

**OPINIONS**  
**OF THE LORDS OF APPEAL**  
**FOR JUDGMENT IN THE CAUSE**

**Trennery (Respondent)**

**v.**

**West (Her Majesty's Inspector of Taxes) (Appellant) and four  
other actions**

**ON**  
**THURSDAY 27 JANUARY 2005**

The Appellate Committee comprised:

Lord Steyn  
Lord Hoffmann  
Lord Millett  
Lord Rodger of Earlsferry  
Lord Walker of Gestingthorpe

**HOUSE OF LORDS**

**OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT  
IN THE CAUSE**

**Trennery (Respondent) v. West (Her Majesty's Inspector of Taxes)  
(Appellant) and four other actions**

**[2005] UKHL 5**

**LORD STEYN**

My Lords,

1. I have read the opinions of my noble and learned friends Lord Millett and Lord Walker of Gestingthorpe. I agree with their opinions. I would allow the appeal and make the order which Lord Walker proposes.

**LORD HOFFMANN**

My Lords,

2. I have had the privilege of reading the speeches of my noble and learned friends, Lord Millett and Lord Walker of Gestingthorpe in draft. I too would allow the appeal and make the order which Lord Walker proposes.

**LORD MILLETT**

My Lords,

3. The question in this appeal is whether a tax avoidance scheme known as “the flip-flop scheme” or “the two settlement route” to reduce

the rate of capital gains tax payable in respect of a chargeable gain succeeded in its object or was struck down by statutory provisions which, at least at first sight, appear designed to counter just such arrangements.

4. Capital gains tax on chargeable gains accruing to an individual is charged at the taxpayer's highest rate of income tax, usually 40%. Tax on chargeable gains accruing to the trustees of a settlement, however, is charged at the lower rate of 25%. In order to protect the revenue, it is obviously necessary to prevent taxpayers from obtaining the benefit of the lower rate of tax by transferring assets pregnant with capital gains into a settlement in which they retain an interest before procuring the trustees to dispose of them.

5. This stratagem is dealt with by Section 77(1) of the Taxation of Chargeable Gains Act 1992 ("the Act"). This provides that where (i) in any year of assessment the trustees of a settlement make a chargeable gain from the disposal of all or any of the settled property and (ii) the settlor has an interest in the settlement at any time during that year then the trustees are not to be chargeable to tax in respect of the gain but the settlor is to be chargeable as if the gain had accrued to him.

6. There is no necessary connection between (i) the settlor's interest, which may be remote, or its value, which may be small, and (ii) the property disposed of, in which the settlor may have no interest and the value of which may be very great. To this extent the Section may be said to operate harshly: a settlor who has any interest however small in a settlement is at risk of being charged to tax in respect of capital gains accruing to the trustees even from the disposal of assets in which he has no interest at all. Section 78, however, entitles the settlor to recover the amount of any tax which he has paid from the trustees, so the effect of the section is not to alter the ultimate incidence of the tax but to ensure that the tax is charged at the appropriate rate. The appropriate rate depends on whether the settlor has an interest in any of the settled property during the relevant year of assessment.

7. Section 77(2) is an anti-avoidance provision which extends the scope of Section 77(1) in order to prevent taxpayers circumventing it. It does this by directing that a settlor shall be regarded as having an interest in a settlement in a number of situations in which, absent the Subsection, he would not be so regarded. Thus it provides that a settlor is to be regarded as having an interest in a settlement if any property which

may at any time be comprised in the settlement is or will or may become payable to or applicable for the benefit of the settlor *or his spouse* in any circumstances whatsoever. The relevant provisions on which the Revenue rely in the present case are those which bring in “derived property”. Omitting words which are immaterial for present purposes, a settlor is to be regarded as having an interest in a settlement if (a) any property.....comprised in the settlement *or any derived property* is..... payable to or applicable for the benefit of the settlor; or (b) the settlor.....enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement *or any derived property*.

8. “Derived property” is defined by Section 77(8) as follows:

“(8). In this section “derived property”, in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or income from, that property or income therefrom.”

9. The taxpayer submitted that the Subsection merely extends the scope of the Section to income. “Derived property”, he submitted, means income from (i) that property..... or (ii) any other property.....

10. This is a possible way of reading the Subsection, but I have no doubt that the Court of Appeal were right to reject it. The Subsection is concerned with the extraction of value from a settlement for the benefit of the settlor or his spouse before the year in which a chargeable gain accrues to the trustees of the settlement. On the taxpayer’s construction the Subsection catches the extraction of value in the form of income but not of capital. It is impossible to ascribe to Parliament so capricious an intention, which not only leaves a gaping hole in the protection which the Section is intended to afford the revenue but makes no sense. It is more natural, as well as making more sense, to read the Subsection as referring to (i) income from that property or (ii) any other property directly or indirectly representing proceeds from, or income of, that property or (iii) income therefrom.

11. In my opinion the provisions of the Section are carefully crafted to catch the extraction of value in any form for the benefit of the settlor or his spouse without introducing an undesirable degree of overkill. The Revenue must work their way through the Section and satisfy a number of requirements before they can charge the tax at the settlor’s rate.

12. The first question is whether a chargeable gain has accrued to the trustees of a settlement from the disposal of all or any part of the settled property (Section 77(1)(a)). In the present case the answer is “yes”: a chargeable gain accrued to the trustees of the first (or “flip”) settlement during the 1995-6 tax year when they sold the Einkorn shares. This disposal identified the first settlement as the relevant settlement and the 1995-6 tax year as the relevant year.

13. The next question is whether the settlor had an interest in that settlement during the relevant year. The answer is “no”: he had divested himself of all interest in the first settlement before the year began.

14. That is not, however, an end of the story. The next question is whether the settlor *is to be regarded* as having an interest in the first settlement during the relevant year even though he did not have one in fact. The Revenue say that the answer to this question is “yes”: he was entitled to receive derived property (Section 77(2)(a)) or was enjoying a benefit derived directly or indirectly from the property comprised in the first settlement (Section 77(2)(b)) during the relevant year.

15. To make this good the Revenue must first identify the property which they allege was payable to or applicable for the benefit of the settlor or from which he was deriving a benefit during the relevant year. For this purpose they identify the income of the moneys comprised in the trust fund of the second (or “flop”) settlement which was payable to the settlor. Secondly they must identify the property which was still comprised in the first settlement during the relevant year in which they allege the settlor is to be regarded as having an interest. The only property which was still comprised in the first settlement during the relevant year (pending their disposal) was the Einkorn shares. The Revenue identify these as the property in relation to which (“in relation to any property”) the moneys comprised in the trust fund of the second settlement and the income therefrom were derived property: (Section 77(8)).

16. The final question is whether the Revenue are correct in contending that the moneys comprised in the trust funds of the second settlement during the relevant year and the income therefrom which was payable to the settlor constituted derived property within the meaning of Section 77(8) in relation to the Einkorn shares. There can be only one answer to this: of course they do. The moneys comprised in the trust fund of the second settlement directly represented the proceeds of a

mortgage of the Einkorn shares and the income payable to the settlor during the relevant year represented the income therefrom. If the trustees of the second settlement had invested the moneys in stocks and shares, these would have indirectly represented those proceeds. It will be observed that I have equated the proceeds of a mortgage of property with the proceeds of the property itself. But the Subsection does not refer to “the proceeds of a sale of that property”, but to “the proceeds of that property”; and this covers any process, whether sale or mortgage or otherwise howsoever, by which value is extracted from one property and transferred to another.

17. The taxpayer contended that he did not derive any benefit from the proceeds of the mortgage of the Einkorn shares during the relevant year. He had obtained the benefit of those proceeds once and for all when they were transferred to the trustees of the second settlement during the previous year. Thereafter he derived benefit exclusively under the trusts of the second settlement. The difficulty with this argument is that it does not deal with the relevant question: whether in relation to the proceeds of the mortgage of the Einkorn shares the moneys comprised in the second settlement constituted derived property. They plainly did when they were received by the trustees of the first settlement; they did not change their character when they were transferred to the trustees of the second settlement; and the settlor continued to enjoy the income from them during the relevant year. The fact that the settlor obtained his right to income under the trusts of the second settlement is immaterial if the income represented the income of the proceeds of property comprised in the first settlement.

18. The taxpayer submitted that this was an extravagant application of the statutory provisions, since whatever assets were comprised from time to time in the trust funds of the second settlement they would never cease to represent, directly or indirectly, the proceeds of the mortgage of the Einkorn shares. That is true, but once the Einkorn shares were sold the assets in the second settlement and the income therefrom would cease to constitute derived property in relation to any property for the time being comprised in the first settlement.

19. Accordingly I would rule that the rate of tax chargeable in respect of the gain accruing on the disposal of the Einkorn shares was the settlor’s highest marginal rate of income tax and not the lower settlement rate.

20. The Court of Appeal reached the contrary conclusion. They reasoned that the word “proceeds” in Section 77(8) referred to property which was comprised in the chargeable (ie. the first) settlement; once the proceeds of the mortgage left the first settlement, they ceased to retain their character as proceeds. In my opinion there is no warrant whatever for such a construction, which emasculates the Section 77(2) and deprives the elaborate provisions relating to derived property of all effect. These are not aimed at property which remains in the relevant settlement, in regard to which they would be otiose, but at property held outside the settlement but which is derived property in relation to property comprised in it.

21. While the proceeds of the mortgage of the Einkorn shares remained in the first settlement they were both property comprised in the settlement in their own right and property representing the proceeds of such property, viz. the Einkorn shares; and (pending his exclusion from all benefit under the settlement) the settlor had an interest in the first settlement without recourse to Section 77(2). Once they left the first settlement they ceased to be property comprised in that settlement with the result that the settlor had no interest in that settlement during the relevant year. But they continued to represent the proceeds of the mortgage of the Einkorn shares (what else could they represent?) with the result that the settlor fell to be regarded as having an interest in the first settlement by virtue of Section 77(2) so long as the Einkorn shares continued to be comprised in it.

22. For these reasons I too would allow the appeal and make the order which my noble and learned friend Lord Walker of Gestingthorpe proposes.

## **LORD RODGER OF EARLSFERRY**

My Lords,

23. I have had the privilege of reading the speeches of my noble and learned friends, Lord Millett and Lord Walker of Gestingthorpe in draft. I agree with them and for the reasons they give I am satisfied that the construction of section 77 of the Taxation of Chargeable Gains Act 1992 adopted by the Court of Appeal is unsound. I would accordingly allow the appeal and make the order as to costs which Lord Walker proposes.

## LORD WALKER OF GESTINGTHORPE

My Lords,

24. These appeals are concerned with capital gains tax (“CGT”) claimed in respect of a chargeable disposal of settled property which occurred during the 1995-6 year of assessment. There are five linked appeals which have similar facts and all depend on the same point of law. In each appeal the issue is not whether CGT is payable, but whether it is payable at the trustees’ rate (25%) or at the settlor’s rate (40%). Your Lordships have to construe section 77 of the Taxation of Chargeable Gains Act 1992 (“the 1992 Act”) as substituted by the Finance Act 1995 (“the 1995 Act”). The legislation has since been changed again, by the Finance Act 2000, which introduced into the 1992 Act a new section 76 B and Schedule 4B tailor-made to frustrate the scheme which the taxpayers used in this case. Another way of putting the issue in the appeals is whether the changes made in 2000 were strictly necessary.

25. The parties’ written cases, and the oral submissions of Mr Green QC (whom the House heard first on behalf of the respondent taxpayers), have developed some refined and complex points. Before I address those there are some more basic points to be made about the scheme and structure of the CGT legislation. CGT was introduced nearly 40 years ago in a relatively simple code set out in Part III of the Finance Act 1965. The legislation has since become very much more complicated. One feature of the tax which has survived unchanged is the rule that the creation of a mortgage or charge as security for a debt is not a disposal for CGT purposes, even though the equity of redemption may be worth only a fraction of the full value of the mortgaged property (or may even be worthless). The other side of this coin is that a sale of mortgaged property is treated as a disposal of the whole property by the mortgagor, even if it is a sale effected by the mortgagee under a power of sale. In an extreme case a hopelessly insolvent mortgagor may be liable to pay CGT as a result of a sale from which he personally gets nothing. These rules are now found in section 26 of the 1992 Act.

26. The CGT legislation has from its inception treated trustees of settled property as a taxable unit. The trustees of a settlement are regarded as “a single and continuing body of persons (distinct from the persons who may from time to time be the trustees)”: section 61 (9) of the 1992 Act. “Settled property” is defined in section 68 (any property

held in trust other than property held by a nominee or bare trustee) and the expression “settlement” reflects the meaning of “settled property”. A settlement for CGT purposes is therefore (in broad terms) what a chancery lawyer would call a settlement, as opposed to the very wide definition (“includes any disposition, covenant, agreement, arrangement or transfer of assets”) used for income tax purposes and now found in section 660G of the Income and Corporation Taxes Act 1988 (“the 1988 Act”). In *Roome v Edwards* [1982] AC 279 this House considered the meaning of “settlement” in the capital gains tax legislation, and in particular whether the establishment of a new appropriated fund leads to the creation of a separate settlement, whose trustees are a separate taxable unit (see the speech of Lord Wilberforce at pages 292-295). Since *Roome v Edwards* there have been other decisions exploring this area, but it is unnecessary to go into them. It is common ground that for CGT purposes property can pass from one settlement to another, not only as a result of a resettlement effected by one or more of the beneficiaries, but also (as occurred in these appeals) as a result of trustees exercising powers of appointment or advancement.

27. Initially CGT was charged at a flat rate of 30%, subject to a modest annual exemption for individuals (and an even more modest annual exemption for trustees and personal representatives). But in 1988 Parliament decided to charge an individual’s net chargeable gains at income tax rates and as the top slice of income. So if an individual makes very large gains (not offset by allowable losses) he pays CGT at a marginal rate of 40% and at an average rate very little if any lower. The rate paid by trustees of a settlement with a subsisting interest in possession was however fixed at 25% (until recent changes not relevant to these appeals). So in 1995-6 there was a clear advantage to taxpayers if any large chargeable gains could be taxed, not as gains of individuals, but as gains of trustees of an interest in possession settlement.

28. If an individual owned assets with a large unrealised gain which was likely to be realised shortly, he had an incentive to try to shelter the assets in an interest in possession settlement (if they could be put into the settlement tax-free, especially by claiming holdover relief for business assets), to have the gain realised by the trustees, and later (as a beneficiary of the settlement) to enjoy access to the proceeds. But if he was to achieve that aim he and his advisers had to find a way around section 77 of the 1992 Act (charge on settlor with interest in settlement). That section in its original form was a consolidation of Schedule 10, paragraphs 1-4 of the Finance Act 1988. As amended by the 1995 Act (and I shall come back to the circumstances and effect of that

amendment) section 77 of the 1992 Act, so far as directly material, was in the following terms:

“(1) Where in a year of assessment—

- (a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property,
- (b) after making any deduction provided for by section 2 (2) [allowable losses] in respect of disposals of the settled property there remains an amount on which the trustees would, disregarding section 3 [annual exemptions], be chargeable to tax for the year in respect of those gains, and
- (c) at any time during the year the settlor has an interest in the settlement,

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

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

- (a) any property which may at any time be comprised in the settlement, or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever, or
- (b) the settlor or his spouse enjoys a benefit deriving directly or indirectly from any property which is comprised in the settlement or any derived property.

...

(8) In this section ‘derived property’, in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income therefrom.”

The dispute between the parties centres on the definition of “derived property”.

29. The taxpayers whom the Inland Revenue wish to tax under section 77 were all shareholders in an unquoted company, Einkorn Ltd (“Einkorn”), which ran buses. At the beginning of 1995 they were negotiating to sell their shares in Einkorn to a company called North British Buses Ltd (“North British”). The shareholder whose case was taken as typical was Mr Stephen Trennery. He had 10,000 Einkorn shares. He was married to Mrs Christine Trennery and they had two children, David and Andrew, then aged 19 and 17. Mr and Mrs Trennery, and the other shareholders and their wives, embarked on a plan devised by their solicitors and accountants with a view to achieving a 25% rate of CGT on the bulk of the shares intended to be sold.

30. The plan was described in an advice letter dated 20 April 1995 written by the shareholders’ solicitors and it was carried into effect by a number of documents executed between 30 March and 5 April 1995. The steps are described in detail in an agreed statement of facts set out in the Special Commissioners’ decision and also annexed to the judgment of Peter Smith J: [2002] STC (SCD) 370,373; [2003] STC 580, 602. Before the Special Commissioners and in the Chancery Division there were some subsidiary issues which are no longer live. It is sufficient to give a short summary of the essential steps taken by Mr and Mrs Trennery.

- (1) On 1 April 1995 Mr Trennery settled £10 on trust for himself for life, with power for the trustees to pay capital to him, and then on trusts and powers primarily for his children and remoter issue. The details are unimportant except that clause 7 contained a power exercisable by the trustees (subject to various constraints) to pay or transfer capital or income of the trust fund to any other settlement for the benefit of any of the beneficiaries; and clause 12 gave the trustees power to exclude beneficiaries. The trustees of this settlement (“the first settlement”) were Mr and Mrs Trennery. They had previously applied to National Westminster Bank for an advance of £770,000, describing themselves as “trustees of a life interest settlement trust”; and the bank had agreed to make the advance.
- (2) On 4 April Mr Trennery transferred 8,000 of his 10,000 Einkorn shares to himself and his wife as trustees of the first settlement.
- (3) Also on 4 April Mr Trennery made another settlement (“the second settlement”) with a second nominal sum of £10. Its trusts and powers were similar, but not identical, to those of the first settlement. Its trustees were two partners in Mr Trennery’s solicitors.

- (4) Also on 4 April Mr and Mrs Trennery, acting as trustees of the first settlement, drew down the advance of £770,000 and authorised their solicitors to hold the share certificates in respect of the settled shares (or the proceeds of sale of those shares) as security for the bank loan. They then proceeded to execute a deed of appointment of this sum, in exercise of the clause 7 power, to the trustees of the second settlement to the intent that the sum should, “from that time cease to be held upon and with and subject to the trusts powers and provisions of the [First] Settlement and shall (with all future income of the same) for all purposes become subject to the trusts powers and provisions contained in the Second Settlement and form part of the Trust Fund of the Second Settlement as a separate settlement for all purposes.” The transfer was effected by entries in the solicitors’ client account.
- (5) On 5 April Mr and Mrs Trennery, as trustees of the first settlement, executed a deed excluding themselves as beneficiaries and replacing their interests with life interests in possession conferred on their two sons.
- (6) On 13 April Mr and Mrs Trennery, as trustees of the first settlement, sold their 8,000 Einkorn shares to North British at £130.58 per share (a very small proportion of which was deferred for one year). The rest of the purchase price was paid on 18 April and the bank loan was paid off.

31. The agreed statement of facts included the facts that all the steps down to (and including) 5 April 1995 were “preordained” but the sale to North British was not “preordained” (in each case, in the sense described in *Craven v White* [1989] AC 398). In your Lordships’ House the parties agree that no issue arises “under the so-called *Ramsay* doctrine” (see *W T Ramsay Ltd v IRC* [1982] AC 300). The issue is one of statutory construction, to be determined in accordance with the principles stated by the House in *IRC v McGuckian* [1997] 1 WLR 991.

32. I approach the parties’ competing contentions on the issue of statutory construction by examining the six successive steps summarised in the penultimate paragraph. Much of the analysis is uncontroversial. At step one Mr Trennery created a settlement for CGT purposes. He and his wife were the first trustees (probably because no one else was willing to undertake the borrowing of such a large sum on the security of a minority holding of shares in an unquoted company) but as trustees they were regarded as a separate taxable unit. At step two Mr Trennery made a disposal of 8,000 Einkorn shares, but he avoided CGT because he could claim holdover relief for business assets under section 165 of

the 1992 Act. The shares became settled property and the settlor had an interest under the settlement, so that section 77 of the 1992 Act certainly applied during the 1994-5 year of assessment. At step three Mr Trennery created another, separate settlement for CGT purposes. Its trustees were another separate taxable unit. The stage was then set for the essential steps which were to follow.

33. At step four the trustees of the first settlement made a highly-g geared borrowing on the security of their Einkorn shares. This was not a disposal of the shares, which still had to be regarded, for CGT purposes, as retaining their full value (section 26 of the 1992 Act). The trustees of the first settlement then transferred £770,000 to the trustees of the second settlement, but there was no immediate capital gains tax consequence as it was cash that was transferred.

34. At step five (still, it is to be noted, within the 1994-5 year of assessment) Mr and Mrs Trennery were excluded from any beneficial interest under the first settlement (the effectiveness of their exclusion was previously in issue, but that point is no longer taken by the Inland Revenue). It is common ground that, had section 77 not referred to “derived property”, that section would have ceased to apply to the first settlement at the end of the 1994-5 year of assessment. The issue is whether the “derived property” provisions produce a different result.

35. At step six the trustees of the first settlement disposed of their 8,000 Einkorn shares for a total of about £1 million. They accept that they must pay CGT of the order of £250,000 (more precise figures are set out in paragraph 10 of the Special Commissioners’ decision) but they resist the Inland Revenue’s claim that Mr Trennery must pay CGT of the order of £400,000, with a right to reimbursement (under section 78 of the 1992 Act) from himself and his wife in their capacity as trustees of the first settlement. If CGT is payable at the higher rate, the remaining resources of the first settlement are insufficient to make reimbursement in full. But Mr Trennery remains a beneficiary who can receive income or capital under the second settlement.

36. The issue of construction has already been argued and decided three times, and the parties’ fortunes have fluctuated. The Special Commissioners (Dr J F Avery Jones CBE and Mr Malcolm Gammie QC) decided it in favour of the taxpayers: [2002] STC (SCD) 370, 380. On appeal by the Inspectors of Taxes, Peter Smith J reached the opposite conclusion: [2003] STC 580, 599-600. On further appeal by

the taxpayer the Court of Appeal (Kennedy, Jonathan Parker and Longmore LJ) reversed Peter Smith J and restored the decision of the Special Commissioners. It is unnecessary to embark on a summary of their reasons, since (apart from Mr Green's primary submission to your Lordships, mentioned below) essentially the same arguments have been put forward at every level. They centre on whether the correct interpretation of section 77 is that any "derived property" must remain comprised in the relevant settlement, and ceases to be derived property if it passes out of that settlement.

37. The structure of section 77 is rather awkward (Jonathan Parker LJ, who gave the leading judgment in the Court of Appeal, used stronger language) and it is important to keep in mind how the different subsections fit together. Subsection (1) focuses on a year of assessment (in these appeals, 1995-6) in which chargeable gains accrue to trustees and lays down the general rule that the settlor of the relevant settlement ("the chargeable settlement") is to be liable to CGT if

"at any time during the year the settlor had an interest in the settlement."

Subsection (2) explains the meaning of those words by reference to two paragraphs, (a) and (b), which broadly correspond to (a) the settlor's entitlement to any sort of beneficial interest, whether present or future and whether fixed or discretionary; and (b) the settlor's actual receipt of a benefit. (Each of these references to the settlor must be taken as including the settlor's wife or husband; this extension should be read in throughout the following discussion.) It is hard to see what paragraph (b) adds to the very wide language of paragraph (a). Mr Green suggested that it covered a benefit conferred in breach of trust, and that may well be so. The paragraph may also cover the possibility of an assignment of a beneficial interest made to the settlor (without any impropriety) by a beneficiary (that possibility is to be disregarded, unless and until it happens, under section 77 (4) (b), a provision which was not referred to in the course of argument and which may reduce the disquiet engendered by some of Mr Green's more extreme examples). On any view, however, there is probably an overlap between paragraphs (a) and (b). Such an overlap is not unusual in taxing statutes (see for instance, out of many possible examples, subsections (2) and (3) of section 739 of the 1988 Act, relating to transfers of assets abroad). To my mind the important point about section 77 (2) is that (the chargeable settlement and the relevant year of assessment having been identified) it

requires beneficial entitlement of some sort, in that year, in respect of property comprised in the settlement “or any derived property.” That sends the reader to the definition in subsection (8), which I repeat:

“In this section ‘derived property’, in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income therefrom.”

38. Mr Green’s primary submission was that in this definition the words “income from” (where they first occur) govern all the following phrases. He advanced this argument in the Court of Appeal, although it had not been advanced before the Special Commissioners, and indeed a different analysis had apparently been conceded (see paragraph 17 of the Special Commissioners’ decision and paragraph 49 of the judgment of Jonathan Parker LJ). I agree with the Court of Appeal in rejecting it, for the reasons which they gave. The only natural reading of subsection (8) is that its structure has five elements: that “derived property” in relation to any property (“P”), means

- (i) income from P;
- (ii) any other property directly or indirectly representing proceeds of P;
- (iii) income from any such other property at (ii) above;
- (iv) any other property directly or indirectly representing proceeds of income from P; and
- (v) income from such other property at (iv) above.

39. The taxpayers’ next main point is that if section 77 is to apply through any of these five elements the property or income in question must, in the relevant year of assessment, be comprised in the chargeable settlement. Any other interpretation would, it is said, give section 77 an almost unrestricted reach, leading to extraordinary results and possible hardship to taxpayers.

40. Mr Green developed this argument with great skill, but to my mind it faces an insuperable objection. If he is right, the whole elaborate definition in subsection (8) could have been replaced by a simple reference to any capital or income of the property comprised in the chargeable settlement. Section 77 (2) (a) and (b) already refer to

property comprised in the settlement, before the reader ever gets to derived property. So the taxpayers' contention deprives the latter expression of any force. But Parliament must be taken to have intended the expression to add something to the effect of section 77, and it would occasion no great surprise if the addition were found to be a category of property which is settled property, and is derived from settled property comprised in the chargeable settlement, but is not itself still comprised in the chargeable settlement.

41. Mr Green put forward various imaginary scenarios in which, on totally different facts, taxpayers might be faced with tax claims which might appear oppressive. He was understandably rather reluctant to spend long on analysing the sequence of events which actually occurred in these appeals. But he did (as I understand it) accept that the £770,000 borrowed by Mr and Mrs Trennery on the security of the settled Einkorn shares was initially "derived property" in relation to those shares. However the £770,000 did (in his submission) cease to be derived property within hours or even minutes of the draw-down of the loan, when the money was (by the deed executed at step four and the simultaneous ledger entries in the solicitors' client account) transferred to the trustees of the second settlement. It was in consequence, at the dawning of the 1995-6 year of assessment, comprised in a settlement separate from the first settlement. (To state, as the respondents' printed case does, that it was an entirely separate settlement might be said to overlook the effect of the rule against perpetuities, as explained by this House in *Pilkington v IRC* [1962] AC 612; the trust law analysis is that the second settlement served as a vehicle to receive and continue the act of bounty effected by the first settlement, with the rule against perpetuities acting as a sort of umbilical cord between the two settlements; the fact remains, however, that it was a separate settlement for CGT purposes.) Mr and Mrs Trennery were then excluded from the first settlement, which at that stage comprised 8,000 Einkorn shares and £10, subject to the trustees' liability to service and repay the loan of £770,000. That loan was secured on the shares, and Mr and Mrs Trennery, in their capacity as trustees, were entitled to be indemnified for the liability against the whole trust fund (the shares and £10).

42. In my opinion the £770,000 started off as derived property (and was also, for a matter of hours or minutes, property comprised in the first settlement). It continued to be derived property after it was appointed out of the first settlement. The effect of the taxpayers' argument would be to cut off the operation of the "derived property" provision at the very moment when it started to have some work to do. The economic effect of the arrangements was to transfer about three-

quarters of the value of the shares to the second settlement, but without any disposal of the shares for CGT purposes. Mr Trennery was a beneficiary under the second settlement, and continued to be a beneficiary in 1995-6. Both on the natural meaning of section 77 (2) and (8) and in normal parlance, Mr Trennery was in 1995-6 beneficially interested in property derived from (that is, representing proceeds of) the shares which remained in the first settlement. The only property in the second settlement which was not “derived property” was the second nominal sum of £10 which Mr Trennery settled on 4 April 1995.

43. That construction seems to me well within Parliament’s likely intention in enacting section 77 in its amended form. By 1995 it was well known that (under the rule then embodied in section 26 of the 1992 Act) secured borrowing could be used to produce economic results which were, at least in the short term, at odds with the analysis of the transaction for CGT purposes. It was also well known, and had been since the decision of this House in *Roome v Edwards* [1982] AC 279, that special powers of appointment and advancement could be used to make settled property pass from one settlement to another, without any intervening period of absolute ownership, and that such transfers might have important CGT consequences. In my opinion the transactions on which the taxpayers embarked fall squarely within the language, and the likely legislative intendment, of section 77 as amended.

44. In the end the taxpayers’ case is based, as it seems to me, not on the way in which the Inland Revenue seek to apply the statutory provisions in these cases, but on the anomalous and oppressive effect which they might have in other hypothetical circumstances far removed from those of the present case. Section 77’s requirement that the chargeable settlement should, in the year of assessment in question, contain some property (what I have referred to above as “P”) to which the derived property can be linked, provides some restriction on its scope, but I would accept that it does not meet every possible hard case. One possible answer to the alleged anomaly and oppression is that in 2000 Parliament enacted the far more detailed code now found in Schedule 4B to the 1992 Act. But a more complete answer was given by Lord Wilberforce (with whom Lord Scarman, Lord Roskill and Lord Brandon agreed) in *Leedale v Lewis* [1982] 1 WLR 1319, 1330,

“I would only refer to one other argument, that based on the alleged ‘hardship’ of accepting the Revenue’s contention. I do not think that this is a relevant consideration at all. If there were two equally possible constructions of this subsection, it might be correct to

choose that which is the more favourable to the taxpayer, on the basis that subjects can only be taxed by clear words. This principle cannot apply where there are decisive legal reasons for preferring one construction rather than another. Once this step has been taken considerations of ‘hardship’ do not enter into the discussion.”

Parliament has for very many years passed many enactments aimed at settlors who seek to use settlements to shelter assets from high rates of tax, and later to enjoy the benefit of the settled property themselves. The possibility of even a small benefit may have severely adverse consequences. That is well understood by those who advise settlors. As Lord Wilberforce added after the passage just quoted,

“Settlors, after 1965, make their settlements with knowledge of the legislation and of its consequences.”

45. I wish to add a few comments (which can be regarded as an appendix, and not required reading) on the legislative history of section 77. This is a point noted by the Special Commissioners (who have great experience and learning in these matters), and Mr Green attached some (but not much) importance to it in his printed case and his oral submissions.

46. The expression “derived property” seems to have appeared first in a taxing statute in section 28 of the Finance Act 1946, in provisions designed to charge higher rates of income tax on some categories of income covenants and other settlements of property in which the settlor retained a beneficial interest. It was, I think, the third round of amending legislation aimed at curbing income covenants, and the proviso to section 28 (1) responded to the decision of this House in *IRC v Duke of Westminster* [1936] AC 1. The section went through various consolidations, emerging (with later accretions) as sections 683 to 685 of the Income and Corporation Taxes Act 1988 (“the 1988 Act”). Section 685 (1) provided:

“For the purposes of section 683 and 684, the settlor shall not be deemed to have divested himself absolutely of any property if that property or any derived property is, or will or may become, in any circumstances whatsoever, payable to or applicable for the benefit of the settlor or, in the case of a settlement made after 6 April 1965, the wife or husband of the settlor.”

Subsection (3) provided (apart from an immaterial amendment made by the Finance Act 1989):

“In subsections (1) and (2) above ‘derived property’, in relation to any property, means income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or any income therefrom.”

47. The obvious similarity of wording suggests that this definition provided the model for the amended version of section 77 enacted in 1995. But it was at best an imperfect model, because the relevant definition of “settlement” was quite different, and because the notion of the settlor having “divested himself absolutely of any property” naturally focused on the particular property which he had settled (whereas section 77 referred more generally to the property comprised in the settlement).

48. In 1995 Parliament decided to rationalise the ragged patchwork of provisions which had come to be included in Part XV (Settlements) of the 1988 Act. Chapters I and II and part of Chapter III (including sections 683 to 685) were repealed. Instead sections 660A to 660G were enacted. Section 660A (1) and (2) provide as follows:

- “(1) Income arising under a settlement during the life of the settlor shall be treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person unless the income arises from property in which the settlor has no interest.
  
- (2) Subject to the following provisions of this section, a settlor shall be regarded as having an interest in property if that property or any derived property is, or will or may become, payable to or applicable for the benefit of the settlor or his spouse in any circumstances whatsoever.”

Section 660A (10) contains the now familiar definition of “derived property”. These amendments were made by the 1995 Act, which also amended section 77 of the 1992 Act. The amendments to section 77 (in form, though not in substance, the substitution of a whole new section)

were made by section 74 of and Schedule 17, Part III, paragraph 27 of the 1995 Act, in a part of the Schedule headed “Consequential amendments of other enactments”. Previously section 77 had not referred to derived property.

49. So the income tax provisions were in 1995 recast to ask the question (much as section 77 does) whether there is a settlement of property “in which the settlor has no interest,” and that question is explained in terms of “that property or any derived property”. But the model is still far from perfect because the meaning of settlement for income tax purposes (now in section 660G (1)) is still far wider, and much further from the traditional language of chancery lawyers, than the fairly traditional meaning given to the expression for CGT purposes. For income tax purposes the transfer from the first settlement to the second settlement was a non-event; the £770,000 was derived from Mr Trennery’s original disposition and he did not cease to be the settlor of it (and would not have ceased to be the settlor even if some other individual had provided the second nominal sum, and had been named as settlor of the second settlement). So any apparent parallel between the income tax provisions and the CGT provisions may be misleading.

50. Mr Green submitted that on the Inland Revenue’s argument Parliament did in 1995 make a fundamental change in section 77, and that it is remarkable to see it described as a consequential amendment. I see some force in that. But it is possible that the in-depth review which must have preceded the 1995 Act led to this point being identified as one on which a significant change in the CGT legislation was expedient. In any event the use of the label “consequential amendments”, even if rather inappropriate, cannot alter the construction of the amended section 77. With all respect to the Court of Appeal I consider that the construction which they adopted is clearly wrong. I would allow the appeal, set aside the order of the Court of Appeal, and restore the order of Peter Smith J. But (in accordance with the terms on which leave to appeal was granted) the appellants must pay the respondents’ costs in this House. I would order the respondents to pay the costs in the Court of Appeal.