

ICTA 1988 s.353, s.362, s.787 - Whether transactions effected to obtain reduction in tax, interest claimed on loan to spouse of identical sum transferred as a gift by him to other spouse, whether money advanced to partnership - Circular transaction - Appeal refused

THE SPECIAL COMMISSIONERS SpC 00232

A LANCASTER Appellant

- and -

COMMISSIONERS OF INLAND REVENUE Respondents

Special Commissioner: T G COUTTS QC

Sitting in Edinburgh on 8 November 1999

The Appellant in person

Mr D S Wishart, of the Inland Revenue Solicitors Office Scotland on behalf of the Respondents

ANONYMIZED DECISION

This appeal was against the disallowance of interest relief under sections 353 and 362 of the Income and Corporation Taxes Act 1988 for each of the four years 1992/93 to 1995/96.

The hearing was held at Edinburgh in private at the request of the Taxpayer.

A statement of agreed facts was produced along with bundles of productions for each party. From these the following facts were found to have been established:

1. The Appellant, who is a Chartered Accountant was the senior partner in a firm of Chartered Accountants, hereinafter referred to as "the firm", from which he retired on 5 April 1996.
2. In each of his Income Tax Return forms for the years 1992/93, 1993/94, 1994/95 and 1995/96 the Appellant claimed a deduction of £3,000 under the terms of section 362(1)(b) of the Income and Corporation Taxes Act 1988 in respect of interest claimed to have been paid to his wife.
3. The Appellant and his wife operated a joint current account with their bank.
4. The firm operated three accounts, Nos.1, 2 and 3 with the same branch of the bank. The No 3 account was operated purely for funding and settling the firm's tax liabilities. The account was credited monthly for this purpose.
5. On 23 August 1990 the Appellant drew a cheque for £30,000 made payable to his wife. The cheque was drawn on the firm's No 2 account and was debited from the account on 31 August 1990.
6. The sum of £30,000 was credited to the joint account of the Appellant and his wife on 31 August 1990.
7. On 23 August 1990 the Appellant's wife drew a cheque for £30,000 payable to the firm. The cheque was drawn on the joint account of the Appellant and his wife and debited from the account on 31 August 1990.
8. On 31 August 1990 the sum of £30,000 was credited to the firm's No 2 account.
9. As at 31 August 1990 the firm was overdrawn on both the No 1 and No 2 accounts, in excess of the overdraft limit.
10. Prior to 31 August 1990 the Appellant had a meeting with the manager of their branch of the bank. At the meeting, the Appellant informed the manager that he intended to convey part of his estate to his wife. As the Appellant had no other funds available, he informed the manager that he intended to make payment to his wife out of his share of the capital in the firm. It was his further intention to seek payment immediately from his wife in order to restore the capital in the firm to the same position. As the intended transactions had a

neutral effect on the firm's borrowing position with the bank, the manager expressed no objection to the proposed transactions.

11. No deed of gift or loan document was executed by either the Appellant or his wife. There is no document specifying whether, when or at what rate interest would be paid.

12. As at 31 August 1990, the Appellant's estate exceeded the nil rate band of £128,000 for Inheritance Tax.

13. The Appellant executed a Will prior to 31 August 1990. The Will provided for legacies payable to each of his three children and for payment of the residue to his wife, whom failing, to his three children equally. The Appellant revised his Will in July 1998.

14. The Appellant's wife also executed a Will prior to 31 August 1990 which was revised in July 1998. The terms of the Will, as revised, in effect deleted the bequest to the Appellant of his pro indiviso share of their dwelling house. Her children were and remain residuary beneficiaries.

15. The Appellant's wife has certified on four certificates dated 9 September 1993, 7 November 1994, 14 August 1995 and 25 June 1996 that she has received annual interest of £3,000 in each of the years 1992/93, 1993/94, 1994/95 and 1995/96 respectively from her husband in respect of a debt of £30,000. There was no documentary evidence of any such sum changing hands, but the Appellant gave evidence that he had, on one occasion accounted for said sum by way of recovery of payments he had made for the spouse's holiday.

16. The Appellant's claims to interest relief under sections 353 and 362 of the Income and Corporation Taxes Act 1988 for each of the years 1992/93, 1993/94, 1994/95 and 1995/96 were refused by HM Inspector of Taxes, Special Investigations Section on 10 September 1998.

While the above facts were either agreed or not disputed there were also the following facts found by the Commissioners:

(a) The earlier transaction was pre-arranged and every step thereof agreed before the cheques were presented, not only between the Spouses but also with the firm and its banker.

(b) The Appellant's wife had no investments or savings of consequence and she was able to declare the said sums of £3,000 as untaxed interest and pay virtually no tax on them, (Production 8).

(c) The cheque drawn by the Appellant's wife in the joint account was originally dated 11 May 1990 but there was no explanation for that correction, nor could she remember how it came about that she wrote that cheque to the firm and not to her husband, nor any circumstances relating to the banking of the cheque made payable to her. She knew nothing about Inheritance Tax.

Submissions of the Respondents

The Respondents submitted that the Appellant did not contribute the sum of £30,000 to any partnership during the year 1990/91 in terms of section 362(1)B of Income and Corporation Taxes Act 1988.

On the facts there were no additional funds paid into the firm's account by the Appellant.

The Appellant had failed to show that he contributed money to the partnership to be used wholly for the purposes of the trade, profession and business carried on by the partnership in terms of the said section. The only purpose served by the credit of £30,000 to the firm's current account was to cover the debt of £30,000 which the appellant had withdrawn as the initial step in the scheme for arrangements which he put in place in order to claim tax relief. Reference was made to *Sheppard v McKnight* 1999 STC 669. Nor did the Appellant incur any obligation to repay the loan on which interest was payable. The Appellant had never divested himself of , nor invested the donee in, the subject of the gift in any real sense. It was always the Appellant's intention to do what he did in fact, deposit the sum of £30,000 in the firm's account immediately after the sum was withdrawn by him. The alleged gift was subject to the condition that the sum of £30,000 should be immediately repaid. The gift was revocable and there was no true gift. Furthermore the cheque alleged to have been given to his wife alone was in fact deposited in the joint account of the Appellant and his wife. The Appellant was equally entitled to draw the sum of £30,000 from the account and accordingly cannot be said to have borrowed money which was at his own disposal. Any sums paid by the Appellant to his wife after 23 August 1990 were not paid on satisfaction of any loan from her but were regular payments for her personal use or gifts. Payments on expenditure incurred by the Appellant on his wife's share of family holidays are not payment of interest. The Appellant's wife was never deprived of her money and accordingly no interest was due. Since the Appellant provided the money, borrowed from the firm's account, the claim that he became liable to pay interest to her for the use of her money lacks all reality and there was no objective evidence to show any obligation from one spouse to the other.

Even if the Appellant did legally incur a liability to pay interest to his wife the Appellant was not entitled to relief under section 353(1). By section 787 of the Act the sole benefit or at least the main benefit which might have been expected from the arrangement was to obtain reduction in his and also his wife's liability to income tax. The claim that the arrangements were carried out for the purpose of mitigating the liability to inheritance tax on the Appellant's death does not preclude the application of section 787.

The principle in *The Commissioners of Inland Revenue v W T Ramsay* 1981 AC 300 applied in the present case. The transactions were only circular and artificial. There was no commercial or business purpose the sole purpose of the transactions was avoidance of tax. Reference was made to the development of the law subsequent to *Ramsay* in *Furniss v Dawson* 1984 STC 153, *Craven v White* 1988 STC 7476, *IRC v McGuckian* 1997 STC 908 and *MacNiven v Westmoreland Investment Ltd* 1998 STC 1131. Reference was also made to the dicta of Lord Fraser of Tullybelton in *CIR v Burmah Oil Co Ltd* 54 TC 200 page 221.

Appellant's contentions

The Appellant contended that it was his purpose to make a gift to his wife of £30,000 in order to equalise his and his wife's estates and thereby affect the family's inheritance tax position. He paid his wife interest at the rate which was appropriate to

sums borrowed by the firm and has since his retiral partially repaid the capital sum borrowed. Since, he said, there was a legitimate purpose in the transaction none of the strictures about circular transactions applied.

Decision

Whatever may be the position about gifts between spouses in relation to inheritance tax, a matter not before me, the question to be determined is not whether the Appellant was entitled to make a gift to his wife in some way out of the capital he had in his partnership account but whether he was entitled to relief from income tax on sums claimed to have been paid as interest on the money he intended his wife to have. Whether it may be possible to gift part of the capital in the firm and borrow it back thereby assisting in the family's inheritance tax planning is not for me to determine. I have no doubt that the Appellant wished to do that and wished his wife to have the £30,000. Nor do I have any doubt that from the point of view of an accountant he felt that he had made payment of interest on that sum by deducting his wife's share of a joint family holiday which he had in the past always paid for himself. The principal question remains whether in terms of section 787 of the ICTA 1998 he is entitled to relief on payment of interest. That section states (1) relief shall not be given to any person under any provision of the tax acts in respect of any payment of interest if a scheme has been effected or arrangements have been made (whether before or after the time when the payment is made) such that the sole or main benefit that might be

be benefits to others in the event, for example, of his wife predeceasing him but that has nothing to do with the payment of interest. It has to do with the transfer of capital.

Nor in any event am I satisfied that the circumstances of the transaction fall within section 362 of the Act since the true net result of the circular transaction was that no money was contributed or advanced to the partnership which it did not already have.

For these reasons the appeal fails and the claims to relief for interest paid in the years 1992/93 to 1995/96 are refused.

T G COUTTS QC

SPECIAL COMMISSIONER

SC 3058/99

Cases cited but not referred to in the Decision

McNichol v McDougal (1889) 17 R 25

Cairns v MacDiarmid [1983] STC 178

Schulze v S W Bensted 7 TC 30

