The Offshore & International Taxation Review

TAXING TIMES FOR ENGLISH SETTLORS

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1. The Principle in *Government of India v Taylor*

One of the basic principles with which we are all familiar is that revenue demands made by the revenue authority in one jurisdiction are unenforceable in another jurisdiction.[2] The justification for this principle has been a matter of academic controversy,[3] but one long-held view is that for one country's revenue authority to enforce its own revenue demands in another country would be an invasion of the sovereignty of the other country.[4] In the USA the rule is known as the Mansfield doctrine after Lord Chief Justice Mansfield, and has been subject to considerable criticism. The consequence of the rule is that the revenue authority of one country will not be successful if it brings proceedings in a different country from the one in which it is established for the recovery of unpaid tax. Nor will the revenue authority of one country be allowed to procure by indirect action in proceedings in another jurisdiction the recovery of tax, or to achieve the same result by the actions of another party, whether he is making a claim or raising a defence in proceedings in a country other than that in which the relevant revenue authority is established.

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2 *Government of India v Taylor* [1955] AC 491.

3 See FA Mann, *Studies in International Law*, (1973) pp. 495-499.

4 *Government of India v Taylor* [1955] AC 491 at 511 per Lord Keith of Avonholme.

That principle is applicable in England and it is also applicable in Jersey: see *ReTucker,*[5] and *Re X's Representation*[6] where the Bailiff Sir Peter Crill said:

> "It is not the duty of the Royal Court to facilitate the collection of taxes imposable in a foreign jurisdiction, but the Court may properly order information to be provided to persons in those jurisdictions who are under a duty, or may be required, under the laws of those jurisdictions to file tax returns."

That quotation indicates that the application of the principle in specific cases requires detailed consideration, something which appears clearly from the cases.

Two cases demonstrate the limits on the application of the principle and the care with which it must be applied. In *Re Reid,*[7] an English incorporated trust company acting as executor of a deceased person who had left assets in England and Canada, sought in Canadian proceedings to be indemnified out of the Canadian situs assets in respect of a liability to English estate duty to which it was subject in England and which it had already discharged, on the footing that the charge to duty was one in respect of which, in its capacity as executor, it was entitled to be indemnified. The objection was taken that this was an attempt to use the Canadian court to enforce indirectly a liability to English estate duty. The objection was held ill-founded: there was no direct or indirect enforcement of an unenforceable foreign tax demand, for the tax had already been paid, and the Inland Revenue was supremely unconcerned with the result; what was sought was indemnification in respect of an enforceable onshore (i.e. English) tax demand against an English incorporated trust company. And in *Re Lord Cable,*[8] the English court was not willing to issue an injunction restraining an Indian incorporated corporation and three English residents, who were all the trustees of the will of a deceased person who had died domiciled in India, and who were all accountable for Indian estate duty, from remitting assets situated in the United Kingdom to India for the purpose of paying the Indian duty. Slade J held that the personal protection of the trustees was a factor which the English court could take into account, as was the fact that the will trustees could hardly be said to be in breach of trust by complying with the provisions of the system of law which the testator had by necessary implication selected to regulate the rights of the parties

5 (1988) JLR 473.

6 Royal Court, (28th January 1994), *Butterworths Offshore Cases and Materials* 600.

7 (1970) 17 DLR (3d) 199.

8 [1977] 1 WLR 7.

under the trusts constituted by his will.[9]

2. The Statutory Right of Indemnity

The Inland Revenue has adopted a clever method of attempting to circumvent the rule. In the context of Capital Gains Tax, the machinery is provided in section 86 and Schedule 5 of the Taxation of Chargeable Gains Act 1992 ("the TCGA"), to which reference should be made for the detail of the statutory provisions. Essentially, however, if a settlement is of a kind which qualifies under the statute, the trustees of which are situated offshore, and the settlor of which is resident or ordinarily resident in the United Kingdom, then capital gains realised by the trustees are attributed to the settlor, and he is liable to be faced with a charge to tax.

So, in a relevant tax year where the conditions are satisfied, and investments are sold realising capital gains, the Inland Revenue is entitled to raise an assessment against the settlor in the United Kingdom. The UK resident settlor either pays up or faces enforcement proceedings brought against him by the Inland Revenue, but, being "onshore", in the same jurisdiction as the Inland Revenue, he cannot raise the defence that the claim against him is an unenforceable offshore revenue claim. He either pays up or is at risk of being made bankrupt by the English court.[10]

Having paid up, however, he is entitled to a certificate from the inspector certifying the amount of the gains concerned and the amount of tax paid by him (see paragraph 6 (3) of Schedule 5 of the TCGA), and is then given a statutory right of indemnity against the trustees by paragraphs 6 (1) and (2) of Schedule 5, which provide:

> "(1) This paragraph applies where any tax becomes chargeable on and is paid by a person in respect of gains treated as accruing to him in a year under section 86 (4).
>
> (2) The person shall be entitled to recover the amount of tax from any person who is a trustee of the settlement."

That looks perfectly easy: the tax has been paid by the settlor, so there is no question of the Inland Revenue having any interest in the indemnity proceedings - there is no question of "indirect enforcement"; the inspector helpfully provides him

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9 [1977] 1 WLR 7 at 26; 23-4.

10 We shall not consider here the practical problems which might be faced by a settlor who does not have the resources to meet the tax charge and is forced into insolvency.

with a certificate showing the amount of the gains and the amount of the tax paid; and the settlor, in reliance on the right solemnly conferred on him by the English statute, is thus enabled to recover the sum in question from the trustees. Note, however, that the decision by the settlor whether to seek to recover the tax has, in the view of the Inland Revenue, Inheritance Tax ramifications: a failure to do so is regarded as the making of a gift of the amount not sought to be recovered into the settlement. This was a classic means of "tainting" a pre-1991 offshore trust during the 1991 - 1998 regime and a trap for the unwary.

3. Enforcing the Statutory Right of Indemnity

The settlor might first of all request the trustees to reimburse him pursuant to his statutory right, but the trustees might refuse to do so. There are three obvious reasons upon which they would rely: first, they might point to the fact that (other than in the most exceptional cases) the settlor is not a beneficiary of the settlement, and the trustees are obliged to exercise their powers in a fiduciary manner for the benefit only of the beneficiaries of the settlement. It would be an improper exercise of their powers to pay monies out of the settlement to someone who is not a beneficiary. Second, they might also consider that their fiduciary duties to the beneficiaries mean that they should attempt to preserve the advantageous situation in which the tax otherwise exigible from the trustees at the expense of the trust fund has been discharged by a third party, leaving the gains protected within the trust, and apparently freed from any further liability to be depleted by a tax charge or an equivalent sum under the right of indemnity.

Third, they might also seek to rely upon the principle in *Government of India v Taylor.*[11] So the settlor finds himself left to take enforcement proceedings in order to assert his right. He has, of course, a choice of two jurisdictions in which to sue: England, where the statutory right of indemnity is undoubtedly enforceable, and Jersey, where the trustees are established.[12]

11 See above.

12 We shall assume that the trustees do not have an office or other place of business within the jurisdiction of the English courts, which would enable them to be served with proceedings without the need for leave for service out of the jurisdiction to be obtained. In the light of what follows, there would appear to be clear dangers for offshore trustees to maintain such an office or place of business within the jurisdiction of the English courts.

4. Enforcement in England

If he sues in England, he faces an immediate practical and procedural difficulty: the trustees are in Jersey, so he will have to serve them validly out of the jurisdiction.[13] Jersey is not a Brussels Convention country, so the long-standing English rules contained in Order 11 of the Rules of the Supreme Court apply.[14] In any event, as we shall see, the Brussels Convention does not apply to direct or indirect tax enforcement claims. The unsatisfactory English case of *Prestwich v Royal Bank of Scotland*[15] decided by HH Judge Howarth sitting as a judge of the Chancery Division on 17th December 1998 illustrates some of the difficulties.

Mr Prestwich, a UK resident was deemed to be the settlor of a qualifying settlement for the purposes of section 86 and Schedule 5 of the TCGA. He had paid the substantial sums demanded for Capital Gains Tax arising from assessments raised under section 86 in two successive tax years, and accordingly had the right to obtain a certificate from the inspector. He commenced two sets of proceedings against his Jersey trustees. The first relied solely upon the statutory tax indemnity. The second added to the tax indemnity claim a further claim based on alleged negligence on the part of the trustees, being the breach of an alleged duty of care owed to him in his capacity as settlor.

His legal advisers did not seek leave to serve the first set of proceedings outside the jurisdiction of the English courts in Jersey, but merely posted them to Jersey where they were received by the trustees. His Jersey trustees were advised to seek to have service of the proceedings set aside. Between the time of the making of the application to set aside the proceedings and the hearing, a second application was launched for leave to serve the second set of proceedings out of the jurisdiction in Jersey. The second set of proceedings relied on both the statutory indemnity claim and the negligence claim.

So the hearing before Judge Howarth was concerned with the most preliminary of issues: whether or not the first set of proceedings had been properly served, and whether leave should be given for service of the second set of proceedings. This meant that it was not appropriate for any evidence to be received on the question of the enforceability in Jersey of the statutory indemnity claim in Jersey, or the enforceability of any English judgment on the indemnity claim. This was perhaps

[13] See note 12 above.

[14] Now contained in R11 of Schedule 1 to the Civil Procedure Rules 1998.

[15] (1998) 1 ITLR 565; there is only a note, rather than a full report, of the *ex tempore* judgment.

unfortunate, because the judge felt it necessary to express the view that the statutory indemnity claim would fall within the indirect enforcement aspect of the *Government of India v Taylor* principle in Jersey, and that it was a remedy which was enforceable only in the United Kingdom. He rejected the claim that leave could be given under RSC Ord. 11 Rule (1) (j), which covers claims brought to execute trusts which ought to be executed according to English law where the person to be served is the trustee. But he accepted that there was jurisdiction to grant leave under RSC Ord. 11 Rule (1) (n), which covers claims brought against a defendant, not being domiciled in Scotland or Northern Ireland, in respect of a claim by the Commissioners of Inland Revenue for or in relation to any duties or taxes. In relation to the negligence claim, he held that it disclosed no reasonable cause of action, for reasons that are more obscure than illuminating, although the conclusion is, in my view, clearly correct.

The judgment is highly unsatisfactory. Both sides appealed, but the hearing of the appeal was adjourned and the parties reached a compromise. Therefore the Court of Appeal will not have the opportunity to review the judge's decision.

It seems to me that the judge was wrong in his view that this was a case where as a matter of English law, there was a right to serve the proceedings out of the jurisdiction without obtaining leave; the English authorities make it clear that such exceptional cases depend upon there being clear wording on the face of the statute in question; in this case there was none. It also seems to me that the judge was wrong in holding that he had jurisdiction to grant leave on the footing that this was a claim relating to a revenue claim. There was, of course, no subsisting revenue claim. Although the trustees won on the point that it was not a claim concerned with the execution of a trust, there may have been arguments supporting that contention. But the judge was in my view quite right to hold that the negligence claim was unsustainable. The conflict between their duties to the beneficiaries and a putative duty owed to a settlor who was not a beneficiary makes it impossible to impose on trustees the duty contended for. The point is neither theoretical *nor* academic in such cases as these, because the settlor is almost invariably excluded from benefit, and, if the tax indemnity claim cannot be enforced against the trustees, the trust fund is (and the beneficiaries are[16]) freed from further liability in respect of the tax which the settlor has paid.

There was incidentally another reason why Mr Prestwich may have been advised to sue in the English courts. The trustees held assets in England. Therefore, if he had obtained judgment against them, he would have been able to execute it in England against trust assets held within the jurisdiction in which he was suing. That was

16 There is a further provision attributing capital gains to beneficiaries in section 87 of the TGCA; but the two sections are mutually exclusive.

plainly advantageous to him and must be a relevant consideration in similar cases.

5. Enforcement in Jersey

I am not aware of any proceedings brought in Jersey for the purpose of enforcing the statutory right of indemnity conferred by paragraph 6 of Schedule 5. But Paul Matthews has considered the question in depth in an article in the Jersey Law Review.[17] He starts from the proposition that the fact that a cause of action is based on a foreign statute does not as such make it unenforceable in Jersey: see *Guernsey States Insurance* v *Farley*.[18] He characterizes the claim as a kind of statutory claim in debt, and infers that the proper law of the debt obligation is English law, since it is an English statute which confers the right of indemnity on a settlor who is UK resident, and who has paid tax in the UK. So, is the claim nevertheless barred by the application of the *Government of India v Taylor* principle? He considers not, because, just as in *Re Reid*, the tax has been paid. As Lord Mackay of Clashfern observed in *Williams & Humbert* v *W & H Trademarks (Jersey)*,[19] it is essential for the *Government of India v Taylor* principle to be applicable that there should be an existing unsatisfied claim by the revenue authority. This is not the case in the situation under consideration.

Paul Matthews derives support for the proposition that the indemnity can be enforced from the Jersey cases of *Herzog v Toia*[20] (damages for personal injuries suffered by a German resident plaintiff grossed up to reflect the deduction of German tax which the plaintiff would suffer on receipt;) *Le Marquand v Chiltmead*,[21] *Re Walmsley*,[22] and *Re X's Settlement*.[23]

But he derives further and independent support for the proposition from a factor which we have not yet discussed in the trust context. The estates cases (*Re Reid, Re Lord Cable*) make the point that the rights which the deceased's executors were

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17 (1999) 3 JLR 56.

18 [1953] 1 JJ 47.

19 [1986] AC 368 at 440-441.

20 [1970] JJ 1611.

21 [1987-1988] JLR 86.

22 [1983] JJ 35.

23 Royal Court, (1st June 1994), *Butterworths Offshore Cases and Materials* 608.

seeking to enforce were rights which arose as a consequence of the law of the deceased's domicile and which governed the administration of his estate. In the trust context, the analogy is with the proper law of the trust. In Mr Prestwich's case, the settlements (which were not in evidence before the court) were originally established in England with English trustees; implicitly, English law was the proper law of the settlements. In other cases, the settlements in respect of which the settlor wishes to assert his statutory right of indemnity are subject to express English choice of law clauses. But others may be subject to different choice of law clauses: Jersey law, for example.

6. The Relevance of the Proper Law of the Settlement

If the proper law of the settlement is English law, what consequences does that have? It means that the settlor has selected that the law which governs the obligations relating to the trust is English law. Paul Matthews argues that, in the same way that this imports into the trust obligations the provisions of the English Trustee Act 1925, there is an argument that it brings in other provisions of English law - such as the statutory right of indemnity under paragraph 6 of Schedule 5 of the TCGA. Therefore, there is very little scope for argument that the right of indemnity should not be given full effect to in Jersey in the case of a trust the settlor of which has expressly chosen English law as the governing law. But as he himself acknowledges, it remains open for argument as to what the exact effect of choosing English law as the governing law of the settlement may have. There is another equally respectable view that the choice of English law may import such provisions of English law as affect the rights and obligations of the trustees and the beneficiaries into the settlement - but not the rights of third parties, which, for present purposes, is what the settlor is.

The argument based on the lock, stock and barrel incorporation of English law does not, however, obtain in a case in which the settlor has chosen a law other than English law in the example under consideration. As Wilberforce J said in *Re Latham*,[24] a case on section 9 (6) of the Finance Act 1894:[25]

> "What I have here is a Canadian settlement, or a settlement whose proper law is that of one of the provinces of Canada, and if that is so the rights of the beneficiaries under that settlement and the rights in respect of the trust

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24 [1962] Ch 616.

25 "A person having a limited interest in any property, who pays estate duty in respect of that property, shall be entitled to the like charge as if the estate duty in respect of that property had been raised by means of a mortgage to him."

> property must be governed by the proper law of the settlement, which would be the law of Canada or the appropriate province. It seems to me that if they have rights of that character it would not be possible for a piece of English statutory legislation such as this to interfere with those rights and to confer upon one of the beneficiaries under the settlement a charge over the trust property inconsistent with the rights which the beneficiaries have under their own law."

I find that argument compelling in the case of a settlement the proper law of which is not the same as that of the taxing statute imposing the charge and the indemnity. But it also supports the view that the importation of provisions from the law chosen as the governing law affects "the rights of the beneficiaries under that settlement and the rights in respect of the trust property" - which arguably do not extend to the settlor's right of indemnity against the trustees.

7. What Should the Trustees Do?

Mr Prestwich's settlement did not contain a power for the trustees to pay taxes, whether or not the tax demands could be enforced against them, and whether or not payment was in the interests of one or more of the beneficiaries. Such powers are frequently contained in well-drawn trust instruments. But even if it had contained such a power, the usual wording of the conventional power to pay taxes does not extend to indemnifying settlors who have *already paid* such taxes, so draftsmen ought to reconsider the wording of the common form of such provisions.

If the trustees have a reasonable doubt as to what to do, and if there is a possibility of their being accused of breach of trust if they simply go ahead and pay the tax indemnity, the obvious course to take is to make an application to the court for directions under Article 47 of the Trusts (Jersey) Law 1984, or the equivalent provision in other jurisdictions.

This was the course that was taken in *Re X's Representation*,[26] a hotly contested application in Jersey on the question whether trustees should disclose, against the wishes of the protector of the trusts, the existence of substantial offshore settlements to the US personal representative of a deceased US trust grantor (there was also a "dummy settlor" on the scene whom we can ignore). Disclosure was directed. Obtaining directions from the court defuses the possibility of the trustees subsequently being accused of breach of trust in taking whatever decision they take. The court will convene the appropriate parties, and the issues can be hammered out.

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26 Royal Court, (28th January 1994), *Butterworths Offshore Cases and Materials* 600.

And unless the court is of the view that the very act of seeking directions was itself unreasonable, the trustees will get their costs of bringing a representation before the court. That can hardly be the case if there is a difficult question before the court of the kind under consideration.

8. Why Would There be Arguments that Indemnifying the Settlor Would be A Breach of Trust?

Because it is highly likely, for UK tax driven reasons, that the settlor will be excluded from benefit. But there are a number of contrary arguments which trustees may be able to use.[27]

First, the beneficiaries might consider that it is appropriate for the settlor to be reimbursed, in which case the trustees would argue that to do so would be in the interests of the beneficiaries. Note the recent English judgment in the Chancery Division of Lightman J in *Fuller v Evans*[28] in which he held that the trustees could properly exercise their powers to provide monies from the trust for the maintenance of the settlor's children, even though a by-product of doing so would be to relieve the settlor from his obligations under a consent order in divorce proceedings, and the settlor was expressly excluded from benefit under the settlement. This argument is powerful if the settlor is a parent of the beneficiaries or otherwise closely related to them.

Second, there might be a power in the settlement authorising them to indemnify the settlor, although the conventional power authorising them to meet unenforceable tax demands may not be wide enough.

The trustees may, however, be in a more difficult position if it is contended that the tax charge could have been avoided or delayed, but it was incurred or brought forward as a result of their own actions, for example, where they have "tainted" a trust following the Finance Act 1991 changes. In such a case, if such an issue arises, there is even more likely to be a conflict of interest for them. In such a case, it is therefore even more desirable that they should seek the directions of the court, rather than waiting to be sued for breach of trust by the beneficiaries either (1) for putting the trust in a position where it faces the settlor's indemnity claim, which

27 It is conceived, however, that because sections 86 and 87 of the TGCA are mutually exclusive, and it lies solely within the power of the Inland Revenue to decide whether to assess the settlor or the beneficiaries to tax, the trustees cannot in practice rely on the fact that the amount of tax charged to the settlor may be less than that charged to the beneficiaries once the provisions of section 91 of the TGCA have been applied.

28 [2000] 1 All ER 636.

could otherwise have been avoided or postponed; or (2) meeting the indemnity claim, which could otherwise have been avoided or postponed. Trustees ought for similar reasons to give consideration to the prudence (1) of holding assets against which judgments obtained in England can be enforced directly, and (2) of maintaining branch offices of their Channel Islands trustee companies within the jurisdiction of the English courts.

9. What is Left of *Government of India v Taylor*?

The statutory method of imposing an enforceable, onshore liability on the settlor by the device of attributing to him gains which have in fact been realised by the offshore trustees, and, once that liability has been enforced against or satisfied by him, conferring on him a right of indemnity against the trustees, appears to put in place the same kind of situation which obtained in *Re Reid*.[29] In that case, what relevance does the *Government of India v Taylor* principle continue to have?

The principle may have been somewhat circumscribed in the particular circumstances of the charges under section 86 and 87 of the TCGA; but otherwise it is still alive and kicking.

In *QRS 1 Aps v Frandsen*,[30] a Danish liquidator was appointed to pursue a claim for unpaid Danish corporation tax and interest of about £4M against the respondent, the former owner of the companies. The companies' assets had been sold for cash, and the cash used to buy the respondent's shares. This was, apparently, a breach of Danish company law prohibiting companies from providing financial assistance for the acquisition of their own shares.

The English Court of Appeal held that the facts were in the material respects indistinguishable from the Irish case of *Peter Buchanan v McVey*,[31] an Irish first instance decision explicitly approved by Lord Keith of Avonholme in the *Government of India v Taylor* case, and reported as a note at the conclusion of the report of the House of Lords' decision in the English Law Reports.

The Court of Appeal held that the principle still applied in all its vigour, drawing comfort for their view from the judgment of Lord Goff in the *State of Norway's*

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29 Subject to the question of the proper law of the settlement.

30 [1999] 3 All ER 289.

31 [1955] AC 516n.

Application,[32] where he held that the rule was deeply embedded in the law of both the common law countries and the civil law countries, both in relation to direct claims, and indirect claims, such as the liquidator's claim in *McVey* and in the present case. But they also pointed out that the important observation of Lord McKay of Clashfern in the *Williams & Humbert* case[33] (that there had to be an outstanding, unsatisfied tax liability before the principle could be relied upon) meant that its scope was relatively narrow. As we have seen, it means that the principle is irrelevant where the right to an indemnity only arises *after the tax has been paid*.

They held that, being an indirect revenue enforcement claim, it was a "revenue matter" and as such excluded from the provisions of the Brussels Convention (embodied in England as the Civil Jurisdiction and Judgments Act 1982).

The claim was accordingly struck out on the basis that it was only capable of being heard in the Danish courts.

The decision is important for a number of reasons. First, it shows that the principle is so well established that it can only be abolished by legislative action, and not by creative judicial law-making. Second, it clarifies the exception for "revenue matters" contained in the Brussels Convention. Third, it scotched an attempt to categorize the case as "proceedings relating to the winding-up of insolvent companies" by the successful respondent.

32 [1990] 1 AC 723 at 808-809.

33 See n. 19 above.