"Willoughby"

Section 739 and offshore bonds

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The House of Lords has recently upheld the decision of the Court of Appeal in Willoughby (see [1997] STC 995). It agreed with the Court of Appeal that for the purposes of s.739 ICTA, as originally drafted, the transferor had to be ordinarily resident in the United Kingdom at the time of the relevant transfer before a charge under that section could arise. It further agreed with the Court of Appeal that on the facts of the case the decision of the Special Commissioner that the statutory defence in s.741(a) applied, could not be reversed.

The significance of the decision of the Courts with regard to the requirement for ordinary residence has been eliminated as to the future as a result of the amendment to s.739 provided for by s.81 Finance Act 1997. The case remains important as regards the operation of s.741, most particularly in its consideration of what amounts to tax avoidance for the purposes of that section.

Readers will recall that s.741 provides a statutory defence not only to s.739 but also s.740. Charges under those sections cannot apply if the individual concerned:

> "… shows in writing or otherwise to the satisfaction of the Board
>
> (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;
>
> (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."

In Willoughby though the Special Commissioner found that both paragraphs (a) and (b) applied, both the Court of Appeal and the House of Lords considered only paragraph (a).

The facts of Willoughby can be briefly stated. The taxpayer, Professor Willoughby, sought to provide for his retirement by subscribing for three personal portfolio bonds with a non-resident life insurance company. Such bonds were subject to a tax regime introduced in 1984 and now incorporated in ss.539 to 554 ICTA. To compensate for the fact that the funds of such companies are not subject to UK tax (unless from a UK source) any gain made in respect of such bonds is subject to income tax at both the basic and higher rates. This contrasts with the taxation of gains made in

respect of like bonds issued by UK resident companies when only higher rate income tax is chargeable. It was in respect of the income from the investments linked to the offshore bonds subscribed for by Professor Willoughby that the Revenue sought to claim tax under s.739.

A particular feature of the case was that Professor Willoughby, in choosing to invest in the offshore bonds, was well aware of the tax position relating to them, in particular that the underlying income and gains of the bond would not be subject to UK tax and thus could in effect be "rolled up" tax free. This fact was stressed by the life insurance company in its advertising material. It did not follow from this however that Professor Willoughby had a tax avoidance purpose within s.741 when he took out the bonds. In the Court of Appeal Moritt LJ said as follows (see [1995] STC 143 at p.183):-

> "I do not see why the choice of an offshore bond or policy, for the taxation of which Parliament has made express and recent provision, should be regarded as tax avoidance at all."

In the House of Lords Lord Nolan said (see [1997] STC 995 at p.1004):-

> "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 s.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 broad terms what the above statements indicate is that it is not tax avoidance to choose the least heavily taxed of different forms of investment or to choose the most tax efficient of various courses of action. This is said subject to the proviso that the investment or course of action chosen must not be one designed to conflict with the evident intention of Parliament. On this basis it followed in Willoughby that as the offshore bonds were intended to be subject to the particular taxation regime in ss.539 to 554, it could not be tax avoidance to invest in such bonds and take advantage of it.

An interesting question arising out of the approach of the Courts in Willoughby is: in what circumstances can a course of action be regarded as conflicting with the intention of Parliament and involving tax avoidance? If, for example, an individual resident in the UK decides to create a settlement for his children and because of a more benevolent tax regime abroad decides to set it up outside the UK does he engage in tax avoidance? The likely answer is yes. If the answer were no it would make the operation of both s.739 and s.740 very limited indeed. The point about such an example is that

it can hardly be said that Parliament made a deliberate decision that such an offshore trust should be free from tax. The inference from what is said in Willoughby on the other hand is that in the case of offshore bonds Parliament had made a deliberate decision to allow income from the underlying investments attached to the bonds to accumulate free from tax. On this basis tax avoidance was not involved.

The difficulty with the Courts' conclusion in Willoughby is that the more likely explanation why Parliament had sought to apply a particular tax regime to offshore bonds was simply a recognition of the fact that it could not tax directly the income of the non-resident life insurance company. Parliament did not intend to confer upon such bonds a freedom from tax at all but merely sought to impose a tax regime which took account of such freedom from tax. The most obvious parallel in this connection is the capital gains tax treatment of individuals who receive benefits from offshore trusts contained in TCGA 1992 s.87. If an individual creates a settlement abroad with a view to creating a trust the gains of which will be subject to tax only under s.87 does he engage in tax avoidance within s.741? We assume for this purpose that the reference to taxation in s.741 is not limited to income tax (as to which see the decision in Sassoon v. IRC (1942) 25 TC 154 in which the reference to "taxation" in what

is now s.741 was held to include estate duty - a decision doubted by many). The argument open to the individual as a result of Willoughby is that all he has done is to seek to take advantage of a tax treatment laid down by Parliament.

The formulation of Lord Nolan that tax avoidance within s.741 "is a course of action designed to conflict with or defeat the evident intention of Parliament" carries with it the difficulty of allowing very subjective views of what is the intention of Parliament. A gut feeling that what is being done cannot have been intended by Parliament to enable tax to be avoided may be sufficient to distinguish one case from another. Thus in Willoughby the inference to be drawn was that Parliament had given specific consideration to the tax regime applicable to offshore bonds and had provided for a regime that deliberately took account of the lack of tax on the underlying funds, providing for the possibility of a tax charge higher than would apply in the case of gains realised in respect of onshore bonds. To assess the bondholder in addition under s.739 would arguably have run counter to the intention of Parliament in that it would have created a heavier burden of taxation than that applicable to onshore bonds.

In argument both in the Court of Appeal and the House of Lords in Willoughby the Crown accepted the view that to invest in an offshore bond would not in general terms involve tax avoidance. The Crown's approach was not to say that all offshore bonds could give rise to charges under s.739. It was simply to pick out "personal portfolio bonds", that is to say those bonds where the bondholder or a person authorised by him had the right to nominate the funds the value of which would determine the value of the bond. The basis of the Crown's argument was to allege that in effect the bondholder had the management and benefit of his own portfolio of investments, there merely being the insertion of a bond structure on top. It was the existence of this alleged "own portfolio of investments" that meant that the bond was being used as a vehicle for tax avoidance. Parliament, it was alleged, could not have intended that the insertion of the bond structure meant that income tax could be avoided on the income and gains from those investments as they arose.

All of the Special Commissioner, the Court of Appeal and the House of Lords showed no sympathy for the Crown's approach. The fact was that the desire to have control over the underlying investments had no obvious tax motivation. Bondholders having control might do better or worse than those not having control. Nowhere in the relevant legislation applicable to bonds had

Parliament seen fit to impose a condition that such control should or should not be had. In the House of Lords emphasis was placed on the fact that the underlying reality was not that the bondholder had his own portfolio of investments. He had in fact a contractual right against the insurance company, no more and no less.

It is apparent that conclusions in a case on law can be affected by the facts of the particular case. In Willoughby the Crown were forced to present their argument in the light of facts that from their point of view were distinctly unpromising. If Professor Willoughby had been a wealthy gentleman resident abroad with a large portfolio of investments who before returning to the UK had sought advice as to how he could avoid tax on the income from such portfolio once he returned to the UK and had been told to "shelter" it with a bond, the result might have been different. As it was the picture in the case was not this at all. It was simply of a man providing for his retirement who chose one form of investment rather than another.

There are many people who have in the past paid tax under s.739 in respect of offshore personal portfolio bonds as a result of the blandishments of the Revenue that no defence under s.741 could be available. Such people should consider their position with a view to obtaining a repayment from the Revenue. The decision in the

Courts has a wide rather than narrow effect and cannot be confined to sets of facts similar to those of Professor Willoughby. It will apply generally to all taxpayers whether resident in the UK or not who invested in such bonds.

One disappointment regarding the decision in the House of Lords is that it makes no reference to the comments of the Court of Appeal as to the relevance of Hansard. Section 739 in its original form was introduced by the Finance Act 1936 and in the passage of the 1936 Finance Bill through Parliament explicit statements were made by a Government Minister that the section could only apply if an individual made a transfer of assets while ordinarily resident in the UK. On the face of it such statements met the criteria referred to in the speech of Lord Browne-Wilkinson in Pepper v. Hart [1993] AC 593 at p.640 so that if there was any ambiguity in the legislation reference could be made to what was said in Parliament. In the Court of Appeal in Willoughby (see [1995] STC at p.174) Moritt LJ considered that because of the forensic and legislative history of the section after 1936 the statements made in Parliament were of no value. The particular suggestion appears to have been that because Parliament had amended the legislation in 1969 after the decision in the case of Herdman v. CIR (1967) 45 TC 394 - where in the Court of Appeal in Northern Ireland the view had been expressed that the

section could apply notwithstanding that the transferor was not ordinarily resident in the UK at the time of the transfer - it should be assumed that Parliament had accepted the position as that stated in Herdman.

The taxpayer in Willoughby strongly disputed the view of the Court of Appeal on the basis that whatever else Parliament did when it amended the law in 1969 it certainly made no assumption as to the correctness or otherwise of the view of the Court of Appeal in Northern Ireland in Herdman. The approach of the Court of Appeal in Willoughby could also be said to be inconsistent with the approach of the House of Lords in Stubbings v. Webb [1993] AC 48. Be that as it may, the House of Lords in Willoughby made no reference to this point. As it took the view that the correct interpretation of the section was clear it did not of course have any need to. Nevertheless it would have been helpful if it had.

The approach of the Court of Appeal in Willoughby to the use of Hansard appears generally to typify a desire on the part of the courts to permit reference to Hansard only in the rarest of cases. Nevertheless, the specific reason why the Court of Appeal was unwilling to refer to Hansard is, the authors consider, of no validity. It involved an assumption as to Parliament's intention for which

there was no basis in fact. It seems to the authors to fit ill with the approach of the House of Lords in Pepper v. Hart in which reference was permitted to Hansard to allow account to be taken of the true intention of Parliament, to then seek to disregard it on the basis of what can only be described as a fiction as to there being a change of intention by Parliament later.