The Personal Tax Planning Review

THE HONOURABLE PROFESSION OF CARPETBAGGING[1]

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Carpetbaggers

Carpetbaggers are individuals who open Building Society accounts in anticipation of receiving substantial capital sums (many times larger than the capital invested) on the conversion of the Building Society to a bank. Normally these capital sums can only be within the scope of capital gains tax. As most of the gains are of the order of £1,000, they are easily covered by the annual exemption (£6,500 for 97/98) and no capital gains tax is actually paid. The capital gains tax position was considered in *Foster and Horan v CIR* (1997) SpC 113 which concerned the cash bonuses paid following the takeover of the Cheltenham & Gloucester Building Society by Lloyds Bank. As a result of that case, depositors are not liable on the cash payments received, but share account holders remain liable to capital gains tax. Later conversions resulted in share distributions which give rise to no capital gains tax until the shares are sold.

However, where a carpetbagger opens a number of accounts, we should consider whether the honourable profession of carpetbagging falls within the ambit of Cases I or II of Schedule D. Whether the receipt is in the form of cash or shares makes no difference for calculating the profits of a trade.

Schedule D Case II: Income from Trades or Professions

The traditional starting point is the statutory definition of trade to be found in section

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832 Income and Corporation Taxes Act 1988 which states that trade includes "...every trade, manufacture, adventure or concern in the nature of trade" and thus is of little help.

One of the most comprehensive attempts at a definition was made by Lord Wilberforce in the case of *Ransom v Higgs* (1974) 50 TC 1 in which he said "...the word trade is no doubt capable of bearing a variety of meanings according to the context in which it is used. In its most restricted sense it includes the buying and selling of goods; in a slightly wider sense it includes the buying and selling of land; there is no reason to exclude, in an appropriate sense, the buying and selling of choses in action. It is commonly used to denote operations of a character which the trader provides to customers for reward, some kind of goods or service." He went on to say at page 88: "Everyone is supposed to know what "trade" means: so Parliament, which wrote it into the law of income tax in 1799, has wisely abstained from defining it."

The Badges of Trade

In borderline transactions it is often difficult to decide whether or not one or a series of transactions amounts to a trade. Some guidance can be gleaned from the results of the 1955 Royal Commission (the Radcliffe Committee Cmnd 9474, para 116) which identified six badges of trade. These badges are merely guidelines in helping to identify a trade, some being of greater importance than others in different cases.

The first badge is subject matter, the second the length of the period of ownership, the third the frequency of the transactions, followed by the fourth, fifth and sixth, being adaptation, circumstances responsible for the sale, and profit motive respectively.

Subject Matter or Nature of the Asset

Let us consider the authorities for the view that an asset which neither yields income nor pride of possession is more likely to be the subject of a trade. In the case of *CIR v Fraser* 24 TC 498, a Scottish woodcutter who bought many gallons of whisky was found by the court to be within Case I of Schedule D. The Lord President (Normand) said at page 502:

> "But the purchase of a large commodity like a quantity of whisky, greatly in excess of what could be used by himself, his family and friends, a commodity which yields no pride of possession, which cannot be turned to account except by a process of realisation, I can scarcely consider to be other than an adventure in a transaction in the nature of trade."

Another relevant case is that of *Wisdom v Chamberlain* 45 TC 92. Here an actor

bought a large quantity of silver bullion as a hedge against devaluation. The deal was financed by loans at a substantial rate of interest. Harman LJ said at page 106:

> "...it was nevertheless entered into on a short term basis for the purpose of making a profit out of the purchase and sale of a commodity, and if that is not an adventure in the nature of trade I do not really know what it is. The whole object of the transaction was to make a profit."

A Building Society account clearly yields no pride of possession, unlike a painting. Although there is an income yield, this is so low compared to the anticipated capital profits (for some Building Society accounts an investment of only £100 was needed to qualify for a payout of £500), that the income yield can be effectively disregarded. Thus it falls within the dicta in *CIR v Fraser*.

Frequency of Transaction

In *Leach v Pogso* 40 TC 585, the taxpayer started up and subsequently sold 30 driving schools. Normally the setting up and sale of a business is a capital matter. But where it is repeated many times one can be found to be trading in that most unlikely asset of driving schools. The point of issue in the case quoted was whether the Special Commissioners could use hindsight to hold that the first driving school sold was also a trading transaction in the light of the admitted trading in the next 29. Ungoed-Thomas J first considered, at page 594, the House of Lords approval of Pearce's judgment in 40 TC 490 that "...it (the agreement) did not stand alone. It has to be considered in the light of surrounding circumstances. Subsequent events may, and in my judgment do, throw light on it." Ungoed-Thomas J then went on to say:

> "In the light of these authorities the Commissioners were clearly entitled to take into account the subsequent 29 transactions to throw light upon the nature of the original transaction."

Most carpetbaggers will have opened numerous Building Society accounts. Thus the repetition of a normal capital matter suggests liability to income tax as a trade. This point was also made in the case of *Pickford v Quirke* 13 TC 251, where the purchase and sale of four cotton mills was held to be trading. Any one cotton mill "turned over" would not have constituted a trade (stated case p.259 and repeated with approval at p.269), but considered together they did constitute a trade.

> "In our view the transactions considered separately are capital transactions, and the first transaction considered by itself would not have constituted a trade nor would it have attracted liability under Case VI. As however there was more than one transaction we have to ask ourselves whether, when all the four transactions are regarded together, the Appellant can be said to have entered

> "habitually" into profitable contracts in such a sense as to constitute the four transactions into which he did enter, a trade: in other words, and stating the matter in the language of the day, `did he make a business of turning mills over?'

The Special Commissioners the decided at page 260:

> "What he did was done in the course of what must be called a business of turning to his advantage the very peculiar conditions of the period during which the transactions took place."

The point at which a number of capital transactions cross that fuzzy border into a trade is a question of degree to be determined as a question of fact by the appeal commissioners.

Adaptation or Work Done on the Asset

Evidence of work done is the concerted efforts made prior to the Nationwide Building Society annual general meeting to force through a conversion against the wishes of the directors. The more people who could be persuaded to open accounts and join the carpetbaggers, the more likely they would be successful. The directors fought back with a publicity campaign promoting the advantages of mutuality. They also raised the minimum deposit required to open an account to deter new carpetbaggers. Whilst the 1997 AGM vote went against the carpetbaggers, new carpetbaggers have continued to open accounts. *The Financial Times* of 17th October 1997 reports that in the year to 30th September 1997, the Nationwide Building Society gained 710,000 new customers compared to 130,000 for the previous year. Thus there is a possibility that the 1998 AGM outcome would be very different. The Nationwide Building Society has replied with a "poison pill" defence requiring new account holders to agree to surrender any windfall profits to charity. No doubt the carpetbaggers could respond by preposing a motion at a subsequent AGM to release these people from their obligation.

Destination of the Sale Proceeds

The last of the indicia is the destination of the sale proceeds. Whilst many have spent the monies on holidays, some (it is reported in *The Sunday Times* of 12th October 1997 at pages 4-6) are investing in moribund sports clubs to reap a profit when the cricket field is sold off for redeveloped. This article quotes the example of a cricket club at Weybridge where an offer of £6 million has been received for the 6 acre site. If the deal goes ahead, members are expected to receive windfalls of £50,000 each, a very good return on an annual membership fee of £80 and a few bruised ribs from flying cricket balls. Those individuals investing their Building Society windfalls in moribund

sports clubs are even more likely to be trading. Others have started to target the mutual life assurance companies. The Norwich Union has already gone public, paying out a average of £1,500 in shares to qualifying policyholders. The de-mutualisation of such life companies is much riskier than carpetbagging a Building Society. It requires a longer term commitment and regular payments to keep the policy in force. Surrender charges should be take into account and these could substantially reduce any profit. Another option would be to buy second-hand life policies. Where a large number of these are purchased, the individual could be held to be trading in these alone following the decision in *Smith Barry v Cordy* 28 TC 250.

Profit Motive

There is a very obvious profit motive by the carpetbagger.

Time Interval

Short time intervals between acquisition and realisations, whilst weaker indicia, nevertheless point towards trading. However, the case of *Marson v Morto*n 59 TC 381, the potato merchants who bought land as an investment but sold it within four months, demonstrates that a short time interval in itself does not change the character of an investment.

Share Dealing by Individuals

Normally the Revenue are very reluctant to admit that share dealing by an individual amounts to a trade in view of the linked claim to loss relief. This does not apply to a limited company, who may be successful in their claim (e.g. *Lewis Emanuel & So Ltd v White* 42 TC 369). The Revenue point to individuals not having an organisation for the buying and selling of shares, that they bought and sold shares as customers of the market, they did not make a market in the shares but were little more than passive observers. The Revenue used these arguments successfully in the individual case of *Salt v Chamberlain* 53 TC 143.

A major attraction for the Revenue to claim that carpetbagging is a trade is that there is no downside potential: Building Society accounts, unlike stock exchange shares, do not fall in value.

Selection of the Victim

A suitable target for the Revenue would be a carpetbagger who had opened up at least

five Building Society accounts and had achieved success in a minimum of three of these. In view of the hostile attitude of the building society movement to carpetbaggers, considerable co-operation from it to identify a suitable victim could be expected. In order to exclude genuine long term investors, the Revenue should announce that in the event of a favourable decision from the courts, they would not seek to apply the decision to any accounts opened more than one year prior to the conversion.

Potential Yield

There are various estimates of the amounts being paid out on Building Society conversion. One popular one is £10 billion. Trying to estimate the percentage paid to carpetbaggers is extremely difficult and subject to a wide margin of error. For sake of argument, assume 10%. The potential yield would be £1 billion at 23%, that is £230 million. Not only would this be a useful contribution to the government coffers, but also a most cost-effective ANT (adventure in the nature of trade) challenge.

Self Assessment

If the Revenue were able to mount a successful challenge to carpetbaggers, would penalties etc flow to those who failed to declare profits from carpetbagging or would the Revenue allow extra time to file a return in the light of a change in perceived liability?