LETTERS TO THE EDITORS

From Mr Terry Jordan
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Dear Sirs,

Deeds of Variation: A Euro-pitfall (Volume 2, Issue 1)

I was interested to read Hilda Wilson's article under the above heading and I should like to make a couple of observations.

The problem outlined is apparently not restricted to benefits under Deeds of Variation and should be borne in mind when advising clients on the drafting of their wills.

In the situation outlined by Ms Wilson the problem of the German-resident son could presumably by circumvented by the variation creating a nil rate band discretionary trust, the class of beneficiaries under which includes the children, rather than by an outright gift to non-exempt beneficiaries. This approach would have the added advantage that the surviving spouse could also be a potential beneficiary without reservation of benefit problems. The disadvantages of achieving this result by a variation rather than under the original Will is that the surviving spouse is the settlor for income tax purposes and, following the decision in *Marshall v Kerr*, for most CGT purposes.

I was puzzled by the following passage on page 73:

> "...and since UK law would regard the disposition effected by the deed of variation as made by the deceased spouse, it seems prima facie that the disposition in favour of the son would be regarded for the purposes of German inheritance and gift tax as a transfer of property by reason of death."

Is it not the case that under UK general law a variation is a lifetime transfer (in this case made by the surviving spouse) which for limited and defined fiscal purposes, provided the requisite elections are made, is treated as if made by the deceased?

From Hilda Wilson
Gray's Inn Chambers
Gray's Inn
London WC1R 5JA

I agree that the problem is not restricted to Deeds of Variation, but I wrote the article about Deeds of Variation because it seemed to me that these might be a peculiarly UK phenomenon.

I agree too that there might be other solutions but not - obviously - in the situation which I envisaged, which was that of a surviving spouse who did not wish to increase his/her estate and only one desired beneficiary for the surviving spouse's largesse, namely, the German-resident son. However, I see that "dummy" beneficiaries might be included in a discretionary trust although, if the property which was to be disposed of by the Deed of Variation was a share of real property in the United Kingdom which might shortly be sold, I think that the discretionary trust might be more trouble than it was worth.

The reason for the statement quoted in the fourth paragraph of Mr Jordan's letter is to be found in the sentence which preceded it in the article, and is that I thought that UK inheritance tax law might be regarded, under German rules relative to the conflict of laws, as part of the succession law of the United Kingdom. However, as I implied in the article, before one could come to a firm conclusion on this, I think that one would have to get advice on the position in German law. I also think one would have to look at the English conflict of laws position.

From Mr Robert W Maas
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Dear Sirs,

Demergers and Trusts

I am intrigued by Christopher McCall's suggestion that trustees, faced by a proposed specie dividend demerger, should seek the life tenant's consent to treat part of his "income" as capital and if that consent is not forthcoming to threaten to sell the investment so as to prevent the income being received (page 302, Issue 3). I am not a lawyer, but I would think it unlikely that a court would be terribly sympathetic to a trustee in an action for breach of trust if an aggrieved income beneficiary said "He told me that I was legally entitled to receive X, but he thought it morally unfair to pay it to me and told me that if I did not agree to forego receiving my legal due he would take steps to stop the income ever being received".

Surely a trustee has responsibilities to both income and capital beneficiaries. He cannot deliberately take steps to "avoid loss of capital" to the detriment of the income beneficiaries without considering the interest of both income and capital beneficiaries.

I would have thought it would clearly be in breach of trust for trustees, for example, to decide to deprive the income beneficiary of all income by adopting a policy of selling shares immediately before they paid a dividend and buying them back after payment of the dividend so that no income ever arises. I would have thought it equally in breach of trust to deliberately adopt an investment policy of investing in shares that do not pay dividends on the basis that accumulation of profits by investing companies would enhance their capital value. How then can it be acceptable for a trustee to sell shares not because he considers this a sensible investment decision, but rather because he is seeking to deprive income beneficiaries of an amount that the law regards as income, but that the trustees think ought morally to be capital? I find it difficult to believe that if the income beneficiary were to sue, the courts would be agree to absolve the trustees of liability in circumstances where they had deliberately sought to avoid the effect of what they presume the law to be.

I would have thought that trustees would be better advised simply to credit the receipt to capital when it arrives so that they could at least say, if faced by a challenge, that it is an area where the law was unclear and they had done what they considered to be right on the basis of an article in PTPR by an eminent QC, Mr McCall.

The only real answer is for the law to be changed to remove the uncertainties. In the meantime if trustees want to ask an income beneficiary to forego his probable entitlement to income and seek to threaten him to reinforce their point of view, a more sensible threat than that to sell the shares might be to threaten to seek directions from the court, the legal cost of doing which would fall on the trust funds and therefor reduce the available income.

From Christopher McCall QC
7 New Square
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London WC2A 3QS

Robert Maas puts his finger on a point of considerable difficulty, and he could hardly have done more to make clear the need for legislation; yet that, we now know, is the one thing for which we cannot hope.

So what is the answer to the dilemma? Can a trustee safely sell shares pregnant with a demerger dividend? Mr Maas is certainly not alone in taking the view that it is open to doubt. For my part I do not share those doubts. It seems to me that the instance of the trustee who seeks to deprive his income beneficiary of all income is not a fair parallel. A trustee who deliberately seeks to avoid keeping a balance between income beneficiary and remainderman is clearly open to criticism; but surely it is not the same when a trustee who has invested with a view to keeping that balance then finds that events may be about to occur in which the balance he has sought will be grossly distorted. In such a case it hardly seems convincing to say that he is failing to keep the balance if what he is failing to do is to acquiesce in something which destroys the balance which he sought to achieve. In just the same way the income beneficiary would surely complain if the trustee insisted on retaining a substantial holding of shares which had been bought as an income-producing asset but by virtue of the deliberate decision of the directors suddenly came to assume a form in which there would be no further income yield but every prospect of capital appreciation. Unless the loss of income could be seen to be of no great substance when viewed as part of the overall picture, not to take action would be to allow the balance to be lost; and I know of no rule that says that trustees who rightly adopt the policy of keeping a balance can take no action if the policy they have set out to achieve is about to be negated. By definition that is not to keep the balance. I find it difficult to believe that the courts would not say that in such a case a preemptive strike was well within the discretion of trustees, who after all have a power to realise their investments as they think best in the interests of their beneficiaries as a whole (and most trustees will surely think that if they have been asked to hold their funds on terms that entitle the income beneficiary to a continuing income benefit it is at least open to doubt how far it is consistent with the intentions of the settlor to allow the income beneficiary a benefit that deprives him of a substantial element of his future income as well as depriving the remainderman of his fair expectation). I accept that the courts have indicated that the benefit of a dividend is an income benefit; that does not mean that the income beneficiary's right to the demerger benefit is part of the balance which the purchase of the shares in question was designed to achieve, and it does not mean that the courts would not recognize that to retain the shares might be productive of injustice, above all when the demerger benefit is something for which the trustees have paid over capital when purchasing the underlying shares.

The question remains whether it is clear that the life tenant's claim to the demerger benefit would be accepted. The view that legislation is not necessary seems to be based on a certain optimism that a demerger can be distinguished from the case of *Hill v Permanent Trustee Co* [1930] AC 720; and referring back to the debate in *Bouch v Sproule* 12 App Cas 385 and the explanation there given of *Irving v Houston* and similar cases, one does feel a little hope. "It can scarcely be [the testator's] meaning that the [life tenant] should run away with a bonus that may have been accumulating ... for half a century"; "on no ground of equity could it be contended that the [life tenant] was entitled to accumulations made during the lifetime of the testator"; could not Lord Watson's comments equally apply where the "bonus" was already part of the capital value of the shares when purchased in the sense that it represents a business that was then already part of the permanent concern? If "we must look both at the substance and the form of the transaction" (per Lord Herschell) is it not remarkable to treat as an income transaction the division of a business in two by a transaction the form of which is dictated solely by the desire to achieve that substantial capital separation? Let us hope that someone will challenge the received wisdom after ICI.

From Mr Malcolm London
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Dear Sirs,

I wonder whether I might presume to take issue with the learned author of "Capital Gains Tax and Personal Insolvency" which was one of the articles in Issue 1 of Volume 2, 1992/93.

When commenting on the tax position where there is a sale by a mortgagee of charged property, the author sites the decision in *Re McMeekin* as authority for the proposition that "if the mortgagee leaves the trustee with insufficient funds both to pay the capital gains tax bill and to discharge the mortgage, in such circumstances it appears that the capital gains tax liability must be satisfied first" and that "the mortgagee will have to prove, as an unsecured creditor, in respect of any funds accruing from the realisation which are taken to pay the capital gains tax liabilities".

However, the author may have misinterpreted the relevant part of the Judgement of Lowry CJ. What he said was:

> "I would also be prepared to hold that, where the proceeds of sale are insufficient to discharge the incumbrancer, they must be used as far as possible for that purpose, leaving the mortgagee to prove as an unsecured creditor for the balance of his debt."

Thus there is no question of any funds accruing from the realisation of the mortgaged property being taken to satisfy the capital gains tax liability thereon in priority to the amount owing to the mortgagee. It is only in cases where the proceeds of sale themselves are insufficient to discharge the incumbrancer, that the mortgagee is left to prove as an unsecured creditor for the balance of his debt - which is hardly surprising.

Re McMeekin is of course a decision in the Queen's Bench Division of the Northern Ireland High Court and therefore is persuasive, but not binding, in the English and Scottish Courts.

From Philip Ridgway
Barrister
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Dear Sirs,

Capital Gains Tax and Personal Insolvency

In the spirit of enhancing "the quality of debate and learning" I am writing to take issue (albeit politely) with Hugh McKay's view of the law expressed in the paragraph entitled "Sale by a Mortgagee of Charged Property" on page 21, Vol 2 Issue 1 of PTPR.

Mr McKay states that "[i]f the mortgagee leaves the trustee with insufficient funds both to pay the capital gains tax bill and to discharge the mortgage, in such circumstances it appears that the capital gains tax liability must be satisfied first." As authority for this proposition he cites *Re McMeekin (a bankrupt)* [1974] STC 429 at 432. With respect, I would submit that *Re McMeekin* is authority for entirely the opposite proposition.

In *Re McMeekin* Lowry CJ poses four questions. (Questions one and four are irrelevant for the purposes of the current discussion.) Question two is, "Whether capital gains tax is payable in respect of gains from the sale of property of the bankrupt which was subject to charges or mortgages created before adjudication". Lowry CJ found that the answer to this question was yes, in which case question three needed to be answered which was "whether liability falls on the Official Assignee [Trustee in Bankruptcy] or on the chargees or mortgagees or partly on the Official Assignee and partly on the chargees and mortgagees". In answer to this question he said, "Counsel for [the mortgagee] ... submitted that there was, from his point of view, no problem, since the proceeds of sale had to be applied first of all in payment of incumbrances. He relied by way of analogy on [s.26 TCGA 1992] as illustrating the position of mortgagor and mortgagee. His argument was not disputed or disputable, and I accept it as correct. I would also be prepared to hold that, where the proceeds of sale are insufficient to discharge the encumbrancer [ie mortgagee], they must be used as far as possible for that purpose, leaving the mortgagee to prove as an unsecured creditor for the balance of his debt. In either case the mortgagee is a complete stranger to the liability for capital gains tax."

To me the position is clear. It is analogous to the position in corporate insolvency where the holder of a fixed charge can realise his security without reference to either the costs of liquidation or other preferential debts.

Lowry CJ goes on to say "The liability is to be treated as part of the costs of administration of the bankruptcy, which are to be discharged in priority to all debts". Although at first sight this may appear to contradict what he said earlier and support Mr McKay's assertion, it does not. A mortgagee can only prove for a debt to the extent that it is not secured by the mortgage (See S.I. 1986 No 952 Rule 6.109). The capital gains tax therefore ranks ahead of the unsecured part of the debt, but as far as the secured part is concerned," the mortgage is a complete stranger to the liability for capital gains tax".

Perhaps a more simple way of looking at the problem is to say that once an asset is charged with a mortgage the only interest of the bankrupt is in the equity of redemption. If the charged asset is disposed of, either by the Trustee in Bankruptcy or by the chargee as a nominee, to pay the secured debt and the secured debt exceeds the value of the security, the equity of redemption is worthless. In such a case the proceeds of sale never fall into the bankrupt's estate and there is never any question of the mortgagee leaving the trustee with insufficient funds to pay both the capital gains tax liability and discharge the mortgage as the funds never belong to either the trustee in bankruptcy or the bankrupt. There is therefore nothing in the bankrupt's estate out of which to pay the capital gains tax. If the value of the charged asset exceeds the secured debt, it is only the excess which will become part of the fund out of which the preferential debts will be paid. One of the preferential debts is "the amount of any capital gains tax on chargeable gains accruing on the realisation of any asset (without regard to whether the realisation was effected by the trustee, a secured creditor, or a receiver or manager appointed to deal with a security)" Rule 6.224 (p).

From Mr T A C Fletcher FCA
Chartered Accountant
Laynes House
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Dear Sirs,

Holiday Let-Out (s.504 Taxes Act 1988)

Recently my attention was drawn to the article by David Ewart published in the PTPR 1991/92 Issue No 3, at pages 157 to 161, inclusive.

Whilst I follow the direction of the argument in the second full paragraph on page 158 (beginning "it has been suggested") I believe it would be a very unusual case that, given the pattern of months put forward for consideration, still managed to satisfy all of paragraphs (a) (b) and (c) in s.504(3).

The month from 5 July to 4 August contains 31 days, on all of which the property was available for letting as holiday accommodation and for some of which (if not all) such lettings were made.

Somewhere else in the same year of assessment one needs to find a minimum of 109 days when the property was available for letting as holiday accommodation, and also a balance (after counting out any holiday lettings in July) of not less than 70 days when holiday accommodation lettings were actually made.

It follows that at least some of the lettings in April, June, August, October, December, and February must have been as holiday accommodation, because otherwise the circumstances would fail to clear the condition made by s.504(3)(b).

However if the letting in, say, the month of June was part of a holiday letting which had begun in May, then the latter month needs also to be included in the period which is referred to in s.504(3)(c). There is nothing to limit the number of months comprised in that period to just seven. Any number more than seven is "at least seven" just as much as seven itself.

When April, May, and June are put together it seems inevitable that any single occupation in excess of 31 continuous days during these months must be picked up for purposes of applying s.504(3)(c). (I assume that "occupation" has a wider meaning than actual physical presence of the same person on each day in question.)

Enclosed please find a copy of a small illustrative example.

HOLIDAY LET-OUT EXAMPLE
S.504(3) TAXES ACT 1988

MONTH		TENANT OCCUPIERS		
FROM	TO	COLUMN 1	COLUMN 2	COLUMN 3
6 APRIL	5 MAY	A	A	A
6 MAY	5 JUNE	VOID	VOID UNTIL 4 JUNE THEN 5 JUNE B	VOID UNTIL 3 JUNE THEN 4/5 JUNE B
6 JUNE	5 JULY	B	B	B
6 JULY	5 AUGUST	C	C	C
6 AUGUST	5 SEPTEMBER	D	D	D
6 SEPTEMBER	5 OCTOBER	VOID	VOID	VOID
6 OCTOBER	5 NOVEMBER	E	E	E
6 NOVEMBER	5 DECEMBER	VOID	VOID	VOID
6 DECEMBER	5 JANUARY	F	F	F
6 JANUARY	5 FEBRUARY	VOID	VOID	VOID
6 FEBRUARY	5 MARCH	G	G	G
6 MARCH	5 APRIL	VOID	VOID	VOID

NOTES

1. All lettings are as "holiday accommodation".

2. For s.504(3)(c) purposes the period of months must include April, June, July, August, October, December, and February (for all columns) and (just for columns 2 and 3) May, since these were the months with holiday lettings.

3. If the letting in February (to G) had not been as holiday accommodation, it would not be obligatory to include that month in the period referred to in s.504(3)(c).

4. In column 3 the 32 continuous days of occupation by B means relief under s.503 is not available.

From T A C Fletcher FCA
Chartered Accountant
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London NW7 4RS

Dear Sirs,

Holiday Let-Out (s.504 Taxes Act 1988)

This follows my letter above.

In s.504(3)(c) the use of the phrase "not normally" is an indication that in a few cases treatment in accordance with s.503 may still be applied, even though a letting in the period of 7 months may have run on for more than 31 continuous days.

I would like to amend the note, at the end of the schedule example I sent to you with my letter, to read "In column 3 the 32 continuous days of occupation by B might mean that relief under s.503 was not available, although the taxpayer would probably argue that that particular letting was 'not normal' in the context as a whole."

From David Ewart
Barrister
Pump Court Tax Chambers
16 Bedford Row
London WC1R 4ER

Dear Sirs,

I have had the opportunity of considering Mr Fletcher's comments on my article in Volume 1 Issue 3 of this Review. Having done so, I am still not sure whether he agrees with my views or not. The point on which he writes is the question of the correct construction of the phrase "a continuous period exceeding 31 days" in TA 1988 s.504(3)(c). It was put to me that the *whole* of the "continuous period exceeding 31 days" had to fall within the seven months mentioned in s.504(3)(c). Therefore, a six month shorthold letting was possible. Let us imagine the shorthold letting began on 20th April 1992 and ended on 20th October 1992. In the year of assessment 1992/93, one can (so the argument runs) choose seven months in which the property is not "in the same occupation for a continuous period exceeding 31 days". For this purpose "April" means 6th April to 5th May etc. The months in question are November, December, January, February, March (all uncontroversial), *April 1992* and *October 1992*. This is because, looking at just the seven month, chosen, there is no occupation in either April or October for a continuous period exceeding 31 days.

As I made clear in my article, I do not consider this construction to be correct. Incidentally, neither do the Revenue. In the paragraph to which Mr Fletcher refers I was demonstrating why the above construction must be wrong. My example was only intended to illustrate an absurd situation in which (if the above construction were correct) paragraph (c) of s.504(3) would be satisfied. I was not suggesting that either paragraph (a) or paragraph (b) would be satisfied. However, any case which did satisfy paragraphs (a) and (b) would necessarily have more periods of holiday accommodation, and therefore would not prevent the application of paragraph (c). My point was, therefore, that (on the construction which I reject) paragraph (c) would always be satisfied where paragraphs (a) and (b) were satisfied. This would mean that paragraph (c) was redundant. As I say in my article, a court would not favour a construction which robs a provision of any effect, therefore the above construction should be rejected in favour of the construction which I set out in the last paragraph on p.158.

I would be interested to know if Mr Fletcher agrees with that construction and, indeed, what point he was trying to make. In any event, I think he was concentrating on the less interesting issue. There is a real controversy over the Revenue's interpretation of the bracketed words in para (c). I have set out the arguments on pp159-161. It would be interesting to know Mr Fletcher's (or anyone else's) views on that argument.