The Offshore & International Taxation Review

# WHEN AN OFFSHORE TRUST IS NOT TAX AVOIDANCE

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## 1 Scope of the Article

In this article, I examine the judicial imposition of limitations on the concept of "tax avoidance" as shown in a recent decision of the United Kingdom Special Commissioners for Income Tax Purposes. I conclude that, while the case is a step in the right direction, several important questions are left unanswered.

## 2 Professor Willoughby's Legacy

In my article *Tax Avoidance after IRC v Willoughby* in Volume 7, Issue 3, at page 139 of this Review, I suggested that, their Lordships in that decision,[2] had given a restricted meaning to the phrase "avoiding liability to taxation", which could be enormously beneficial to taxpayers challenged under any anti-avoidance provision which contained identical or similar wording and would have far-reaching consequences. While Professor Willoughby himself is happily still with us, his leading case may well in his own lifetime prove to be a valuable legacy to taxpayers.

Their Lordships accepted "as a generally helpful approach to the elusive concept of "tax avoidance"" the submission 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

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2 Reported at (1997) 77 Tax Cases 57

to him by the tax legislation and genuinely suffers the economic consequences Parliament intended to be suffered by those taking advantage of the option. As Lord Nolan said: "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 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."

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 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.

I concluded that 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.

## 3 *A Beneficiary v Commissioners of Inland Revenue*

### 3.1 The Result

Professor Willoughby's case concerned the motive defence to Taxes Act 1988 section 739 assessment, conferred by section 741. In *A Beneficiary v Inland Revenue Commissioners* [1999] STC (SCD) 134, the Special Commissioners, T H K Everett and Stephen Oliver QC (the President of the Tax Tribunal), had to consider the same defence in the context of an assessment under section 740 (tax avoidance by transfers of assets abroad: liability of non-transferors). They reached a decision in favour of the taxpayer which would in some respects have been surprising before the *Willoughby* decision, but which now seems but a natural application of it. The new decision shows in concrete terms how important the *Willoughby* decision was.

3.2 The Statute

Section 740 (Liability of non-transferors) provides, in so far as relevant:

> "(1) This section has effect where-
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> (a) by virtue or in consequence of a transfer of assets, either alone or in conjunction with associated operations, income becomes payable to a person resident or domiciled outside the United Kingdom; and
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> (b) an individual ordinarily resident in the United Kingdom who is not liable to tax under section 739 by reference to the transfer receives a benefit provided out of assets which are available for the purpose by virtue or in consequence of the transfer or of any associated operations.
>
> (2) Subject to the provisions of this section, the amount or value of any such benefit as is mentioned in subsection (1) above, if not otherwise chargeable to income tax in the hands of the recipient, shall-
>
> (a) to the extent to which it falls within the amount of relevant income of years of assessment up to and including the year of assessment in which the benefit is received, be treated for all the purposes of the Income Tax Acts as the income of the individual for that year;
>
> (b) to the extent to which it is not by virtue of this subsection treated as his income for that year and falls within the amount of relevant income of the next following year of assessment, be treated for those purposes as his income for the next following year,
>
> and so on for subsequent years, taking the reference in paragraph (b) to the year mentioned in paragraph (a) as a reference to that and any other year before the subsequent year in question.

(3) Subject to subsection (7) below and section 744(1), the relevant income of a year of assessment, in relation to an individual, is any income which arises in that year to a person resident or domiciled outside the United Kingdom and which by virtue or in consequence of the transfer or associated operations referred to in subsection (1) above can directly or indirectly be used for providing a benefit for the individual or for enabling a benefit to be provided for him ..."

Section 741 (Exemption from sections 739 and 740) provides:

"Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either-

(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

(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.

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."

3.3 The Facts

A Japanese settlor, who, it appears, was at no material time domiciled, resident or ordinarily resident in the United Kingdom, established a settlement in Jersey, principally for the benefit of his granddaughter, B, the appellant, who was ordinarily resident in the United Kingdom. He had moved the money used to fund the settlement from Japan to a London bank account, but then moved it to Jersey in order to avoid United Kingdom inheritance tax on his death. His purposes were (a) to make provision for B and her family before he died (b) to ensure that the money would be safe and professionally managed and (c) to avoid the Japanese laws of inheritance which required that B's mother would inherit at least 50% of his worldwide estate. His solicitor recommend that the settlement should be created in the Channel Islands "where, at present, the tax regime is beneficial. However, the settlement will be capable of being moved to other jurisdictions if that is wise and appropriate from time to time." The settlement was created on 4 June 1992 with an initial capital of £100 and just one trustee, resident in Jersey. There had been a suggestion that the English resident solicitor might act as a trustee, but in a letter dated 22 May to the grandfather, he had said that 'it may be preferable if I am not a trustee just in case the British Inland Revenue make an argument that the settlement is managed in England and is therefore subject to English tax'.

One of the first actions of the trustee was to consider the appointment of investment advisers. Subsequently, the solicitor requested the trustee to prepare a tax memorandum on all the aspects of the settlement and in due course advice was obtained from leading counsel. In due course a wholly-owned non-resident investment holding company, Investments Ltd (Investments), was incorporated in Jersey on 8 September 1992 and its inaugural meeting of directors was held on 17 September 1992. A substantial sum of money was lent to Investments by the settlement for investment purposes. Investments was formed to protect against inheritance tax liabilities arising in respect of any holding of United Kingdom investments and to preclude any additional rate income tax leviable under section 686 of the Taxes Act 1988 being chargeable in respect of income from United Kingdom sources.

In October 1992 B wished to buy a house in London and to this end the settlement trustee exercised its power to appoint capital to her. Those moneys did not derive from Investments and the funds lent to it by the trustee of the settlement.

The question was whether the section 741 defence was made out.

### 3.4 Subjective or Objective Purpose?

The first question was whether the relevant purpose was a subjective or objective one. In the Revenue Interpretation of April 1999, it is stated firmly that it is an objective one. I criticised that view in section 4.4 of my article *Tax Avoidance by Transfers of Assets Abroad: the Revenue View* in Volume 9 Issue 1 of this Review at page 45. The Special Commissioners held that the test to be applied is a subjective test.

### 3.5 The Transfer of Funds from London to Jersey

The second question was whether the transfer of funds from London to Jersey by the grandfather in 1992 constituted tax avoidance or mere tax mitigation. The Special Commissioners noted that was "plain that the reason for the transfer was to ensure that the large sum of money in question did not suffer inheritance tax at the rate of 40% on the death of the grandfather. Counsel for the Revenue has submitted that such a transfer of funds constituted tax avoidance and ranked either as a transfer or as an associated operation to a transfer." The Special Commissioners considered the famous passage in the speech of Lord Templeman in *Commissioner of Inland Revenue v Challenge Corp Ltd* [1986] STC 548 at 554-555 [1987] AC 155 at 167-168, approved by the House of Lords in *Willoughby*.

The Special Commissioners noted that the effect of section 157(1) of the Inheritance Tax Act 1984 was that if the grandfather arranged for the funds which he transferred to Jersey to be left in London but in the form of Swiss francs, no inheritance tax would have been payable on the occasion of his death. Most interestingly, counsel for the Revenue accepted that had the grandfather adopted such a course it would not have been viewed as tax avoidance.

They then noted that section 6(1) of the 1984 Act provides as follows: 'Property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom.' They concluded: "It was that section which was taken advantage of by the grandfather and we are unable to discern any difference in principle between an action designed to take advantage of the provisions of section 157 as against actions designed to take advantage of the provisions of section 6. Accordingly, we hold that the transfer of the funds from London to Jersey by the grandfather amounted not to tax avoidance but to tax mitigation."

I respectfully agree with them. Parliament, in determining that non-UK domiciliaries will escape inheritance tax in respect of excluded property have made such persons an offer of freedom from taxation which they can accept by converting their wealth into excluded property. To accept it is not to defeat the evident intention of Parliament and thus is not tax avoidance. What is amazing is that counsel for the Revenue should have sold the pass on section 157(1).

### 3.6 The Making of the Settlement

#### 3.6.1 The Decision

The final question which the Special Commissioners had to decide was "whether, subjectively, the grandfather had as one of his purposes the motive of tax avoidance when creating his discretionary settlement in Jersey in 1992." On the evidence before them, they found that the grandfather had no such motive in mind. They found that there was no evidence that the grandfather sought tax advice in relation to United Kingdom tax. They went on:

> "The creation of the settlement in Jersey followed the transfers of the funds to that island but it is also clear from the documents that the possibility of transferring the settlement into another jurisdiction or jurisdictions was foreseen. Although resident in this country at the time of the appeal B has always enjoyed living in France and has a residence in Paris. At one time she considered the possibility of living in New York and it is by no means certain she will remain resident in this country for the whole of her life. The choice of Jersey for the creation of the settlement was almost accidental. It is by no means certain that the settlement will remain there for all time.
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> "In summary, we accept that United Kingdom tax was a consideration of the grandfather's advisers. They would have been failing in their professional duties if they had not identified the implications of having United Kingdom trustees and comparing these with the possible advantages of using Channel Island trustees. But we are satisfied from the evidence that the tax implications of siting the trust in Jersey were a matter of indifference to the grandfather."

### 3.6.2 Critique of Decision

This part of the decision is not entirely satisfactory. It would seem that the Special Commissioners took the view that, provided that the grandfather's original intention was not to avoid United Kingdom tax, it was irrelevant that his advisers then persuaded him that he should achieve his objective in a tax-efficient way. It would have been better if they had gone on to consider whether that amounted to tax avoidance. Instead, they found that "the tax implications of siting the trust in Jersey were a matter of indifference to the grandfather." If that were really the case, why did he accept his advisers' advice and indeed site the trust there? This part of the decision is, I fear, too good to taxpayers to be true.

The Revenue will clearly be very unhappy with this part of the decision, as they stated in their Interpretation of April 1999 "The role of advisers is taken into account in assessing the purpose of the transaction when considering the application of s.741." See section 4.5 of my article *Tax Avoidance by Transfers of Assets Abroad: the Revenue View*.

The Special Commissioners should, in my respectful view, have acknowledged that the grandfather was ultimately persuaded to establish a trust with no United Kingdom resident trustee because of United Kingdom tax. It would appear that those tax considerations must have included ensuring that neither the trustees nor their beneficiaries paid any capital gains tax. Yet in my view that would not have been tax avoidance. Parliament had deliberately provided that non-UK resident trustees were not in general liable to capital gains tax, even if they had United Kingdom resident beneficiaries. It had established anti-avoidance provisions - now contained in Taxation of Chargeable Gains Act 1992 section 87 - but had deliberately decided that they would not apply where the settlor was at no material time domiciled in the United Kingdom. In deciding to establish a non-UK resident trust, therefore, the settlor was not engaging in tax avoidance but taking advantage of a freedom from tax which Parliament had offered the trustees and their beneficiaries.

As regards income tax avoidance, there was simply no evidence that the grandfather had it in mind. It is clear that once the settlement was created the trustees very much had in mind the mitigation of the income tax charge on United Kingdom source income. One reason for establishing the investment company was to limit the charge to the basic rate. If the income had been received directly by the trustee, it would have been taxable at the additional rate too.[3] The position is clouded in that another purpose was the removal of a potential inheritance tax charge by the creation of excluded property, which would not have amounted to tax avoidance. One day, there will be a decision on whether such income tax planning amounts to avoidance. In my view, a strong case can be made that it does not.

### 3.6.3 What was Not Argued

What is odd is that it does not seem to have been argued by counsel for the Crown that the funding of the investment company was an operation associated with the original transfer and that B had to show that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which that associated operation was effected. Section 741 refers in terms to associated operations. While that is probably limited to relevant associated operations, namely ones whereby income arises to a non-resident person within the meaning of section 740(1)(a), it would appear that all the income in fact arose to the company as the result of the funding of it. Possibly, it was considered that the only purpose in relation to the associated operation which was relevant was that of the original transferor. (In this case, so far as appears, the settlor had no purpose at all in relation to that step.) If so, that represents a very important concession by the Revenue.

3 In 1999 / 2000 a non-UK resident company is in effect taxed at a rate between 20% and 23% whereas trustees of a discretionary trust are taxed at 34%.

## 4 Conclusion

The case is a good step in the right direction. It is a pity that part of it turns on findings of fact - and findings which are not entirely beyond challenge. It is a tantalising case in that a key point appears not to have been argued by the Revenue and one is left wondering why. Was it a policy decision or mere oversight? Because the decision is "anonymised" one does not know the identity of the counsel and is thus not in so good a position to judge whether the omission was deliberate.

It is now clear that the creation of excluded property is not tax avoidance and that the purpose in section 741 is a subjective purpose. The Special Commissioners who decided the appeal did not appear to pay much attention to refinements introduced by professional advisers for reasons of United Kingdom tax planning, yet it would be unwise to place too much reliance on this aspect of the decision. What the case does not decide is that for a non-UK domiciliary to have established a non-UK resident trust for reasons of United Kingdom capital gains tax planning was not tax avoidance.[4]

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4 The position in relation to trusts made after March 16th 1998 is arguably different, on account of the amendment made to Taxation of Chargeable Gains Act 1992 section 87 by Finance Act 1998.