existent income, even if there was no corresponding income arising under the settlement. The public outcry against this part of the package was so great that the Revenue was forced to back down. Perhaps in pique, it decided to leave us with the capital sums legislation.

Whatever may have been the position a decade ago, in my view, the capital sums legislation appears to me no longer to serve any useful purpose, as least as regards income which has arisen to the trustees of a United Kingdom resident trust, since what is now called "the trust rate" (and was, before Income Tax Act 2007 came into force, called "the rate applicable to trusts") was increased, as from April 6th 2004, so as to equal the top rate at which the income of individuals is charged to tax. In short, there is no longer any income tax advantage in not distributing income arising under such a settlement.

In the case of a non-UK resident trust, so far as I can discern, Income Tax Act 2007 sections 727–730 (Charge where capital sums received) perform the same function and more as does the capital sums legislation contained in the Provisions.

8 What is a "Settlement"?

8.1 The Statute

Crucial to the application of the Provisions is ascertaining that there exists a "settlement".

Income Tax (Trading and Other Income) Act 2005 section 620 (Meaning of "settlement" and "settlor") provides:

> "(1) In this Chapter-
>
> "settlement" includes any disposition, trust, covenant, agreement, arrangement or transfer of assets (except that it does not include a charitable loan arrangement) …"[26]

This definition presents an immediate difficulty of interpretation in that it confuses two distinct types of phenomenon. The word "settlement" is itself ambiguous, in that it may refer to an historic act of settling, as in "by a settlement dated April 1st

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26 For the meaning of "charitable loan arrangement", see 8.3.

2000" and to the ongoing state of affairs resulting from an historic act of settling, as in "the settlement of which I am currently a trustee was created on 1st April 2000". "Disposition", "covenant", "agreement" and "transfer of assets" refer to historic acts, "trust" refers to an ongoing state of affairs and "arrangement" can, like "settlement", refer to either. Is therefore a "settlement" an historic act or an ongoing state of affairs?

In some, probably most, contexts in the Provisions, the answer to this question is of no consequence. For example, the central section 624(1) catches certain income "which arises under a settlement". I cannot see that it matters whether this means income arising in consequence of an historic act of making a "settlement" or income which arises from an ongoing state of affairs which is a "settlement".

There are other contexts in which the word "settlement" is used ambiguously of which the most remarkable example is the Inheritance Tax legislation – remarkable because Finance Act 1975, which introduced Capital Transfer Tax, as Inheritance Tax was then known, was probably the best drafted United Kingdom tax statute ever. While "settlement" is given a definition, in section 43, which in terms refers to a disposition having certain consequences and thus relates to an historic act, the word is then clearly used on many occasions to refer not to that historic disposition but to the ongoing state of affairs created by it, usually a trust.

8.2 The Judicial Gloss: the Need for Bounty

8.2.1 The Need for Gratuitous Intent

Given that the definition of "settlement" is in terms impossibly wide, the Courts have not construed it literally but have imported a judicial gloss that for something to constitute a "settlement" there must be an element of what was traditionally referred to as "bounty". As Lord Hoffmann said in *Jones v Garnett*:

> "7. Not every transfer of property is a settlement for the purposes of section 660A. There has to be an "element of bounty" in the transaction. This old-fashioned phrase, apparently derived from the judgment of Plowman J in Commissioners of *Inland Revenue v Leiner* (1964) 41 TC 589, 596 and approved by the House of Lords in *Inland Revenue Commissioners v Plummer* [1980] AC 896, 913, conjuring up the image of Lady Bountiful in The Beaux' Stratagem, is perhaps not the happiest way of describing a provision for a spouse or minor children. A donation to a spouse or child is traditionally expressed in a deed to be "in consideration of natural love and affection" rather than the donor's bounty. It is nevertheless exactly the kind of thing at which the anti-avoidance

> provisions are aimed. In *Chinn v Hochstrasser* [1981] AC 533, 555 Lord Roskill cautioned against treating the word "bounty" as if it had been included in the statute.[27] It seems to me that the general effect of the cases is that, under the arrangement, the settlor must provide a benefit which would not have been provided in a transaction at arms' length."

Lord Neuberger agreed with Lord Hoffmann. He said, at paragraph 76,

> "76. The word "bounty" rings slightly uncomfortably, at least to my ears. It seems a somewhat outdated expression which smacks of condescension. However, in the light of the judicial decisions on these provisions, it seems to me that the law is now tolerably clear and sensible, and, particularly given the need for clarity and the room for difficulties in this area, it would be inappropriate to risk introducing uncertainty or new complications by redefining the principles, even if only linguistically."

I do not myself find the word "bounty" old-fashioned. Lady Hale preferred the expression "gratuitous transfer". There is no difference in meaning between "bounty", "liberality" or "gratuitous intent".

8.2.2 At What Stage is Bounty Required?

One question to which their Lordships in *Jones v Garnett* paid substantial attention was the point at which "bounty" was required.

The traditional view has been that unless the transfer (or other arrangement) relied on by the Revenue as constituting the "settlement" itself conferred a gratuitous benefit, then the mere fact that it was setting the scene for the possible conferring of a later gratuitous benefit was irrelevant. Cases such as *Crossland v Hawkins* [1961] Ch 537 would thus be distinguishable from *Jones v Garnett* on the ground that the arrangement included a binding contract by Mr Hawkins to serve for £50 per week the company, the shares in which were issued to the trustees of a settlement for the benefit of his children.[28] Similarly, cases like *Butler v Wildin* (1988) 61 TC 666, in which minor children of the alleged settlors had subscribed at par for shares in a newly formed company, were explicable on the basis that the

27 For Lord Roskill's (suspect) views, see 8.2.3.

28 *Inland Revenue Commissioners v Mills* [1974] STC 130 was another variant on this theme.

fathers had personally guaranteed the company's borrowings from the bank.[29]

Lord Hoffmann stated that one should take "a broad and realistic view of the matter": paragraph 11. He appeared to take the view that it was enough that when the share was issued to Mrs Jones, there were "merely … expectations that [Mr Jones] would work for the company at a salary to be fixed from time to time and that in practice the salary would be set at a low level." However, he argued, that, as the value of a share always depends upon expectations of future yield, such expectations would give the shares a far greater value than the nominal sum for which they were transferred. His speech is thus at this point ambiguous in that he might be suggesting that there was the conferring of gratuitous benefit at the time the share was issued. He does not explain, however, how that would mean that the share would have any other than a nominal value. Prima facie, anyone buying it would assume that once Mrs Jones was no longer the owner, Mr Jones would no longer choose to pump value into the company.[30]

Lord Hoffmann rejected, at paragraph 20, Sir Andrew Morritt C's distinguishing of *Crossland v Hawkins* on the ground that the arrangement included a binding contract by Mr Hawkins to serve the company for £50 a week: "In this case, there was no such contract. Mr and Mrs Jones agreed their salaries retrospectively from year to year on the advice of the accountant. But I do not think that this makes a difference. The Wildin brothers were not obliged to fund the development by the company. They could have stopped at any time. I agree with Park J, who said in this case (at [2005] STC 1667, 1709, para 39) that it would have made no difference if there had merely been expectations that Jack Hawkins would work for the company at a salary to be fixed from time to time and that in practice the salary would be set at a low level."

This would have utterly convincing if the Revenue had successfully argued that Mr Jones agreeing to render his services to the company at an undervalue was, although not contractually binding, part of the arrangement which constituted the "settlement". The first difficulty is that the Revenue did not argue that.[31] The

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29 Amazingly, although three of their Lordships in *Jones v Garnett* referred to this case, not one of them mentioned what was to my mind this crucial factor, which was at the heart of the reasoning of Vinelott J: "The risk that the development would not prove profitable and might result in loss was taken by the [alleged settlors]."

30 See below my comments on Lord Neuberger's speech.

31 See, for example, per Baroness Hale at paragraph 69: "But the Revenue has expressly eschewed that approach. It relies on the initial acquisition of the company's shares as the "settlement"." I have not been able to find any satisfactory explanation of why the Revenue eschewed such an approach, unless, possibly, they were deciding to "go for broke".

second difficulty is that, if they had, it seems to me they ought to have succeeded. Yet Lord Hoffmann was at pains, at paragraph 21, to reject the obviously sound argument that in *Butler v Wildin*, "the acquisition of the shares, the agreement with British Rail and the development of the land were all part of one arrangement." Why was that? Because if, in *Jones v Garnett* the settlement consisted of anything more than allowing Mrs Jones to subscribe for her share at par, then it would be clear that what is now Income Tax (Trading and other Income) Act 2005 section 626 would not have been in point, as the "settlement" would have been something other than "an outright gift … of property from which income arises". And he was quite understandably as determined as the rest of the Appellate Committee that his finishing point should be that Mr Jones would win on this point. Hence, the conclusion dictated the reasoning, rather than vice versa.

Lord Neuberger gave, to my mind, the most coherent, explanation of what he was deciding and why. He stated, at paragraph 79: "It seems to me clear that, when considering whether there was an "arrangement" within the meaning of the sections, i.e. an arrangement which involved an element of bounty, one should assess the position at the time that the alleged arrangement was made, but, in carrying out that exercise, one should not disregard what happened thereafter. In particular, if the parties intended an element of bounty to accrue, and that element of bounty does indeed eventuate, then, absent any other good reason to the contrary, there is indeed an "arrangement" within the meaning of section 660G (1)."

Had Lord Neuberger stopped there, the position would have been much clearer. Unfortunately, he then went off along similar lines to Lord Hoffmann, stating, at paragraph 87:

> "87. The fact that the company had no legally enforceable right to require Mr Jones to work for it, either at all or at a reduced level of pay, does not mean that that was not something that the company and its shareholders expected to happen, and which therefore gave the shares value. As Lord Hoffmann pointed out in argument, valuation of an asset, whether land, shares, intellectual property or anything else, is very often based, at least to some extent, on profits which may be hoped or expected to be realised, but to which the owner of the asset has no present legal right. In this case, it can be said that there is a curiosity in that the hope and expectation of profits accruing to the company were (and no doubt still are) limited to the extent that the two shares were owned by Mr and Mrs Jones. In other words, that Mrs Jones's share only had a substantial value at the date it was allotted to her as long as she was its owner and Mr Jones owned the other share. However,

> the notion that a particular piece of property has value (or has considerably enhanced value) only so long as it is owned by one particular person or class of person, because of some attribute which that person enjoys, or only so long as a particular state of affairs subsists, is conceptually unsurprising and not unfamiliar in practice.
>
> "88. The essential point here is that, in the light of reasonable expectations as to what Mr Jones would achieve in terms of winning contracts for the company and would be prepared to accept by way of remuneration (which expectations were in due course fully realised), the value in 1992 to Mrs Jones of her share was considerably greater than the £1 which she paid. In those circumstances, there was indeed an element of bounty involved in her acquisition of the share, and that bounty was provided through the expectation of what Mr Jones would do. The fact that the bounty primarily arose from an expectation of what he would do, rather than from what he had done, does not appear to me to be in point."

This addition was most unfortunate. Lord Neuberger, like Lord Hoffmann, was clearly thinking in terms of subjective value rather than, say, market value. Suppose Mrs Jones had died immediately after subscribing for her share and it had passed under her will to a non-exempt beneficiary. Could the Revenue have claimed inheritance tax from her estate on the basis that it had anything beyond a nominal value?

Lord Walker, who of all their Lordships had the greatest experience in these matters, merely agreed with Lords Hoffmann and Neuberger. He said, at paragraph 40: "I cannot usefully add to what my noble and learned friends say about "bounty".

Lord Hope did not express on independent view on this point, although he did agree with the other (male) Law Lords.

Baroness Hale understandably had serious reservations about all this. As she stated at paragraph 71:

> "71. Thus my reservations about the Revenue's case that this is a settlement at all are very similar to those of the Chancellor:[32] it only becomes a "settlement" within the meaning of section

32 In the Court of Appeal.

> 660A(1) because of expectations about later events which are too uncertain and fluid to be included as part of the initial arrangement."

She, however, was very much in a minority.

What then can one make of all this? How can one reconcile what their Lordships said with common sense and earlier authority?

I must confess that I was at first surprised by their apparently holding, without any apparent consciousness that they were in any way departing from a constant body of earlier authority, including the decision of their Lordships' House in *Plummer v IRC*, that a "settlement" could be effected without any gratuitous benefit being conferred on any one at that stage or, indeed, at any stage.[33]

On further reflection, however, it seems to me that there is no inconsistency or departure from earlier authority, but rather a refining of it. In my view there are two quite separate, albeit interrelated, points involved. The first is whether it is necessary to have an intention gratuitously to benefit a third party at the moment when what constitutes the alleged "settlement" is made. The second is whether the intention must be carried into effect *at that moment* (i.e. there must be what one might term actual bounty) or whether it is enough that the alleged "settlement" is an ingredient in a larger plan under which one intends to confer gratuitous benefit at a later stage (i.e. one must be effecting the "settlement" with bounteous intent).

The word "bounty" is ambiguous. It can mean

(a) a benefit actually conferred, as in "Queen Anne's Bounty" or

(b) an intention or disposition to benefit third parties.

I suggest that what is now tolerably clear from the decision in *Jones v Garnett* is that all that is needed for there to be a "settlement" is an intention at the time of making the transfer or arrangements in question to confer gratuitous benefit, whether presently or in future. Quite how firm that intention needs to be and how realistic the possibility of its realisation will need to be at the moment of creation of the settlement will need to be worked out by future case law. The questions of whether the estate of someone other than the settlor was immediately increased in value as a result of the making of the settlement is in my view immaterial.

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33 If no gratuitous benefit were ever in fact conferred, then in most, possibly all, cases, whether or not there was a "settlement" might well be purely academic in that no one's tax position would be altered.

8.2.3 Lord Roskill's Views

8.2.3.1 The Views

It is unfortunate that Lord Hoffmann in *Jones v Garnett* resurrected Lord Roskill's comments in the rum decision which he calls "*Chinn v Hochstrasser*" but which is often known as "*Chinn v Collins*".[34] It is firstly unfortunate in that Lord Roskill's remarks were made in the middle of a passage which lead to a conclusion which is flatly inconsistent with the *ratio decidendi* of *Jones v Garnett*. It is also unfortunate in that Lord Roskill's remarks were not entirely accurate, as has been established by later authority.

The full context of Lord Roskill's comments was:

> "On the authorities as they now stand it seems clear that if the particular transaction is a commercial transaction devoid of any element of what has been called "bounty" it is not within the section and the majority of your Lordships in Plummer's case accepted that the transaction there in question escaped as being a commercial transaction without the necessary element of "bounty". ... My Lords, I would venture to point out that the word "bounty" appears nowhere in the Statute. It is not a word of definition. It is a judicial gloss upon the Statute descriptive of those classes of cases which are caught by the section in contrast to those which are not. The courts must, I think, be extremely careful not to interpret this descriptive word too rigidly. I would recall some sapient observations of Frankfurter J. in *Tiller v Atlantic Coast Line Railroad Co.* (1943) 318 US 54, at p 68, "A phrase begins life as a literary expression; its felicity leads to its lazy repetition; and repetition soon establishes it as a legal formula, undiscriminatingly used to express different and sometimes contradictory ideas."
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> "What the cases have sought to do is to distinguish between those cases where the recipient has in return for that benefit which he has received accepted some obligation which he has to perform, either before receiving the benefit or at some stated time thereafter, and those cases where the recipient benefits without any assumption by him of any correlative obligation."

8.2.3.2 Critique

Lord Roskill's test, which requires one to identify a correlative obligation, may

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34 As, for example, in the report at 54 TC 311.

very well provide the right answer in most situations, but not, in my view, in all. In the case of a settlement which a man makes on his loyal and loving wife out of natural love and affection and as a reward for her loyalty and devotion, there will be no correlative obligation and a "settlement" whereas in the case of the purchase of an annuity for full consideration[35] there clearly will be a correlative obligation and thus no "settlement". Yet what of the settlement which a man makes on his wife who has betrayed and deserted him – who in former times would have been whipped at the Bridewell as an adulteress and sent packing without a penny – not because he wishes to benefit her or even feels he owes her anything but because the English courts compel him so to do in their eagerness to reward feckless drones who have breached their contract of marriage? There is no correlative obligation there but there is very clearly no bounty and so no "settlement".

What of the corporate employer which confers benefits on its employees to which they have no legal entitlement, for example, through an employee benefit trust? If its motive is simply to further its own interests by incentivising them, there is again no correlative obligation, yet no bounty and so no "settlement".

8.2.3.3 *Inland Revenue Commissioners v Levy*

The Revenue tried to rely on Lord Roskill's dicta in *Inland Revenue Commissioners v Levy* [1982] STC 442. Mr Levy had conferred a benefit on a wholly owned company by lending it money on terms which were intended to be advantageous to it. The Revenue argued that he had made a "settlement" and that income of the company was income arising under the "settlement". Nourse J convincingly rejected that contention. Although there was no correlative obligation, Mr Levy had acted purely in his own interests. He had no bountiful or gratuitous intent. Of course, viewed from a very narrow perspective, the company had obtained a net benefit – which it had been fully intended to obtain. Yet one no more looked at the matter from that narrow perspective than one would, in determining whether an employer's contribution to an employee benefit trust was bountiful, focus merely on the fact that the beneficiaries of the trust were getting – and were intended to get – something to which they had no legal entitlement.

8.2.3.4 The Actual Decision *Jones v Garnett*

I mentioned at 8 2.3.1 that it was particularly unfortunate that Lord Hoffmann in *Jones v Garnett* had resurrected Lord Roskill's comments in *Chinn v Hochstrasser*

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35 As in *Inland Revenue Commissioners v Plummer* [1980] AC 896. While that decision must now be considered in the light of *Moodie v Commissioners of Inland Revenue* [1993] STC 188, in which the House of Lords reached a different result in a similar factual situation by applying the *Ramsay* doctrine as it was then understood, *Plummer* is still authority for the proposition that in order for there to be a "settlement" there must be bounty.

/ *Chinn v Collins*. One of the reasons was that Lord Roskill's remarks were made in a passage which lead to a conclusion which is flatly inconsistent with the *ratio decidendi* of *Jones v Garnett*. The point arose in that case in the context of whether it could be said that the exercise of a power of appointment by the trustees of a settlement (in the Chancery sense of a trust) could itself constitute a "settlement".

Lord Roskill stated the point:

> "It was argued for the taxpayer that the settlor's "bounty" had been exhausted in 1960 when he created the settlement and that there was no exercise of "bounty" by the trustees as they possessed no beneficial interest in respect of which they could be bountiful. This was the view which appealed to the learned Lords Justices."[36]

His answer was:

> "Under this scheme there was an appointment without consideration. Anthony was among the objects of the 1960 settlement but before the power of appointment was exercised there was no absolute certainty – however strong the probability – that Anthony would receive any of the shares held by the trustees. In my judgment there was a very real "bounty" conferred when the trustees with the settlor's consent exercised the power of appointment in question in Anthony's favour. As Mr. Nicholls Q.C., for the Crown, put it, when the power of appointment was exercised a blank was filled in the original settlement which left blank how the final distribution of the trust's assets was to be made. That in my judgment was a clear act of "bounty"."

This conclusion – which astounded not only tax practitioners but every one in Lincoln's Inn[37] – is quite inconsistent with *Jones v Garnett*. Just as the House of Lords made it clear in that case that Mr Jones had made his "settlement" when he allowed his wife to subscribe for her share in the company and that what happened subsequently did not give rise to a fresh "settlement" but was simply the working out of the original "settlement", so, too, in *Chinn*, the only "settlement" was the classic settlement made by the settlor and the exercise by the trustees of that settlement of a power of appointment conferred on them by the settlor did not give rise to a new "settlement".

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36 who heard the appeal in the Court of Appeal

37 Lord Roskill had been a commercial lawyer and was thus not hampered by an extensive knowledge of trust law.

8.3 Charitable Loan Arrangements

It will be recalled that Income Tax (Trading and Other Income) Act 2005 section 620(1) provides that "settlement" does not include a charitable loan arrangement.

Section 620(5) defines the expression "charitable loan arrangement" to mean "any arrangement so far as it consists of a loan of money made by an individual to a charity either-

(a) for no consideration, or

(b) for a consideration which consists only of interest, and

Now a loan is always made for a consideration – namely the obligation to repay it. Hence, in my view, the drafting of this subsection must simply be regarded as inept and "no consideration" must be read as meaning "for no consideration other than the obligation to repay it".

There are considerable difficulties with this definition. See my The Taxation of Trusts 2007 22A.8.3.

9 "Trustees" of Settlements

It is clear that a "settlement" within the meaning of the Provisions may be something other than a trust or classic settlement. Yet the Provisions contain many references to "trustees". How are these to be read, given that there is no definition of the word for the purposes of the Provisions? In my view, in the absence of a definition, one should give the words "trustee" and "trustees" their ordinary and natural meaning. The consequence is that if there are no "trustees" of a "settlement" within the meaning of the Provisions, then the part of the Provisions in point can have no application.

While this may seem a striking conclusion, there is a great deal to be said in its favour. The contrary view was one which I at one time entertained. I thought that, just as "settlement" was given a wide definition, so too, by implication, must "trustee" and "trustees" and that the "trustee" of a settlement must be either the person to whom income arising under the settlement in fact arose or the person (if different) in whom was vested (whether beneficially or in fiduciary capacity) the source of the income arising under the settlement. I imagined myself trying to argue the contrary before Lord Templeman and concluded I would not last very long. However, in the debate in the House of Lords on the changes to the

Provisions which were to be effected by the Finance Bill 1995, I was told[38] categorically that I was quite wrong. If there was no "trustee" in the classic sense, then those provisions which referred to trustees simply did not bite. I was suitably chastened. I have ever since waited for the Revenue to tell me that I was, after all, right. They have never done so. Nor do I expect them to. For, no matter how much that would assist them to collect a greater amount of tax, it would involve their admitting that they were wrong in being so dogmatic.

Section 646(1) in my view now offers support for my view that "trustee" should be interpreted in its usual sense and not in any extended sense. It provides:

> "(1) A settlor is entitled to recover from—
>
> (a) any trustee, or
>
> (b) *any other person to whom the income is payable in connection with the settlement,*
>
> the amount of any tax paid by the settlor which became chargeable on the settlor under section 624 or 629."[39]

There are many sections in the Provisions which use the words "trustee" or "trustees". I have identified fifteen, namely sections 624A(1A), 628, 630, 631, 632, 633, 635, 636, 637, 638, 640, 641, 643, 646(8) and 646A

10 Who is a "Settlor"?

Income Tax (Trading and other Income) Act 2005 section 620 (Meaning of "settlement" and "settlor") provides:

> "(1) In this Chapter-
>
> …
>
> "settlor", in relation to a settlement, means any person by whom the settlement was made.

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38 through Lord Eatwell, who was attacking proposed new scandalous provisions which would have deemed non-existent income to arise to a settlor where an interest-free loan was made, and not simply deemed real income to be that of the settlor, instead of the person to whom it actually belonged. Lord Eatwell's concern was to ensure that persons who made interest-free loans to charities or to family members were not penalised. Although my views were rejected, the Government thought twice about the proposed new provisions and decided not to enact them.

39 Italics added by R.V.

(2) A person is treated for the purposes of this Chapter as having made a settlement if the person has made or entered into the settlement directly or indirectly.

(3) A person is, in particular, treated as having made a settlement if the person-

(a) has provided funds directly or indirectly for the purpose of the settlement,

(b) has undertaken to provide funds directly or indirectly for the purpose of the settlement, or

(c) has made a reciprocal arrangement with another person for the other person to make or enter into the settlement.

There appears to have been no discussion in *Jones v Garnett* as to whether, if there was a settlement, Mr Jones was a "settlor". That was no doubt because the Revenue's argument appears to have been that the only settlement he made was allowing Mrs Jones to subscribe for her share at par.

The Revenue's reticence to argue that he made a settlement when he provided services to the company at an undervalue may have been based on reading – arguably a misreading – of the decision of the House of Lords in *Inland Revenue Commissioners v Mills* [1974] STC 130. Viscount Dilhorne, who gave the lead speech, said:

> "In support of his conclusion that there must be a motivating intention to benefit those interested under the trust Buckley LJ [1972] 3 All ER at 900, [1973] Ch at 243, 244, [1973] STC at 14 pointed out that the employees of a company, some shares in which were held by trustees, could be said to contribute to the profits of the company and so to the shareholders' dividends and so to the income of the settlement. He also pointed out that a stockbroker might, if the advice he gave to the trustees of a settlement proved well founded, be said to be contributing to the settlement. The difference between those cases on the one hand and *Crossland (Inspector of Taxes) v Hawkins* and this case on the other is that in *Crossland (Inspector of Taxes) v Hawkins* and in this case funds, which ordinarily would have been received by Mr Hawkins and by the taxpayer for their acting, were diverted to companies which were channels for their transmission to trustees. **It is not the provision of services but of funds**

which comes within the section."[40]

In both *Crossland v Hawkins* and *Inland Revenue Commissioners v Mills* the persons who the Revenue successfully argued were settlors had not merely donated their services but had entered into contracts to do so at an undervalue.

11 "Income" and "Income Arising Under a Settlement"

There is no definition of "income" in the Provisions. In a taxing statute, the word "income" prima facie means income chargeable to income tax. Secondly, it can also mean income of such a nature that it would be chargeable to income tax but for characteristics of the recipient e.g. his not being resident or domiciled in the United Kingdom. Thirdly, it can mean "income" in a general sense. There are also other permutations. It is possible that the word bears different meanings in different parts of the Provisions.

There is a partial definition, in section 648, of "income arising under a settlement". Section 648(1) provides:

> "(1) References in this Chapter to income arising under a settlement include-
>
> (a) any income chargeable to income tax by deduction or otherwise, and
>
> (b) any income which would have been so chargeable if it had been received in the United Kingdom by a person domiciled, resident and ordinarily resident there."

Thus, it includes any income of the second type.

See further 3.2 and 5.7.3.

The question whether incomes arises under a settlement must be considered in the light of the question whether it arises "from property in which the settlor has an interest": see 3.3.

There is a limited amount of authority on when incomes arises under a settlement. In most cases, the question in dispute is whether there is a settlement at all, whether income arises from property comprised in the settlement or whether

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40 Emboldening added by R.V.

income arises "from property in which the settlor has an interest". These last two questions will often themselves involve a determination of the precise nature of the settlement. See further the discussion at 3.3.

In *Jones v Garnett*, Lord Walker said, at paragraph 52: "I would add that in my opinion the wording of section 660A(1) ("income arising under a settlement") does not impose a more demanding test, and may impose a rather less demanding test of causal connection, than the expression "by virtue and in consequence of." This should be regarded as confirmation from an authoritative high source that the precise meaning "of income arising under a settlement" may yet fall to be determined.

12 Non-UK Resident or Domiciled Settlors

What if the settlor of a settlement is not resident or, if resident, not domiciled in the United Kingdom? The application of the Provisions is modified in such a case. The technique is slightly unusual in that it is the definition of "income arising under a settlement" which is altered.

Section 648(2) to (5) provide:

> "(2) But this is subject to the rule in subsection (3) which applies if, in a tax year, the settlor is-
>
> (a) not domiciled in the United Kingdom,
>
> (b) not UK resident, or
>
> (c) not ordinarily UK resident.
>
> (3) The rule is that references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax year in respect of which the settlor, if the settlor were actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of the settlor not being domiciled in the United Kingdom, UK resident or ordinarily UK resident.
>
> (4) Subsection (5) qualifies the rule in subsection (3) if such income is remitted to the United Kingdom in circumstances such that, if the settlor were actually entitled to the income when remitted, the settlor would be chargeable to income tax because of being UK resident.

(5) The income is treated for the purposes of this Chapter as arising under the settlement in the year in which it is remitted."

These subsections arguably do not operate as one would expect them to.

One might naively suppose that this restriction on the operation of the Provisions was a concession to the taxpayer. Not so. So far as I can discern, it can operate only for the benefit of the Revenue!

Suppose a settlor who is at no material time domiciled, resident or ordinarily resident in the United Kingdom creates a settlement under which he retains an interest and is foolish enough to appoint only United Kingdom resident trustees.[41] Prima facie, they will be taxable on the worldwide income (and capital gains) of the trust. Such is the (negative) support given to our financial services industry by Parliament! Were it not for these subsections, then on any fair and literal interpretation of the Provisions,[42] the income would be deemed for income tax purposes to be that of the Settlor. If it did not have a United Kingdom source, it would therefore not be taxable. The effect of the subsections, however, is that the income is taken outside the Provisions and remains taxable.

Suppose the settlor had appointed non-UK resident trustees. In that case, even without the subsections, non-UK source income would not have been chargeable to United Kingdom income tax.

Contrast the US grantor trust provisions, which also deem income arising under a trust to be that of the settlor ("grantor"). They operate fairly without discrimination. Sometimes they benefit the Revenue and sometimes the taxpayer.

It is doubtful whether subsections (4) and (5) add anything to the effect of the section.

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41 He might, for example, have regard to the high reputation this country, with its Judeo-Protestant tradition, has for integrity and reliability and it might simply not occur to him that it could suffer from a government which was mad enough to shoot its own financial services industry in the foot by discriminating against those who choose to base their trusts here.

42 In my view, one old case to the contrary can be easily dismissed on the basis that it was argued by a taxpayer in person before a judge whose main experience of Revenue law was gained in appearing as counsel for the Revenue.