TAX AVOIDANCE AFTER *IRC v WILLOUGHBY*

Robert Venables QC[1]

1 The House of Lords Decision[2]

In another landmark decision, the House of Lords on 11th July unanimously rejected the Revenue's appeal against the quashing of assessments on Professor and Mrs Willoughby under what is now Taxes Act 1988 section 739 (Tax Avoidance - Transfer of Assets Abroad). Professor Willoughby had taken out single premium insurance policies with offshore insurers, one while he was resident and ordinarily resident in Hong Kong and the others after he had retired to the United Kingdom. The policies were of the "personal portfolio" type under which benefits payable were linked to a fund which was managed in consultation with the policyholder's investment advisers and with which no policies belonging to any other policyholder were linked. The insurance element in such policies is usually tiny. They are in substance indistinguishable from personal investment, except that as income and gains of the linked fund belong to the offshore insurer, they are not, section 739 apart, directly taxable as those of the policyholder. Instead, there is, broadly speaking, a charge to income tax under the Chargeable Event provisions, now contained in Taxes Act 1988 Part XVII Chapter II, on any gain the policyholder realises from the policy. The Revenue assessed Professor Willoughby under section 739 to income tax on the income arising within the linked fund.

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1 Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ.
Tel: (0171) 242 2722 Fax: (0171) 831 8095.

Consulting Editor of this *Review*.

2 Other recent authorities on the meaning of "Tax Avoidance" are considered by me a companion article '"Tax Avoidance" Challenge Corporation and Ensign Tankers after *Willoughby*' in the *Personal Tax Planning Review*, Volume 6, 1996, Issue 1.

2 Importance of the Decision

The decision is important for three reasons. Firstly, it establishes that a person can be caught by section 739 only if at the time of the offending transfer the transferor was ordinarily resident in the United Kingdom. Although the decision will bring a measure of comfort to transferors who made their arrangements before they were ordinarily resident in the United Kingdom, this aspect of the decision has been reversed by Finance Act 1997 section 81 as respects income arising after 25th November 1996.

Secondly, their Lordships, who all concurred in one judgment given by Lord Nolan, gave a restricted meaning to the phrase "avoiding liability to taxation", which could be enormously beneficial to taxpayers challenged under any anti-avoidance provision which contains identical or similar wording. If, as a result of the consultation process which the Chancellor of the Exchequer is instituting, a general statutory anti-avoidance provision is introduced into United Kingdom law, the decision will be more important than ever.

Thirdly, by complete contrast with *IRC v McGuckian*,[3] the speeches in which had been delivered only four weeks earlier, there was no hint of anti-taxpayer bias. On the contrary, their Lordships appear to have leant over backwards to accommodate the worthy Professor. On the first point, they impliedly rejected any purposive construction of the statute and found that the construction for which his counsel contended was the “inevitable” one, albeit recognising that a differently constituted Appellate Committee had, fifty years earlier in *Congreve v IRC*,[4] formed a diametrically opposed view! On the second point, they took a narrow view of “tax avoidance”.

In each case there was an Appellate Committee of five Law Lords. Only one Lord of Appeal in Ordinary, Lord Clyde, served on both Committees. He was one of the "doves" in *McGuckian*. One of the Appellate Committee in *Willoughby* was Lord Hutton, who, as Hutton CJ, had been one of the judges of the Court of Appeal in Northern Ireland who had been reversed by the House of Lords in *McGuckian*! A very encouraging sign for taxpayers is that another of the Appellate Committee in *Willoughby* was the Chancery judge, Lord Hoffmann, a former Oxford law don and a formidable intellect, who in the past has sometimes given the impression that he is prepared to construe tax statutes robustly in order to defeat tax avoidance.

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3 See my earlier article in Volume 7, Issue 2, of this *Review* at page 69.

4 30 TC 163.

The moral to be drawn from the two decisions is that the result in any sensitive case, especially one involving tax planning/tax avoidance, may involve a large element of pure chance, depending on how the tribunal seised of the matter happens to be constituted. This is one of the perhaps inevitable consequences of the growth in the numbers of the judiciary in recent years. For taxpayers with a weak case, there is an incentive to "have a go", especially when the amounts at stake are large in proportion to the costs involved. For taxpayers with strong cases, the increase in the randomness factor makes the probability of the outcome the more difficult to determine.

The lack of clearly defined principles consistently applied also involves the inherent danger of irrational and undemocratic factors being taken subconsciously into account. Countesses preserving their ancestral wealth from capital taxation and modestly-paid professors managing their unapproved pension fund may fare better than entrepreneurs or pop stars. No tax adviser should ever underestimate the element of what barristers call "prejudice".

3 Need the Transferor be Ordinarily Resident in the United Kingdom at the time of the Transfer?

The Revenue contended that the suggested restriction of liability to individuals who were ordinarily resident in the United Kingdom *at the time of the transfer* was unwarranted by the statutory language and would give rise to anomalies; it would not be sensible to distinguish between the cases of an individual intending to take up residence in the United Kingdom, who made a transfer of assets with a view to a future avoidance of United Kingdom tax and who had settled here a few days after the transfer, and another individual acting with precisely the same intention who settled here a few days before making an identical transfer.

Many judges would have considered this a crucial consideration and would have found for the Revenue unless constrained by the statutory language. Some would even have found for the Revenue even though they were constrained by the statutory language! In this case, their Lordships decided that the statement in the section that it is to "have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax" lead "inevitably" to the conclusion that the individual concerned must be the only type of transferor with which the section is concerned and that he is a transferor ordinarily resident in the United Kingdom. The Revenue could legitimately counter that, as a matter of plain English, that conclusion does not "inevitably" follow. Their Lordships could equally well have found that the purpose of the section was to prevent the avoidance of tax by persons during such periods as they were ordinarily resident in the United Kingdom, especially as the precondition of the application of the section is that there must have been an *earlier* transfer of assets, prior to any income arising, and a transfer will suffice even if made before the ultimate ancestor of section 739 was enacted in 1936.

The decision is quite stunning in that their Lordships adopted what they considered to be the literal construction - and a highly questionable one which they recognised was "diametrically opposite" to that of a previous decision of the House of Lords (*Congreve*) - and clearly eschewed the purposive construction, so beloved of Lords Steyn and Cooke in *McGuckian*, which must have inevitably led to a Revenue victory. So confident were their Lordships that they did not feel it necessary to consult *Hansard*, in reliance on *Pepper v Hart*.[5]

4 Avoiding Liability to Taxation

The restricted meaning their Lordships gave to "avoiding liability to taxation" will, if it is followed, have much more far-reaching consequences. Professor and Mrs Willoughby had taken out further bonds with an offshore insurer at a time when they were ordinarily resident in the United Kingdom. They claimed that section 739 did not apply, because of section 741, which allows the taxpayer to escape if he can prove, inter alia, 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".

Their Lordships accepted "as a generally helpful approach to the elusive concept of "tax avoidance"" the submissions of Launcelot Henderson QC on behalf of the Revenue that the hallmark 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 a reduction in his tax liability; whereas the hallmark 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 Parliament intended to be suffered by those taking advantage of the option. The ancestry of this concept is the speeches of Lords Templeman and Goff in *Ensign Tankers (Leasing) Limited v Stokes*.[6]

While the test is in itself a reasonable one, it leaves open the $64,000 questions "*When* has Parliament afforded taxpayers a fiscally attractive option and on what conditions?" and "When the taxing acts appear to offer scope for the reduction in

5 [1992] STC 898.

6 [1992] STC 226.

taxation, when is this intentional and when is it not?" As, traditionally, the difference between tax avoidance and tax mitigation was irrelevant, there is very little authority on how one discerns the distinction.

In this case their Lordships could so easily have taken the view that a person was engaging in tax avoidance if, faced with the choice of investing between an onshore insurance policy and an offshore insurance policy, the major, if not the sole, advantage of which was that the life fund of the insurer would grow free of United Kingdom taxes, thus resulting in a larger payment to the policyholder, he chose the offshore policy because it would give him a better return.

Yet the House of Lords decided quite the opposite. Lord Nolan, after remarking that since 1st January, 1984 offshore policies could not be "qualifying" policies for United Kingdom tax purposes so as to escape a charge to United Kingdom on maturity under the Chargeable Event provisions, said: "In a broad colloquial sense tax avoidance might be said to have been one of the main purposes of those who took out [qualifying policies issued by non-UK resident companies] 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."

One might ask, with respect to their Lordships, whether it can be sensibly considered that Parliament, in enacting in Finance Act 1984 that thenceforth no offshore policy should be a qualifying policy, was expressing the intention that holders of offshore non-qualifying policies should thenceforth be free from taxation under section 739 in respect of all such policies. Let us consider the history and purpose of the Chargeable Events legislation. Before the provisions were first enacted, a sum received on maturity, sale or surrender of a life policy would represent capital in the policy holder's hands and thus be exempt from income tax. (Life insurance policies have also been in general exempted from capital gains tax.) The only tax suffered would be that borne by the insurer on its life fund, which would normally be at a lower rate than a higher-rate taxpayer would suffer if he beneficially owned the assets underlying his policy. Parliament introduced the Chargeable Event provisions to charge higher-rate taxpayers at the higher rates only (allowing a credit for the basic rate tax) on disposals of their policies. In order to encourage saving, it considered that policies under which premiums were paid regularly and evenly over a long period should be exempted from this charge. Hence, it drew a distinction between "qualifying policies" and "non-qualifying policies", only the latter being subject to the charge. I am sure that in so doing it did not give any thought to offshore insurers at all, largely because between 1939 and 1979 exchange control regulations would normally have prevented individuals ordinarily resident in the United Kingdom from taking out such policies. It is to my mind utterly inconceivable that Parliament intended to provide a fiscal incentive for United Kingdom taxpayers to place their life insurance business abroad rather than in the United Kingdom.

As soon as exchange control was suspended by Margaret Thatcher in 1979, well-informed taxpayers began to perceive the advantage of taking out offshore policies, namely, that the pre-tax proceeds of disposal would be greater because the offshore company would not have borne United Kingdom tax on its life fund, yet there was no distinction between the taxation of the proceeds of onshore and offshore policies. It took the Revenue a mere four years to decide that something needed to be done. Finance Act 1984 provided that no new offshore policy should thenceforth be a qualifying policy and that when the holders of non-qualifying policies were chargeable under the Chargeable Event provisions they should no longer be given credit for basic rate tax.

Given that the qualifying policies legislation did not refer in any way to offshore policies, there must surely have been an argument that while an offshore policy might in principle constitute a "qualifying policy", all that meant was that the policy was not subject to the charge on disposal imposed by the non-qualifying policy provisions. Section 739 had existed, in one form or another, since 1936. It deals with transfers of assets generally whereby income becomes payable to persons domiciled or resident outside the United Kingdom. To my mind, it would have been quite extraordinary if their Lordships had held that the introduction of later anti-avoidance provisions which deal with a very limited area, namely insurance policies, which impose a charge on some policies (non-qualifying policies) but not on other policies (qualifying policies) should somehow be construed as evidencing an intention on Parliament's part that policies not caught by the new provisions (qualifying policies) should thenceforth also be exempted from the effect of section 739.

In fact, none of the single premium bonds which Professor and Mrs Willoughby took out and which were the subject matter of the assessments under dispute could *ever* have been qualifying policies. (It is not altogether clear why Lord Nolan referred to qualifying policies at all.) Paradoxically, that makes their Lordships' conclusion rather easier to sustain. It is not at all implausible that, in subjecting offshore policies to one anti-avoidance regime, Parliament was impliedly relieving them from the section 739 regime, especially where no provision is made for the avoidance of double charges which would otherwise arise. Even this argument has its weaknesses, as subsequent events in this case showed: Professor Willoughby emigrated to Alderney before disposing of the policies and will thus, in my view, escape tax completely under the Chargeable Events provisions, even as respects income which arose to the insurer while he was ordinarily resident in the United Kingdom.

5 Conclusion

One difficulty is that we are given limited guidance by Lord Nolan's speech as to how we discern when Parliament has intended to allow a tax benefit to be obtained and when it has not. The danger is that the law may take a decade or more to develop and settle down. In by view, it would be legitimate to look for further elucidation to the judgment of the Court of Appeal,[7] as the House of Lords was in broad agreement with their approach.

I leave my readers with some brain-teasers. To what extent would the Revenue in each case be able to uphold assessments before the same Appellate Committee? Each strategy is undertaken either by A, an individual domiciled and ordinarily resident in the United Kingdom at all material times, or by B Ltd, a corporation resident in the United Kingdom at all material times.

6 Problem Cases

Case 1

A buys a material interest in an offshore fund. The Revenue assess him under section 739 on a corresponding part of the income of the fund. (A is assessable to income tax on disposal of his interest under Taxes Act 1988 Part XVII Chapter V.)

Case 2

A transfers his investment portfolio to an offshore company in exchange for shares and debentures. The Revenue assess him under section 739 on the income of the company. (A will be liable to income tax on dividends and interest from the company and to capital gains on the disposal of his shares in the company.)

Case 3

A transfers his investment portfolio to the offshore trustees of a discretionary trust of which he is a beneficiary. The Revenue assess him under section 739 on the

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7 [1995] STC 143.

income of trustees. (The income of the trustees will be deemed to be his by virtue of Taxes Act 1988 Part XV.)

Case 4

B Ltd transfers investments to a wholly-owned offshore company. The Revenue assess it to corporation tax under Taxes Act 1988 Part XVII Chapter IV (controlled foreign companies) on the income of the offshore company. (B Ltd will be liable to corporation tax in respect of dividends and interest from the offshore company and in respect of capital gains from a disposal of its shares in the company.)