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The Verstay Tax Care

ECONOMIC POLICY

OCTOBER 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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PREM 19/196

Dd 533270 5M 2/78 8362633 JET

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21 November, 1980

You wrote to me on 17 November enclosing a Draft Consultative Document on Section 478 ICTA 1970. This is to confirm that the Prime Minister is content for the document to go out.

T. P. LANKESTER

R I Tolkien, Esq
HM Treasury

CONFIDENTIAL

Mr Whitmore
Mr Lankester

Prime Minister

Content for this consultation document to go out?

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

17th November 1980

Tim Lankester Esq.
Private Secretary
10 Downing Street
LONDON
SW1

TL
Yes 17/11

Dear Tim,

In the light of the publicity which has recently been given to the tax affairs of the Vestey family, the Prime Minister should know that Treasury Ministers are authorising the Inland Revenue to consult the relevant professional bodies, in confidence, about the changes which might be made in the law to deal with the consequences of the House of Lords' decision that certain payments to beneficiaries of Vestey family trusts were not liable to tax.

.... I attach a copy of the proposed consultation document. It explains that the Government does not propose to restore the law in this area to what it was thought to be before the House of Lords decision but rather to revise it generally in the light of criticisms which their Lordships voiced of the legislation.

Thus individuals who themselves transfer assets abroad for tax avoidance purpose will remain generally liable to tax on income in which they retain an interest. Others, however, who may receive benefits from the arrangements will be taxed only on what they receive.

The tax law impinges here on a wide variety of family and business arrangements where the law is intricate and complicated.

To ensure that this tax law is revised in a satisfactory manner it is necessary to consult the professional bodies which have most to do with it, and to ask them in particular to consider the practicality of methods of achieving the desired result which are canvassed in the paper or any others which seem to them appropriate, and to indicate where any hardship or inequity might arise.

/The Inland

The Inland Revenue propose to consult the Bar Council, the Revenue Bar Association, the Law Society, the Consultative Committee of Accountancy Bodies, the Confederation of British Industry and the Association of British Chambers of Commerce.

Yours ever,

Richard Tolkien

R.I. TOLKIEN
Private Secretary

Draft Consultative Document on Section 478

Introduction

1. Ministers have authorised us to consult you in confidence about proposals to alter the law which they are considering in the light of the decision of the House of Lords in the Vestey case last year [1979 3 WLR 915].

2. This concerned Section 478 ICTA 1970 which was specifically designed to prevent avoidance of tax by way of transfers of assets abroad. Such avoidance has most commonly involved the use of overseas settlements although other non-resident bodies - such as overseas companies - have also been used. The tax treatment of the transferor is substantially unaffected by the House of Lords decision; but it is now clear that anyone not associated with the transfer of assets will not be covered by Section 478. This, as Lord Dilhorne pointed out in his judgment in the Vestey case, leaves a gap to be filled, and Ministers agree that it must be closed. They do not however propose to restore the law to where it was thought to stand before the House of Lords decision.

3. In the light of the criticisms voiced by the House of Lords in the Vestey case about the earlier interpretations of Section 478, Ministers have decided however that it is necessary to review the whole concept of Section 478 and the attendant provisions of Chapter III of Part XVII of ICTA 1970. They propose not to change significantly the situation of transferors such as settlors of overseas settlements but they do propose in addition a charge on other residents who benefit from this kind of arrangement. They take the view however that it would be unsatisfactory to seek to tax such beneficiaries on more than they actually receive out of the income of the relevant trust etc. (though in the concept of

receipt they would include benefits indirectly representing the income). Decisions have not been taken about the methods to be adopted in implementing these proposals and your views are sought as to the practicability of certain possible approaches and as to the extent to which any of them may give rise to genuine hardship or injustice. But we should be grateful for your views also on possible alternative methods.

Transferors: Settlements

4. So far as the treatment of transferors is concerned it is for discussion whether their tax treatment should be preserved by the continuation of Section 478 or by some entirely new legislation. Since the position of the transferor was not affected by the Vestey decision, the most straightforward method would be to retain the existing provisions. But it can be argued that the concept of power to enjoy which is used in Section 478 is very wide and could give rise to uncertainty. So far as settlors are concerned Part XVI of the ICTA 1970 is effective to a degree to counter the avoidance which settlors might otherwise achieve, although the underlying concepts of Part XVI and S 478 are different, and this would have to be taken into account. In the absence of Section 478 it would be necessary, in order to preserve the same general treatment for settlors to ensure that settlors of overseas settlements remained liable to tax on the income of companies owned or controlled by the settlement whether directly or indirectly through other companies or settlements. It would be necessary to ensure that the settlor remains liable on such income which, in the present words of Section 478, he has power to enjoy, not by the express words of any trust deed but by virtue of or in consequence of any transactions associated with the original transfer of assets, and to ensure that the settlor remained liable to the whole income of any

settlement from which he received a capital sum. On the other hand it will be necessary to consider whether there would be any need in the new legislation for safeguards such as are provided for settlors by Part XVI in such circumstances as the deaths of potential beneficiaries to a marriage settlement.

5. It is for consideration how this might be done and how far the law may be made more certain in these respects without becoming less effective. It seems clear that the necessary legislation would be lengthy and very complicated.

Transferors: Other non-residents

6. As it now stands, Section 478 applies whether the assets in question are transferred to an overseas settlement or to any other non-resident. If Section 478 were to be replaced by new legislation, it is for consideration whether the present position could be appropriately and effectively maintained by extending in some manner the treatment of "close companies" to cover non-resident companies. This would in fact go somewhat beyond the intention of preserving the tax treatment of transferors, but in principle there is no reason why UK resident participators in non-resident close companies should not be liable to tax on the income of such companies, at any rate in the same way as participators in resident companies. Since the company is likely to be out of the jurisdiction it would be necessary to consider to what extent tax due from the participator should include tax at the basic rate as well as at the higher rates, and the rules concerning service of notices on a company and companies' obligations to produce information would have to be adapted appropriately. It would also be for consideration whether other adaptations would be necessary and whether for example the provisions concerning companies' rights to submit accounts and ask for a clearance would be appropriate in the context of non-resident companies.

7. Since there may be more than one participator resident in the UK it would be for consideration for example how far any participator might be required to produce information about the relevant company, including information about the shareholdings of or directorships held by other persons, or how far he should be able to call, without the agreement of other resident participators, for a clearance.

Non-transferors

8. One of the most commonly voiced criticisms of Section 478 as it was applied before the Vestey decision was that it could theoretically impose a tax liability on, for example, the beneficiaries of an overseas discretionary trust, on income which they had not received, which they might never receive and over which they may have no control. Clearly this could give rise to practical problems and Ministers have concluded that legislation to restore the law to the pre-Vestey position would not be appropriate. It is however difficult to argue that it would be wrong to charge such beneficiaries on benefits that they do actually receive out of the relevant income, whether these are paid or expressed to be paid in income or in capital form. Ministers therefore believe that such a charge would be justified. Receipt in this sense must be understood not only to include income remittances of cash to the beneficiary in the UK but to include constructive payments as well. What precisely should be included in the term "constructive payment" would be for discussion but it seems appropriate for example to include at any rate any amount applied for the benefit of the beneficiary, or raised by the sale of his interest.

9. The question of the circumstances in which the liability should arise may present some difficulty. Again the problem seems to be whether these 'circumstances should be newly defined or whether they should be those prescribed under Section 478. In that case, for liability to arise there would have had to have been a transfer of assets as a result of which either alone or in conjunction with associated operations income has arisen to a non-resident which has now been received by a UK resident individual, and liability would not arise even so if the transfer or associated operations had not been effected for the purpose of avoiding liability to taxation or were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation. The result could be achieved by applying Section 480(4) ICTA 1970 to non-transferors.

10. If the circumstances are to be newly defined then it may be that the rules should apply in the first place in a rather more restricted field - ie simply to payments made by non-resident trustees to a UK resident individual.

11. Although this is a restricted field it may still seem too wide and it would be for consideration whether it should be narrowed by some exclusion from the charge, as in Section 478 at present, of benefits where the trust itself was not set up nor were any associated operations producing income for the trust undertaken for the purpose of avoiding tax. Or additionally benefits might be excluded from the charge in particular situations where genuine hardship or injustice would occur if they were not. It would be necessary to define such situations and your views on what these might be and how they could be so defined would be welcomed.

12. It would be appropriate to ensure that the taxation of beneficiaries in this way did not result in the taxation of more than the total income of the relevant non-resident trust or other person. Thus it is proposed to allow relief from the tax if and to the extent that the beneficiary can show that what he has received represents the original capital of any relevant trust or other person and not their current or accumulated income. It would be for consideration how this might be achieved but the simplest method would be to regard any payment made by the non-resident as paid ou of income insofar as there was undistributed income out of which to pay it. If more than one beneficiary could claim such relief in any tax year it would be necessary to apportion the relief - the most obvious way would be in relation to the total benefit received in that year by each beneficiary.

Spreading

13. If it is thought that circumstances could arise in which it would be necessary to spread over a period of years for tax purposes payments made to a beneficiary in any one year to avoid hardship or inequity you may have comments on the grounds for spreading and on the feasibility of devising a satisfactorily workable scheme for this purpose.

Information Powers

14. If new legislation superseding Section 478 were adopted it would be necessary nevertheless to provide powers for the Inland Revenue to require the production of information equivalent to those provided for the purposes of Section 478. While Lord Keith's committee is sitting Ministers would not propose to seek new information powers but it would be necessary to ensure that the powers contained in Section 481 applied in the new context, with any necessary modifications.

Conclusion

15. The intention is to introduce the necessary legislation in the 1981 Finance Bill and we would be glad to have your comments therefore by the middle of December 1980. Please send any written comments to the Policy Division, Board of Inland Revenue, Room S7 West Wing, Somerset House, Strand WC2R 1LB. We should of course be very happy to discuss this question with you if you prefer.

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10 DOWNING STREET

From the Private Secretary

8 October 1980

The Vestey Case

The Prime Minister had a short meeting this morning with the Chancellor to discuss his minute of last night on the Vestey case.

The Prime Minister said she was very concerned to undo the bad publicity following Lord Thorneycroft's interview about the Vestey case. Accordingly, the Chancellor should announce as soon as possible that he intended to introduce legislation in the next Finance Bill to deal with the issues raised by the Vestey case. He should make it clear that the Revenue had been looking at the possible means of blocking the loophole, but that it had not been possible to prepare a suitable provision in time for the last Finance Bill. He should also make the general point that, whatever the technical legalities, the Government expected people who enjoyed the benefits of UK residence to pay their fair share of tax. She agreed with the Chancellor that restrospective legislation should be ruled out.

The Chancellor said that he would make a statement on the lines suggested. He would not do this in his Conference speech because that would detract from the rest of it; but he would take the opportunity of a radio interview, if possible later today, to announce it.

T. P. LANKESTER

Peter Jenkins, Esq.,
HM Treasury.

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cc Mr Wolfson
Mr Cattin
Mr. Gow

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

THE VESTEY CASE

I should say at once that if the Vestey decision was allowed to stand the tax loss on the best evidence available to the Revenue would be of the order of £5-10 million per year. There is no factual basis for the figure of £1,000 million mentioned by the Sunday Times.

2. In fact Peter Rees initiated a general review of tax avoidance earlier this year, with particular reference to the consequences of the abolition of exchange control. Scarce staff resources and the size of the Finance Bill made it impossible to complete this in time for inclusion of any of the conclusions of this in the last Finance Bill.

3. The issues raised by the Vestey case were only part of this review. The history of previous legislation in this field makes it important to get any new provision right.

4. It will however be possible to separate the Vestey problem from the more general review. The approach which Peter Rees favours at this stage, and which could be implemented in the 1981 Finance Bill, independent of more general corrective measures, would be to abolish Section 478

Prime Minister 1

You may want to have a word with the Chancellor about this tomorrow morning. It seems to me it would be worth considering making a statement on the lines of x below in any case - i.e. without one being pressed. This would undo the bad publicity following Lord Thomycroft's interview. Of course, it would be for the Chancellor to make such a statement - presumably in his speech.

8/10

entirely and to create a new tax charge covering payments, whether ostensibly a capital or revenue nature, received by UK resident beneficiaries of overseas settlements related to the quantum of the settlement income.

5. Retrospective legislation, and a fortiori retrospective legislation aimed at the Vesteys, would be quite inconsistent with the stance adopted by the party when the last administration legislated retrospectively in the fiscal field.

Points to make

6. I suggest that if we are pressed in the course of this week about the Vestey case we should restrict ourselves to making the following points:-

(i) Ministers have certainly had the issues raised by the Vestey case under review with a view to early decision;

(ii) In view of the history of legislation in this field and the complexity of the whole question it was not possible to prepare an adequate and fair provision in time for inclusion in the last Finance Bill;

(iii) The amount of tax at stake is nothing like as great as has been suggested. In particular the figure of £1,000 million which has been mentioned can have no factual basis;

(iv) If pressed: it is hoped that an appropriate clause to deal with the issues raised by the Vestey case will be included in the 1981 Finance Bill.

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..... 7. I am attaching to this minute a summary of the House of Lords' decision.

G.H.

(G.H.)

7 October 1980

THE VESTEY CASE : REFORM OF SECTION 478 : SUMMARY OF DECISION

The House of Lords published their decision in the Vestey cases in November 1979. The question was whether United Kingdom resident beneficiaries of an overseas trust were liable to United Kingdom tax on the accumulated income of the trust. The Inland Revenue contended for liability under what is now Section 478 of the Income and Corporation Taxes Act 1970 which was designed to protect the Revenue against avoidance of tax by the transfer of income bearing assets into the hands of non-residents, leaving the enjoyment of the income effectively in the hands of United Kingdom residents. The effect of the House of Lords decision (which reversed an earlier decision of the same House in the Congreve case) is that tax is only payable where the beneficiary is the original transferor of the assets. This leaves it possible for income to accumulate for the benefit of United Kingdom beneficiaries of discretionary trusts free of United Kingdom tax, in some other country where the tax is low or non-existent.

The Lords' strongly criticised the overkill in Section 478 and the "extra statutory" approach that the Revenue had to adopt over the years to make it operate in a sensible way. Their opinions have emphasised that Section 478 would need to be reviewed - not exclusively in the direction suggested by the press.

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

7 October 1980

PS/PRIME MINISTER

THE VESTEY CASE

The House of Lords published their decision in the Vestey cases in November 1979. The question was whether United Kingdom resident beneficiaries of an overseas trust were liable to United Kingdom tax on the accumulated income of the trust. The Inland Revenue contended for liability under what is now Section 478 of the Income and Corporation Taxes Act 1970 which was designed to protect the Revenue against avoidance of tax by the transfer of income bearing assets into the hands of non-residents, leaving the enjoyment of the income effectively in the hands of United Kingdom residents. The effect of the House of Lords decision (which reversed an earlier decision of the same House in the Congreve case) is that tax is only payable where the beneficiary is the original transferor of the assets. This leaves it possible for income to accumulate for the benefit of United Kingdom beneficiaries of discretionary trusts free of United Kingdom tax, in some other country where the tax is low or non-existent.

The Inland Revenue have been studying how to plug the gap. A paper has been put to Treasury Ministers outlining possible ways, and suggesting legislation in the 1981 Finance Bill.

The figure of £1,000m tax loss which has been quoted does not relate to the Vestey cases. [It was the figure given in the recent submission to Ministers as the total income

involved in a group of avoidance cases embracing a much wider area of law.] The published reports of the recent Vestey case show that the litigation concerned payments to beneficiaries of £2.6m made between 1962 and 1966.

There have been two groups of Vestey cases in which what is now Section 478 was in point - one reaching the House of Lords in 1949 and the recent one. The Inland Revenue lost both. Two other Vestey cases on different issues, in 1931 and 1961, were also won by the Vestey family. The question of the tax liability of the Dewhurst chain was not in point in the recent case.

If the question of legislative action is raised, Ministers could say that the matter is a highly complex one which has been under intense study since the House of Lords' decision. They will bring forward appropriate proposals when that study is completed. However, for reasons of confidentiality, no comment can be made in particular cases.

PS INLAND REVENUE