PERSONAL PORTFOLIO BONDS AND TAXES ACT 1988 SECTION 739

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An important case has been decided by the Special Commissioners in March concerning the application of Taxes Act 1988 s.739 (tax avoidance - transfers of assets abroad) to "Personal Portfolio Bonds". These are policies of assurance, usually ones under which the policyholder pays one lump-sum premium, with perhaps the option to top up the premium from time to time. The benefits payable are linked to the value of a fund which belongs to the insurer. That in itself, of course, is not at all unusual. What is unusual is that the policyholder will be the only person whose policy or policies are linked to that fund. The policyholder is therefore likely to take an active interest in the management of the fund and may even make suggestions from time to time or appoint his own investment adviser to advise the insurer. While the element of insurance cover is often of the most modest proportions, that, of course, is true of many non-qualifying policies taken up with onshore insurers, which nobody denies are contracts of assurance. From the point of view of the policyholder, however, they are basically investments.

The tax advantages of such an offshore Personal Portfolio Bond held by a United Kingdom resident individual are very obvious. While he will obtain no tax relief for payment of the premiums, the linked fund will belong in law and in equity to the insurer. If, as in the present case, the insurer is not resident in the United Kingdom, then its exposure to United Kingdom taxation will be limited. Thus, income and gains can roll up within the fund for many years bearing a much lower rate of tax than if they had belonged to the policyholder absolutely. Indirectly, of course, the policyholder is entitled to the benefits of these income and gains (minus the various charges and commissions levied in respect of the policy). One might have thought - and, after a decade or so, the thought eventually occurred to the Revenue - that the income arising within the linked fund might be deemed to be that of the policyholder (provided he were ordinarily resident in the United

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Kingdom) by virtue of what is now s.739 Taxes Act 1988. There has clearly been a transfer of assets - the payment of the premium by the policyholder to the insurer - by virtue of which income has become payable to a person resident outside the United Kingdom - the insurer - and the policyholder clearly has "power to enjoy" such income.

The Revenue in recent years have laid down guidelines as to when they will and when they will not seek to apply section 739 to a person who takes out an offshore policy. These guidelines are extremely crude and rest on a most unsure legal foundation. One of the guidelines is that a Personal Portfolio Bond is in principle always caught by the section.

A complication is that there exists a separate code of taxing gains from non-qualifying[2] insurance policies, sometimes referred to as the Chargeable Events Provisions.[3] Although the provisions are extremely complicated, broadly speaking the policyholder is taxed on anything he receives in excess of his investment as though it were income. In terms of income tax, the principal advantage over holding assets in his own name is the deferral of tax unless and until cash is withdrawn. The advantages of such deferral are not to be underestimated. A secondary advantage is that the policyholder in effect obtains a deduction for all the charges borne in respect of the bond. By contrast, if he had employed his own investment manager for a portfolio owned by him absolutely, he would not be able to deduct the charges in computing his income tax liability. The drawback is that the policyholder will lose any *credit* for any tax suffered anywhere in the world by the insurer on the income. In effect, he will obtain only a *deduction* in computing his taxable income.

So far as capital gains are concerned, the position is much more interesting than is generally realised. Again, the policyholder has the advantage of deferral of tax on gains realised by the insurer within the linked fund unless and until they are received by the policyholder. There is nothing in the CGT legislation corresponding to TA 1988 s.739. In particular, the Offshore Settlor Provisions do not apply, as the arrangement does not count as a "settlement" for these purposes. Capital gains are in effect charged as income when they are received by the policyholder. For the chargeable event provisions do not distinguish between gains on the policy as being attributable to (a) income gains or (b) capital gains which have accrued within the linked fund. Given that IT rates and CGT rates are more or less the same, an offshore bond has, particularly since the introduction of the Offshore Settlor Provisions in 1991, become a much more attractive method of

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2 Although the position has not always been the same, a policy taken out nowadays with an offshore insurer cannot be a qualifying policy.

3 and contained in TA 1988 Part XIII Chapter II.

deferring liability to CGT long-term. Although such a bond is, of course, a far less sophisticated arrangement than an offshore trust and cannot of itself produce the many advantages, both fiscal and non-fiscal, of such a trust, there is nothing to stop the bond being held by the trustees of such a trust. In that way, it should be possible, given appropriate drafting of the trust instrument and careful attention to detail in the creation of the trusts, to achieve the best of all worlds. One disadvantage of an offshore bond is that no CGT indexation relief is given. A further drawback is that no credit will be given for taxes on capital gains suffered by the insurer anywhere in the world. In practice, this tends to be much less of a problem than in the case of taxes on income.

The perceived income tax advantages will accrue only if s.739 is not in point. The appeal before the Special Commissioners[4] was, as all such appeals, confidential. Royal Life Insurance International Limited, a life assurance company registered in the Isle of Man, which was apparently the insurer concerned, has, however, issued a Briefing Note in May 1993 headed "SECTION 739 INCOME AND CORPORATION TAXES ACT 1988 - AVOIDANCE OF UK INCOME TAX - PERSONAL PORTFOLIO BONDS". While the Briefing Note appears to be extremely full and helpful, it cannot be a proper substitute for the Decision of Special Commissioner. The Inland Revenue have, not surprisingly, expressed dissatisfaction with the Special Commissioner's determination and have required a case to be stated for the opinion of the High Court. In due course, therefore, the details of the appeal will become public.

The Briefing Note sets out 6 issues (issue 5 being itself divided into 2), divided up into the question, the respective submissions of the taxpayer and the Revenue, and the finding of the Special Commissioner. While no facts are given, one can readily surmise that the policy was taken out while the policyholder was not resident or ordinarily resident in the UK but that in a later year of assessment he became ordinarily resident in the UK. One can also surmise that the policyholder was at all material times domiciled in the United Kingdom.

The first issue was whether s.739 can apply to a transfer of assets made by a transferor at any time when he was not ordinarily resident in the United Kingdom. The Special Commissioner held that it cannot. The taxpayer had a two-pronged attack. Firstly, he said that the decision of the House of Lords in *Vestey v IRC* (1979) 54 TC 394 covered the point in favour of the taxpayer. The Special Commissioner found that although their Lordships were not considering the case where a transfer is made by a non-UK resident who later becomes resident, the construction of the section adopted by their Lordships pointed towards a

[4] It appears that the appeal was in fact heard by only one Special Commissioner, Mr David Shirley.

requirement that the transferor should be ordinarily resident at the time he makes the transfer. I have already expressed my opinion in an article on s.739 in OTPR Vol 1, Issue 1, that this view is erroneous.

More interestingly, however, the taxpayer also argued that, following the guidance of the House of Lords in *Pepper v Hart* [1992] STC 898[5], the issue was put beyond doubt by reference to statements made by Mr W S Morrison, then Financial Secretary to the Treasury, in a debate on the Finance Bill which became Finance Act 1936, s.18 of which was the first ancestor of s.739. Now this was a much more interesting argument. The statements of Mr Morrison were unambiguously in favour of the taxpayer. Having made up his mind on the first point, all that the Special Commissioner did was to state that any lingering doubt there might be on the topic was put to rest by reference to the statements.

Is the taxpayer likely to succeed on appeal on this first issue? *Pepper v Hart* apart, I do not see how he can. The *Pepper v Hart* point is much more interesting. Yet, for it to be invoked, the Court must be satisfied that the provision in question is ambiguous or obscure. My prediction is that the courts will work backwards. They will first ask whether it makes any sense at all to allow an individual ordinarily resident in the United Kingdom, and, quite possibly, domiciled here, to avoid income tax simply by ensuring that he sets up the necessary arrangements at a time when he is not ordinarily resident here. Having started from that proposition, they will first find that the wording of s.739 does not require one to be ordinarily resident in the United Kingdom at the time one makes the offending transfer. Knowing that if they look at Mr Morrison's statements, they will be forced to a contrary conclusion, they will decide that s.739 is unambiguous and therefore Mr Morrison's statement continues to be, as it always was, inadmissible in construing the section.

The second issue is whether s.739 can apply to a transfer of assets situate outside the United Kingdom and made by a transferor at a time when he was ordinarily resident in the United Kingdom. It was held that s.739 can apply to such a transfer. This issue would perhaps have been stated more clearly if there had been substituted for "at a time when he was ordinarily resident in the United Kingdom" the words "even if he was at the time of the transfer ordinarily resident in the United Kingdom". The taxpayer's argument was thus that there was no transfer of assets abroad if nothing left the United Kingdom. For example, if the payment of the premium were by a transfer from a Jersey bank account to an Isle of Man bank account. Such a limitation would be so clearly absurd that it is hardly surprising that the Special Commissioner rejected it.

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5 *Pepper v Hart* had not, of course, been decided when my earlier article was written.

The third, and quite interesting, issue is whether s.739 can apply to income arising on a policy of life insurance to which the Chargeable Event Provisions are applicable. The taxpayer's first argument was that s.739 should not apply, given the alternative charge. The second, and more powerful argument, is that if both s.739 and the Chargeable Event provisions apply the taxpayer would be subject to double taxation. The Revenue replied that a double charge is excluded by s.547(2) and s.743(4). The decision of the Special Commissioner on this point was more adverse to taxpayers than the position of the Revenue! He found that the sections do not provide for relief against double taxation, but even though there were double taxation that did not prevent s.739 applying! The attitude of the Revenue has, correctly and understandably, always been that they would not levy a double charge to tax. S.547(2) and s.743(4) provide a sufficient basis for the Revenue to avoid levying a double charge, provided they are not scrutinised too closely. Given that this appears to have been a test case on behalf of policyholders generally, in the interests of such policyholders as a group, I would, if I had been arguing the case myself, as a tactical decision have expressly abstained from advancing this argument. Its chances of success were too small and the consequences of its back-firing, as it in fact did, too serious.

The fourth issue is whether the *deferral* of a liability to United Kingdom income tax could constitute the *avoidance* of liability to income tax for the purpose of s.739. The Revenue submitted that deferment of liability to tax is capable of constituting avoidance, and in particular relied on dicta in *Furniss v Dawson*. Moreover, they pointed out that in the present case liability to tax was deferred only until such time as the taxpayer chose to realise his investment while resident in the UK, which he might never do. The Special Commissioner found that deferring liability to income tax *can* constitute the avoidance of liability to income tax for the purposes of s.739. This decision is not surprising. The argument was, however, worth a try and, unlike that on issue 3, held no hidden dangers.

Issue 5 concerned the statutory defence in s.741 which provides:

> "Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either -
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> (a) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or
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> (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.
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> The jurisdiction of the Special Commissioners on any appeal shall include jurisdiction to review any relevant decision taken by the Board in exercise of their functions under this section."

Interestingly enough, the taxpayer did not argue, as he might well have done, that the effect of the decision in *Vestey* is that the only person who is caught by s.739 (as opposed to s.740) is one who has made the offending transfer with the motive of avoiding liability to United Kingdom income tax. In many cases it would be easier for the taxpayer to make out that he did not have that motive than to rely on limb (a) or limb (b) of s.741. It should be noted in particular that the Court of Appeal has held, rightly or wrongly, in *Sasoon v IRC* 25 TC 154 that "taxation" in what is now s.741 is not limited to liability to income tax but would include, for example, death duties.[6]

As regards limb (a), the question was whether on the facts as found the purpose of avoiding liability to taxation was the purpose or one of the purposes for which the transfer of assets to the insurance company or any operation associated therewith was effected. This part of the Briefing Note is the least satisfactory. Firstly, it does depend on the facts as found by the Special Commissioner, which facts are not sufficiently reported. Moreover, precisely because the decision does depend on the facts found, it would not be binding in other, apparently similar, cases. The taxpayer argued that it was the purpose of the taxpayer to make provision for his retirement. Counsel for the taxpayer must have had considerable difficulty in keeping a straight face: he is of the generation that remembers the retort of a lady close to a then Socialist Prime Minister that in investing in certain slag heaps she was not engaging in land speculation but simply making provision for her retirement. He then went on to make a subtle distinction: the taxpayer was aware of the tax consequences of the various actions, yet mere awareness of the consequences does not amount to a purpose of avoiding tax.

The Revenue argued that since in all respects other than taxation the arrangements secured the same result as would have been secured by a free choice of investments, by which they meant, presumably, investments held in the name of the individual, these tax advantages amounted to avoidance.

The Special Commissioner found in favour of the taxpayer on this point. He stated, quite correctly, that it did not follow that because the taxpayer adopts a course which is less fiscally expensive than another, his purpose in adopting the

[6] On the illogicality and authority of that decision, I have commented elsewhere.

one course involves as a corollary that one of his purposes is avoiding liability to taxation. He remarked, with some force, that this is especially the case if one course falls within a tax regime which Parliament considers appropriate, in this case the Chargeable Events legislation. So far as that goes, that is quite unexceptionable. In itself, however, it did not take the taxpayer home. The Special Commissioner then stated, secondly, that although taxation was taken into account by the taxpayer, he "did not find that avoiding liability to taxation was one of the purposes for which the transfer of assets or associated operations were effected." One hopes that the Decision is couched in rather fuller and rather different language. Otherwise, it is open to attack on appeal. Technically, for the taxpayer to win on the point, it was not sufficient for the Special Commissioner not to find that avoiding liability to taxation was one of the purposes. On the contrary, the Special Commissioner needed expressly to find that avoiding liability to taxation was *not* one of the purposes. Possibly he did.

On the second limb, the arguments were broadly the same. The Revenue said that the arrangements were *bona fide* commercial as concerns the insurance company but not as concerns the taxpayer. The Special Commissioner found that the transfers and associated operations were *bona fide* commercial transactions. I do not see how he could have found otherwise. He went on to make the much more important finding that the transfer and associated operations were not designed for the purpose of avoiding liability to taxation. If he had already found under limb (a) that the purpose of avoiding liability to taxation was not *one* of the purposes for which the transfer was effected, then this conclusion followed *a fortiore*.

He then added that that they were designed for the increase of the taxpayer's retirement funds taking advantage of a favourable tax regime and not for the purpose of avoiding liability to taxation. There may well be some judges who will find the Special Commissioner's distinction hard to grasp. Moreover, they might ask, "Does it not prove too much?" Suppose, for example, I decide to hold a portfolio of funds within a wholly-owned offshore company. My motive is to provide for my retirement and therefore I ensure that all profits of the company are retained. Could it not equally be said that the arrangement is designed for the increase of my retirement funds, taking advantage of a favourable tax regime, namely that income profits of the offshore company are not taxed unless and until they are distributed to me?

The sixth and last issue was whether the income and gains sought to be imputed to the taxpayer under s.739 are exempted from taxation in the United Kingdom by Article 3(2) of the Double Taxation Arrangement between the United Kingdom and the Isle of Man of the 29th July 1955 (1955 SI No. 1205) as being the "industrial or commercial profits of a Manx enterprise"? Thus was raised, in a particularly convoluted form, a very simple point. Suppose that a wholly owned offshore company of mine is entitled to UK-source interest. Under the Double Taxation

Treaty between the state of the residence of the company and the UK such interest is exempted from UK tax. Is the exemption personal to the company or can I also take advantage of it if I am assessed under s.739?

In this case, the argument was far less clear-cut. It was not clear that the income from the underlying fund was at all the same thing as the industrial or commercial profits of the Manx insurer. Now "industrial or commercial profits" must mean trading profits. Yet exemption was being claimed in respect of that part of its gross receipts which would, in effect, eventually be handed over to the taxpayer and could thus form no part of its profits. One would have thought, therefore, that this argument could simply not get off the ground in this case. Unfortunately, it is impossible to tell from the Briefing Note whether it was for this reason that the Special Commissioner found against the taxpayer. We are merely told that the income of the insurance company deemed to be the taxpayer's income did not come within the provisions of Article 3(2) of the Double Taxation Arrangement. The Special Commissioner did, however, also say that there is a distinction between actual income of an individual and actual income of another person which is deemed to be the income of the individual. His argument appeared to be, however, that such income is not industrial or commercial profits of the individual nor is it deemed to be industrial or commercial profits or deemed to be his income as if it were such profits. These sophisticated arguments are taking us into very deep waters. It is useless to discuss them without the full text of the Decision.[7]

My guess is that even after one has seen the full Decision, it would be clear that the simple point still remains open. It is a very interesting point. Technically, it has much in its favour. Of course, much depends upon the wording of any individual Double Taxation Treaty. If the treaty says that a resident of the other state shall not be taxable in respect of a certain income, then that can clearly afford no defence to the person assessed under s.739. Where, however, the treaty says that the income shall not be taxable, then the position is very different. My prediction, however, is that the courts would set their face against any such construction. They would point to the anomaly that where the income of the non-resident was not liable to UK tax in the first place, and therefore treaty relief was not needed, the individual assessed under s.739 would have no defence to an assessment. The whole purpose of s.739 is to tax an individual on income of a non-resident which has escaped UK tax or, at least, UK tax at as high a rate as the individual would have paid. In principle, therefore, it should not make one iota of difference whether the reason the non-resident escapes UK tax is because of the

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[7] As to the Special Commissioner's views as to how far the deeming should operate, I should say, in fairness to him, that he must have written his Decision *before the judgments of the Court of Appeal in Marshall v Kerr were reported.*

UK tax code standing alone or because of some Double Taxation Treaty or Arrangement.

This case will almost certainly go further. It raises very many interesting problems, some, if not all, of which will be probably be decided at quite a high level. Apart from the back-firing on the double taxation point, it is a very good victory for the taxpayer. Even if some of the points are lost on appeal, the case could still be a good one for taxpayers generally. Realistically, though, one must predict that the taxpayer will not have so easy a time before the Courts as before the Special Commissioner.

If the decision on non-UK ordinarily resident transferors were to be upheld on appeal, legislation seems inevitable. While such legislation would be unlikely to be retrospective in catching income arising before it was announced, one would expect it to apply to transfers of assets made before it was announced. After all, the original forebear of s.739 applied to transfers of assets made at any time, even before 1936.