CAPITAL GAINS TAX – "flip flop" scheme – whether settlor caught by TCGA 1992 s.77 as benefiting from "derived property" – no; whether settlor-trustee's indemnity for borrowing meant that the settlor could benefit after being cut out – no; whether settlor could benefit after being cut out as in IRC v Botnar *– no; whether on the facts the cash in the second settlement was tied up until the sale of shares in the first settlement – no*

THE SPECIAL COMMISSIONERS

MR TEE Appellant

- and -

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: DR JOHN F AVERY JONES CBE

MALCOLM GAMMIE QC

Sitting in private in London on 15, 16, 17 and 18 April 2002

David Ewart and Richard Vallat instructed by Brachers for the Appellant

Christopher McCall QC and Michael Gibbon instructed by the Solicitor of Inland Revenue for the Respondents

ANONYISED DECISION

1. This is an appeal by Mr Tee (the Appellant, where the issue is common to all of the Appellants, or the Chairman where he is referred to personally) against an assessment to capital gains tax for 1995/96 of £1,530,351 and is one of five appeals each relating to a "flip-flop" scheme for reducing capital gains tax carried out by different sellers of shares in the same company (together the Appellants). Mr David Ewart and Mr Richard Vallat appeared for the Appellants; and Mr Christopher McCall QC and Mr Michael Gibbon appeared for the Inspector.
2. The essence of a flip-flop scheme is that an asset pregnant with a gain is transferred to the First Settlement in which the settlor is a beneficiary on a hold-over election; cash is borrowed by the trustees on the security of the asset and the cash is advanced to the Second Settlement in which the settlor is interested; the settlor is then cut out from being a beneficiary of the First Settlement, leaving other beneficiaries with an interest in possession; and in the following tax year the asset is disposed of from the First Settlement. It is hoped that the rate of capital gains tax in the First settlement is only (at the time) 25%, rather than the 40% that would have applied to the settlor or the First Settlement if the settlor had still been a beneficiary. The scheme was legislated against in the section 92 of and Schedule 26 to the Finance Act 2000. The scheme is attacked by the

Inspector on four grounds: primarily on the wording of section 77 of the Taxation of Chargeable Gains Act 1992, in particular the definition of "derived property", secondly because the settlor as trustee of the First Settlement was indemnified against liability for the borrowing; and two fall-back arguments, one based on the decision in *IRC v Botnar* that the settlor was not completely excluded from benefiting from the First Setttlement; and the other based on the facts the cash was tied up until the sale of the asset.

3. We had two folders of documents containing witness statements and the documents relating to the Appellant's settlements, and two further folders relating to the other Appellants. We heard evidence from the Chairman and his wife, Partner 1 and Partner 2 of the Appellant's solicitors (the Solicitors), and the Inspector called the Banker and the Assistant of High Street Bank plc.
4. There was an agreed statement of fact which we set out below with some minor amendments so that it specifies the particulars relating solely to the Appellant:

1. The Appellants were on 1 January 1995 all shareholders in Buses Limited ("Buses Limited") an unquoted UK bus company. The Appellant held 10,000 shares.
2. In October 1994 the Solicitors on behalf of the Appellants, had a meeting with the Chartered Accountants, to consider various possibilities for structuring the proposed sale of Buses Limited to Bigger Buses Limited to avoid and reduce the liability to capital gains tax accruing on that proposed disposal.
3. On 20th March 1995, the Solicitors in a letter to the Chairman and his wife gave advice and explained " the two settlement route".
4. On 30th March 1995, each Appellant (and their respective spouses) expressing themselves as acting as "Trustees of a Life Interest Settlement Trust" made an application for an advance to the High Street Bank's local branch in the case of the Appellant of a maximum of £937,508. In the unlikely event that the sale did not proceed as planned, it was the intention of the Banker of High Street Bank that the outstanding loan in the name of the First Settlement Trustees would be assigned to the Second Settlement Trustees who would be holding the equivalent capital sum.
5. On 30th March 1995, the High Street Bank, South East Office, approved a total advance of £9.3 million in respect of the Appellants (and another shareholder, Mr Bee who was borrowing £1,937,700) for a period of one month "or sooner should matters not proceed as anticipated". The Appellant's trustees' share of the total advance was £770,000.
6. On 31st March 1995, the High Street Bank provided an "Advice of Borrowing Terms" ("the Borrowing Terms") in respect of each advance. In relation to each Settlement the Borrowing Terms record that it was anticipated that the advance would be repaid on the sale of the Trust's holding of Buses Limited shares on 7th April 1995 and that the purpose of the advance was expressed to be "to meet the Trust's cash requirements".
7. Between 31st March and 1st April 1995, each Appellant, executed a Life Interest Settlement ("the First Settlements"). The Appellant's First Settlement was dated 1 April 1995 and the trustees were the Chairman and his wife.
8. On 4th April 1995 each of the Appellants disposed of a proportion of their shareholding in Buses Limited to the Trustees of the First Settlement, in the case of the Appellant 8,000 shares were transferred.
9. On 4th April 1995 each of the Appellants executed a Deed of Settlement on Life Interest Trusts ("the Second Settlements"). The Trustees of the

Second Settlements were never liable to the High Street Bank for any of the amounts advanced to the Trustees of the First Settlements.

10. On 4th April 1995, the Trustees of the First Settlements provided a letter of authority to the Solicitors to hold the Buses Limited share certificates or the proceeds of the sale of the Buses Limited shares to the order of the High Street Bank in consideration of the advance made by the Bank.
11. On 4th April 1995, the Trustees of the First Settlements by letter gave an authority to the High Street Bank to advance the funds payable under the borrowing facility to the Solicitors.
12. On 4th April 1995, the Solicitors, on behalf of the Trustees of the First Settlements, provided a written undertaking to the High Street Bank to hold the share certificates representing the shares held by the Trustees of the First Settlements or the proceeds of the sale of the shares to the Bank's order in consideration of the Bank making the respective advances to the Trustees.
13. On 4th April 1995, the respective advances were credited to Loan Accounts in the names of the Trustees and then transferred to the Solicitors' designated Number One Clients Account. In the Appellant's case the advance was £770,000.
14. By Deeds of Appointment, dated 4th April 1995, each of the Trustees of the First Settlements appointed that part of the Trust Fund of their respective Settlements be immediately transferred to the Trustees of the Second Settlements so as to form part of the Trust Funds of the Second Settlements. In the Appellant's case £770,000 was transferred.
15. On 4th April 1995, client account ledgers of the Trustees of the Second Settlements with the Solicitors were credited with the amounts appointed by the Trustees of the First Settlements as described in paragraph 13 above. The Trustees of the Second Settlements were under no legal obligation at any time to leave that money in the Solicitors' client account. The Solicitors placed £5,890,000 on the money market through High Street Bank; (1) from 4th to 7th April; (2) from 7th April to 10th April; (3) from 10th to 12th April; (4) from 12th April to 13th April and (5) from 13th to 18th April.
16. On 5th April 1995, the Trustees of each of the First Settlements executed a Deed of Exclusion and Appointment irrevocably excluding the Appellants, the life tenants of the First Settlements, and their respective spouses as beneficiaries under those Settlements and appointing the children of the respective Appellants to be the beneficiaries under each of the First Settlements.
17. The sole purpose of the steps set out in paragraphs 7, 8, 9, 13, 14 and 16 above was to reduce the capital gains tax liability in respect of an anticipated sale of the Buses Limited shares, which sale the Appellants hoped and expected to be and which was in the events which happened effected some 12 days after the establishment of the First Settlements.
18. Prior to the making of the First Settlements, it was preordained in the sense indicated in *Craven v White* [1989] AC 398 that the First Settlements would be made and that the First Settlement Trustees would make the borrowing, the appointments to the Second Settlement Trustees and the Deeds of Exclusion and Appointment, all necessary arrangements for the same having been set out in train prior to the making of the First Settlements.
19. On 13th April 1995, the Chairman, in his capacity as Chairman of Buses Limited, wrote to the shareholders of Buses Limited recommending acceptance of a cash offer by Bigger Buses Limited to purchase the Buses Limited shares at £130.58 per share.
20. On 13th April 1995 the Trustees of each of the First Settlements sold the Buses Limited shares to Bigger Buses Limited for £130.58 per share. On

5th April 1995 this sale was not "pre-ordained" in the sense described by the majority of the House of Lords in *Craven v White* [1989] AC 398.

21. On 18th April 1995 Bigger Buses Limited paid the consideration for the purchase of the Buses Limited shares to the Solicitors (although not contained in the agreed statement we interpose here that £625,000 of the consideration was deferred until 29 March 1996, the date on which ACT of that amount was expected to be set against mainstream corporation tax; in the event it was paid in October 1996). On that date the Solicitors credited the client ledger accounts of the Trustees of the First Settlements with their proportionate share of the proceeds of sale. In the Appellant's case the amount received was £995,452.79. Also on that date the outstanding loans in the High Street Bank accounts of the First Settlement Trustees were repaid and the accounts were closed. In the Appellant's case the amount repaid including the fee and interest was £776,523.45.
22. From 19th April 1995 the Trustees of the First and Second Settlements opened investment accounts with Local Building Society.
23. On 27th April 1995 the Solicitors were released from their undertakings to the High Street Bank.

5. We make the following additional findings of fact from the evidence of the witnesses. Buses Limited was the parent company of Subsidiary Buses Limited which had been acquired on a management buyout in 1986 from Another Bus Company following deregulation of the bus industry by the Transport Act 1986. In the early 1990s acquisitions by major companies in the field were taking place and by the Autumn of 1994 there were only half a dozen or so significant independent companies remaining, including Subsidiary Buses Limited. The Chairman received regular offers from all the major groups except one. By September or October 1994 the leading shareholders who held 100,000 out of 110,196 of the shares decided in principle to sell Buses Limited and obtained a valuation from the Chartered Accountants. An information memorandum was prepared and sent to prospective purchasers and offers were received from four groups, of which Bigger Buses Limited was considered the most attractive taking into account the positions offered to two of the directors. Negotiations were continued with Bigger Buses but one of the others remained in touch as serious bidders.
6. The Chairman either met with the Banker or telephoned him on 23 March to explain the two settlement proposal and to request the borrowing from the bank. The Banker and the Assistant met Partner 2 of the Solicitors who was dealing with the preparation of the settlements on 29 March. The bank prepared a memorandum to the regional office on 30 March which processed it the same day and gave their approval to the borrowing for one month "or sooner should matters not proceed as anticipated." The submission to the bank's regional office included the following:

   "Repayment of the borrowing to come either from the sale of each shareholder's Buses Limited shares or, alternatively, Assignment of the Loan to the No.2 Trust. Any documentation prepared by the Solicitors in respect of the Assignment to be overseen by the Bank's Legal Advisors."

   On the question what would happen regarding repayment of the loan if the sale to Bigger Buses had fallen through the Appellant believed that another sale on similar terms would have been possible within about a month. Another of the four bidders had continued to show interest and seemed to know that the completion of the Bigger Buses purchase had been postponed. If the Bigger Buses sale had fallen through the Chairman

would have approached that other bidder immediately. The Banker discussed the possibility of repayment of the loan out of a dividend if the deal fell through but this was not pursued because being unable to sell was not considered a likely scenario.

7. The suggestion that repayment should be by way of assignment was based on a suggestion of the Banker's and did not come from the parties and had not been discussed with anyone. The Banker would not have called in the loan if the sale to Bigger Buses had fallen through. He would have informed his regional office if this had occurred but the likely result would have been a renegotiation of the terms of the borrowing. He knew that a different sale was likely. Partner 2 of the Solicitors would not have considered the Second Settlement taking on the liability for the loan but *in extremis* as trustee he would have considered helping the Appellant by making a loan to him out of the funds of the Second Settlement. Clearly the funds of the Second Settlement could be used to benefit the Appellant as he was the primary beneficiary of that settlement. But this was not the intention of the trustees who did not think that it was likely to be necessary.
8. The bank's submission to the bank regional office also contained the following:

   "The Solicitors' informal agreement – i.e. not to be included within the facility letter – that the proceeds of the respective advances should not leave High Street Bank PLC, albeit the funds will be held on the Solicitors Clients Account"

9. We find that Partner 2 of the Solicitors told the bank that in accordance with his normal practice the funds advanced to the Second Settlement would be placed in his firm's separate client account for trusts controlled by partners of the firm. Because the Appellant was fully occupied selling Buses Limited which at the time of the borrowing on 4 April he expected to be able to finalise on 7 April, it was unlikely that the trustees of the Second Settlement would be able to discuss investment with him until after the sale and so it was unlikely that the funds would move until the sale was completed. There was, however, nothing to prevent the funds from being moved and the Banker accepted that it would have been possible for them to be moved to another bank to obtain a higher rate of interest. Accordingly the reference in the bank's submission to an "informal agreement not to be included within the facility letter" was not to an existing agreement that was to be hidden by not including it in the facility letter, but was a reference to something that was not an agreement at all. It is merely that it was unlikely that the funds would move. Partner 2's manuscript note of a meeting with the Banker on 29 March 1995 recorded: "We will get interest for client. Interest on day of borrowing but not day of repayment." The meaning of this is unclear and it was not really clarified in evidence but we think that it showed that he was considering both the deposit of the cash in the Second Settlement in the first sentence, and the borrowing in the First Settlement in the second sentence. We do not read it as meaning that he considered that the deposit was likely to be used to repay the borrowing. This was most unlikely given that at the time the borrowing took place on 4 April 1995 it was expected was that the sale of the shares would be completed on 7 April. Given the short time-scale it is probable that no thought was given to moving the money before the sale of the shares was completed.

10. We also find that, while the Appellant was prepared to bear the interest on the borrowing if necessary, he did not in fact do so and at the time of the borrowing it was not likely that he would do so. The interest on the borrowing was paid at the time of the repayment of the borrowing out of the sale of the shares. The share of the proceeds of sale of Buses Limited attributable to the Appellant's First Settlement was £995,452.79 (implying that the total consideration was £12,443,159, which is the contracted consideration of £13,058,000 for the 100,000 shares for which the offer was accepted less the deferred consideration of £625,000 due on 29 March 1996 equals £12,433,000 plus interest of £10,159). Their share of the deferred consideration was £50,000. In addition, Bigger Buses paid £110,196 in respect of the vendors' costs. Accordingly the borrowing was 73.65 per cent of the total consideration (including the deferred consideration but excluding the interest and costs paid by the purchaser). The capital gains tax would not have been as much as 25 per cent of the consideration because there would be deductions for the base value of £1 per share, indexation, costs and the annual exemption, and the tax was not due for another 20 months during which interest could be earned. The amount repaid to the Bank including interest and costs was £776,523.45 or 74.27 per cent of the total consideration (calculated as before). The assets of the First Settlement were therefore sufficient to repay the borrowing and interest leaving sufficient funds to pay the capital gains tax. At the time of entering into the borrowing the Chairman was expecting the sale to be completed on 7 April 1995 in which case the interest paid would have been less than it was as the consideration was ultimately paid on 18 April (the contracts was entered into after banking hours on 13 April which was the Thursday before Easter). The Chairman was aware that he was taking a risk over the borrowing and the advance to the Second Settlement but he was confident that he could sell Buses Limited to another purchaser within about a month even if the sale to Bigger Buses fell through. No doubt a professional trustee would not have been willing to take the risk but this is not an exceptional risk to be taken by family trustees in the circumstances.

11. It is convenient to deal with each of the Inspector's arguments in turn.

Section 77 TCGA 1992

12. Section 77 was first introduced in 1988 at the time when capital gains tax was first charged at the individual's marginal rate of tax rather than at a flat rate. It was amended in the Finance Act 1995 at the same time as the income tax "settlement" provisions were redrafted. The revised income tax provision in section 660A of the Taxes Act 1988 contains the identical definition of "derived property" to the one introduced for capital gains tax in 1995. In income tax it has applied since section 28 of the Finance Act 1946 where the words which now comprise the definition of derived property were contained in the section. The changes to the operative parts of the section can be seen from the comparison below.

Original version	As amended by the Finance Act 1995
(1) Subject to subsections (6), (7) and (8) below, subsection (2) below applies where—	(1) Where in a year of assessment—
a. in a year of assessment	a. chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the

chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,

b. after making any deductions provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would, disregarding section 3 (and apart from this section), be chargeable to tax for the year in respect of those gains, and

c. at any time during the year the settlor has an interest in the settlement.

(2) Where this subsection applies, the trustees shall not be chargeable to tax in respect of the gains concerned but instead chargeable gains of an amount equal to that referred to in subsection (1)(*b*) above shall be treated as accruing to the settlor in the year.

(3) Subject to subsections (4) and (5) below, for the purposes of subsection (1)(*c*) above a settlor has an interest in a settlement if—

a. any property which may at any time be comprised in the settlement or any income which may arise under the settlement is, or will or may become, applicable for the benefit of or payable to the settlor or the spouse of the settlor in any circumstances whatsoever, or

b. the settlor, or the spouse of the settlor, enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any income arising under the settlement.

settled property,

b. after making any deductions provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would, disregarding section 3 (and apart from this section), be chargeable to tax for the year in respect of those gains, and

c. at any time during the year the settlor has an interest in the settlement,

the trustees shall not be chargeable to tax in respect of those but instead chargeable gains of an amount equal to that referred to in paragraph (*b*) shall be treated as accruing to the settlor in that year.

(2) Subject to the following provisions of this section, a settlor shall be regarded as having an interest in a settlement if—

a. any property which may at any time be comprised in the settlement, or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever, or

b. the settlor or his spouse enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.

.

(8) In this section "derived 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 therefrom.

13. Mr McCall QC contended that as this was an anti-avoidance provision it should not only be given a purposive construction but also wide phrases should be given wide meanings on the lines of Lord Reid's approach in *Greenberg v IRC* [1972] AC 109 at 137. Mr Ewart contends that this is not anti-avoidance legislation on a par with section 703 of the Taxes Act 1988 but legislation designed to charge capital gains tax at the settlor's marginal rate in circumstances where this is obviously the correct rate. On this point we agree with Mr Ewart and see no reason why the section should be given anything other than a normal purposive construction and that we should not strive to give wide meanings to phrases in it. In particular, as Lord Hoffmann said in *Macniven v Westmoreland* [2001] 2 WLR 337 at 397B quoting from his speech in another case, "If [tax avoidance schemes] do not work, the reason…is simply that upon the true construction of the statute, the transaction which was designed to avoid the charge to tax actually comes within it. It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loopholes."
14. The crucial provision for determining whether the section applies is subsection (2):

    "Subject to the following provisions of this section, a settlor shall be regarded as having an interest in a settlement if

    (a) any property which may at any time be comprised in the settlement, or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever, or

    (b) the settlor or his spouse enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property."

15. We consider that "at any time" in paragraph (a) means at a particular time. We do not think this was disputed, although Mr McCall may not have accepted it.
16. The definition of "derived property" is:

    (8) In this section "derived 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 therefrom.

17. There was agreement between the parties that the definition of derived property should be expanded as follows: Derived property in relation to any property means (i) income from that property; (ii) any other property directly or indirectly representing proceeds of that property; (iii) any income from (ii); (iv) any other property directly or indirectly representing proceeds of income from that property; and (v) any income from (iv).
18. Combining subsections (2) and (8) the question is whether:

1. any property which may at [a particular] time be comprised in the settlement is or will or may become payable to or applicable for the benefit of the settlor or his spouse;

2. (i) income from any property at [that] time comprised in the settlement; (ii) any other property directly or indirectly representing proceeds of any property at [that] time comprised in the settlement; (iii) any income from (ii); (iv) any other property directly or indirectly representing proceeds of income from any property at [that] time be comprised in the settlement; or (v) any income from (iv)—is or will or may become payable to or applicable for the benefit of the settlor or his spouse;

3. the settlor or his spouse enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement; or

4. the settlor or his spouse enjoys a benefit deriving directly or indirectly from (i) income from any property which is comprised in the settlement; (ii) any other property directly or indirectly representing proceeds of any property which is comprised in the settlement; (iii) any income from (ii); (iv) any other property directly or indirectly representing proceeds of income from any property which is comprised in the settlement; or (v) any income from (iv).

19. Mr McCall QC contends that since all property comprised in the settlement is included in Nos.1 and 3, Nos.2 and 4, being derived property, must include property outside the settlement, and hence must include the cash advanced to the Second Settlement in which the settlor is clearly interested. He limits this to cases where there is a connection between the property outside the settlement and the property comprised in the settlement, for example freehold comprised in the settlement and a lease (on beneficial terms) held outside the settlement, or, as in this case, there is cash outside the settlement representing a borrowing secured on assets in the settlement. The freehold and leasehold example then gives the same result as the settlor having a licence to occupy property in the settlement. The connection disappears when the first property ceases to be comprised in the settlement or the borrowing ceases to be secured on assets in the settlement.
20. Mr Ewart contends that the natural meaning of the words comprising the definition of derived property is limited to property comprised in the settlement and income therefrom. He suggests that the definition is needed to catch the case of a settlor who had no interest in property comprised in the settlement today, for example a house, but who could benefit from the proceeds of sale of the property. In relation to the freehold and leasehold example, granting the lease to the settlor on favourable terms is clearly a benefit to the settlor but thereafter the leasehold is a separate item of property and not derived property from the freehold in the settlement. He also contends that including property outside the settlement was a major change which one would not expect to find made in a redrafting of the section contained in a Schedule to the Finance Act 1995 headed "Consequential Amendments of Other Enactments". Mr McCall answers this by saying that property outside the settlement was already caught by the benefit obtained indirectly in No.4 of the combined wording above. Mr Ewart replies that a benefit from the Second Settlement does not derive, even indirectly from property in the First Settlement .

21. We prefer Mr Ewart's construction as being the more natural use of language. The effect of the definition of derived property in No.2 above is to catch the possibility of the settlor benefiting from (i) income of the property now comprised in the settlement; (ii) the proceeds of (meaning something representing) the property now comprised in the settlement; (iii) the income of (ii); (iv) the proceeds of that income; (v) the income of (iv). In other words, one starts with the property in the settlement now and adds income and property representing that property or income, and income from that, so that all property derived from the present settled property is caught. Similarly, No.4 above looks at benefits enjoyed (directly or indirectly) from the property in the settlement now and from all property derived from that property. We believe that there is a clear statutory purpose in catching benefits from all such property. The previous version of section 77 only caught benefits from the property now comprised in the settlement and its income, so that it would not catch benefits that could be obtained only from the proceeds the property now comprised in the settlement or from the income of the proceeds of that property. The income tax provisions have since 1946 caught the possibility of benefiting from all such derived property. Section 28(2) of the Finance Act 1946 provides:

    "the settlor shall not be deemed for the purposes of this section to have divested himself absolutely of any property if that property or any income therefrom or any property directly or indirectly representing proceeds of, or of income from, that property or any income therefrom is, or will or may become, payable to him or applicable for his benefit in any circumstances whatsoever….."

22. This has the same content as the defined expression derived property. Bringing the capital gains tax provision into line with the redrafted income tax provision still effectively containing these words through the definition of derived property could properly be described as a consequential amendment.

23. Mr McCall's construction, so far as concerns property outside the settlement, requires a connection to be found for the time being between the settled property and property outside the settlement. In this case he contends that the cash in the Second Settlement is derived property only so long as the borrowing is charged on assets in the First Settlement. When the borrowing is discharged, on his construction the derivation ceases. He founds this construction in the words "'derived property' *in relation to any property* means…." so that the property is derived only so long as the relationship subsists. We consider that his construction strains the language of the section and Mr Ewart's construction is more natural and is fully in accordance with the statutory purpose. On this point accordingly we find in favour of the taxpayer.

Settlor's indemnity

24. The Inspector's second contention is that looking at the position in the second tax year after the settlor has been cut out of benefiting from the First Settlement he still benefits because he has made the borrowing personally and has a right of indemnity from the settled property both for the interest and for any loss on the capital. There is no dispute that since a settlement is not a legal entity any contract, here the borrowing, is made by the trustee personally for which he has an automatic right of indemnity.

25. Mr McCall QC contends that here the borrowing is approximately 75 per cent of the assets of the First Settlement, leaving approximately 25 per cent for the payment of the capital gains tax so that there is no margin on capital with the result that the settlor would lose personally if the proposed sale went off and a subsequent sale was at a lower price, and the settlor had to fund the interest. This was uncommercial and not something a prudent trustee would do. The sale of the shares and repayment of the borrowing was accordingly the removal of the obligation on the settlor to meet these liabilities personally, which is a benefit. He would limit this contention to cases where the settlor-trustee does something which is uncommercial.
26. Mr McCall relies on *Jenkins v IRC* 26 TC 265 in which a settlor had made an interest-free loan repayable on demand to the trustees. The trustees used income from the settled property to repay the loan. The issue was whether the settlor had an interest in the income under a definition that:

    "The settlor shall be deemed to have an interest in income arising under or property comprised in a settlement, 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… in any circumstances whatsoever."

27. Lord Greene MR referred to it not being disputed that the repayment of a non-interest bearing loan was for the benefit of the settlor and he did not express a view on the position if the terms had been different, presumably meaning at a full rate of interest. He held that even before paying off the loan out of income one could say that the income might become payable to or applicable for the benefit of the settlor because the trustees had power to use income for this purpose. Mr McCall contends that by analogy the benefit is cutting off the settlor's burden of paying the interest on the borrowing and paying a capital loss if the sale went off and a new sale was at a lower price.
28. Mr Ewart says that the right of indemnity is inherent in all obligations of trustees and if Mr McCall's argument is correct a settlor is caught by the section in all cases unless the settlor is expressly prohibited from being a trustee. (He made this point before Mr McCall explained that his contention was limited to cases where the settlor-trustee did something uncommercial.) He points out that the borrowing was for the benefit of the settlement, the borrowed money went into the settlement before it was advanced, and the borrowing and interest were discharged from the sale of the shares. In *Jenkins* the benefit to the settlor was having cash in his hands instead of a right to repayment of an interest-free loan.
29. On this point we prefer Mr Ewart's contention. The trustee's right of indemnity is inherent in being a trustee and deals with the technical legal point that a trust cannot contract and so the trustee must do so. The trustee's personal liability follows from this. The indemnity is not a personal benefit to the trustee but something inherent in being a trustee and contracting for the benefit of the trust. Whether or not the contract is a prudent one for a trustee to make does not change this. In contracting for the loan the Appellant was acting on behalf of the trust and for the benefit of the trust. It is natural that the law should give him an indemnity. We do not think that this is the type of benefit that Parliament had in mind in enacting section 77. We do not agree with Mr McCall's contention that the borrowing was imprudent because it represented nearly 75 per cent of the assets of the First Settlement. At the time of the borrowing the trustees still owned the shares and the borrowed money and so there was nothing imprudent about the borrowing. If there is

anything to criticise it is the amount of the advance to the Second Settlement but this is not the point he made. We have found that the Appellant did not bear any interest and was not likely to have to do so if the transaction proceeded as planned, although he was willing to do so if he had to. The position might be different if a settlor intended to rely on the indemnity to pay the interest but that is not the case here. At the time of the borrowing on 4 April 1995 The Chairman hoped to finalise the sale of the shares on 7 April, and in the event the sale was finalised on 13 April with payment made on 18 April, immediately after Easter with interest paid by the purchaser to reflect the delay. The position in *Jenkins* was different in that there was an actual liability to the settlor and there was a clear benefit in the settlor having cash rather than the right to repayment of an interest-free loan.

The *Botnar* point

30. As a fall-back argument the Inspector contends that on the construction of the documents the settlor has not been cut out of the First Settlement because he could benefit through an advance to another settlement in which he was a potential beneficiary. *IRC v Botnar* 72 TC 205 is an example of this occurring and so it is necessary to analyse the terms of the settlement in *Botnar* to see the extent to which this one is similar. There the settlement contained power in clause 3(c):

"to pay or transfer the whole or any part of parts of the capital of the Trust Fund to the trustees for the time being of any other trust….under which any one or more of the members of the Appointed Class are interested notwithstanding that such other trust may also contain trusts powers and provisions (discretionary or otherwise) in favour of some other person or persons or objects and so that after such transfer the money investment and property so transferred shall (i) cease to be regarded as held upon the terms of this Settlement for all the purposes of this settlement and (ii) cease to be regarded as the Trust Fund or part of the Trust Fund of this settlement as the case may be for all the purposes of this settlement."

31. Clause 23 provided:

"No Excluded Person shall be capable of taking any benefit in accordance with the terms of this Settlement and in particular but without prejudice to the generality of the foregoing provisions of this Clause:–

(a) the Trust Fund shall henceforth be possessed and enjoyed to the entire exclusion of any such Excluded Person and of any benefit to him by contract or otherwise,

(b) no part of the capital or income of the Trust Fund shall be paid or lent or applied for the benefit of any such Excluded Person."

Mr Botnar was an Excluded Person.

32. The issue was whether Mr Botnar had power to enjoy the income of the first settlement under section 478 of the Taxes Act 1970 (now section 739 of the Taxes Act 1988) under either of two provisions. The first is section 478(5)(a) under which income is so dealt with as to be calculated to enure for his benefit, a purposive test, and the second is paragraph (d) under which he may by the exercise of various powers become entitled to the

beneficial enjoyment of the income, a test based on the possibility of benefiting in the future. Of these, the second is more relevant to our case. The question in the *Botnar* case in relation to paragraph (d) was whether, reading clauses 3(c) and 23 together, the trustees could advance the settled property to another settlement of which Mr Botnar could benefit by being added as a beneficiary later. Once the property had been advanced under clause 3(c) it ceased to be regarded as held on the terms of the Settlement and ceased to be regarded as the Trust Fund and so the restriction on an Excluded Person taking a benefit "in accordance with the terms of this Settlement" or the requirement for "the Trust Fund" being enjoyed to the entire exclusion of Excluded Persons no longer applied. We know from extraneous material that this was intentional.

33. In the Court of Appeal Aldous LJ concluded that Mr Botnar could benefit as potential beneficiary of another settlement as a matter of construction of the document alone but in reaching that conclusion he regarded items (i) and (ii) in clause 3(c) as important. He did not deal with paragraph (d) but if he considered that paragraph (a) was satisfied he would have considered that paragraph (d) was also satisfied. Morritt LJ decided first that the power to transfer funds to another settlement could not be used for the purpose of benefiting Mr Botnar (which was relevant to paragraph (a)), but that secondly, if the power were properly exercised then if Mr Botnar was added as a beneficiary of the transferee settlement later this was not prevented as a matter of construction of the settlement alone (which was relevant to paragraph (d)) (para.28 on page 283). Mance LJ decided if the circumstances had been been that that Mr Botnar could realistically be taken to have intended to benefit members of the appointed class other than himself he would not have decided that an advancement to another settlement under which Mr Botnar could benefit was possible (page 299D). However, given the surrounding facts he decided otherwise in relation to paragraph (a). In relation to paragraph (d) the same construction, read if necessary with a further power for the trustees to rely on counsel's opinion, meant that the paragraph applied. (page 301B).
34. We compare that with the exclusion clause in this case:

    "The Trustees of the Settlement in exercise of the power contained in clause 12 of the Settlement and of any and every other power them enabling IRREVOCABLY DECLARE that with effect from execution of this Deed the Life Tenant (as defined in the Settlement) shall be excluded as a Beneficiary of the Settlement forthwith and that he shall cease to have any of the powers given to hem under the Settlement …and that the interests of the other Beneficiaries of the Settlement shall be construed for all purposes as if the Life Tenant had died to the intent that :-

    2.1 no capital comprised in the Settlement at any time nor any income which may arise thereunder shall be applicable for the benefit of or payable to the Life Tenant (or his spouse) in any circumstances whatsoever; and

    2.2 neither the Life Tenant (nor his spouse) shall directly or indirectly enjoy a benefit from any such capital or income."

35. It will be seen that the drafting of 2.1 and 2.2 follows the wording of section 77(2).
36. Mr McCall contends that the effect is that the Appellant is excluded as a beneficiary of the Settlement [the First Settlement], and not of any other

settlement, and that it states that the capital comprised in "the Settlement," and not of any other settlement, shall not be applicable for his benefit and nor shall he directly or indirectly enjoy a benefit from it. It follows that the Appellant is not excluded from benefiting incidentally from the property when it is comprised in another settlement in circumstances where the trustees of the First Settlement intended to benefit beneficiaries other than the Appellant but where he could, for example, be included incidentally as a dependent of those beneficiaries. Mr Ewart contends that the exclusion is from benefiting from the capital comprised in the settlement, not as in *Botnar* from benefiting under the terms of the settlement. He points out the contradiction in Mr McCall's construction, first that an advance to another settlement under which the Appellant could benefit incidentally is not prohibited by the exclusion clause because it is not an application for the benefit of the Appellant, but that he can be taxed on the ground that the property is applicable for his benefit on the same wording in section 77.

37. On this point we agree with Mr Ewart. This case seems entirely different from the careful drafting in *Botnar* which was designed to allow the settlor to benefit. In our case the Appellant has been excluded from benefiting from the capital and income of the First Settlement using similar wording to that in section 77. The wording under consideration in *Botnar* is so different that it is difficult to draw any conclusions about what their Lordships would have said in relation to this case, but it seems that Aldous LJ relied on the particular wording in clause 3(c) of the settlement and so did not express any view which could be applied to our wording. Morritt LJ found the position finely balanced on that wording but considered that there was nothing to prevent Mr Botnar from benefiting as an added beneficiary of the transferee settlement. Mance LJ would have decided that an advance to another settlement under which Mr Botnar could benefit was not possible where the circumstances were that the trustees genuinely intended to benefit the beneficiaries of the second settlement. We are unable to draw any firm conclusion given the different wording in *Botnar* and we consider that by using similar wording to that in section 77 the settlor has been excluded from benefiting incidentally from an advance to another settlement after he had been cut out of the First Settlement. We do not think that the possibility of such an incidental benefit is the type of benefit Parliament intended to be caught by the section.

Factual connection

38. The Inspector's other fall-back contention is that the use of the cash in the Second Settlement was fettered until the sale of the shares in the First Settlement so that the shares conferred a benefit on the Appellant by the removal of the fetter when they were sold. Our findings of fact set out above are that there was no fetter on the use of the cash. It was merely likely in practice that the cash would remain on the Solicitors' client account during the short time between the borrowing on 4 April 1995 and the sale which was expected to be finalised on 7 April, and which was finalised on 13 April. Given this finding of fact this argument cannot arise and we find in favour of the taxpayer on this point.

Conclusion

39. Accordingly we find in favour of the taxpayer on all the points, namely that:

a. the property in the Second Settlement is not derived property within the meaning of section 77 TCGA 1992;
b. the settlor's indemnity in relation to the borrowing is not a benefit within section 77;
c. any incidental possibility (if it exists) of the settlor benefiting through another settlement from an advancement out of the First Settlement is not a benefit within section 77;
d. on the facts there was no fetter on the use of the cash in the Second Settlement until the shares had been sold in the First Settlement;

and accordingly we allow the appeal in principle.

1. In accordance with section 56A(2) of the Taxes Management Act 1970 we hereby certify that our decision involves a point of law relating wholly or mainly to the construction of an enactment that has been fully argued before us and fully considered by us. This means that if both parties consent, and if the leave of the Court of Appeal is obtained, the Respondent may appeal from our decision directly to the Court of Appeal.

JOHN F AVERY JONES

MALCOLOM GAMMIE

SPECIAL COMMISSIONERS

SC3004/01

Authorities referred to in skeletons or argument and not referred to in the decision:

IRC v McGuckian 69 TC 1

Muir v City of Glasgow Bank (1879) 4 App Cas 337

Walker v Centaur Clother Group Ltd [2000] 1 WLR 799

Re The Exhall Company Ltd: Re Bleckley (1866) 35 Beav 449; 55 ER 970

Stott v Milne (1884) 25 ChD 710

IRC v Joiner (1975) 50 TC 449

Ensign Tankers (Leasing) Ltd v Stokes [1992] 1 AC 655