"UNSAFE AND UNSATISFACTORY": *R v CHARLTON*

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1 Scope of the Article

The recently reported decision of the Court of Appeal (Criminal Division) in *R v Charlton*[2] resulted in several tax professionals, including a Lincoln's Inn barrister, being incarcerated in consequence of a tax avoidance scheme which, to use a neutral phrase, "went wrong". In my view, the judgment of the Court of Appeal is a blot on our system of jurisprudence and can only be described as "unsafe and unsatisfactory".[3] It makes a fundamental confusion between criminal tax evasion and lawful, albeit possibly ineffective, tax avoidance. It fails to distinguish between steps which have no commercial purpose or justification, being undertaken purely for tax avoidance purposes yet which are nonetheless real, and between mere shams, frauds and smokescreens, which have no reality and which are simply intended to deceive. If this judgment is allowed to stand, no man seeking to mitigate or avoid taxation by lawful means, and no professional advising him how to do so, can be sure of preserving his property, his liberty and his reputation.

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2 [1996] STC 1418.

3 cf Criminal Appeal Act 1968 section 2(1)(a).

2 Avoidance and Evasion

2.1 The Traditional Learning

Most of us are sure we know the difference between criminal evasion and lawful avoidance of tax.[4] The taking of steps to mitigate or avoid liability to tax is not itself unlawful, whether it takes a praiseworthy form, such as giving up smoking, or a highly artificial form, such as the schemes in *Countess Fitzwilliam*,[5] which some would find morally objectionable. What is in general unlawful is to attempt to avoid paying taxes which are lawfully due. Most often, this will take the form of telling lies to the Revenue authorities.[6] As well as the common law offence of cheating the public revenue, that could well involve other offences of dishonesty, such as forgery, false accounting and obtaining a pecuniary advantage by deception. Whatever the precise offence, the core element will almost always involve deliberately misleading the authorities.

This fundamental distinction is mirrored in the concept of a sham. A sham is a fraud, a pretence, something which pretends to be other than it really is. A forged document, for example, is a sham in that it tells a lie about itself. A scheme or arrangement might be highly artificial; it might have no purpose other than tax avoidance, it might or might not be effective to that end, but, provided that transactions involved are intended to be genuine, and not merely a smokescreen for the reality, it is not a sham. Now it will be readily perceived that the participants in virtually every tax avoidance scheme have not the slightest incentive to produce a sham. The strategies depend for their effectiveness on the steps taken being real. And that is none the less the case if those steps are artificial and are contrived purely for the purpose of tax avoidance. Given that there is no difficulty in taking the artificial steps, there is no point whatsoever in not taking them but in merely pretending to take them. Indeed, there is every point in taking them; as otherwise the scheme certainly will not work and will depend for its *de facto* effectiveness on a criminal fraud which is totally unnecessary and the discovery of which will normally give rise not only to the tax, which continues to be due, being in fact collected but the perpetrators being indicted on serious charges.

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4 Although judges in the past have occasionally used "evasion" where we would now use "avoidance", the nomenclature I use has now been firmly adopted by lawyers.

5 Discussed in section 3 below.

6 It may also take the form of failing to inform the authorities of one's liability when there is a duty to do so. The common law offence of cheating Her Majesty's Revenue might conceivably take other forms, but if there are other cases, they will be of marginal importance.

Now the learning on the nature and limits of the concept of a sham was firmly established in English law well before *Ramsay*. A classic case, which had nothing to do with tax, was *Snook v London and West Riding Investments Ltd*.[7] The famous dictum of Diplock LJ at pages 528/802 was cited by Lord Fraser in *Ramsay*:[8]

> "it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create."

As well as introducing the new anti-avoidance rule, *Ramsay* also firmly and authoritatively reasserted the traditional learning on the meaning of a sham. As Lord Wilberforce put it in a key passage:[9]

> "3. It is for the fact-finding commissioners to find whether a document, or a transaction is genuine or a sham. In this context to say that a document or transaction is a 'sham' means that while professing to be one thing, it is in fact something different. To say that a document or transaction is genuine, means that, in law, it is what it professes to be, and it does not mean anything more than that."[10]

2.2 *R v Charlton*

2.2.1 The Background

The appeal in *R v Charlton and others* to the Court of Appeal (Criminal Division) concerned an "invoicing scheme". The defendants, Charlton, an unqualified

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7 [1967] 2 QB 786; [1967] 1 All ER 518.

8 [1981] STC 174 at 170-171.

9 [1981] STC 174 at 161.

10 The judicial language of North American English differs from that of the United Kingdom. An artificial scheme of the *Ramsay* type was described as a sham in *Knetsch v United States* (1960) 364 US 361, cited by Lord Wilberforce in *Ramsay*. In *Countess Fitzwilliam*, Lord Templeman described the artificial schemes under review as "trembling on the brink of a sham". This was powerful rhetoric but bad law. The other four members of the Appellate Committee were so far from considering there to have been a sham that they found that both schemes worked. Nor do the counsel who advised on the schemes appear to have been in any way discredited, as Robert Walker QC has since been appointed a Chancery judge and Mark Herbert has taken Silk.

accountant, Kitchen and Wheeler, chartered accountants, and Bernard Cunningham, an English and Scottish barrister, were charged with various offences of cheating the Revenue. Cunningham was convicted only on charges of concealing the fraud after the event. The judgment of the Court of Appeal was delivered on 22nd February 1995. It was not reported until [1996] STC 1418, which was issued on 20th November 1996.

2.2.2 A Declaration of Interest

I must at this point make a declaration of interest. Bernard Cunningham, the barrister whose conviction the Court of Appeal upheld, was a member of the Revenue chambers at 24 Old Buildings when I joined it in 1988. He lived in Northern Ireland, and practised in Scotland and Spain, as well as from Lincoln's Inn. I consequently did not know him well, although nothing I have ever known about him has suggested that he was capable of the offences of which he has been convicted. He was represented by Leading and Junior Counsel of the criminal bar and, before his life savings were dissipated and he was forced to apply for legal aid, by a prominent firm of West End solicitors. Before the trial, he approached me when I was working late in chambers one evening and informally showed me the indictments. While disclaiming any knowledge of criminal procedure - such knowledge as I had of the criminal law came from teaching it when I was an Oxford don - I expressed the view that the indictments were hopelessly confused and suggested that he and his advisers might consider avoiding the hassle of a long and expensive trial by moving to quash them. That suggestion was not acted on.

After his conviction, it was suggested to him by third parties that I should be instructed to appear at the hearing before the Court of Appeal to explain the difference between tax evasion and tax avoidance and why the direction given to the jury was totally inadequate. When he mentioned this to me, I naturally offered my services on a voluntary basis, while making it clear that I could not take over the conduct of the appeal as such, as I knew as little about criminal law and procedure as his criminal barristers knew about tax. After consulting with his remunerated advisers, Mr Cunningham was persuaded that he should not accept this offer which he had procured.

In the following discussion, I rely on no intelligence other than that which can be gleaned from the law report in Simon's Tax Cases. I did not attend the trial. I have not seen the transcript of the evidence. I have not seen the skeleton arguments. I have no insider knowledge of the case. I do not know whether the defendants were guilty as charged. My concern is that they were not properly convicted according to law.

2.2.3 The Head Note

The head note is inaccurate. If the result had indeed been that the English company "made a lower profit and thus reduced its liability to corporation tax", the defendants would have been innocent. The whole point of the prosecution's case was that the English company had not lowered its profits but that the defendants had pretended that it had! The fact that the law reporter, herself a barrister, could so radically misunderstand the position after considering the Court of Appeal's judgment raises an immediate scepticism as to whether the common jury properly understood the questions they had to decide.

2.2.4 The Facts and the Charges

2.2.4.1 The Facts

The following account of the facts is taken from the judgment of the Court which was delivered by Farquharson LJ:

> "The case for the prosecution was that Charlton had devised a dishonest tax avoidance scheme for the benefit of some of the firm's clients and that the appellants were involved with the implementation of the schemes or the concealment from the Revenue of the existence of the fraud. With some variations in individual cases, there were two schemes which were the subject of the present prosecution. They involved the formation of a company or companies in a tax haven. Taking as an example the scheme which was the subject of the first two counts of the indictment, the client of Charltons concerned was Tyre Sales Birmingham Ltd (TSBL), of which the directors were Huckerby and Jones. The company, as part of its trade, purchased tyres from overseas suppliers. In the ordinary way the directors of TSBL would negotiate the price, amounts and dates of delivery with the suppliers who would in due course render invoices to TSBL. The scheme proposed by the appellant Charlton was that a Jersey company, Fleet International Ltd (Fleet), should purchase the tyres from the overseas supplier and then resell them to TSBL at a higher price. The money thus accumulated by Fleet would be retained for the benefit of the beneficial owners of Fleet, who were of course the directors of TSBL. The result was that TSBL, having purchased the tyres at a higher price than it would have done without the intervention of Fleet, made a lower profit and thus

reduced its liability to corporation tax.[11] Furthermore, the moneys retained by Fleet after paying fees to Charlton for 'administration' were available for the beneficial owners of Fleet.

"For the scheme to be tax effective for the purpose of the United Kingdom revenue legislation, Fleet had to be controlled and administered in Jersey by directors who were not resident in the United Kingdom. It had to be independent of TSBL.[12] In fact, management and control of Fleet remained in the hands of the TSBL directors. The negotiations for the purchases continued to take place between TSBL and the overseas suppliers and delivery of the tyres was made directly to TSBL. The only function of Fleet was to process the invoices, for which it charged inordinately high fees. The moneys retained were applied for the benefit of the directors of TSBL in the form of loans and credit cards, though these benefits were taxable in the hands of a United Kingdom resident.

"It was, and is, Charlton's case that the scheme he proposed was tax effective and perfectly honest. He conceded at the trial that the directors of TSBL applied the scheme dishonestly and in breach of English revenue law, but asserted that he himself was unaware of it.[13] Although the firm

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11 Even in the statement of the facts, the hydra of confusion has raised its first head. If it were really true that TSBL had reduced its liability to corporation tax, then the defendants could not conceivably have been guilty as charged. The charges proceeded on the basis that the profits of TSBL had not been reduced at all, merely that the accounts of TSBL falsely showed its profits as having been reduced. Because false accounts were presented to the Revenue, it paid less corporation tax than it should have done, but at all material times it remained liable to pay the difference. If its liability had been reduced, this could only be on the basis that its profits had been reduced to the level shown in the accounts, in which case the accounts which were presented to the Revenue would have been entirely accurate.

12 These statements are rather misleading. It is quite true that unless the control of the *business* of Fleet resided, at board level, outside the United Kingdom, then it would be resident in the United Kingdom for corporation tax purposes and its profits would be liable to United Kingdom corporation tax so that there would have been no overall tax saving. There was no objection in Fleet itself being controlled by persons resident in the United Kingdom nor any objection to TSBL being connected with such persons who did control it, so that it is going too far to state that it needed to be independent of TSBL. Yet even if the control of the business of Fleet had resided in the United Kingdom or even if TSBL had been the parent of Fleet, so that the perceived tax advantages would not have accrued, the accounts of TSBL as returned to the Revenue would have been perfectly correct and the defendants innocent as charged unless Fleet never carried on business at all on its own account but only pretended to do so.

13 Quaere whether this concession was wisely made.

of Charltons, of course, bore his name, he did not himself have anything to do with the accounting or auditing side of the practice. His task was to sell his tax avoidance schemes to the firm's clients. So far as the day-to-day business of Fleet—and for that matter the other Jersey companies which were involved in the other counts on the indictment—was concerned, it was conducted by Kitchin. Charlton (Jersey) was the accountant for all the Jersey companies except Fleet. The companies were administered in Jersey through the medium of firms owned by Charlton.

"Wheeler was a partner in a firm of accountants named Farmiloe which had its practice in the West Midlands. Farmiloe were the auditors of TSBL and Wheeler was the partner concerned; he audited the accounts of TSBL and examined those of Fleet. During the 1980's when these tax frauds were alleged to have taken place, he made regular visits to Jersey to examine, inter alia, the invoices of both companies.

"Cunningham was consulted from time to time by Charlton and Wheeler on behalf of TSBL, both as regards the schemes devised by Charlton and on the company's response to the Revenue investigation that subsequently took place.

"The Crown contended that Fleet was a mere cipher, under no independent control. It was a device to avoid the payment of corporation tax. There was, of course, no commercial benefit to TSBL in paying more for its tyres than the price asked for by the overseas suppliers."

After discussing a second scheme involving Chelful Ltd with which the rest of the indictments were concerned, Farquharson LJ continued:

"To establish the independence of the Jersey companies it was necessary not only that the company should not be subject to United Kingdom control, but also that its shares should be held in a discretionary trust.[14] With the possible exception of Fleet, trustees were never appointed to the

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14 This is a confused mixture of fact and fiction. As already stated, so far as taxation of the Jersey companies was concerned, they did not need to be independent of control by United Kingdom residents or even by TSBL. For the reasons given below, the holding of the shares in these companies within discretionary trusts was in fact quite irrelevant to the liability of their profits to United Kingdom *income tax*. In order to prevent their profits from being liable to United Kingdom *corporation tax* it was desirable that they be not directly owned and controlled by United Kingdom resident companies, yet there was no necessity that they be not owned and controlled by United Kingdom resident individuals.

offshore companies. The benefits were, as already described, transferred to the United Kingdom directors."

2.2.4.2 The Charges

Each of the appellants was charged in the relevant counts with cheating the Revenue by 'falsely representing that the apparent purchases [by the United Kingdom company] from [the Jersey company] were bona fide commercial transactions.'

2.2.5 The Judges and Counsel

Ten counsel appeared before the Court of Appeal, five of them silks, of whom eight appeared for the defendants. The Court of Appeal consisted of Farquharson LJ, Hidden and Longmore JJ. Not one of these thirteen gentlemen appears to have had any experience of tax, although Longmore J was a distinguished commercial lawyer, whom one would expect to have been at least acquainted with *Snook*. *Ramsay* was not cited. Only three tax cases were cited. Apart from *Countess Fitzwilliam*, which appears to have been of marginal relevance, the others were *De Beers Consolidated Mines Ltd v Howe* (*Surveyor of Taxes*) [1906] AC 455, 5 TC 198, the classic decision of the House of Lords on the residence of corporations, and *Calcutta Jute Mills Co Ltd v Nicholson* (*Surveyor of Taxes*) (1876) 1 TC 83, Ex Ch., an earlier case on the same topic. None of these cases was adverted to in the judgment of the Court.

2.2.6 The Law

2.2.6.1 The Criminal Law

Before looking at what the Court of Appeal decided, let us consider the substantive criminal law involved, which was hardly of the greatest complexity. One crucial direction which should have been put to the jury was that if the Jersey companies really bought and sold goods, then the transactions were genuine and not shams and the defendants must be acquitted. This was none the less so even if the only reasons for setting up the companies and their entering into transactions was tax avoidance and there was no bona fide commercial reason behind them. Indeed, the jury might well have been told that if the defendants believed that they would obtain the desired tax advantage only if the transactions were genuine, that was an excellent reason for inferring that they were genuine. It was likewise an irrelevance whether the Jersey companies were controlled in Jersey by their nominal directors or by any other persons elsewhere in the world, including the directors of the English company which did business with the Jersey company. It was further immaterial that the discretionary trusts had not been put in place and that the directors of the English companies had benefited personally from the Jersey companies. Indeed, it was in general completely immaterial whether the scheme failed, in the sense that any benefits which might have been procured were counteracted by anti-avoidance legislation, provided that the profits of the English companies were depressed as a result of real transactions with the Jersey companies to the level shown in their accounts. The only fraud with which the defendants were charged involved false accounts being presented to the Revenue. If there were no false accounts, then the defendants must be acquitted, even though they might conceivably be guilty of some other offence involving cheating the public revenue.

The jury should have been instructed that they could convict a defendant if and only if they were sure that the goods were in fact purchased by the English companies directly from third party suppliers and that all that the directors of the Jersey companies did was to produce a series of invoices falsely pretending that there had been purchases of goods by those companies followed by sales to the English companies and that the defendants knew at a material time that this was the case. In that case and in that case only would there have been a sham and a fraud.

2.2.6.2 The Tax Law

2.2.6.2.1 On the Basis of a Sham

What of the tax position? If the transactions "evidenced" by the invoices never occurred, so that the invoices were shams and the sums collected by the Jersey companies belonged to the English companies, then quite clearly the English companies would have remained liable to corporation tax on their full profits, including the amount "creamed off" to the Jersey company. Additional corporation tax would be due, together with interest and, possibly, penalties. The fact that directors had received benefits might involve further charges to tax under Schedule E and Schedule F. In the rest of this section 2.2.6.2 I shall consider the position on the basis that there was no sham.

2.2.6.2.2 Constructive Trust

Let me first raise, if only to dismiss, the question of a constructive trust. Prima facie, the directors of the English company were in breach of their fiduciary duties to the English company in allowing the profits to be creamed off and as the Jersey company could not rely on any bona fide purchaser defence it would hold at the very least its profits, and arguably its entire receipts, upon trust for the English company. Hence, if these profits or receipts did not enter into the accounts of the English company, those accounts would be inaccurate. The prosecution did not decide to put their case that way. One possibility is that they did not appreciate there was a constructive trust. In any case they would have to prove not only the existence of the constructive trust as a matter of law but that the defendants knew of it. Now I very much doubt that the Revenue were (or are) aware that such an argument is open to them in such a case. Certainly, I have never seen it advanced. It would hardly lie in their mouth to tell a jury they ought to be convinced that the defendants had known of an esoteric point of law which had passed their own notice.

2.2.6.2.3 Taxes Act 1988 Section 74(1)(a)

A more promising approach might have been for the Revenue to contend that even if the transactions were genuine, the English company was not entitled in drawing up its accounts for corporation tax purposes to deduct the full amount it paid the Jersey company for the goods. For while the simple view - which could nevertheless be the correct view - is that, as the purchase of the goods is a genuine transaction undertaken for the purpose of a trade, then the actual price payable to the Jersey company is deductible, it might have been argued with some conviction that the *full* purchase price had not been "wholly and exclusively laid out or expended for the purposes of the trade" within the meaning of Taxes Act 1988, section 74(1)(a).[15]

The prosecution did not take this point either. That is no doubt because the force of the argument is considerably weakened by the existence in the same Act of the Transfer Pricing Provisions, which presuppose that it is incorrect. Otherwise, they would be quite otiose.

2.2.6.2.4 The Transfer Pricing Provisions

The Transfer Pricing Provisions are contained in Taxes Act 1988 Part XVII (Tax Avoidance) Chapter VI (miscellaneous). They are a fasiculus of sections (770-773) headed "Transactions between associated persons". Section 770(1) provides, *inter alia*, that where property is sold and the buyer and seller are bodies of persons over whom the same person or persons has or have control, then in computing for tax purposes the income of the buyer where the actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price.

In this case, even if the Jersey company had been under the control of the Jersey resident trustees of Jersey resident trusts, yet, provided the English company had

15 Schedule D - General rules as to deductions not allowable.

been controlled by the settlors of those trusts, both companies would have been under the control of the same persons.[16]

Section 770 would therefore have applied. Its application is not, however, automatic. It applies only if the Board of Inland Revenue so direct. There would appear to have been no obligation on the English company to volunteer information to the Board that the circumstances were such that they had the power to make a direction in its case.[17] Thus, unless and until a direction were made, the taxable profits of the English company would have been those shown in the accounts tendered to the Revenue.

2.2.6.2.5 Did the Controlled Foreign Companies Legislation apply?

The Controlled Foreign Companies legislation, contained in Taxes Act 1988, Part XVII, Chapter IV,[18] provides that the Board of Inland Revenue may direct that the profits of a company resident outside the United Kingdom controlled by persons resident in the United Kingdom which is subject to a low level of taxation in the territory in which it is resident (a "controlled foreign company"), may be apportioned among the persons who have an interest in the company. The provisions bite, however, only when part of those profits are apportioned to a *company* resident in the United Kingdom. In this case, the English company did not have any interest in the Jersey company; hence none of the latter's profits could be apportioned to the former.[19] The position would be no different even if the directors or shareholders of the English company had interests in the Jersey company.

In any case, although the Board of Inland Revenue can direct that Chapter IV shall apply to a company, unless and until it does so the taxable profits of that company are unaffected. The Revenue had apparently given no such direction. Hence, the profits of the English companies as stated in their accounts were (assuming them to be otherwise accurate) also their profits for corporation tax purposes.

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16 The test of "control" for section 770 purposes is that contained in Income and Corporation Taxes Act 1988 section 840: see section 773(2). In determining whether any person (alone or with others) has control over a body of persons there may be attributed to him any rights or powers of a person with whom he is connected: see section 773(4). The settlors of the settlements are connected with their trustees: see section 839(3)(a).

17 With the introduction of self-assessment the law has since changed.

18 It was introduced by Finance Act 1984.

19 For the apportionment rules, see section 752.

2.2.6.2.6 What of Taxes Act 1988 Section 739 ?

Taxes Act 1988 Part XVII Chapter III, Tax Avoidance - Transfer of Assets Abroad, can deem income arising to a non-United Kingdom resident person to be that of an individual ordinarily resident in the United Kingdom who has "power to enjoy" that income or who receives a "capital payment".[20] The section applies only to individuals who are transferors. Hence, the Revenue could not rely on it as increasing the English company's profits for tax purposes.

The directors of the English companies had prima facie been concerned in transfers of assets[21] by virtue or in consequence of which income became payable to a person resident outside the United Kingdom, namely the Jersey company. If the defendants' scheme was an honest one, why did they consider that section 739 would not apply? Its application would have been a potentially serious matter, for the directors would have been liable to UK income tax on the income of the Jersey company on an arising basis. Thus, the scheme would have succeeded in substituting for a corporation tax on the English company a charge to income tax on the directors at a higher rate!

It is possible that the defendants might have considered that the income of the Jersey company was not income capable of being caught by the section. For the section to apply, it is necessary that incomes "becomes payable" to a person resident outside the United Kingdom. For over forty years, following the House of Lords decision in *Latilla v Commissioners of Inland Revenue*,[22] it was considered highly arguable that what is now Taxes Act 1988 section 739 could not apply to deem *trading* income of a person domiciled or resident outside the United Kingdom to be that of a "transferor" who was ordinarily resident in the United Kingdom, on the grounds that his trading income was simply an arithmetical difference between receipts and expenditure and, unlike, say, dividend income, did not become "payable" to him at all. It was only after these schemes were set up that Hoffman J in *IRC v Brackett* and the related appeal of *Brackett v Chater*,[23] rejected the argument. The judgment is a rather unsatisfactory one in several

20 The relevant law prior to the Income and Corporation Taxes Act 1988, which is a consolidation act, was contained in Income and Corporation Taxes Act 1970 section 478 et seq.

21 See section 742(9)(b).

22 25 TC 107 (1943).

23 [1986] STC 521.

respects, no doubt because the taxpayer presented his case in person, so that it is possible it might not be followed.[24]

The defendants might also have held the honest but mistaken view that the directors did not have "power to enjoy" the income of the Jersey company. It was intended that the Jersey company should be owned by an offshore discretionary trust, albeit that those responsible for implementing the scheme never got round to attending to this aspect of it. Before the Finance Act 1981 amendments to Taxes Act 1970 section 478, the predecessor of section 739, it was common practice to hold an offshore company within an offshore discretionary trust of which the settlor, who was also a beneficiary, was United Kingdom domiciled and ordinarily resident. The prevailing view, which the Revenue appear to have accepted, was that the settlor would not have had power to enjoy the income of the offshore company because he could enjoy the income only if two separate powers were exercised, as a dividend would have to be declared and then the trustees would have to decide to pay the dividend to him.

Since 1981, such a settlor clearly has power to enjoy the income of the offshore company. For he may "in the event of exercise or successive exercise of one or more powers, by whomsoever exercised and whether with or without the consent of any other person, become entitled to the beneficial enjoyment of the income": section 742(2)(d). The defendants could, especially in the early to middle 1980s, have overlooked this important amendment. Fleet in particular was set up before Finance Act 1981 became law. For myself, I find that more than plausible, given that even in 1997 not everyone has appreciated the full effect of the 1981 amendments!

The defendants might also conceivably have genuinely but mistakenly considered that there had been no transfers of assets, overlooking the extended definition of this term in what is now Income and Corporation Taxes Act 1988 section 742(9)(b), which covers the creation of rights of any kind.

Then again, the defendants might have considered that while the English company had made a transfer of assets, the directors of the company had not. They might have overlooked dicta in *Vestey v IRC*,[25] which were subsequently applied in *Pratt v IRC*.[26] On the other hand, they might (if they later reconsidered whether

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24 See my article 'Transfer of Assets Abroad: Mr Brackett's Problem Case' in *The Offshore Planning Review*, Volume 5, Issue 2, at 65.

25 [1980] STC 19.

26 [1982] STC 756.

the scheme was sound) have relied on *Pratt* for the proposition that section 739 cannot apply where there are multiple transferors whose respective interests in the assets transferred cannot be separately identified.

Now if section 739 did catch the directors, the income of the Jersey company would automatically have been deemed to be theirs for income tax purposes, so that they would have been obliged to include it in their tax returns; and if they deliberately omitted it from their tax returns they would have been guilty of cheating the public revenue.

For reasons as to which one can only speculate, the Revenue did not pursue the section 739 liability in the indictments. Instead they pinned their faith to the argument that all the supposed transactions entered into between the Jersey company and the English company were bogus.

2.2.6.2.8 What of the Settlement Provisions?

What of the Settlement Provisions, now contained in Income and Corporation Taxes Act 1988 Part XV?[27] Unless each director and any spouse of his had been excluded from any possibility of benefiting under his settlement, all income arising under that settlement would have been deemed to be his for income tax purposes. From 1981 until 1989 that would have included income of a company owned by the trustees which (on the hypothesis that it was United Kingdom resident) could have been apportioned to the trustees under the close company apportionment rules.[28] Given that the only income of the Jersey company was trading income, it would not have been capable of apportionment: Finance Act 1972 Schedule 16 para 8(1)(a).

2.2.7 The Argument

Farquharson LJ continued:

> "The Section 10 point
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> "It was the case for the Crown that the accounts presented to the Revenue by the United Kingdom companies were false in that by using Charlton's scheme to transfer part of their profits to the Jersey companies they were not disclosing the full extent of the profits they had made. It was this lack of disclosure which formed the basis of the false representations alleged

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27 Formerly Taxes Act 1970 Part XVI.

28 Taxes Act 1970 section 454(1)(b).

in the indictment. Each of the appellants was charged in the relevant counts with cheating the Revenue by 'falsely representing that the apparent purchases (by the United Kingdom company) from (the Jersey company) were bona fide commercial transactions.' The defence argued that on the evidence the individual purchases by the United Kingdom company were bona fide commercial transactions and that the Crown had laid the wrong charge. Any breach of the law was by the Jersey companies in not making the necessary disclosures under s 10 of the Taxes Management Act 1970. The statutory framework to support this argument has been helpfully summarised for us by counsel as follows. Section 238(1) of the Income and Corporation Taxes Act 1970 provided: 'Corporation tax shall be charged on profits of companies.' Section 243(1) provided—'... a company shall be chargeable to corporation tax on all its profits wherever arising.' Section 246(1) provided: 'A company not resident in the United Kingdom shall not be within the charge to corporation tax unless it carries on a trade in the United Kingdom.'

"Residence is not defined in the Act but it is agreed in these proceedings that a company is resident in the country where its real business is carried on, which is where the central management and control resides. Again, there is no dispute that in the present case control was exercised by the United Kingdom companies. The defence assert that the Jersey companies were accordingly liable to pay corporation tax in the United Kingdom. The tax to be charged would be in accordance with the income tax principles applicable to corporation tax. Specifically by s 130 of the Income and Corporation Taxes Act 1970 it was provided that 'in computing the amount of the profits ... no sum shall be deducted in respect of—(a) any disbursements or expenses, not being money wholly and exclusively ... expended for the purposes of the trade'.

"According to the defence the Jersey companies, in the light of these provisions, were caught by s 10 of the Taxes Management Act 1970 which states:

> 'Every company which is chargeable to corporation tax [for any accounting period] ... shall not later than one year after the end of that accounting period give notice to the inspector that it is so chargeable.'

"No such notices have been given and the defence argue that the offences committed in this case are the breaches of section 10. Accordingly, the allegations in the indictment are not supported by the evidence.

"It is implied in this argument that the sale transactions between the United Kingdom and Jersey companies were genuine and that the accounts of the United Kingdom companies, as submitted to the Revenue, were accurate, that is to say that they were arm's length transactions and a proper consideration was paid by the United Kingdom companies for the goods represented by each purchase.

"The learned judge rejected the defence submissions, saying:

> 'I do not accept the proposition, perhaps the jury will, that sales and purchases do not cease to be real if the objective is to seek the dishonest reduction of tax liability.'

"The first question for this court is whether the judge was right in holding that there was sufficient evidence to go before the jury that these sale transactions were false and were a device employed by the United Kingdom companies to cheat the Revenue.

"It is the appellants' case that the Jersey companies set up by Charlton in Jersey for the furtherance of the goods invoicing scheme were properly incorporated and that the transactions in which they participated were genuine. The directors, who were nominees of the directors of the corresponding United Kingdom companies, were properly appointed. In these circumstances the Jersey companies were competent to enter into binding contracts. No question of agency arose. The profits realised from the company's commercial activities were the property of the Jersey company and not the United Kingdom company. The Jersey company was the contracting party with the supplier and in any dispute with the supplier, arising out of non-payment of the purchase price, the supplier would look to the Jersey company for its remedy.

"The Crown submit that the Jersey companies were a device or sham set up by the United Kingdom companies on the advice of Charlton for the purpose of tax evasion and that s 10 was irrelevant in this context.

"In support of its submissions the Crown point to the following matters:

> 1. Before the setting up of Charlton's scheme the United Kingdom companies dealt directly with the overseas suppliers. All the negotiations for the supply of the goods were conducted directly with the seller by the United Kingdom company. The details of the size of the consignment, the price and the arrangements for delivery were dealt with in this way. The goods

were then delivered directly to or to the order of the United Kingdom company. No other party was involved, nor was there any need for one. Why then, from a commercial point of view, should the United Kingdom companies introduce a Jersey-based company to sell them the same goods at an enhanced price?

2. The directors of the United Kingdom company continued to negotiate the purchases, fixing the price of each consignment and making the necessary arrangements for direct delivery. Most significantly, the United Kingdom directors instructed the Jersey company what price it was to charge for the goods in each transaction. The only explanation for such an arrangement was the creaming-off of part of the profits made by the United Kingdom company so that less corporation tax could be paid and funds would be built up offshore for the benefit of the United Kingdom directors.

"Mr Patience QC, who advanced the bulk of the argument for the appellants on this issue, pointed out that the Jersey company was used for other purposes unconnected with tax, certainly in the case of TSBL. The latter had difficulty in breaking into the domestic market because the overseas suppliers of the tyres already had their distribution arrangements in place. The only way of overcoming this difficulty was for the tyres to be ordered by an overseas company so that the quota arrangements set up by the supplier did not apply. In other words, the Jersey company had a commercial purpose. Furthermore, the Jersey company was also used in those days, that is during the 1980s, to supply goods to South Africa, thus evading trade sanctions.

"Evidence of these transactions was given by Mr Huckerby, one of the directors of TSBL. In those circumstances Mr Patience submits that there was a duty on the judge to leave the question of whether there were genuine commercial transactions to the jury. The TSBL counts in the indictment, counts 1 and 2, allege that the accused falsely represented that the apparent purchases were bona fide commercial transactions. Mr Patience argued that it was for the jury to decide whether the purchases were real or apparent.

"All these transactions were channelled through Fleet, which invoiced TSBL in the manner already described, by adding 10% to the price at which Fleet had, on the instructions of the directors of TSBL, purchased the tyres. As already observed, TSBL were not getting the tyres at the lower price because of the operation of the scheme. While Fleet may have been used for the purpose claimed by Huckerby, the transactions were not bona fide. It was left to the jury to pronounce upon the honesty of the scheme and they found that it was not. The Jersey companies were set up for one purpose—even though one of them may have been used for another. The function the Jersey companies performed had no commercial benefit. The only customer in each of the cases represented by the relevant counts was the corresponding United Kingdom company. The Jersey companies had no separate offices or any trade premises in which to carry on their businesses. As already observed, that was, in any case, limited to the processing of the invoices rendered to the United Kingdom companies. In these circumstances there was ample evidence upon which a jury could conclude that the Jersey companies were not genuine businesses and that the sales which they purportedly made to TSBL were not bona fide commercial transactions. The learned judge was right to reject the submissions. The terms of the indictment were correctly laid on the basis of this evidence.

"The section 10 point, to use an expression favoured by the learned judge, had no 'reality'. If the Jersey companies were genuine companies carrying on a lawful business based on commercial motives, then no doubt the directors had an obligation under s 10 to give the required notice to the Revenue. They did not, in fact, do so. The reasons are obvious: the effective directors who made all the decisions were those of the United Kingdom companies. Plainly there would be no point in revealing the existence of the Jersey companies as it would defeat the whole purpose of setting them up in the first place."

2.2.8 Comment on the Argument

2.2.8.1 The Section 10 Point

It is somewhat surprising that the section 10 point should have been argued so strenuously. It was a complete irrelevance. It ignored the vital issue and very possibly diverted attention from it. As Farquharson LJ rightly pointed out: "It is implied in this argument that the sale transactions between the United Kingdom and Jersey companies were genuine and that the accounts of the United Kingdom companies, as submitted to the Revenue, were accurate ..." Yet the crux of the Crown's case was that they were not. All the argument achieved was to emphasise that there might be liability for conspiring to cheat the public revenue as respects the profits of the Jersey companies! It lead the Court of Appeal to conclude, quite erroneously, that "The reasons [why the Jersey companies served no section 10 notices] are obvious: the effective directors who made all the decisions were those of the United Kingdom companies. Plainly there would be no point in revealing the existence of the Jersey companies as it would defeat the whole purpose of setting them up in the first place." I agree that the reasons are "obvious", but would respectfully disagree with what they were. From my experience of tax professionals in tax havens, especially in the 1980s, the likeliest explanation by far is that no one realised that the Jersey companies were technically resident in the United Kingdom and so liable to give notice.

2.2.8.2 The Fatal Flaws

While the law report does not set out the indictments, we are told in the judgment that:

> "Each of the appellants was charged in the relevant counts with cheating the Revenue by 'falsely representing that the apparent purchases (by the United Kingdom company) from (the Jersey company) were bona fide commercial transactions.' The defence argued that on the evidence the individual purchases by the United Kingdom company were bona fide commercial transactions and that the Crown had laid the wrong charge."

In my respectful view, the fatal flaw in the prosecution's case was already contained in the indictment. It was a complete irrelevance that the purchases were not *bona fide commercial* transactions. The only relevant question was whether they were *real* transactions. Even if they were not effected for a bona fide commercial purpose, they did not cease to be real. While the Revenue (as well as the Judge and the Court of Appeal) were in error, the defence simply compounded that error if they really did contend that the purchases were bona fide commercial transactions.

The trial judge fell into exactly the same error. He said:

> 'I do not accept the proposition, perhaps the jury will, that sales and purchases do not cease to be real if the objective is to seek the dishonest reduction of tax liability.'

Quite apart from the fact that the word "dishonest" begs the whole question, the trial judge had fallen into the fundamental error of considering that because a transaction is undertaken to reduce a tax liability, so it ceases to be real!

The Court of Appeal, after citing the judge's above comment, asked themselves whether he was right in holding that there was sufficient evidence to go before the jury that these sales transactions were false and were a device employed by the United Kingdom companies to cheat the Revenue. The judges noted the Crown's submissions. Why, it was argued, *from a commercial point of view*,[29] should the United Kingdom companies introduce a Jersey based company to sell them the same goods at an enhanced price?" Further, the Crown argued, the directors of the United Kingdom company continued to negotiate the purchases and instruct the Jersey company what price it was to charge for the goods in each transaction. The Crown contended that the only explanation for such arrangement was the creaming off of part of the profits made by the United Kingdom company so that less corporation tax could be paid and funds would be built up offshore for the benefit of the United Kingdom directors.

The short answer to the first point is that of course the interposition of the Jersey company was not commercial: it was effected with a view to lawfully avoiding tax. Yet that did not make its interposition any the less real. As to the second point, it is perfectly possible to have a scheme for the creaming off of profits based on *real* transactions. The fact that the directors of the United Kingdom company in effect carried on the business of the Jersey company was just another reason why the scheme did not work. Yet the vital questions - which were apparently nowhere raised - were why the scheme did not work and whether the directors knew it did not work. If, for example, the reason the scheme did not work was that the Jersey company was liable to United Kingdom corporation tax, then even if the directors were aware of that fact, they would still have been innocent of having presented to the Revenue false accounts of the English companies.

In those circumstances, the Court of Appeal stated flatly that "the transactions were not *bona fide*. It was left to the jury to pronounce upon the honesty of the scheme and they found that it was not. The Jersey companies were set up for one purpose - even though one of them may have been used for another. The function that the Jersey companies performed had no commercial benefit." The Court of Appeal concluded that "there was ample evidence upon which a jury could conclude that the Jersey companies were not genuine businesses and that the sales that they purportedly made to [the UK companies] were not *bona fide* commercial transactions. The learned judge was right to reject the submissions. The terms of the indictment were correctly laid on the basis of this evidence."

The judgment of the Court of Appeal is fundamentally flawed. It runs together two completely different questions:

(a) were the transactions genuine or were they a sham? and

(b) were they effected for commercial reasons or for the purposes of tax avoidance?

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29 Italics supplied.

To say that the transactions were not *bona fide* involves an ambiguity. It could mean that they were not *bona fide* transactions in the sense that they were not real transactions. On the other hand, it could mean that they were not *bona fide* commercial transactions in that they were effected for tax avoidance purposes.

2.2.9 Conclusion

The defendants were sentenced to imprisonment. They were convicted after a trial lasting six months before a jury of ordinary people whose only qualification was that they were on the electoral role, between 18 and 65, and were not peers, lunatics or practising barristers. Such persons would have found it very difficult to understand the distinction between a sham and a transaction entered into for a tax avoidance purpose even if it had been explained to them. It was not, because it was clearly not understood by the judge. The appeal was dismissed because it was likewise not understood by the members of the Court of Appeal. The Court of Appeal decision can only be described as thoroughly "unsafe and unsatisfactory".[30]

In my view, the matter should be referred by the Secretary of State to the Court of Appeal for reconsideration[31] and the Court should include at least one judge from the Chancery Division who is knowledgeable about tax and tax avoidance. If the appellants had any sense, they would ensure that their legal team included a barrister who understood the relevant tax law.

I do not criticise the judges of the Court of Appeal, who could not be expected to give a better judgment than the argument presented before them. I do not criticise counsel for the defendants, who were not tax practitioners. If I tried to defend one accused of tax fraud, except as part of a multi-disciplinary team, I am sure I would soon fall into errors on criminal procedure, yet I could hardly be criticised for doing the job badly [32]

2.2.10 The Moral

Churchill is reputed to have said that war was far too serious a matter to be left to generals. Perhaps the moral to be draw from this case is that criminal tax proceedings are far too serious a matter to be left to criminal lawyers.

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30 cf Criminal Appeal Act 1968 section 2(1)(a).

31 Under the Criminal Justice Act 1968 section 49.

32 Whether I might be criticised for accepting the instructions without at least a criminal junior is another matter.