THE TAXPAYER'S TALE[1]

Professor Peter Willoughby[2]

Professor Peter Willoughby examines the issues which arose in his appeal against assessments made by the UK Inland Revenue.

'He shall have merely justice, and his bond'
(Merchant of Venice, Act IV, Scene 1, line 339).

'Then shall stand up in his estate a raiser of taxes in the glory of the Kingdom; but within a few days he shall be destroyed, neither in anger, nor in battle'
(Daniel 11:20).

Litigants Who Comment on their own litigation inevitably do so subjectively. While every attempt will be made to be objective, readers should make allowances for the author's inevitable subjectivity.

The *Willoughby* case began with a letter from the taxpayers to the Special Investigation Section of the United Kingdom Inland Revenue in March 1991. This letter explained the background to investment savings held in three personal portfolio bonds which were part of a long-term retirement savings plan which began in 1979. The litigation did not end until the decision of the House of Lords was announced on 10th July 1997. It was thought that the matter was not yet entirely closed because the taxpayer had made a number of complaints to the Adjudicator, Elizabeth Filkin, and her report was expected later in 1998. However, the Revenue have agreed to repay tax to all the aggrieved bond holders and therefore much of what was needed to be

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achieved for bond holders who used bonds as a genuine alternative (and ultimately taxable) pension arrangement, has been achieved. The taxpayer has withdrawn his complaints and the Chairman of the Board of Inland Revenue has apologised in most gracious terms. Since then the Inland Revenue have published a Press Release No.38 (17th March 1998) following the 1998 Budget Speech in which personal portfolio bonds are referred to as "designed primarily for tax avoidance purposes". The Budget itself contains some harsh and retrospective proposals which, if implemented without fund holders being given a chance to convert their bonds to the managed type will have monstrously unfair consequences. A possible way forward is indicated at the end of this article.

Following the decisions respectively of the Special Commissioner in March 1993, the Court of Appeal in December 1994 and the House of Lords in July 1997, there have been a large number of articles written about various aspects of the case. Very few of these have attempted to cover all the legal issues raised by the case. Several recent articles following the decision of the House of Lords have failed to state the facts correctly (two invented new 'facts'), failed to state the law correctly and failed to emphasise the most important part of the House of Lords decision which concerned the meaning of tax avoidance. It should be added that, as has not been made clear in many articles, those who have used private portfolio bonds (or managed portfolio bonds) as part of wider tax planning schemes, such as putting them into trust to avoid inheritance tax and income tax after the death of the bond holder settlor in reliance upon the so-called 'dead settlor' loophole in section 547, are not covered by the decision in the House of Lords in the *Willoughby* case and may not be able to rely on the section 741 escape clauses should the Revenue decide to apply section 739 in their cases to post-26th November 1996 bond income. The 1998 Budget proposals included a provision to cancel the tax advantages of putting bonds into trust. Although this was, in the writer's view, unnecessary this proposal cancels a provocative tax planning scheme which cannot reasonably have been within the intention of Parliament when the 1984 chargeable events regime was enacted.

This article attempts to put the record straight on the facts, the law and the public policy issues. It is divided into three parts. First, the facts are summarised, second the legal issues are explained and, third, public policy considerations are considered in outline. It should be said that this case is not merely a tax case; it has exposed serious shortcomings in the operational procedures of the Inland Revenue, lack of sound judgment on the part of the Board of Inland Revenue in pursuing a very weak case and flagrant disregard of the intention of both Parliament and the Board of Inland Revenue itself when the legislation was first enacted in 1936. As a consequence many individuals have been wrongly assessed to income tax, an issue conceded by the Inland Revenue in a Press Release issued on 18th December 1997. Since then the Revenue have ignored the unanimous decision of the House of Lords that the use of personal portfolio bonds as part of a long term retirement arrangement is not tax avoidance and announced savage legislation to render personal portfolio bonds wholly

impracticable. This is disturbing, particularly as the House of Lords referred to the Revenue's argument that their use was tax avoidance as "absurd".

The facts

The taxpayers, Professor and Mrs Willoughby, have spent the greater part of their working lives in developing countries in non-pensionable employments. In 1979 the taxpayers became aware of qualifying 10+ policies and life insurance bonds which provided a means of saving for retirement which, for an expatriate, could achieve some of the advantages of retirement annuities or personal pensions which are only available to United Kingdom residents.

In November 1983 the Revenue issued a Press Release which explained how offshore life insurance bonds would be taxed under legislation which was enacted in the Finance Act 1984 (see Schedule 15). In July 1986 Professor Willoughby retired from his post as Professor of Law with the University of Hong Kong and received a lump sum provident fund payment from a Hong Kong Revenue approved retirement scheme. Acting on advice, this was invested in a series of life insurance bonds with Royal Life International of the Isle of Man in the taxpayers' joint names. The intention was that the taxpayers would be liable to income tax on all gains made within the bond at maturity after twenty years or on earlier withdrawals which exceeded 5% per annum of the initial premium. If it had been possible to place the lump sum in a UK based tax exempt retirement fund to which the taxpayers could have contributed from their 'relevant income' on returning to work in the UK, which at retirement produced a taxable pension, they would have done so.

In 1989 and 1990 three qualifying 10+ policies matured to produce tax exempt funds. The taxpayers had an option to extend the policy for a further ten years with the same tax exempt benefits at maturity. Again acting on advice, the taxpayers did not exercise their option but transferred the underlying investments from the 10+ policies into further life insurance bonds with Royal Life. The reasons for doing this were to obtain greater investment flexibility, administrative convenience and lower charges when investments were changed.

In investing in a total of three personal portfolio life insurance bonds, the taxpayers relied on the Inland Revenue Press Release of November 1983 and the 1984 tax regime which provided for the taxing of bonds on gains when realised (see now section 553 Taxes Act 1988). The 1984 regime ensured that all gains would eventually be taxed in full at higher rates if appropriate.

In about 1990 the taxpayers became aware that the Revenue were planning to attack insurance bonds as tax-avoidance schemes. In March 1991, Professor Willoughby wrote to the Revenue with a full explanation of the bonds and explained that they

were intended as a *bona fide* long-term retirement arrangement which would eventually be taxed. A clearance was requested but refused in a letter from the Revenue sent some three and a half months later.

After a long period of delay, various assessments were made on the taxpayers under sections 478 and 739 Taxes Acts 1970 and 1988. They appealed against the assessments to the Special Commissioner. The hearing of the appeal was in January 1993 and lasted almost four days. The taxpayers raised a large number of legal issues and a decision was given in their favour in March 1993. The Revenue appealed to the Court of Appeal where they were defeated 3-0 and then to the House of Lords where they were defeated 5-0. There was no appeal to the High Court which was leapfrogged.

Breach of the Convention on Human Rights?

In correspondence before the assessments were made the Revenue explained that the taxpayers had 'unwittingly' bought into a tax-avoidance scheme, a somewhat unusual concept! The Revenue supported their argument by referring to two unreported and confidential decisions of the Special Commissioners. A request for copies was refused although a brief summary of what the Revenue thought was important was provided. Full details of the facts together with the reasoning of the Special Commissioner were refused. Even on the basis of the Revenue's brief summary it was clear that the two decisions of the Special Commissioners' were readily distinguishable. In passing it is interesting to consider whether, by relying on unpublished and confidential material which was not available to the taxpayers, the Revenue are in breach of Article 6 of the European Convention on Human Rights. This calls for equality of arms, this is to say both sides must have access to the same information. A year or so after the decision of the Special Commissioner in the *Willoughby* case, reports of decisions of the Special Commissioners started to be published. What, however, is to become of the numerous decisions prior to the date when publication began? Are these now to be published or should there be a public shredding to ensure compliance by the Revenue with Article 6? It appears that reliance on these unpublished decisions could cause serious problems for the Inland Revenue if the matter is referred to the European Court at some future date.

The legal issues

The legal issues raised by the taxpayers were as follows:

(1) Does the anti-avoidance section 739 Taxes Act 1988 (previously section 478 of the Taxes Act 1970) apply to a transfer of assets to a non-resident by a non-resident?

(2) Are the courts entitled to refer to the intention of Parliament at the time when the legislation was first enacted?

(3) Does section 739 apply only to United Kingdom assets which are transferred abroad but not to foreign assets which have never been brought into the United Kingdom?

(4) Does section 739 apply to income arising within an insurance bond which is subject to a specific code of tax relieving rules (sections 539 to 554)?

(5) Does an assessment under section 739 result in double taxation when gains are assessed under the special regime enacted in 1984 (sections 539 to 554)?

(6) Does the deferment of liability constitute avoidance of liability for the purposes of section 739?

(7) What is the meaning of tax-avoidance for the purposes of section 741(a) and (b) which provide defences to section 739 assessments?

(8) Is income which arises in a bond issued by an Isle of Man insurance company exempt by virtue of the Isle of Man double taxation treaty with the United Kingdom?

These eight legal issues will now be considered in more detail, together with the question of the relevance of the taxpayers becoming non-resident again.

The first issue: transfers between non-residents

The legislation which has become section 739 was first enacted in 1936 (see section 18 Finance Act 1936). The intention was to discourage wealthy resident British subjects from transferring their United Kingdom assets to offshore companies or trusts abroad and being able to continue to enjoy the benefit of these assets without United Kingdom tax liability.

The Inland Revenue argued that the section was, as a matter of construction, intended to apply to transfers made by individuals at a time when they were not resident in the United Kingdom. The Special Commissioner, three Court of Appeal judges and five House of Lords judges were, however, unanimous in saying that the section, as a matter of construction, did not extend to a transfer made at a time when the transferor was non-resident. The House of Lords pointed out that in the *Hansard* report of the debate in the House of Commons in 1936 it was made clear by the Financial Secretary to the Treasury that the section only applied to transfers made by residents. Although never mentioned in the court proceedings, the briefing notes prepared by the Board

of Inland Revenue for use by ministers in both the House of Commons and the House of Lords debates in 1936 made it clear beyond doubt that it was never the Revenue's intention to apply this legislation to transfers made by non-residents. For example, on page 5 of the Board's guidance notes for use by ministers in the House of Lords, the Board of Inland Revenue stated:

> 'It should be noted in particular that the charge under this clause applies only to individuals who are ordinary residents in this country and in respect of transfers of assets which they made while ordinarily resident in this country.'

The position is further confirmed in correspondence between the Board of Inland Revenue and the Treasury in 1938. It follows, therefore, that both Parliament and the Inland Revenue never intended the legislation to be applied to transfers made by non-residents. Nevertheless, some time in the late 1950s or early 1960s, the Revenue evidently decided to give the legislation a wider construction directly contrary to their own policy, as explained to ministers, and the intention of Parliament, without first going back to Parliament to get the law changed. It therefore appears that tax has been collected for between thirty and forty years under either a deliberate or an extremely careless misinterpretation of the legislation. This could result in a large number of claims against the Revenue for repayment of tax, with repayment supplements (tax free interest), that has been wrongly assessed, under the principle of equitable restitution. There is recent House of Lords authority for this in *Woolwich Equitable Building Society v Commissioners of Inland Revenue* [1989] AC 70. Reference should also be made to *David Securities Pty Ltd* v *Commonwealth Bank of Australia* [1992] 24 ATR 125 where the High Court of Australia decided that payments made under a mistake of law should *prima facie* be recoverable.

The amendment made by the Finance Act 1997

In November 1996 it was announced that section 739 was to be amended so that it could apply to a transfer made at a time when the transferor is non-resident (section 81 Finance Act 1997). Section 739 was also amended to make it clear that it can apply where there is an intention to avoid a tax other than income tax, for example inheritance tax. Many advisers have misunderstood this second amendment and have, for example, stated that the section can apply in cases where there is no tax-avoidance purpose. That is not correct. If there is no tax avoidance purpose in relation to *any* tax, section 739 cannot apply whether in its old form or its new form because the section 741(a) and (b) defences, which are explained below, will apply. The Board of Inland Revenue is perfectly entitled to invite Parliament to change the laws but surely it should have admitted that it had in the past interpreted the legislation against Parliament's intention and not merely imply, as it did in the Press Release REV 17 issued on 26th November 1996 that section 739 had not been achieving its intended effect. Also it should not have asked Parliament to change its mind by legislation

which has retrospective effect.

While the litigation in the *Willoughby* case is now complete, the background to what is now section 739 may have been instrumental in persuading the Inland Revenue to refund tax wrongly assessed under the section and its predecessors. It may be, however, that repayment will have to be made to others, that is to say not merely to aggrieved bond holders but also to others who have been wrongly assessed at earlier dates in relation to quite different issues. In these cases the Revenue might refuse payment on the ground that tax paid has been assessed in accordance with existing practice. The *Hansard* report of the debate on the Finance Bill 1997 for 18th February 1997 reports Mr Jack, the Treasury minister, as saying that the amendment 'clearly restates the current position'. While this was strictly correct, Mr Jack did not explain that the 'current position' was based on Revenue practice which was not only contrary to the original intention of Parliament but also contrary to the original intention and policy of the Board of Inland Revenue. It was therefore a very wrongful practice which Mr Jack and the then Conservative Government should not by implication to have supported. Any claim for repayment will be based on the equitable remedy of restitution for unjust enrichment which has no statutory time limit (delay will, however, bar an equitable claim) and, therefore, this background will be of great importance in demonstrating the inequitable behaviour of the Inland Revenue. In fairness to the Inland Revenue it should now be said that their press release issued on 18th December 1997 concedes that in most cases involving bond holders tax will be repaid. The good intentions of this press release have unfortunately been largely reversed by the Press Release (No.38) issued on 17th March 1998.

There is one further point which should be made in relation to the amendment made to section 739. It is that the Inland Revenue proposed the change before the appeal to the House of Lords in the *Willoughby* case had even been set down for hearing, let alone decided! In the debate on the Finance Bill referred to above, Mr Jack declined to discuss the *Willoughby* case 'for subjudice reasons'. In saying this Mr Jack was entirely incorrect. A case is not subjudice merely because it is subject to an appeal, it is subjudice before the initial trial when public comment might influence witnesses. He was quite free, therefore, to comment both inside and outside the House of Commons.

The second issue: the relevance of Parliament's original intention

It was established in the case of *Pepper v Hart* [1993] AC 593 that where legislation is ambiguous it is permissible to consult the official *Hansard* report of a debate to discover the intention of Parliament. In the *Willoughby* case the Special Commissioner, having decided that section 739 did not apply to a transfer made when a transferor was non-resident, went on to say that if he had any lingering doubts these were resolved by consulting *Hansard*.

In contrast, the Court of Appeal thought that the words used by Parliament when the legislation was first enacted 'were superseded by acceptance by Parliament of the later decisions of the courts'. In the view of the Court of Appeal, this later acceptance was implied because the income tax legislation had, since 1936, been consolidated twice and considered in relation to an amendment to section 739 which was not relevant to the facts of the *Willoughby* case. This, their lordships thought, had given Parliament opportunities to amend the section if it was felt that the courts had interpreted it incorrectly. The Court of Appeal therefore created a fiction which, with great respect, is somewhat artificial.

If the approach of the Court of Appeal is correct the scope for use of *Pepper v Hart* is severely restricted. The UK has regular consolidations and if ambiguous and uncertain areas in existing legislation are not reviewed by Parliament and amended when tax legislation is consolidated, resort to what was said when the provision was originally enacted is apparently barred.

There are a number of fundamental objections to the approach taken by the Court of Appeal in declining to have regard to the 1936 statements in Parliament:

1 There is no basis on which Morritt LJ, who delivered the unanimous judgment, could properly have concluded that Parliament had at any time after 1936 made any assumption as to the position on the point at issue. Nothing has been said by Parliament on the point. The 1969 amendments related to an entirely different issue and the 1952 and 1970 Acts were consolidations. Moreover, by amending section 739 in the Finance Act 1997 Parliament has indicated that it had not until then changed its mind as to whether the legislation should be extended to transfers made by non-residents.

2 Morritt LJ seems to have concluded that Parliament had one intention in 1936 and that that intention changed in 1952, or in 1969 or in 1970. Not only is that incorrect, any change would have been irrelevant. Statutory interpretation requires the seeking of the intention of Parliament in using particular words. The time at which such words are used and the time when Parliament's intention is formed is the time that the legislation was originally enacted. **There can be no basis for seeking to interpret legislation on the basis of unvoiced assumptions which it is assumed may have been implicit in the mind of Parliament at a later time.**

3 If the approach of Morritt LJ is correct, it is now necessary to approach questions of statutory interpretation, in any case where legislation is ambiguous, obscure or leads to absurdity, by reference not merely to statements made in Parliament when the legislation was first enacted. It would also be necessary to see what cases have been decided which

contradict those statements and then to look to see whether there were later occasions when Parliament had considered the section and see what statements, if any, had been made. It would also be necessary to consider what unvoiced assumptions might be inferred.

4 Since the decision in *Pepper v Hart* there has been a House of Lords decision where statements in Parliament have been referred to even though there had been subsequent litigation which reached a decision contrary to the statements. In *Stubbings v Webb* [1993] AC 498 the legislation in issue had been originally enacted in 1954. Statements were made in Parliament at that time that the intention was to enact the recommendations of the Tucker Committee on the reform of the law of limitations. In *Letang v Cooper* [1965] 1 QB 232 Lord Denning indicated that he was not prepared to assume that Parliament had intended to give effect to the Committee's recommendations. Parliament enacted further legislation in 1963 and 1975 and consolidated the legislation in 1980. Parliament had had the opportunity to amend the law after *Letang v Cooper* but re-enacted the legislation using the same wording. Nevertheless, in 1993 the House of Lords gave effect to the original intention of Parliament. Lord Griffiths stated that he did not think it right to assume that the enactment of the 1963, 1975 and 1980 Limitation Acts were intended to endorse *Letang v Cooper*. The same can be said with regard to the 1969 amendments to what is now section 739. (The above reproduces in slightly abbreviated form the persuasive written argument presented by David Goy QC and Philip Baker to the House of Lords. I am particularly grateful to them and to my solicitor Peter Foster, and to Sir Robert Carnworth who, prior to his elevation to the High Court bench, appeared for us before the Special Commissioner, for the skill and enthusiasm with which they handled the case throughout.)

The third issue: transfers of foreign assets

The finding of the Special Commissioner was that section 739 could be construed to extend to transfers of foreign assets. In the author's view this is technically correct, although it seems unlikely that this was the original intention of Parliament in 1936. The mischief that Parliament was trying to stop was the transfer out of the United Kingdom of United Kingdom assets. However, this was not clear one way or the other from the *Hansard* report. This issue was not taken on appeal from the Special Commissioner.

The fourth issue: income within specific rules providing relief

Probably the most important issue to have arisen in the *Willoughby* case is whether

section 739 can apply to income which is subject to a specific code of tax relieving rules, as is the case with insurance bonds. The problem is how should a widely drawn anti-avoidance provision be construed when there is an apparent clash with other provisions in the tax code which provide for tax reliefs of various kinds. This difficulty has occurred on many occasions in Australia in relation to their general anti-avoidance provisions. The Australian legislation now provides for the legitimate use of tax relieving provisions provided that they are not used in connection with a tax-avoidance scheme. In the *Willoughby* case the problem for the courts was the relationship between a sweeping anti-avoidance provision, section 739, and the tax relieving provisions, sections 539 to 554.

In the Court of Appeal, Lord Justice Morritt said:

> 'I do not see why the choice of an offshore bond or policy, for the taxation of which Parliament has made express and recent provision, should be regarded as tax-avoidance at all. The tax is not avoided, it is deferred. Moreover it is deferred to an event which Parliament has prescribed not to a time of the taxpayer's choice ... The genuine application of the taxpayer's money in the acquisition of a species of property for which Parliament has determined a special regime does not amount to tax-avoidance merely on the ground that the taxpayer might have chosen a different application which would have subjected him to less favourable tax treatment.'

This view was echoed in the House of Lords by Lord Nolan when he said:

> '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.'

The approach adopted by both the Court of Appeal and the House of Lords is similar to the 'choice principle' developed in Australia and will be of particular relevance if the United Kingdom Government decides to enact a general anti-avoidance provision.

The fifth issue: double taxation

Does an assessment under section 739 result in double taxation when gains are assessed under sections 539 to 554? This issue was raised before the Special Commissioner but not before the Court of Appeal or House of Lords. The Special Commissioner decided that the two charging provisions overlapped and therefore do result in double taxation. The Revenue indicated that they would in practice grant relief but when asked how they would calculate it were unable to provide a satisfactory answer. There is no statutory authority for granting relief and since the onus of proof was on the taxpayers, and they were unable to discharge it, there would

have been liability to double taxation if section 739 had applied. It may be that the Special Commissioner thought that this matter would be considered further on appeal. It was, however, decided not to cross-appeal on this issue but to concentrate on the main issues relating to sections 739 and 741.

The sixth issue: deferment of tax

Does deferment of liability constitute tax-avoidance for the purposes of section 739? The answer is that deferment can be tax-avoidance but in the context of section 739 this turns on whether the section 741 defences are available. If deferment of tax liability has been expressly allowed by Parliament then it will not normally involve tax-avoidance provided that the taxpayer has not gone further than what is permitted by Parliament, such as using a relief allowed by legislation as part of a wider scheme designed to avoid tax.

The seventh issue: avoidance not the purpose

Section 741 states that section 739 will not apply if.

> '(a) ... 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) ... the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.'

The *Willoughby* case concerned one insurance bond which was taken out when the taxpayers were non-resident and two bonds taken out on the maturity of three qualifying 10+ policies after the taxpayers had become resident in the United Kingdom. The section 741 defences were, therefore, important in the case of the bonds taken out during the time when the taxpayers were resident in the United Kingdom and also in relation to the earlier bond if the argument that section 739 did not apply had not succeeded.

The Special Commissioner found as a fact that both the section 741 defences applied. The Court of Appeal and House of Lords both agreed that the section 741(a) defence applied but did not find it necessary to rule on the section 741(b) defence. At all three levels of appeal it was stressed that what was involved was bona fide tax mitigation in connection with a genuine long-term retirement saving arrangement for which a substantial premium had been paid, in respect of which costs were incurred and which had to be continued for eight years if penalties were not to be suffered. As the

retirement arrangement was in accordance with a tax relieving code recently enacted by Parliament, the purpose was not one of avoiding taxation and the section 741(a) defence applied. Although the Court of Appeal did not make any finding in relation to section 741(b) the matter was considered in argument. The Revenue argued that for the paragraph (b) defence to apply, both parties had to be engaged in a commercial transaction. Lord Justice Glidewell identified the weakness of this when he asked whether the purchase of a pound of butter was not a commercial transaction because the purchaser was not in the business of purchasing butter. The learned Lord Justice then asked whether if he entered into a contract to insure his life, that was not a commercial transaction because he was not in the business of insuring his life. Counsel for the Revenue seemed to agree that the payment of a premium to acquire a life insurance bond was a commercial transaction for the purposes of section 741(b).

While this issue was not pursued it appears that if the Revenue's argument that the transaction must be commercial for both parties is correct, the section 741(b) defence could rarely, if ever, apply because assessments under sections 739 and 740 are on individuals in their private capacities.

On the question of whether a personal portfolio bond, as contrasted with a managed portfolio bond, involved tax-avoidance the Revenue argued that the discretion given to the bond holder to select investments constituted tax-avoidance because the effect was the equivalent of a direct holding of a portfolio of investments. This argument was firmly rejected by Lord Hoffman in the House of Lords who pointed out that the investments were not owned by the bond holder but by the insurance company. It followed that there was no contractual right enabling a bond holder to claim specific investments, for example in a liquidation, but only to a sum equal to the value of the investments held. The Revenue, however, remain obsessed with the view that a personalised bond involves tax avoidance, as the 1998 Budget proposals make clear. The Revenue agree that a managed portfolio bond which holds managed funds is not tax avoidance.

Why, one may ask, should a bond holding listed shares rather than managed funds involve tax avoidance? What is involved is a bond with greater investment flexibility as was accepted at every level of appeal. Such an obstinate and irrational attitude on the part of the Revenue is deeply worrying.

Before leaving the section 741 defences it is important to point out that in practice they are not the safeguards that at first sight they appear to be. As has already been explained, sections 739 and 740 provide for the assessment of individuals and therefore section 741 provides defences for individuals. In practice relatively few individuals will have the means to pursue an appeal against a section 739 or 740 assessment all the way to the House of Lords with the result that the section 741 defences become of academic importance unless the taxpayer is wealthy or backed by a third party, such as an insurance company, which is prepared to underwrite the

costs incurred by the taxpayer and also the costs of the Revenue should they win and obtain an order for costs against the taxpayer. It follows that where the amount of tax at stake is relatively little when compared with the potential liability for legal costs, taxpayers are likely to cut their losses and pay the tax without a formal protest. This is all the more likely when the Inland Revenue makes it clear at the outset that it is prepared to take the matter to the House of Lords if necessary.

In this context it is relevant that in an article published in the *Times* for 6th October 1990, the Principal of the Inland Revenue's special investigation section, Mr Maurice Perry, is quoted as confirming that 'in the event of the special commissioners finding in favour of an investor, he would regard it as "certain that the Inland Revenue would wish to take the matter to the High Court, the Court of Appeal and perhaps to the House of Lords"'.

In other words, the Inland Revenue were quite happy to use their immense resources to discourage challenges from taxpayers, without qualification, in the belief that the Revenue were wholly right in the view they then held and, apparently, still hold! This high-handed approach may have infringed the European Convention on Human Rights as tantamount to denying a right of appeal to the courts. Certainly there were bona fide investors in retirement bonds who paid tax assessed on them, in all probability because they were intimidated by the approach adopted by the Inland Revenue. A more acceptable approach would have been to say that depending on the reasons given by the Special Commissioners and any special facts, the Revenue would decide whether to appeal further.

Finally, it should be stressed that both the Court of Appeal and the House of Lords held that the section 741(a) defence applied to investments in personal portfolio bonds for genuine long-term saving purposes *by residents* as well as by non-residents.

The eighth issue: Treaty exemption

The question of whether income which arises in a bond in an Isle of Man insurance company is exempt by virtue of the double taxation treaty with the United Kingdom was the subject of a highly technical argument which was resolved in favour of the Revenue.

Avoidance through non-residence?

In the course of cross-examination before the Special Commissioner, counsel for the Revenue raised the fact that the taxpayers had moved to Alderney in May 1992 and that therefore they were avoiding liability to United Kingdom taxation under both

section 739 and sections 539 to 554, the chargeable events regime. This issue has been referred to in recent articles and is also mentioned in Press Release No.38 of 17th March 1998. It is therefore appropriate to deal with it even though it has no relevance to any of the findings in the case.

As the Special Commissioner held, the move to Alderney was 'a change of plan' for which a number of reasons were given in evidence. These included connections with the Island going back to 1970, the presence of many friends of the taxpayers in Alderney, the quality of life (especially the absence of serious crime and pollution), the limited number of motor vehicles, the existence of village shops not under threat from supermarkets, the proximity of France and the scope for the taxpayers to indulge their hobby of sailing. United Kingdom taxation played no part in their decision; indeed, as was pointed out in evidence, the taxpayers' bonds became caught by section 67 Income Tax (Guernsey) Law which is a general anti-avoidance provision far wider in scope than section 739.

While often described pejoratively as a tax haven, Alderney's equivalent of stamp duty (a tax on wealth) is 5.5% and, while income tax is levied at 20% , after adding social security contributions and separate contributions to the Guernsey health scheme, the real rate of 'income tax' is much more than 20%. But to return to what the Special Commissioner called a 'change of plan', the move to Alderney was also accompanied by one of the taxpayers returning to work in Hong Kong, thus giving rise to further tax liability in another jurisdiction. For the record the author nows pays taxes regularly in five jurisdictions.

It is, nevertheless, correct that the taxpayers are no longer at risk to United Kingdom income tax under sections 539 to 554. It is not correct, as appears to have been suggested, that they disposed of their bonds after moving to Alderney. If this had been done a substantial liability to Guernsey income tax would have arisen. In point of fact they have retained their bonds for use as a pension fund from which withdrawals will be made when the time comes for retirement. It should be added that the United Kingdom Revenue has no ground whatever for complaint that the bonds have left their jurisdiction. The savings involved were saved out of Hong Kong taxed income without any relief from United Kingdom taxation. There is therefore no reason whatever why the United Kingdom Revenue should have any interest in the fact that the chargeable events legislation (sections 539 to 554) is no longer relevant.

Public Policy Issues

The *Willoughby* case raises a number of public policy issues. There are many former expatriates who invested retirement savings in life insurance bonds in good faith and merely attempted to provide for taxable retirement income in a responsible way comparable with the arrangements available for United Kingdom residents.

Nevertheless, a number of expatriates were advised to transfer their bonds into trust as part of wider schemes to avoid income and inheritance tax and therefore have probably been engaged in tax planning. It is quite legitimate to attack schemes which go further than what was intended by Parliament, but the Revenue were guilty of a gross error of judgment in launching a general attack on all personal portfolio bond holders, an error of judgment in which they continue to persist. Many of those assessed are people of modest means, a fact which the Revenue appear to have overlooked; indeed, they appears to have thought that they had discovered a seam of gold from which extra tax revenue could be extracted.

The 1998 Budget

It is clear from the Inland Revenue's Press Release No.38 issued on 17th March 1998 following the 1998 Budget Speech that the Revenue remain obsessed with the misuse of personal portfolio bonds which the Press Release states 'are designed primarily for tax avoidance purposes'. It is correct that there are taxpayers who have used these bonds for tax avoidance purposes but it is equally correct that there are many others who, like the Willoughbys, were merely looking for *an ultimately taxable 'pension'*. The reason for using a personalised bond was to obtain greater investment flexibility so as to, for example, include a shareholding in a particular listed company in addition to unit trusts and other approved funds. The apparent rejection of the unanimous decisions of the Special Commissioner, the Court of Appeal and the House of Lords that personal portfolio bonds in themselves do not involve tax avoidance is disturbing.

Discharge of assessments and repayment of tax

If, as is only right and proper, the Revenue have been required to discharge assessments wrongly made under section 739 and to repay tax with a repayment supplement in some instances to those who were engaged in tax avoidance, they only have themselves to blame. These proceedings were misconceived from the outset and, in my opinion, biased though it may be, they have shown the Revenue to have been guilty not merely of serious misjudgment but also of an oppressive abuse of power.

With regard to the question of repayment of tax that has been wrongly assessed, a number of matters are relevant. The first is the general point that the Inland Revenue, in misapplying section 739, contrary to the intention of Parliament and their own policy, should not be permitted to rely on the excuse that they were acting in accordance with an existing practice.

The principle of equitable restitution for unjust enrichment should surely not be

ousted by such a wrongful 'existing practice'. The equitable principle was applied by the House of Lords in *Woolwich Equitable Building Society v Commissioners of Inland Revenue* [1989] AC 70 where tax had been collected under invalid legislation. However, Lord Goff who delivered the leading judgment, observed that:

> 'This principle [of equitable restitution] should extend to embrace cases in which the tax or other levy has been wrongly exacted ... because the authority has misconstrued a relevant statute or regulation.'

It should be appreciated that as an *equitable* rather than a statutory remedy there is no express time limit. Delay in bringing proceedings for recovery, if excessive, will prevent a court of equity from allowing restitution.

No taxation without misrepresentation

In this instance, however, the Revenue have not merely misconstrued the legislation. They have deliberately misrepresented the intention of the legislation and attempted to apply it contrary to their own advice to ministers and through them to Parliament. It would be difficult to find a stronger case for the intervention of equity or, if necessary, the European Court, to ensure restitution. In the light of the Press Release issued on 18th December1997, this seems to have been accepted. The Press Release set out the details of tax repayments to fund holders.

Analysis of categories of bond holders

The next matter involves an analysis of the different categories of retirement bond holders. For a start, one can leave out managed portfolio bonds because the Revenue have stated all along that they were not concerned with them in the context of section 739, although if they have been used as part of a wider tax avoidance plan, section 739 will probably apply and the section 741 escape clauses will not be available. Where bonds have been held in trust the Budget proposals when enacted will nullify any tax advantage obtained. With regard to holders of portfolio bonds there are, perhaps, four categories of bonds to consider:

(1) Bonds which have been taken out for genuine long term retirement planning which did not involve tax avoidance and in respect of which assessments have been made but no tax has been paid. These are outside section 739 in both its old and amended form. In these cases the assessments should be discharged;

(2) Bonds which are in the same category as (1) above except that tax has been

assessed and paid. In these cases the assessment should be discharged and the tax repaid with a repayment supplement. It is understood that the Revenue have been repaying tax, with a repayment supplement, to those bond holders who appealed against assessments or who paid under protest. It may be that repayment has not in all cases been made to those who had paid tax without protest. These bond holders are, perhaps, in the greatest need of consideration because they were not properly advised. It would have been very unfair to exclude them from repayment and it is now understood that repayments have been made in many, if not all, these cases;

(3) Bonds within the same category as (2) above except that bond holders have surrendered their policies. In these cases the assessments should be discharged, the tax repaid with a repayment supplement, and compensation should be paid for loss of retirement planning arrangements. It is not known what has happened in these cases; and

(4) Bonds taken out in part to avoid inheritance tax at a time when the bond holder was non-resident. In these cases assessments made before 26th November 1996 should be discharged and any tax paid repaid with a repayment supplement. In these cases, however, there will often have been a tax avoidance purpose but, even though the section 741 defences may not apply, neither can section 739 in respect of pre-26th November 1996 income and gains. Assessments under section 739 in its old form will therefore be ultra vires. However, the *Furniss v Dawson* doctrine might apply to pre-26th November 1996 bond income and gains, as might the doctrine of a disposition by associated operations where an attempt has been made to avoid inheritance tax.

It is now clear that the Inland Revenue have conceded that they have acted wrongly because their Press Release for 18th December 1997 admits that many taxpayers 'have already experienced a long period of uncertainty over their tax position and 'In the interest of resolving outstanding issues as quickly as possible, the Inland Revenue has decided, with the approval of Ministers, that, in the exceptional circumstances of this matter, including the particular handling in the past of individual cases it will repay tax with repayment supplements in most cases and apply the chargeable events legislation as appropriate i.e. the 1984 special regime for taxing insurance bonds.'

If the matter had been left there all would have been fine. Those who had used personal portfolio bonds for genuine retirement purposes would be in the clear and those who had engaged in wider tax avoidance by using trusts and relying on the drafting error which resulted in the so-called 'dead settlor' schemes would be caught by the amended section 739, the *Furniss v Dawson* principle and the "associated operations" doctrine in the case of inheritance tax. Regrettably, and unnecessarily, the Revenue seem to have persuaded the Government, effectively and retrospectively, to

impose a deemed tax penalty on all personal portfolio bonds with effect from 6th April 1999. The intention is also to amend the chargeable events regime to nullify the use of trusts to shelter bonds from income tax. The author has no quarrel with the latter as the dead settlor schemes almost certainly did involve tax avoidance. What is objectionable is the continued insistence that personal portfolio bonds were primarily used for tax avoidance purposes when the House of Lords has said that this view is not merely wrong but 'absurd'. At the time of writing, the Finance Bill has not been published and it may be that bonds that have not in fact been 'personalised' by the holding of personal investments, as opposed to managed funds, will not be penalised even though power exists to hold personalised assets.

Abuse of power: the lessons

In addition to misrepresenting legislation as having an intention opposite to that originally intended and referring to unpublished and confidential decisions of the Special Commissioners in correspondence with the taxpayer, the Revenue have also broken one of the cardinal rules applicable to revenue authorities, namely over-zealously putting at risk one of their strongest anti-avoidance weapons. It is a matter of further regret that Treasury Ministers in John Major's Conservative government were apparently prepared to support the Inland Revenue's approach without applying the necessary checks and balances on which British constitutional law depends. It now appears that in this regard Tony Blair's administration is no better. This background is of particular relevance if the United Kingdom is to have a general anti-avoidance provision. It is clear that safeguards will be needed to prevent abuse of such a power by the Revenue, particularly in relation to individual taxpayers of modest means. A partial solution would be to shift the burden of proof from the taxpayer to the Revenue. This would give the taxpayer the benefit of the doubt in any borderline case. The Revenue would also be wise not to use a general anti-avoidance provision too frequently because once cases start to be lost, the provision will lose its deterrent effect. The experience in Australia with its section 260, the general avoidance section which preceded Part IVA of the Australian Income Assessment Act, has demonstrates this all too clearly.

Wider policy issues

On a more general matter, the Government should consider whether expatriates are to be encouraged to save for retirement before their eventual return to the United Kingdom in a prudent tax-efficient way comparable with that available for residents. If the Government were to take a fresh look at this matter, ignoring the paranoia and the tunnel vision of the Inland Revenue, the retirement savings of many expatriates could be invested onshore to the benefit of the United Kingdom economy rather than offshore in other jurisdictions. As it is, the mishandling of the personal portfolio

bonds saga may well have resulted in many expatriates deciding not to return.

Facing a juggernaut

From a personal point of view, the experience has demonstrated how difficult it is for a private individual to resist what Lord Goff has described as the 'coercive power of the state'. An individual who wishes to resist a wrongful assessment is at a huge disadvantage having regard to:

(a) Limited resources in contrast with the Revenue;

(b) Lack of inside information (the Revenue were able to rely on unpublished Special Commissioners' decisions, which reliance may have been a breach of Article 6 of the European Convention on Human Rights);

(c) The assessment process, which is largely under the control of the Revenue and can be accelerated or delayed as it suits the Inspector;

(d) The onus of proof which is on the taxpayer; and

(e) The requirement that the appellant must pay his own costs before the Special Commissioners and run the risk of costs in subsequent appeals if the Revenue insist on pursuing the taxpayer to the House of Lords.

Contrary to the Taxpayer's Charter, the Revenue have been slow in making assessments, replying to letters and also in meeting deadlines required by the litigation process. It took six years and four months from the first letter written by the taxpayer to the Revenue to achieve a decision from the House of Lords, even though the High Court level of appeal was leapfrogged at the taxpayers' request. The delay and expense of civil litigation has been criticized recently and is subject to review. It is important that any reforms take into consideration the plight of the individual who has to take on the deep pocket of the State. Perhaps those in the public service found to have abused their power should run the risk of some of form of personal financial penalty.

Conclusion

The case raises many legal issues of importance to tax practitioners and to the Revenue. What is also at stake, and what is perhaps more important, is the fair treatment of individuals who have acted in good faith in reliance upon the Revenue's Press Release of 1983 and the subsequent 1984 legislation when entering into retirement arrangements. These are in substance little different from retirement annuities and personal pensions available to United Kingdom residents except that the savings have been accumulated outside the United Kingdom. Unfortunately, the use

of personal portfolio bonds by aggressive, and some might think irresponsible, tax planners has so distorted the attitude of the Inland Revenue that the end result, that all personal portfolio bonds are to be effectively outlawed, is not really a surprise. The Inland Revenue's apparent rejection of the unanimous view of the Special Commissioner, the Court of Appeal and the House of Lords that personal portfolio bonds, used sensibly, do not involve tax avoidance is an equally discreditable overreaction. At least the Government has allowed personal portfolio bond holders a year in which to sort matters out. It is to be hoped that this can be done by converting personal portfolio bonds to managed portfolio bonds without the need to surrender the former and thereby trigger a tax liability on all gains in the bond. If this is not possible and a reasonable solution cannot be found for those bond holders who have not engaged in tax avoidance, it may be that disgruntled personal portfolio bond holders will have to get together and fight all the way to the House of Lords yet again!