LETTERS TO THE EDITORS

From S A Sherman
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Dear Sirs,

PTPR - Volume 2 1992/93 Issue 3

Artificial Payments of Interest(s.787 ICTA 1988)

I was interested to read the article by Philip Ridgway and Adam Francis on s.787 ICTA 1988 and in particular that part headed "Commercial v Artificial" on page 235.

I note the authors advise that a company can create Schedule D Case IV or V income by placing the proceeds of the original loan on deposit with a Swiss bank.

Unless, however, the promoters of the arrangement advise the Swiss bank what is intended, if the monies are to be deposited in sterling the Swiss bank is likely to re-deposit the funds as fiduciary (i.e., nominee) with either their own UK branch or subsidiary or with another bank in the UK with the result that the interest earned may have a UK source and may not be Schedule D Case IV or V.

I also understand that doubt has been thrown on a number of aspects of the "Swiss Roundabout" principle as set out at B1.8.1 of *International Tax Systems and Planning Techniques* by Roy Saunders.

S A Sherman

Reply from Philip Ridgway
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Dear Sirs,

PTPR - Volume 2 1992/93 Issue 3

Artificial Payments of Interest(s.787 ICTA 1988)

I have had an opportunity of considering Mr Sherman's comments on our article referred to above. With regard to the question raised in the third paragraph of his letter, the Swiss bank is not acting as agent of the company when it deposits funds in the UK. The deposit of the funds in the UK will be a commercial decision made by the Swiss bank. It will not therefore affect the source of the interest payable to the UK depositor. The interest payable to the Swiss bank will probably have a UK source; however, I can see no reason why this should be imputed to the original deposit of the funds in Switzerland by the UK company.

With regard to the fourth paragraph of Mr Sherman's letter, I agree that some doubt has been thrown on the "Swiss roundabout" principle. This doubt arises because of the uncertainty of whether a UK company can create a foreign source obligation. Until the abolition of exchange controls in 1979, the Inland Revenue accepted that a resident taxpayer could create a foreign source obligation. The means by which this was achieved was by entering into and keeping an agreement, subject to foreign law, and made under seal outside the UK and providing for the interest to be payable abroad in a foreign currency. Further, it was necessary that the loan was not secured on UK property. After 1979 the Inland Revenue's attitude changed. However, I consider it doubtful whether their view was correct and I do not consider it accorded with the decision in the case of *Westminster Bank Executor & Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* 46 TC 472. In their Tax Bulletin of November 1993 at page 100 the Inland Revenue have restated the factors that they will consider when determining whether a loan has a foreign source. These factors are:

(i) the residence of the debtor, i.e., where the debt will be enforced;
(ii) the source from which the interest is paid;
(iii) the nature and location of the security of the debt; and
(iv) where the interest is payable.

If all these factors point to the UK then the interest will have a UK source. However, if these factors point away from the UK a foreign source obligation could be created. Obviously, where the company borrowing the money is in the UK the first factor, namely the residence of the debtor, will be UK. However, it is submitted that this factor is not decisive otherwise the other factors would be otiose.

Therefore, I consider the Swiss roundabout still has the potential to create a charge on income provided the factors are sufficiently strong for the UK company to create a foreign source debt. Care will need to be taken when structuring the loan to give the best possible chance of arguing a foreign source.

Philip Ridgway

From Richard Oerton
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Dear Sirs,

PTPR - Volume 2 1992/93 Issue 3

Vested or Contingent Interest?

The article by Shân Warnock-Smith which appears under this title (Volume 2, Issue 3, page 165) seems open to question in several respects. She takes a case in which a testator leaves his residuary estate

> "upon trust for my sister A and my brother B in equal shares upon their respectively attaining the age of 40 years and if only one of them shall attain the age of 40 years then for that one absolutely"

with a gift over, if they should die before the testator or under 40, to their children contingently on reaching 18.

She takes the view that while A and B are under 40 their interests are to be classified, not as contingent, but rather as vested subject to divesting (or vested but defeasible) under the rule in *Phipps v Ackers* (1842) 9 Cl & Fin 583. There may be some slight doubt about this because the circumstances in which the primary gift does not become indefeasibly vested (which include the situation in which both A and B die before the testator or under 40 without leaving any child who attains a vested interest) are not exactly the same as the circumstances in which the gift over takes effect (which do not include that situation). But in *Re Mallinson*

Consolidated Trusts [1974] 2 All ER 530 Templeman J (as he then was) said that, although there must be correspondence between the two, the latter circumstances need not necessarily be the "identical counterparts" of the former.

At all events Shân Warnock-Smith devotes the rest of her article to considering the nature and incidence of vested but defeasible interests of this kind, doing so in paragraphs numbered 1 to 4, and it is the contents of these paragraphs which seem open to question.

In paragraph 1 she says that A's and B's interests would not (in the absence of some express testamentary provision) carry income until they reached 40, so that the income in the meantime would pass on intestacy. In support of this she quotes cases which concerned vested but defeasible interests in residue but in which those interests were preceded by prior trusts and were future (or deferred) ones. The interests of A and B, however, are not future interests but interests in possession and, as such, would certainly carry the intermediate income. It hardly seems necessary to quote cases in support of this proposition but reference may be made to *Re Nash* [1965] 1 All ER 51 which shows its correctness and in which Ungoed-Thomas J (at pp. 53-4) quoted *Re Master's Settlement* [1911] 1 Ch 321 as showing that

> "if the gift to the residuary legatees is not of a future vested interest but of an interest vested in possession, then the ... income is payable ... to the residuary legatees ... despite the possibility of defeasance of their interests."

Re Kilpatrick's Policies Trusts [1966] 1 Ch 730 is a further illustration.

In her paragraph 2, Shân Warnock-Smith says that if the intermediate income did pass as on intestacy (as she thinks it would), and trusts for minors arose as a result, the provisions of Trustee Act 1925 s.31 would turn them into accumulation and maintenance trusts for income tax purposes, so that additional rate tax would be payable, but that it would "be otherwise if the persons entitled have a vested and indefeasible right to the income". Well, of course, that's right, but surely those with vested but indefeasible interests in capital do not necessarily *have* vested and indefeasible rights to income? Under Trustee Act 1925 s.31(2), income may be accumulated during their minorities and they may never become entitled to the accumulations.

In paragraph 3 she returns to the factual situation in her original example and asks what would happen if A and B both died childless under 40. Had their interests been contingent, she says, the result would have been an intestacy; but since their interests are vested subject to divesting "the estates of both would probably take under the Will (subject to a possible argument in favour of the estate of the survivor only)". If this is right, then the very event upon which A and B are to be divested of their interests causes those interests to become indefeasibly vested.

In the absence of clear authority, this result is hardly credible. Early statements of the rule in *Phipps v Ackers* rest it upon the supposed intention of the testator that the first donee should take whatever interest the donee under the gift over is not entitled to, but they are not to be read as producing a result wholly inconsistent with the purpose of the condition.

For one reader at least, Shân Warnock-Smith's paragraph 4 is difficult to follow. It seems to hark back to her earlier view (with which disagreement has already been voiced) that the income of the residue passes as on intestacy whilst A and B are under 40, and it explores (among other things) the implications of the fact that "the settled property may or may not constitute relevant property" for inheritance tax purposes. But can one think of any circumstances in which it might be relevant property?

Richard Oerton

From Matthew Hutton
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Dear Sirs,

PTPR - Volume 3 1993/94 Issue 1
Inheritance Tax - Lifetime Transfers and Business Property

I found your above article very stimulating; I cannot recall having seen such a helpful treatment of the clawback provisions.

I wonder if I might raise one or two points:

1. While you discuss in some depth the way in which the necessary conditions must be satisfied, there is I think one type of case which you do not consider. An example would be where, for agricultural property relief purposes, there is the surrender of a tenancy and the asset concerned simply disappears by being subsumed within the greater freehold interest. I imagine that the Capital Taxes Office would take the common sense view and not seek to apply the clawback where in practice the transferee continued to farm during the relevant period. However, there is no such provision as s.43 TCGA 1992 where an asset becomes subsumed by another.

2. On page 78, final paragraph, you suggest that accumulation and maintenance trusts should be avoided unless all the potential beneficiaries are less than 11 years of age. Presumably in the normal case this could safely be 18 years of age in that the use of a 21 year accumulation period could prevent s.31 Trustee Act 1925 taking effect at age 18 - unless of course more than 21 years had elapsed since the date of the Settlement. Clearly, the combination of s.31 with available accumulation periods has to be regarded in the light of individual circumstances.

3. At page 89 in the top paragraph you state your view that the whole of the consideration is not applied in purchasing the replacement asset if part is used to pay Capital Gains Tax. A 'Loose End' by Robert Page in *Taxation* of 1st April 1993 page 18 reports recent confirmation by the CTO that they would not regard Capital Gains Tax paid on sale (in addition to reasonable professional costs of sale) as included within the reference to the "whole consideration". This may be of interest to you.

Matthew Hutton

Reply from Robert Argles
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Dear Sirs,

PTPR - Volume 3 1993/94 Issue 1
Inheritance Tax - Lifetime Transfers and Business Property

I reply to the three points raised by Matthew Hutton with the cautionary words that so far as what follows may be considered as advice it is given without responsibility.

(1) If an agricultural tenancy (or, I dare say, a tenancy entitled to the protection accorded to business tenancies) falls within the definition of "the original property" in s.113A(8) Inheritance Tax Act and is then surrendered (or, perhaps, forfeited), s.113A (or s.124A in the case of agricultural property) would operate to deny relief to the value transferred when the transfer of value subsequently becomes chargeable on the death of the transferor. This would be so whether the reversion was owned by the transferee or not. It can hardly be said that a tenancy which has ceased to exist remains in the beneficial ownership of the tenant. This

would be more clearly the case where the transfer of value consisted in an assignment (with the consent, presumably, of the landlord) of a pre-existing tenancy (or interest therein) of which the transferor was the tenant. It is a moot point, however, as to whether the tenancy can really be regarded as "the original property" which is relevant business property in relation to the original PET when that PET was constituted, not by an assignment of a pre-existing tenancy, but by the creation of a new tenancy by act of the transferor. In my opinion the provisions would apply in those circumstances but one can see strong argument as to why they should not.

(2) I agree that if an accumulation and maintenance settlement was established with a vesting age (in income or capital) of 25 and accumulation period of 21 years from the date of the settlement one could safely include as beneficiaries any persons who had not attained the age of 18 years. The solutions mentioned on page 78 are not intended to be exhaustive. They were intended rather as reminders of the trap contained in those settlements to which section 31 applied and to indicate some possible solutions to the problem.

(3) I thank you for drawing my attention to the 'Loose Ends' contribution in *Taxation* - which hitherto escaped me. I do not regard this statement by the Revenue as a matter of interpretation (i.e., as if it were a statement of practice). I regard it rather as yet another illustration of an unofficial concession by the Revenue intended to ameliorate the harsh (and perhaps unintended) effects of the legislation which they were primarily responsible for introducing.

Robert Argles