

TAX RECOVERY CLAIMS BY THE SETTLOR

Leon Sartin¹

Under section 86(4) and Schedule 5 of the Taxation of Chargeable Gains Act 1992, the gains of offshore trusts are attributed to UK settlors. The Finance Act 1998 brings into the scope of the charge, trusts set up many years ago. The new legislation also changes the test as to whether the settlor has an interest to include post-March 1998 settlements which benefit the settlor's grandchildren. The settlor is given a statutory right of reimbursement out of the trust fund for any tax which he has to pay: paragraph 6 of Schedule 5. This article will consider whether or not trustees are bound or entitled to satisfy the settlor's claim for repayment.

Many trusts will have been set up for the benefit of the settlor's children and remoter issue with the settlor expressly excluded from benefit. More often than not, the settlor's ongoing tax liability will not have been provided for in the trust instrument. Trustees may not therefore have power to make payments to the settlor and so the question arises as to whether or not the settlor's right of recovery is enforceable.

Enforcement of UK Tax Laws?

There is a well recognised principle of international law that the courts of one country will not enforce the tax laws of another country. The leading case is the decision of the House of Lords in *Government of India v Taylor* [1955] AC 491, where it was held that a foreign State cannot make a direct claim for tax, so that (on the facts) it cannot prove in the liquidation of an English company in order to claim tax. Lord Keith stated at 511:

¹ Leon Sartin, Barrister at 5 Stone Buildings, Lincoln's Inn, London WC2A 3XT.
Tel: (0171) 242 6201. Fax: (0171) 831 8102.

“enforcement of a claim for taxes is but an extension of the sovereign power which imposed the taxes, and that an assertion of sovereign authority by one State within the territory of another, as distinct from a patrimonial claim by a foreign sovereign, is (treaty or convention apart) contrary to all concepts of independent sovereignties.”

The same applies to indirect claims where the foreign State (or its nominee) in form seeks a remedy, not based on revenue law, but which is in substance designed to achieve the same effect. For example, the rule applies to a claim brought by the liquidator of a foreign company, if the only creditor is a foreign revenue authority (*Peter Buchanan Ltd and Macharg v McVey* noted at [1955] AC 516), but not where there are other creditors (see, for example, *Le Marquand and Backhurst v Chiltmead Ltd (by its Liquidator, Halls)* (1987-88) JLR 86). Accordingly, a foreign court will not normally give leave to trustees to make payments to the UK from trust assets situate in the foreign country if the only purpose for those payments is to meet a UK tax liability: see *Scottish National Orchestra Society Ltd v Thomson's Executor* [1969] SLT 725, although the courts did in *Re Reid* (1970) 17 DLR 3d 199 and *Re X's Settlement* (1994), unreported, Royal Court of Jersey, *Butterworths Offshore Cases and Materials*, 1996, p.608.

The tax liability is, of course, that of the UK settlor not the offshore trustees. The settlor is not a nominee of the UK government. He will have already paid the tax and is simply seeking reimbursement for it. However, it may be the case that enforcement of the settlor's right of recovery would be seen as indirect enforcement of UK tax law. By treating offshore gains as taxable in the hands of the settlor, the UK government is doing indirectly what it cannot achieve directly. One view is that foreign trustees are themselves (in effect) being taxed, albeit with payment being made to a third party: the settlor. The short issue is whether there is any material difference between a tax claim and an indemnity claim in respect of tax.

One important difference is that there is no revenue claim which would otherwise be unsatisfied. The settlor is not the equivalent of the liquidator in that sense. This may mean that the rule will not apply: see the decision of Lord Mackay at 440H-441A in *Williams & Humbert Ltd v W & H Trade Marks (Jersey) Ltd* [1986] AC 368 (and also *Re Reid* (1970) 17 DLR 3d 199, 205, not followed in *Stringam v Dubois* [1993] WWR 273). However, the case concerned the enforcement of company law claims following a foreign decree of expropriation. It did not relate to tax, though tax cases were relied on in argument. Moreover, a House of Lords decision is not binding authority in the jurisdictions likely to be hearing cases of this type.

This author's view is that there is little difference between tax claims and indemnity claims in respect of tax. It is extra-territorial in the sense that the settlor's indemnity claim, like tax claims, depends wholly and exclusively on UK tax legislation and

nothing else. This may be contrasted with, say, powers of investment implied by the UK's Trustee Investment Act 1961. They are not forced upon the trust in the same way as the settlor's statutory right to recovery. The system of law which governs the trust is chosen (as the Recognition of Trusts Act 1987 and Hague Convention make clear) by the settlor and accepted by the trustees when they take office.

Where the proper law of the trust is the law of a territory outside the UK, it may well be the case that the foreign courts will not allow UK legislation to interfere with the rights of the beneficiaries under the settlement (see *Re Latham* [1962] Ch 616, 639), for example, by not allowing distributions to be made to someone who is not a beneficiary. As a further point, paragraph 6 of Schedule 5 necessarily imposes a liability on foreign trustees. It may be that the UK Parliament is not competent to legislate in such a manner as a matter of constitutional (as opposed to private international) law.

Authorisation by the Court

A foreign court might be prepared to give leave to the trustees to make payments to UK settlors if there is sufficient justification for doing so. However, the case law is confined to situations in which the trustees or beneficiaries (or some of them) face personal liability for failing to make the payments: see, for example, *Re Walmsley deceased* (1983) JJ 35, reported in Butterworths, *Offshore Cases and Materials*, 1996, p.584. It may be that a court would not so act where, if no payment is made, it is the settlor (not the trustees) who is potentially liable in the UK. If the settlor's interest is to be considered, this author notes that failure by the settlor to exercise his right to repayment may be treated as a transfer of value for inheritance tax purposes: Statement of Practice SP 5/92, paragraph 9. In any event, the courts may not be willing to authorise the payment unless the proper law of the trust is that of the UK, the government of which is seeking to enforce its revenue laws: *Re Lord Cable* [1977] 1 WLR 7, 26.

Faced with these types of problems, the courts may be torn in two directions. On the one hand, they may be reluctant to look at the interest of the settlor who is "external" to the trust. On the other hand, they may not want to penalise the settlor by allowing him to be taxed for somebody else's capital gains.

Protecting Your Position As Trustee

In the absence of an indemnity from the beneficiaries, trustees are best protected by making an application to the court of the relevant jurisdiction asking whether or not they are bound or entitled to pay the settlor's claim. This is justified wherever it is

not clear whether such a claim is enforceable as a matter of law. The trustees' fundamental duty is to protect and preserve the trust property with which they have been entrusted. They should not therefore pay any UK settlor unless authorised to do so by the court, otherwise there is a risk that the beneficiaries will claim breach of trust. The trustees will normally be entitled to be indemnified out of the trust fund for those proceedings and, if an order for payment is made, for the amount of the settlor's claim. In this context the application may have to be made, not only to the courts in the jurisdiction of the trust's proper law (if the proper law is English the outcome in the English courts may be clearly predictable), but to the courts of the territory where the settlor's claim falls to be enforced (by virtue of the trustees' residence or the location of the trust assets).