[2019] UKFTT 520 (TC)

TC07316

Appeal number: TC/2017/08285

INCOME TAX – transfer of assets abroad – whether taxpayer was transferor – held not – whether taxpayer could claim motive defence – held not – whether TOAA legislation infringed the free movement of capital – held yes – whether infringement justified and proportionate – held yes – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

ANDREAS RIALAS **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE PHILIP GILLETT
IAN ABRAMS

Sitting in public at Taylor House, London on 29 – 31 July 2019

Alastair Wilson and Menna Bowen, both of Gunnercooke LLP, for the Appellant

Sadiya Choudhury, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal against two closure notices dated 7 November 2017, issued by the Respondents ("HMRC") under s28A Taxes Management Act 1970. These closure notices assessed Mr Andreas Rialas to additional income tax of £430,774.40 in respect of 2005-06 and £663,292.00 in respect of 2006-07.

2. These additional amounts of income tax are calculated as personal income tax on interim dividends paid by Argo Capital Management Limited ("Argo") in 2005 and 2006, which HMRC consider are due under s739 Income and Corporation Taxes Act 1988 ("ICTA"), on the grounds that Mr Rialas is either the transferor, or has procured the transfer, of assets to a person abroad, as a consequence of which dividends on shares in Argo were received by a person abroad and that Mr Rialas had the power to enjoy that income.

THE FACTS

3. We received witness statements and oral evidence from Andreas Rialas ("Mr Rialas") and Kyriacos Rialas ("Kyriacos"), his brother, both of whom we found to be credible and reliable witnesses, although their memory as to precise timings was sometimes uncertain as a result of the significant passage of time since the events in question. We also received witness statements from John Baxivanos, of Magnetic Corporation, a Greek company, and Constantinos Messios, Andreas's lawyer, based in Cyprus. Neither Mr Baxivanous nor Mr Messios gave oral evidence and their evidence could not therefore be properly tested under cross-examination. We could not therefore give substantial weight to their evidence.

4. We find the following as matters of fact.

5. During the years of assessment 2005-2006 and 2006-2007, Mr Rialas was resident and ordinarily resident, but not domiciled, in the UK. He has at all times been a national of Cyprus, and holds a Cypriot passport.

6. Argo was incorporated in England and Wales on 18 May 2000. At the relevant times, its issued share capital consisted of 1,998 Ordinary Shares of £1.00 per share nominal value, with no special or preferred rights. By June 2002, Mr Rialas was the registered holder and full beneficial owner of 999 issued Ordinary Shares, and Mr Gary Cressman was the registered holder and full beneficial owner of the other 999 issued Ordinary Shares. Mr Rialas and Mr Cressman were the founders of Argo, which carried on business as an investment adviser, and was authorised and regulated by the UK Financial Services Authority, with registration number 195997. Since each of them owned 50% of the issued share capital, neither Mr Rialas nor Mr Cressman had control of Argo.

7. Argo provided investment advice to Argo Capital Management (Cyprus) Limited ("Argo Cyprus"), which is a fund manager resident in Cyprus, and holds licence number 023/04 from the Cyprus Securities and Exchange Commission authorising it to carry on fund management business. All investment management

was however delegated to Argo which therefore acted as the de facto investment manager for the funds under management.

8. In the years under appeal, the directors of Argo were:

Year to 31 December 2005: Andreas Rialas, Aelita Arampova and Nick Corby

Year to 31 December 2006: Andreas Rialas and Aelita Arampova

9. The interim dividends paid by Argo in the years under appeal, on 50% of which Mr Rialas has been assessed to income tax under section 739 ICTA 1988, were:

Year to 31 December 2005: £2,153,873.00

Year to 31 December 2006: £3,318,460.00

10. The Articles of Association of Argo confirm that it was incorporated in accordance with the Companies Act 1985, and that the regulations in The Companies (Table A to F) Regulations 1985, as amended, applied to the company, except where excluded or varied by its Articles of Association. Under the Articles of Association and those Regulations, the Articles of Association of Argo:

(1) Did not include any share pre-emption provisions.

(2) Did include an absolute discretion exercisable by the directors to decline to register any transfer of a share.

(3) Did not include any "tag along" provisions, such as might allow shareholders to join in a sale of shares on the same terms as agreed by another shareholder.

(4) Did not include any "drag along" provisions, such as might allow a shareholder selling his shares to compel other shareholders to sell their shares, on the same terms.

(5) Provided for all the issued shares of the company to be ordinary shares carrying no special rights, and for each shareholder to have one vote on a show of hands at any meeting of members, or one vote per share held on any poll, in accordance with Regulation 54 of The Companies (Table A to F) Regulations 1985.

(6) Provided for:

(a) Final dividends to be declared by ordinary resolution of the shareholders in Argo, in accordance with Regulation 102 of The Companies (Table A to F) Regulations 1985.

(b) Interim dividends of Argo to be determined by its directors, in accordance with Regulation 103 of The Companies (Table A to F) Regulations 1985.

11. There was no shareholders agreement in respect of Argo Capital Management Limited.

12. There were no other agreements creating options or other rights over the shares in Argo held by either shareholder, which might allow any person to direct or compel the sale or transfer of their shares in Argo.

13. There were no employment or service agreements between the directors of Argo and that company other than a contract of employment between the company and Mr Rialas which was entered into some time after the events in question, although it was stated to have been effective since 2000.

14. From 1 December 2001, Argo was authorised by the Financial Services Authority to carry on business as a fund manager, and did so at all material times. Mr Rialas and Mr Cressman worked full time in the business of Argo. The business was very successful.

15. On 13 March 2004 Mr Rialas's son was born and he was encouraged by a business contact, Ali Sarikani, to meet the estate planning department of Chiltern Financial Services Ltd. In a consultation with Nicholas Hughes of Chiltern, he was advised that both he and his wife should make wills and consider setting up an offshore trust to shelter family wealth. Chiltern suggested using their services to set up trusts but Mr Rialas considered these expensive and he did not therefore progress things further, although Mr and Mrs Rialas did draw up wills with the assistance of Chiltern.

16. Around Christmas 2004 Mr Rialas consulted Constantinos Messios, a solicitor practising and resident in Cyprus, whom he had known since they were at school together in Cyprus, and they discussed the idea of Mr Messios acting as a trustee through his company, Madrigal Holdings, and potential structures for a trust. Mr Messios recommended a Cyprus International Trust, and an overseas company owned by that trust, which would hold assets for the trust beneficiaries, which, for flexibility, should include Mr Rialas, his wife and his son.

17. In the period from around December 2004, relations between Mr Rialas and Mr Cressman deteriorated, specifically, Mr Rialas considered that:

(1) his credibility supported investor confidence while Mr Cressman was considered as somewhat of a wildcard.

(2) Mr Cressman upset other personnel employed by Argo, and Mr Rialas received complaints from those personnel about his aggressive behaviour. Mr Rialas raised these issues with Mr Cressman, but he denied the complaints and refused to modify his behaviour.

(3) Mr Rialas felt that he was trapped in a 50/50 venture supporting somebody that could not carry his weight.

(4) Investors' capital had no lock up period and with the slightest hiccup it could be withdrawn. Mr Rialas was acutely aware of this position unlike Mr Cressman who as a result of their success became overconfident, and, most importantly,

(5) Having created a valuable company, Mr Rialas wanted to monetise this value and reduce his personal risk through a sale, whereas Mr Cressman wanted things to carry on as they were.

18. In spring 2005, Mr Rialas approached RAB Capital Limited ("RABCAP"), an unconnected UK fund management company whose shares were listed on the Alternative Investment Market, and discussed the possible purchase by RABCAP of the issued shares in Argo. RABCAP had invested, through a fund of funds managed by RABCAP, in The Argo Fund Ltd, which was advised by Argo. There was therefore an existing business connection between RABCAP and Argo. This approach by Mr Rialas led to discussions about a possible share sale and purchase with RABCAP executives and lawyers. Mr Cressman was aware of and was involved in those discussions.

19. During the discussions with RABCAP concerning due diligence in advance of the possible purchase by RABCAP of the issued shares in Argo Capital Management Limited, Mr Cressman upset the RABCAP Chief Executive Officer Philip Richard, and RABCAP insisted that it would only buy shares in Argo if Mr Cressman was not involved in Argo. These discussions therefore went cold for a few months.

20. We received no evidence as to the precise form of the transaction which had been discussed at this stage but we were shown a Heads of Agreement with RABCAP from July 2005 which Mr Rialas said outlined a very similar structure. Importantly, this provided that the shareholders in Argo would receive 50m shares in RABCAP in exchange for their shares in Argo, and although they would be permitted to sell 10m of these shares immediately, they would only be permitted to sell the remaining shares over the next few years, and then only subject to retaining at least $500m assets under management during that period. These Heads of Agreement also contained a provision that Mr Cressman was to have no future involvement with Argo.

21. In order to continue with his plans for selling the company, therefore, Mr Rialas discussed with Mr Cressman the possible acquisition of his shares. Mr Cressman said that he would only be prepared to sell his shares in Argo if he received a cash price equivalent to the indicative price of US$15m which had been discussed with RABCAP.

22. Mr Rialas therefore considered what might be the best structure for the purchase of the shares in Argo from Mr Cressman. Mr Rialas did not have the funds to purchase the shares personally. He could have borrowed the funds himself but this would have effectively doubled up his risk, ie, if the value of Argo were to fall he would have lost the value of both his 50% of the shares and the 50% to be acquired from Mr Cressman, but would still owe $15m. He therefore decided that the best arrangement would be for a new company to be formed to borrow the $15m, which would buy the shares from Mr Cressman, and for that new company to be 100% owned by a trust for the benefit of his family.

23. Mr Rialas had already discussed the broad outline of a suitable structure with Mr Messios and, in early March 2005, it was agreed that Madrigal Holdings Limited would act as trustee of a new family trust to be established by Mr Rialas, and that a

new non-UK company would be incorporated to be owned by the family trust. Madrigal Holdings Limited was at all times incorporated and managed and controlled in Cyprus and Mr Rialas was at no time a director or officer of Madrigal.

24. On 22 March 2005, Farkland Ventures Inc ("Farkland") was incorporated in the British Virgin Islands on the instructions of Constantinos Messios. Farkland was formed by Mr Messios as a shelf company and its ownership was subsequently transferred to Mr Rialas's family trust and it was then used to acquire Mr Cressman's shares in Argo. The issued shares of Farkland consisted initially of 100 shares of US$1.00 nominal value per share, issued part paid as to US$0.01 per share.

25. Farkland was at all relevant times managed and controlled and therefore tax resident in Cyprus. It was required to produce accounts for the Cyprus tax authorities but importantly it was not required to file accounts at the Cyprus company registration office, which would have been the case had the company been formed in Cyprus. There was no requirement for it to file accounts with any company registration office in the BVI, thus its privacy would be maintained.

26. On 18 April 2005, a trust deed creating the Rialco Trust ("Rialco") was executed by Andreas as settlor and Madrigal Holdings Limited as sole corporate trustee. This trust was a discretionary family trust, the beneficiaries being Mr Rialas, his wife and his son. The trust was governed by the Cyprus International Trusts Law of 1992. The protector of the trust was Mr Rialas's brother Kyriacos. Mr Rialas contributed C£10 (10 Cyprus Pounds) to the Trust Fund of this trust, which was used to acquire Farkland and to pay the necessary fees to Mr Messios. Kyriacos estimated that the costs of forming a BVI company was approximately US$1,000 whereas the cost of forming a company in Cyprus would be of the order of EUR 2,000.

27. Once Farkland had been transferred to the ownership of Rialco. Kyriacos was appointed as a director of Farkland. He was at all times personally resident in Cyprus.

28. In March 2005, Mr Rialas also had initial discussions with Magnetic Corporation ("Magnetic") about a possible loan to Farkland to enable it to pay for Mr Cressman's shares in Argo. Mr Rialas knew the directors of Magnetic, which was the treasury and investment company of the Polemis family, a large Greek ship-owning family. Magnetic had invested in the Argo Fund, which was managed by Argo and had obtained excellent returns from their investment. Magnetic was at all times domiciled and managed and controlled in Greece.

29. On 28 April 2005, a sale and purchase agreement was signed by Mr Cressman and Farkland, under which Mr Cressman agreed to sell, and Farkland agreed to buy, all Mr Cressman's 999 Ordinary Shares in Argo Capital Management Limited for a cash price of US$15,300,000, payable on completion of that share sale and purchase. It was not clear how the final price had been arrived at but on the balance of probabilities we find that this price was primarily negotiated and agreed by Mr Rialas, using the indicative pricing from the RABCAP deal as a benchmark.

30. On 10 May 2005, a loan agreement was signed between Magnetic and Farkland under which a loan of US$15,300,000 was provided to Farkland. This agreement was signed by Kyriacos, as director of Farkland, and by John Baxivanos, as director of Magnetic. The loan documentation indicated that the purpose of this loan was to acquire the shares of Mr Cressman in Argo. It was unsecured and the interest rate was LIBOR plus 1.5%. Its term was stated to be for three years, with a facility for early repayment.

31. We considered that it was very unusual that such a loan, equal to 100% of the value of the shares to be acquired and unsecured, should be advanced at such a low rate of interest, but Mr Rialas explained that this was entirely because of his relationship with Magnetic, who had done very well from their investment in the Argo Fund, and who therefore trusted him and believed that he would be able to repay the loan within the three year life of the loan, based on the prospect of substantial dividends to be paid from Argo to Farkland.

32. Mr Rialas also said that Magnetic would have been unwilling to loan funds to a company in the UK or even to a Cyprus registered company because they valued their privacy and would therefore only lend to a company in a jurisdiction such as the BVI, with which they were familiar from other transactions. We accept this as factually correct.

33. On 10 May 2005, US$15,300,000 was transferred by Magnetic to Farkland, the paying bank being JP Morgan Chase, 270 Park Avenue New York, USA. This US$15,300,000 was then paid by Farkland to Mr Cressman as the cash price for the sale of his shares in Argo.

34. Following the sale of the Argo shares to Farkland, Argo paid interim dividends to Farkland of £1,076,936.50, being 50% of the 2005 dividend of £2,153,873.00 dividend, referred to above, and £1,659,230.00, being 50% of the 2006 dividend of £3,318,460.00, referred to above.

35. In January 2007 Mr Rialas and Farkland sold 100% of the shares in Argo to Absolute Capital Management Holdings Limited, a UK listed company, for a mixture of shares and cash worth approximately US$50m. Kyriacos also sold his shares in Argo Cyprus as part of the same deal.

36. On 28 March 2007 Farkland repaid the balance of the loan of $9,590,827.36 to Magnetic. This was financed by means of a loan from Anglo Irish Bank (Suisse) SA to Farkland of $9,591,000.

37. Mr Rialas's motivation for deciding on this particular acquisition structure is clearly important, and in that respect we make the following findings of fact as to his motives:

(1) He wanted to monetise the value of his holding in Argo.

(2) In order to do this he needed to buy out Mr Cressman, who was not keen on selling out, especially if he would be required to continue working in the business, but under the overall control of a larger organisation.

(3) He did not have the funds himself to buy out Mr Cressman and therefore need to borrow the necessary funds, but wanted to do so in a way that he would not be personally liable for the borrowing should things go wrong. He wanted to retain the upside if Argo continued to grow but avoid any downside if it did not.

(4) He wanted to acquire Mr Cressman's shares in a way which did not involve the introduction of a new party into the ownership chain, who would require approval by the UK FSA.

(5) The lender, who was prepared to lend on what we considered unusually favourable terms, would only lend to a company based outside the UK and preferably based in a jurisdiction such as the BVI, which would preserve the privacy which they sought.

(6) Mr Rialas wanted to hold these new assets via an offshore trust in order to reduce his exposure to UK Inheritance Tax. He had not received any specific UK tax advice on this structure but he was aware from his discussions with Chiltern that the interposition of an offshore trust was a "good thing" from a UK Inheritance Tax perspective.

THE LAW

38. For the years 2005/06 and 2006/07, s739 ICTA stated as follows:

"**739 Prevention of avoidance of income tax**

(1) … the following provisions of this section shall have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the United Kingdom.

(1A) Nothing in subsection (1) above shall be taken to imply that the provisions of subsections (2) and (3) below apply only if—

(a) the individual in question was ordinarily resident in the United Kingdom at the time when the transfer was made; or

(b) the avoiding of liability to income tax is the purpose, or one of the purposes, for which the transfer was effected.

(2) Where by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled outside the United Kingdom which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise, that income shall,

whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts"

39. Section 741 contains what may be termed the motive defence and stated:

"**741 Exemption from sections 739 and 740**

(1) Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either –

(a) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or

(b) that the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.

The jurisdiction of the Special Commissioners on any appeal shall include jurisdiction to review any relevant decision taken by the Board in exercise of their functions under this section. "

40. Section 742 then provided:

"**742 Interpretation of this Chapter**

(1) For the purposes of this Chapter, "an associated operation" means, in relation to any transfer, an operation of any kind effected by any person in relation to any of the assets transferred or any assets representing, whether directly or indirectly, any of the assets transferred, or to the income arising from any such assets, or to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets. It is immaterial whether the operation is effected before, after, or at the same time as the transfer.

(2) An individual shall, for the purposes of section 739, be deemed to have power to enjoy income of a person resident or domiciled outside the United Kingdom if—

(a) the income is in fact so dealt with by any person as to be calculated, at some point of time, and whether in the form of income or not, to enure for the benefit of the individual; or

(b) the receipt or accrual of the income operates to increase the value to the individual of any assets held by him or for his benefit; or

(c) the individual receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income; or

(d) the individual may, in the event of the exercise or successive exercise of one or more powers, by whomsoever exercisable and whether with or without the consent of any other person, become entitled to the beneficial enjoyment of the income; or

(e) the individual is able in any manner whatsoever, and whether directly or indirectly, to control the application of the income.

(3) In determining whether an individual has power to enjoy income within the meaning of subsection (2) above –

(a) regard shall be had to the substantial result and effect of the transfer and any associated operations, and

(b) all benefits which may at any time accrue to the individual (whether or not he has rights at law or in equity in or to those benefits) as a result of the transfer and any associated operations shall be taken into account irrespective of the nature or form of the benefits.

(4) Subsection (5) below applies where a person resident or domiciled outside the United Kingdom throughout any chargeable period in which an interest period (or part of it) falls would, at the end of the interest period, have been treated under section 714(2) as receiving annual profits or gains or annual profits or gains of a greater amount if he had been resident or domiciled in the United Kingdom during a part of each such chargeable period.

(5) Sections 739 to 741 shall have effect as if the amount which the person would be treated as receiving or the additional amount (as the case may be) were income becoming payable to him; and, accordingly, any reference in those sections to income of (or payable or arising to) such a person shall be read as including a reference to such an amount.

(6) Where income of a person resident or domiciled outside the United Kingdom throughout any chargeable period in which an interest period (or part of it) falls consists of interest—

(a) which falls due at the end of the interest period, and

(b) which would have been treated under section 714(5) as reduced by an allowance or an allowance of a greater amount if he had been resident or domiciled in the United Kingdom during a part of each such chargeable period,

then for the purposes of sections 739 to 741, the interest shall be treated as being reduced by the amount of the allowance or by the additional amount (as the case may be).

(7) In subsections (4) to (6) above “interest period” has the meaning given by section 711.

(8) For the purposes of sections 739 to 741, any body corporate incorporated outside the United Kingdom shall be treated as if it were resident outside the United Kingdom whether it is so resident or not.

(9) For the purposes of sections 739 to 741—

(a) a reference to an individual shall be deemed to include the spouse or civil partner of the individual;

(b) "assets" includes property or rights of any kind and "transfer", in relation to rights, includes the creation of those rights;

(c) "benefit" includes a payment of any kind;…

(d) references to assets representing any assets, income or accumulations of income include references to shares in or obligations of any company to which, or obligations of any other person to whom, those assets, that income or those accumulations are or have been transferred.

(9A) Where the trustees of a settlement are treated, by virtue of section 685E(7), as neither resident nor ordinarily resident in the United Kingdom, then for the purposes of this Chapter they shall be treated as resident and domiciled outside the United Kingdom."

41. Finally, s743 stated:

"**S 743 Supplemental provisions**

(1) Income tax at the basic rate, the lower rate or the dividend ordinary rate shall not be charged by virtue of section 739 in respect of any income to the extent that it has borne tax at that rate by deduction or otherwise but, subject to that income to which section 739 applies shall be charged to income tax.

(1ZA) The charge to income tax under subsection (1) above operates on income falling within subsection (1A) below by treating the income as if it were income to which section 1A applies by virtue of subsection (2)(b) of that section.

(1A) Income falls within this subsection if it is—

(a) income chargeable under Chapter 3 of Part 4 of ITTOIA 2005 (dividends etc. from UK resident companies etc.);

(b) income chargeable under Chapter 4 of that Part (dividends from non-UK resident companies);

(c) income chargeable under Chapter 5 of that Part (stock dividends from UK resident companies);

(d) income chargeable under Chapter 6 of that Part (release of loan to participator in close company); or

(e) a relevant foreign distribution chargeable under Chapter 8 of Part 5 of that Act (income not otherwise charged).

(1B) In subsection (1A) "relevant foreign distribution" means any distribution of a company not resident in the United Kingdom which–

(f) is not chargeable under Chapter 4 of Part 4 of ITTOIA 2005, but

(b) would be chargeable under Chapter 3 of that Part if the company were resident in the United Kingdom.

(2) In computing the liability to income tax of an individual chargeable by virtue of section 739, the same deductions and reliefs shall be allowed as would have been allowed if the income deemed to be his by virtue of that section had actually been received by him.

(3) An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of that section if he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income.

(4) Where an individual has been charged to income tax on any income deemed to be his by virtue of section 739 and that income is subsequently received by him, it shall be deemed not to form part of his income again for the purposes of the Income Tax Acts.

(5) In any case where an individual has for the purposes of that section power to enjoy income of a person abroad by reason of his receiving any such benefit as is referred to in section 742(2)(c), then notwithstanding anything in subsection (1) above, the individual shall be chargeable to income tax by virtue of section 739 for the year of assessment in which the benefit is received on the whole of the amount or value of that benefit except in so far as it is shown that the benefit derives directly or indirectly from income on which he has already been charged to tax for that or a previous year of assessment."

DISCUSSION

42. Three contentions were put forward by Mr Wilson on behalf of Mr Rialas:

(1) Mr Rialas was not the "transferor" within the meaning of this term for the purposes of s739 ICTA, and therefore he is not liable to income tax under s739.

(2) Alternatively, if Mr Rialas is found to have been the "transferor" within the meaning of this term for the purposes of s739 ICTA, he is exempted from liability to income tax by s741 ICTA, the motive defence.

(3) Alternatively, if Mr Rialas is found to be the "transferor" within the meaning of this term for the purposes of s739 ICTA, the imposition of liability to income tax under s739 would infringe his right to free movement of capital under Article 56 of the Treaty Establishing the European Union (2002).

43. We will deal with these contentions in turn.

Was Mr Rialas the transferor?

44. The actual wording of s 739 is potentially very broad in its application in that it refers to

> "… preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the United Kingdom."

45. Superficially therefore it might seem to be capable of applying whenever there is any transfer of assets, irrespective of who made the transfer. However, the meaning of this expression and in particular the meaning of the words "such an individual", in s739(2), was considered by the House of Lords in *Vestey v IRC* 54 TC 503. In *Vestey*, Lord Wilberforce said, at p587 at A, that the words "such an individual" must be:

> "… interpreted as applying only where the person sought to be charged **made**, or maybe, was associated with **the transfer** …"

46. Much of the argument in *Vestey* concerned the previous decision in *Congreve v IRC* 30 TC 163, and whether that previous decision could and should be overruled.

47. In *Congreve*, a precursor of s739 ICTA was held to apply to an individual, Mrs Congreve, who was the largest shareholder of a company where the transfers in question had been made by her father. The Court of Appeal concluded that Mrs Congreve was liable to tax under the section as she had received the benefits as a result of the transfers and associated operations. This conclusion was upheld on appeal by the House of Lords but was subsequently overruled by the House of Lords in *Vestey*.

48. However, there was a second ratio in *Congreve*. Cohen LJ, who gave the unanimous judgment of the Court of Appeal, had noted, at p193, that it was a fair inference from the fact that throughout the transactions in question Mr Glasgow, Mrs Congreve's father, was "acting with the authority of his daughter who signed such documents as he advised her to sign."

49. Cohen LJ then went on to state at p197:

> "But even if we were prepared to accede to the argument that the preamble connoted activity by the individual concerned, we think that this condition would be fulfilled if the execution of the transfer were procured by the individual concerned even though it was not actually executed by him or his agent. …it is, we think, in the present case, a reasonable inference from the facts found that the execution and performance of the transfers and associated operations in question by all the companies concerned were procured by Mrs. Congreve acting through her agent Mr. Glasgow. We should have been prepared, if it had been necessary, on this alternative ground to uphold the decision of the Commissioners."

50. This alternative ratio was not overruled by the House of Lords in *Vestey*. Therefore, under the remaining valid ground in *Congreve*, an individual who "procures" a transfer of assets by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable to persons resident

or domiciled outside the United Kingdom, is chargeable to income tax under s739 ICTA.

51. The scope of the term "procurement" has been refined in later cases. In *IRC v Pratt* [1982] STC 756, Walton J noted, at p791 j, that the alternative ratio in *Congreve* had not been disturbed by the House of Lords in *Vestey*. After quoting the passage from Cohen LJ's judgment in *Congreve* referred to above, he stated, at p792 e-f:

> "So here we have it established that a person who is not a transferor may nevertheless be liable as if he were a transferor, if he "procured" the transfer. It is convenient to use the phrase of junior counsel for the Crown and call such a person a "quasi transferor". Now, founding himself on *Congreve*, leading counsel for the Crown submitted that in a company case there might well be more than one quasi transferor. For example, there might be a two-man company, A and B being the directors and shareholders, or a three-man company, X, Y and Z being similarly situated. It would be absurd to think that if all two or three procured the company to effect a transfer, that would not be within the provisions of the section."

52. At p793 a he described the issue as follows:

> "…what the Special Commissioners had to decide on this topic was, quite simply, notwithstanding that the transfer was a transfer made by the Company itself, was the reality of the matter that somebody else was the real transferor? To answer that question, nobody has so far produced a better suggestion than that of "procurement". It may not be completely apt, but it is far nearer an apt definition than anything else which has so far been suggested."

53. He then went on to say, at p796 e:

> "The only authority dealing with quasi-transferors so far as a company is concerned - or indeed at all – is Congreve's case, and what that case does is, whilst recognising that a transfer by an individual, even one owning 99.9% of the shares of the company, is not the same as a transfer by the company, to hold that a transfer by the company "procured" by a quasi-transferor holding the vast majority of the shares in the company is to be regarded as having been made by the quasi transferor himself. The word used by Cohen LJ was "procured". This clearly indicates that the person in question had the ability to "procure". Of course I must not fall into the trap which I shall expose in a minute in the submissions of counsel for the Crown, of equating a speech in the Court of Appeal with a statutory provision, but in the context of that case its meaning is obvious enough. Because she could by the exercise of her voting strength in the company, get it to do whatever she wanted, Mrs Congreve was a quasi-transferor.
>
> How different – how very, very different – are the facts of the present case. The sale here was obviously a board matter, about which the board was duly consulted and approved. There was no question of any of the three taxpayers in

this case, either alone or in concert, assuming that that could be material, being able either at board or at shareholder level, to "procure" M and J to do anything. And, indeed, this is precisely why the submission of counsel for the Crown which I read out earlier adopts the words "have a hand in" and "associated with" which obviously were used by Lord Wilberforce. But, as I have already observed, those words are not to be treated as if they were in a statute: plainly they are not.

Nor, however widely one construes any wording to be found in section 412, is the substance of a person being "associated with" or "having a hand in" a transfer necessarily equivalent in any way to that person himself making the transfer. It may be stretching the words of the section – indeed, I think it is – to say "la societe anonyme c'est moi", but the elastic will have snapped long before one can say " I had a hand in the transfer, therefore I made it, or, "I am associated with the transfer, therefore I made it."

54. In *Carvill v IRC* [2000] STC (SCD) 143, one of the issues was whether Mr Carvill was the transferor for s739 purposes of shares held by unconnected minority shareholders in a UK company which were exchanged for shares in a new offshore company. The Special Commissioner acknowledged at [71] that "transferor" for the purposes of the section could in some circumstances be wider than merely the person who made the transfer himself and referred to *Congreve* and *Pratt*. He added:

"For an individual to be the transferor in relation to a transfer by another individual would be a considerable extension of this principle. However, there might be cases where, as a matter of fact, **one individual's influence over another was so strong that he was the transferor of the other's shares** but this would clearly be an **exceptional** case…"

55. He went on to hold at [72] that there was no evidence that the appellant had forced his will on the other shareholders so as to become the transferor of their shares.

56. Finally in *Fisher v HMRC* [2014] UKFTT 804 (TC), the FTT considered, at [194], that the question of whether a transfer had been procured may be inferred from the facts. It went on to state at [195]:

"The term "procure" is not a term which was set out in the statute and is, as Walton J put it in *Pratt*, a question of who the transferors are in reality. It is implicit in Walton J's obiter comment (set out at [173] above) that "two or three" owners of a company could (aside from his fundamental legal objections in relation to apportionment as discussed above) be quasi-transferors and therefore given what he says about procurement that in the case of a small jointly owned company that there could be more than one person procuring. Joint procurement is therefore possible in principle."

57. Ms Choudhury, for HMRC, submitted that the following facts demonstrated that Andreas was a transferor or quasi-transferor, ie, that he procured the transfer:

(1) The Appellant established the trust/corporate structure to acquire Mr Cressman's shares in Argo by providing funds for the creation of the Trust and its acquisition of Farkland's issue share capital.

(2) He recommended that Madrigal, in its capacity as the trustee of the Trust, acquire the shares in Argo.

(3) He approached Magnetic to lend Farkland the necessary funds for the share purchase.

(4) He agreed the initial terms of the loan required with Magnetic.

(5) He effected introductions between Magnetic, the lender of the funds, and Farkland, purchaser of the shares; and

(6) He guaranteed an income stream to Farkland in the form of dividends, where possible.

58. Ms Choudhury argued that all these actions taken Mr Rialas supported the contention that he procured the transfer of Mr Cressman's shares, not that any of these actions themselves constituted part of the relevant transfer for the purposes of HMRC's primary argument.

59. In addition, Ms Choudhury also argued that the following steps constituted associated operations within the meaning of s742(1) ICTA in respect of that transfer:

(1) The settlement of the trust,

(2) The incorporation of Farkland,

(3) The acquisition of Farkland's issued share capital by the Trust, and

(4) The loan from Magnetic to Farkland.

60. We have quoted extensively above from the various cases which attempt to define the meaning of "procure" or "quasi-transferor" for these purposes. Many of the cases are in the context of companies and whether or not the ability of the controlling shareholders of those companies have the power to control the company such that any transfer made by the company is in effect made by the controlling shareholder(s). Some cases have also focussed on whether or not the concept of a controlling shareholder can also encompass two or more individuals, acting together to control the actions of a company. In some ways these questions are relatively easy to answer, in that it is clear that, even if the company were the transferor rather than any one or more individuals, that shareholder, or those shareholders, had the legal ability to dictate what the company did.

61. In *Congreve*, Mrs Congreve was considered to be acting through her agent, Mr Glasgow, and therefore again there was the clear implication that any acts by Mr Glasgow were in reality the acts of Mrs Congreve. There is no such clear legal authority in this case. We heard no evidence whatsoever that Mr Rialas was in a position to control or dictate what Mr Cressman did.

62. In *Carvill*, the Special Commissioner, Dr Avery Jones said:

> "For an individual to be the transferor in relation to a transfer by another individual would be a considerable extension of this principle. However, there might be cases where, as a matter of fact, **one individual's influence over another was so strong that he was the transferor of the other's shares** but this would clearly be an **exceptional** case…"

63. This suggests that there might be cases, exceptional cases, where one individual's influence over another was so strong that he could indeed dictate the actions of the other. HMRC did not even attempt to demonstrate that this might be the case here. There is no doubt that if Mr Cressman wanted to sell his shares, and wanted to obtain the price of $15m which he had in mind, then the "only game in town" was Mr Rialas, but this does not in our view mean that Mr Rialas possessed the necessary influence to dictate whether or not Mr Cressman should sell his shares or to whom he should sell them.

64. Mr Cressman was in an equally powerful position to that of Mr Rialas, because it was in Mr Rialas's interests to ensure that any split between the two was seen to be amicable. Any other outcome would led to a dramatic fall in the value of the shares in Argo. There was perhaps a "balance of terror" but we do not consider that that would amount to Mr Rialas having sufficient influence over Mr Cressman to control his actions.

65. We fully accept, as set out in HMRC's submissions at [57] above, that Mr Rialas orchestrated the purchase side of the transaction. He may have left some of the fine detail as to the precise mechanics, and possibly even the fine detail as to the price paid, to his brother Kyriacos and Mr Messios, but his was the controlling mind. It is however stretching the meaning of the word "procure" beyond breaking point to suggest that the fact that he organised the purchasing structure means that he dictated to whom Mr Cressman should sell his shares.

66. In response to Mr Rialas's first ground of appeal we therefore find that Mr Rialas was not the transferor or a quasi-transferor of Mr Cressman's shares in Argo.

Alternative HMRC argument

67. As an alternative argument HMRC suggested that the transfer of C£10 by Mr Rialas to establish Rialco was in itself a transfer of assets abroad, by Mr Rialas to Rialco. HMRC did not argue this with any great force but we must of course address it.

68. In response to this argument, Mr Wilson, on behalf of Mr Rialas, said that the C£10 had at most only made a small contribution towards meeting the administrative costs and legal fees of setting up the trust. It could not therefore be argued that this transfer, even in conjunction with the other transactions which Mr Rialas had orchestrated, had led to income being transferred abroad.

69. Clearly the argument is that the various additional transactions amount to "associated operations" within the meaning of s742(1). This defines "associated operations" as being:

> "an operation of any kind effected by any person in relation to any of the assets transferred or any assets representing, whether directly or indirectly, any of the assets transferred, or to the income arising from any such assets, or to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets."

70. In other words the operations must be effected "in relation to" the C£10 which Mr Rialas contributed to Rialco. Clearly the words "in relation to" can have a very wide meaning but to suggest that the formation of a subsidiary company, Farkland, the borrowing of $15m by that company, followed by the acquisition of the shares in Argo, were "associated operations" "in relation to" the C£10 again seems to be stretching the words beyond breaking point.

71. If this argument were correct then it would mean that the establishment of any non-resident trust by a UK resident individual, **with however small an initial contribution,** could lead to that individual being taxable on the income from any investments which such a trust might acquire, directly or indirectly, from anywhere in the world, even though the whole of the funds required in order to acquire those investments had been borrowed. We do not believe that this is a consequence which could have been in the mind of Parliament or indeed the draftsman of this legislation. This is simply going too far.

72. The objective of s739 and its successor provisions is to deter a UK resident individual from transferring abroad income producing assets **which he already owns or controls**, such that he might avoid future UK taxation on the income from those assets. This suggested interpretation extends s739 way beyond that objective and cannot therefore be correct.

Summary re s739

73. In summary therefore we find that Mr Rialas was neither the transferor nor a quasi-transferor of the shares in Argo and neither is he caught by HMRC's alternative argument relating to the funds contributed to Rialco when it was first set up. HMRC's case therefore falls at the first hurdle.

The Motive Defence

74. Having found that Mr Rialas was neither the transferor nor a quasi-transferor for the purposes of s739 it is not strictly necessary for us to consider the second and third contentions made by Mr Wilson. However, if we are wrong on the first contention we should consider the second and third contentions for the sake of completeness.

75. As set out above we have found that Mr Rialas's motives in creating this structure were:

(1) He wanted to monetise the value of his holding in Argo.

(2) In order to do this he needed to buy out Mr Cressman, who was not keen on selling out, especially if he would be required to continue working in the business, but under the overall control of a larger organisation.

(3) He did not himself have the funds to buy out Mr Cressman and therefore needed to borrow the necessary funds, but wanted to do so in a way that he would not be personally liable for the borrowing should things go wrong. He wanted to retain the upside if Argo continued to grow but avoid any downside if it did not.

(4) He wanted to acquire Mr Cressman's shares in a way which did not involve the introduction of a new party into the ownership chain, who would require approval by the UK FSA.

(5) The lender, who was prepared to lend on what we considered to be unusually favourable terms, would only lend to a company based outside the UK and preferably based in a jurisdiction such as the BVI, which would preserve the privacy which they sought.

(6) Mr Rialas wanted to hold these new assets via an offshore trust in order to reduce his exposure to UK Inheritance Tax. He had not received any specific UK tax advice on this structure but he was aware from his discussions with Chiltern that the interposition of an offshore trust was a "good thing" from a UK Inheritance Tax perspective.

76. These motives all fall within the broad description of having a commercial purpose with the exception of (6). In other words all the steps in the acquisition structure which Mr Rialas set up were commercial except for the interposition of Rialco, the only apparent explanation for which is the reduction of Mr Rialas's exposure to UK Inheritance Tax.

77. We must therefore ask the question as to whether this amounts to unacceptable tax avoidance or is merely acceptable tax mitigation.

78. The decision in *Willoughby v IRC* 70 TC 57 confirms that there is a critical distinction between acceptable tax mitigation, which would not affect the application of s741, and unacceptable tax avoidance, which would prevent the application of s741. The most widely accepted definition of this distinction was set out by Lord Nolan, as follows:

> "In order to understand the line thus drawn, submitted Mr. Henderson, it was essential to understand what was meant by "tax avoidance" for the purposes of section 741. Tax avoidance was to be distinguished from tax mitigation. The hall mark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hall mark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. Where the tax payer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax

> mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax.
>
> My Lords, I am content for my part to adopt these propositions as a generally helpful approach to the elusive concept of "tax avoidance", the more so since they owe much to the speeches of Lord Templeman and Lord Goff of Chieveley in *Ensign Tankers Leasing Ltd. v. Stokes* [1992] 1 A.C. 655 at 675C-676F and 681B-E. One of the traditional functions of the tax system is to promote socially desirable objectives by providing a favourable tax regime for those who pursue them. Individuals who make provision for their retirement or for greater financial security are a familiar example of those who have received such fiscal encouragement in various forms over the years. This, no doubt, is why the holders of qualifying policies, even those issued by non-resident companies, were granted exemption from tax on the benefits received. In a broad colloquial sense tax avoidance might be said to have been one of the main purposes of those who took out such policies, because plainly freedom from tax was one of the main attractions. But it would be absurd in the context of section 741 to describe as tax avoidance the acceptance of an offer of freedom from tax which Parliament has deliberately made. Tax avoidance within the meaning of section 741 is a course of action **designed to conflict with or defeat the evident intention of Parliament**. In saying this I am attempting to summarise, I hope accurately, the essence of Mr. Henderson's submissions, which I accept."

79. Therefore, Mr Wilson submitted, where a taxpayer takes advantage of a freedom from tax clearly intended by Parliament, this will be tax mitigation, but where a taxpayer takes actions which are designed to conflict with or defeat the evident intention of Parliament, this will be tax avoidance.

80. Unfortunately it is not always easy to ascertain the evident intention of Parliament. Indeed, it is frequently not evident at all.

81. In this case, Mr Wilson suggested that we should look at *Beneficiary v IRC* [1999] STC (SCD) 134. In that case, the interposition of a non-resident trust, which would have had the effect of sheltering the taxpayer from Inheritance Tax, was deemed to be acceptable as tax mitigation. However, a key finding of the Special Commissioners in that case is set out at p11 of the judgement:

> "There is no evidence that the grandfather sought tax advice in relation to UK tax whether from the officers of Barclays, Mr Whiteford, Mr Rothwell or Mr Stanford-Tuck. Equally, there is no evidence that he sought advice from any other source. Certainly there is evidence that he was concerned about and sought advice in relation to Japanese tax but that is not surprising bearing in mind the high levels of taxation there and the sums of money involved. The only reference in the documents to advice in relation to UK tax is concerned with the possibility that he might purchase a residence in this country. In the event he did not do so.

…

> In summary, we accept that UK tax was a consideration of the grandfather's advisers. They would have been failing in their professional duties if they had not identified the implications of having UK trustees and comparing these with the possible advantages of using Channel island trustees. But we are satisfied from the evidence that the tax implications of siting the trust in Jersey were a matter of indifference to the grandfather."

82. In other words, the reason why the Special Commissioners found that the interposition of a non-resident trust did not amount to tax avoidance in that case was because, on an analysis of the motives of the taxpayer, there was no tax avoidance motive. This is very different to the present case.

83. We were also referred to *Burns v HMRC* [2009] STC (SCD) 165, a more recent Special Commissioner's decision, this time a decision of Howard Nowlan. He stated, at p13 of his decision:

> "This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that. Thus where it is shown that the CTT or IHT considerations were one of the purposes of the transfer, or rather where the appellants have not displaced the reasonable presumption that UK [tax] advantages were one of the purposes, I conclude that those purposes involve tax avoidance and not merely tax mitigation."

84. *Burns* is therefore much more on a par with the current case.

85. Mr Wilson argued that even though Mr Rialas had sought to protect his estate from Inheritance Tax what Mr Rialas had done was not tax avoidance because he had merely taken advantage of an opportunity which had been intended by Parliament by inserting a non-resident trust between himself and his UK assets. Mr Wilson attempted to reinforce this argument by referring us to Finance (No.2) Act 2017, which amended the excluded property rules in the Inheritance Tax Act by the insertion of a new Schedule A1 to that Act, with effect from 6 April 2017. The effect of Schedule A1 was to deny excluded property relief where the non-UK property in question was directly owned by a trustee of a settlement created when the settlor was domiciled outside the United Kingdom, but the value of that property could be traced to residential property situated in the United Kingdom.

86. By this provision, he argued, Parliament had, by implication, intended that excluded property relief was available as long as the UK property in question was not UK residential property. In this way, what Mr Rialas had done was within an exemption intended by Parliament and was not therefore tax avoidance.

87. This was an interesting argument, but it does of course refer to a legislative change made in 2017, when the position regarding non-domiciled individuals had been changed dramatically as well as a number of other related changes. We cannot therefore regard it as showing anything other than the fact that, in 2017, in the context

of a very different tax environment for non-domiciled individuals, Parliament decided not to deny excluded property relief for UK property held via a non-resident trust other than where the property was UK residential property.

88. We therefore agree with Mr Nowlan that the interposition of a non-resident trust between Mr Rialas and UK property, ie the shares in Argo, did have a tax avoidance motive.

89. Mr Rialas is therefore in our view unable to take advantage of the defence offered in s742 ICTA.

Does s739 infringe Mr Rialas's right to free movement of capital?

90. Again, having found that Mr Rialas did not fall within s739, we do not in strictness need to consider the question of free movement of capital, but we will do so for the sake of completeness.

91. Mr Wilson put forward three transactions involved in the current appeal which might be affected by the EU right to free movement of capital between Member States within the meaning of the Article 56 TEEU and Directive 88/361:

(1) The sale to Farkland by Mr Cressman of his shares in Argo,

(2) The payment of dividends by Argo to Farkland, and

(3) The gift made by Mr Rialas to the trustee of Rialco.

92. In reply, Ms Choudhury argued that:

(1) the transfer of shares by Mr Cressman was not executed by Mr Rialas and was not therefore in point,

(2) The payment of dividends could not be a restriction on the free movement of capital, and

(3) The gift of C£10 to Rialco was the only transaction within the scope of the free movement of capital

93. It is true that we have found as a matter of fact that Mr Rialas did not transfer or procure the transfer of the shares in Argo. However that is exactly what HMRC have argued that Mr Rialas did and they cannot therefore argue that in this context such a transfer should not be considered. Our aim is to establish whether or not the provisions of s739 ICTA potentially infringe the principle of free movement of capital or are capable of so doing, not whether they actually did infringe Mr Rialas's right to free movement of capital, as set out in *État Belge* Case C-311/08.

94. As regards the question of the payment of dividends it was specifically confirmed in *Staatsecretaris van Financien v Verkoijen* c-35/98 that if dividends paid by a company are, as a consequence of the legislation in question, treated differently in one Member State from how they would be treated in another Member State then that is a potential infringement of the right to free movement of capital.

95. We therefore have to consider whether or not there is any discrimination caused by the provisions of s739 ICTA. This requires us to make theoretical comparisons between the position if the relevant companies were based in the UK and the position Mr Rialas now finds himself in as a result of the provisions of s739.

96. Looking at the simple case of Farkland, if it had been established in the UK then any dividends it received from Argo would not have been subject to tax, being the receipt of dividends by one UK company from another UK company. However, because Farkland is resident in Cyprus, another Member State of the EU, any dividends which Farkland receives from Argo would, if s739 applied, be subject to income tax in the hands of Mr Rialas. It is true that if Mr Rialas were the 100% shareholder in Farkland, either directly or indirectly via a trust, he might eventually pay tax on these dividends, either directly were they to be paid out to him as dividends, or indirectly if he were to sell the company, in which case their value would effectively be taxed by way of a capital gain. However, the immediate effect is that dividends from Argo which would not be taxed if Farkland were UK resident are potentially subject to tax under s739 because they would be taxable directly on Mr Rialas.

97. This comparison involving Farkland is equally valid in the context of the transfer of the shares in Argo to Farkland and the simple payment of dividends to Farkland by Argo. There is therefore clear discrimination and a clear infringement of the principle of free movement of capital.

98. In our view therefore the provisions of s739 do potentially infringe the right to free movement of capital in this case.

99. We must next consider whether or not this infringement is justified.

100. A number of defences are available to HMRC:

(1) Is the integrity of the UK tax system at stake, as per *Bachmann v Belgian State* C-204/90?

(2) Is the measure necessary for some broad economic purpose such as retention of capital in a Member State, or for a balanced application of taxing rights?

(3) Is the measure aimed at tax avoidance and, if so, is it justified and proportionate in its pursuit of this objective?

101. Neither of the first two defences was argued by HMRC. Ms Choudhury argued that:

(1) the provisions of s739 were aimed at tax avoidance and were therefore justified, and

(2) the provisions simply put the taxpayer back into the position he would have been in had he not transferred the assets abroad. They were not therefore penal and were proportionate.

102. For Mr Rialas, Mr Wilson argued that when looking at the tax avoidance justification it was necessary to consider the EU definition of tax avoidance, ie, that of something which is totally artificial. This was considered in *Cadbury Schweppes Overseas Ltd and Cadbury Schweppes plc v HMRC* C-196/04 in the context of the UK CFC legislation. The decision of the CJEU in that case, at [65] et seq states:

> "65 In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.
>
> 66 That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State, as is apparent from the case-law recalled in paragraphs 52 to 54 of this judgment.
>
> 67 As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.
>
> 68 If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary (see Case C-341/04 *Eurofood IFSC* [2006] ECR I0000, paragraphs 34 and 35).
>
> 69 On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement."

103. After reviewing arguments made by HMRC that the transfer of assets abroad rules were justifiable to prevent tax avoidance and were proportionate, the tribunal in *Fisher* stated, at [668] et seq:

> "668 HMRC argue the legislation is proportionate because it is closely targeted on situations in which the transferor has a tax avoidance motive. It does not apply to transactions undertaken purely for commercial reasons.
>
> 669 We disagree with HMRC. Even if the objective of the legislation were articulated as the prevention of the avoidance [of tax] in the European sense of the term, as can be seen from our earlier findings, it operates to catch persons who establish in Gibraltar in order to take advantage of the more favourable tax regime but who have not done so using artificial means. It is not therefore closely targeted at those situations (artificiality as described in Cadbury-Schweppes) which count as avoidance in European law but captures persons such as Anne Fisher who exercise freedom of establishment rights into Gibraltar

and UK nationals who exercise their freedom of establishment into other Member States.

673 Our conclusion is that the TOAA charge does restrict Anne Fisher's freedom of 5 establishment (and by extension her free movement of capital) and that it breaches those freedoms in a way which lacks justification. Even if the breach of those freedoms were justified it is not proportionate to any legitimate justification of fighting tax avoidance as that concept is understood in European law."

104. The decisions in these cases are predicated on the fact that in order to be justifiable under EU case law the tax avoidance provisions in domestic legislation must be narrowly targeted on the EU concept of tax avoidance, ie, on arrangements which are totally artificial.

105. In a recent case however, *X Gmbh v Finanzamt Stuttgart – Korperschaften* (Case C-135/17), issued on 26 February 2019, the CJEU held as follows:

"[84] … in the context of the free movement of capital, the concept of 'wholly artificial arrangements' **cannot necessarily be limited to merely the indications referred to in paragraphs 67 and 68 of the judgment of 12 September 2006, *Cadbury Schweppes and Cadbury Schweppes Overseas* (C-196/04, EU:C:544),** that the establishment of a company does not reflect economic reality, since the artificial creation of the conditions required in order to escape taxation in a Member State improperly or enjoy a tax advantage in that Member State improperly can take several forms as regards cross-border movements of capital. Indeed, those indications may also amount to evidence of the existence of a wholly artificial arrangement for the purposes of applying the rules on the free movement of capital, in particular when it proves necessary to assess the commercial justification of acquiring shares in a company that does not pursue any economic activities of its own. **However, that concept is also capable of covering, in the context of the free movement of capital, any scheme which has as its primary objective or one of its primary objectives the artificial transfer of profits made by way of activities carried out in the territory of a Member State to third countries with a low tax rate.**"

106. This would seem to move the goalposts somewhat. Specifically it states that

"in the context of the free movement of capital, the concept of 'wholly artificial arrangements' cannot necessarily be limited to merely the indications referred to in paragraphs 67 and 68 of the judgment [in *Cadbury Schweppes*]."

107. On the basis of this very recent case therefore, domestic anti-avoidance measures which target transactions other than wholly artificial transactions would now seem to be regarded as potentially justified in the context of the free movement of capital.

108. Prior to this case, in accordance with the doctrine set out in *Cadbury Schweppes*, the provisions of s739 would not be regarded as justified. The case of *X*

Gmbh would seem to change that position markedly such that more broadly targeted anti-avoidance provisions would be considered as justified. Given the specific wording used in [84] of *X Gmbh* we consider that the provisions of s793 are justified and, to that extent, should not be regarded as infringing the free movement of capital.

109. However, in order to be fully permitted under EU law, domestic anti-avoidance provisions must not only be justified, they must also be proportionate.

110. In the recent case of *Stephen Hoey v HMRC* [2019] UKFTT 0489 (TC) the tribunal came to the conclusion that the successor provisions to s739 were not penal in nature. In that case however, the effect of the successor provisions was simply to put the taxpayer into the same position as he would have been had he entered into an employment contract with a company based in the UK rather than one based in the Isle of Man. As such, the tribunal came to the conclusion that, in those particular circumstances, the effect of the provisions was not penal.

111. The declared purpose of s739 is to deter the avoidance of UK taxation by the transfer of assets abroad. However, as discussed at [95] and [96] above, in the circumstances of the current appeal, the effect of s739 is to put the taxpayer in a worse position than he would have been had he formed Farkland in the UK because:

(1) The provision has the effect of looking through the corporate and trust structure, and taxes Mr Rialas directly on the income of the company, Farkland, and

(2) No deduction is allowed for the interest which was paid by Farkland, which would have been possible had the investment been structured in a more conventional way in the UK.

112. This is not therefore merely anti-avoidance in the circumstances of this case, it is penal in nature. It may be regarded as justified but it is penal in nature and is not therefore, in our view, proportionate. As Judge Raghavan said in *Fisher* at [666],

> "This penal nature is incompatible with any justification for the restrictions on the freedoms which result from its application."

113. The principles derived from case law on the approach to be taken in such circumstances were summarised by The Chancellor in *Vodafone 2* [2009] EWCA Civ 446 at [37]:

> "The principles which those cases established or illustrated were helpfully summarised by counsel for HMRC in terms from which counsel for V2 did not dissent. Such principles are that:
>
> > "In summary, the obligation on the English courts to construe domestic legislation consistently with Community law obligations is both broad and far-reaching. In particular:
> >
> > (a) It is not constrained by conventional rules of construction (Per Lord Oliver in *Pickstone* at 126B);

(b) It does not require ambiguity in the legislative language (Per Lord Oliver in *Pickstone* at 126B; Lord Nicholls in *Ghaidan* at 32);

(c) It is not an exercise in semantics or linguistics (See *Ghaidan* per Lord Nicholls at 31 and 35; Lord Steyn at 48-49; Lord Rodger at 110-115);

(d) It permits departure from the strict and literal application of the words which the legislature has elected to use (Per Lord Oliver in *Litster* at 577A; Lord Nicholls in *Ghaidan* at 31);

(e) It permits the implication of words necessary to comply with Community law obligations (Per Lord Templeman in *Pickstone* at 120H-121A; Lord Oliver in *Litster* at 577A); and

(f) The precise form of the words to be implied does not matter (Per Lord Keith in *Pickstone* at 112D; Lord Rodger in *Ghaidan* at para 122; Arden LJ in *IDT Card Services* at 114)."

114. Mr Wilson suggested that the appropriate conforming construction might be to interpret s741 on the basis of the definition of tax avoidance in EU law prior to the case of *X Gmbh*. This does not however achieve the desired result in this case, because *X Gmbh* casts a different light on the meaning of tax avoidance for these purposes.

115. The approach to be taken in such circumstances is set out in Lord Walker's speech in the House of Lords decision in *Fleming t/a Bodycraft v CCE* [2008] UKHL 2 [2008] STC 324:

"My Lords, it is a fundamental principle of the law of the European Union (EU), recognised in s 2(1) of the European 30 Communities Act 1972, that if national legislation infringes directly enforceable Community rights, the national court is obliged to disapply the offending provision. The provision is not made void but it must be treated as being (as Lord Bridge of Harwich put it in *Factortame Ltd v Secretary of State for Transport* [1990] 2 AC 85 at 140): '… without prejudice to the directly enforceable Community rights of nationals of any member state of the E.E.C.' The principle has often been recognised your Lordships' House, including (in the context of taxes) Imperial Chemical Industries plc v Colmer (Inspector of Taxes) [1999] STC 1089 at 1095, [1999] 1 WLR 40 2035 at 2041 per Lord Nolan, and recently *Re Claimants under Loss Relief Group Litigation Order (sub nom Autologic Holdings plc v IRC)* [2005] UKHL 54 at [16]-[17], [2005] STC 1357 at [16]-[17] per Lord Nicholls of Birkenhead. Disapplication is called for only if there is an inconsistency between national law and EU law. In an attempt to avoid an inconsistency the national court will, if at all possible, interpret the national legislation so as to make it conform to the superior order of EU law: *Pickstone v Freemans plc* [1989] AC 66; *Litster v Forth Dry Dock & Engineering Co Ltd (in receivership)* [1990] 1 AC 546. Sometimes, however, a conforming construction is not possible, and disapplication cannot be avoided. Disapplication of national legislation is an essentially different process from its interpretation so as to conform with EU law. Only in the most formal sense (because of the terms of s

2(4) of the European Communities Act 1972) can disapplication be described as a process of construction".

116. Nevertheless, in the current circumstances, where a conforming construction does not achieve a result which is in line with EU law, the only effective solution is to disapply the provisions of s739 in cases where the effect of s739is penal, because it puts the taxpayer into a worse position than he would have been had he formed Farkland in the UK.

117. In summary, as regards Mr Rialas's third contention, we find that the provisions of s739 are not compatible with the EU principle of free movement of capital because, although they may be justifiable on the grounds that they are targeted at tax avoidance, they are penal in nature and are therefore a disproportionate response to the arrangements at which they are aimed. Since a conforming construction does not achieve the desired result, the only appropriate approach is to disapply s739 in cases where the effect of these provisions is penal.

DECISION

118. In summary, we decided that:

(1) The provisions of s739 ICTA do not apply to Mr Rialas because he is neither the transferor nor someone who procured the transfer of the assets in question.

(2) In case we are wrong on this point, we considered whether or not Mr Rialas had a defence available to him under the motive defence provisions in s741. We decided that he could not claim relief under this section because one of his purposes in setting up the acquisition structure in question was the avoidance of Inheritance Tax.

(3) In case we are wrong on either of the two previous points, we also considered whether or not the provisions of s739 were compatible with the EU principle of free movement of capital. In this case we decided that the provisions of s739 were not compatible with the EU principle of free movement of capital because they were penal in their effect and that the only effective remedy in these circumstances was to disapply s739 ICTA.

119. For the above reasons therefore we decided that this appeal should be ALLOWED.

120. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

121. This decision was amended pursuant to Rule 37 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 on 18 October 2019. Amendments were made to paragraphs [108], [110], [111], [116], [117] and [118] to correct typographical errors regarding the correct section number and to paragraph [20] to correct a minor error of fact.

PHILIP GILLETT
TRIBUNAL JUDGE

RELEASE DATE: 07 AUGUST 2019