The Offshore Tax Planning Review

TRANSFER OF ASSETS ABROAD: MR BRACKETT'S PROBLEM CASE

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1 The Question

For over forty years, following the House of Lords decision in *Latilla v Commissioners of Inland Revenue*[2], it was considered highly arguable that what is now Taxes Act 1988 section 739 (tax avoidance by transfer of assets abroad) 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. It is generally supposed that in *IRC v Brackett* and the related appeal of *Brackett v Chater*,[3] Hoffmann J killed the argument. But did he? He also made a highly controversial decision on the meaning of "power to enjoy" and a somewhat less controversial decision on "transfer of assets". What he had to say *en passant* about the meaning of "branch or agency" was also quite startling.

An unusual feature for a case which involved such abstruse matters was that the argument against the Revenue was presented by a taxpayer in person. As is often the case, counsel for the Revenue,[4] although an advocate of considerable ability, was not knowledgeable enough in this arcane area to prevent the judge's wilder excesses. The case might have been decided very differently had it been argued by counsel learned in this branch of the law. The judgment must for that reason carry less weight as a persuasive authority, so that another High Court judge could easily refuse to follow it if he thought it was wrong in principle. Regrettably, Special and General Commissioners are bound by it, except insofar as it can be shown to be plainly contrary to House of Lords authority.

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2 25 TC 107 (1943).

3 [1986] STC 521.

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2 The Facts of *Brackett*

The taxpayer, a chartered surveyor, was at all material times domiciled, resident and ordinarily resident in the United Kingdom. In February 1974 he settled £5 upon trust for his common law wife and the trustees of that settlement formed a Jersey company called Drishane, of which at all material times they held the whole of the issued capital. The settlement and company were not used for the purpose for which they had originally been formed. As part of a different strategy, it was decided that Drishane would set up as business consultants and would render to third parties the services previously rendered by the taxpayer. The taxpayer would be employed by Drishane to give these services on terms that he would draw no salary until he was 70 (in July 1979) and after that would be paid what the directors considered the company could afford in the circumstances then prevailing and the light of the profits which had been made in the intervening period.

Drishane's method of working, as found by the Special Commissioners, was that when the taxpayer was asked for business advice he would explain that he was employed by Drishane who must be instructed to advise. The advice would be worked out by him and passed verbally to the customer who would be invoiced by the company in Jersey when the taxpayer told the office there that the work had been done.

Over the years Drishane received money and paid sums to the trustee shareholders which were used to buy policies on the taxpayer's life. They apparently paid no money to the beneficiary. The company paid no remuneration up to June 1979 but paid £4,000 for the year ended 30th June 1980 and £5,500 for the following year.

The taxpayer also sold two houses to the company. The taxpayer was assessed to income tax on the income of the company on the basis that Taxes Act 1970 section 478[5] applied.

3 Was there a Transfer of Assets?

The first question was whether there had been a transfer of an asset within section 478. The Revenue did not seek to rely upon the transfer of the £5 to the Jersey trustees. They argued that by his agreement with the company the taxpayer created rights in the company, namely the right of the benefit of his professional services, from which it derived income. Although the matter was doubted, the Commissioners found as a fact that it would have been actionable as a breach of

[5] Now Taxes Act 1988 section 739.

contract if the taxpayer had sought to render professional services otherwise than in accordance with the agreement.[6]

The Special Commissioners found that there had not been a transfer of assets in the normal sense. Hoffmann J disagreed with them. He said, at page 538h:

> "The Special Commissioners rejected [the Revenue's argument that by entering into the contract of employment the taxpayer created rights vested in Drishane which were valuable and capable of being turned to account, and that by virtue of those rights, together with the associated operation of carrying on as business consultant, income became payable to Drishane] on three grounds. First, they said that the taxpayer's earning capacity was not an asset in respect of which rights could be transferred to or created in favour of Drishane. This suggests that the "rights of any kind" which can constitute assets under section 478(8) must be rights in rem subsisting over some other assets. I can see no basis for this restrictive interpretation. The Special Commissioners found, in my judgment rightly, that the contract of employment conferred on Drishane enforceable rights against the taxpayer. ... In my judgment they are ... rights which qualify as assets under section 478."

This is almost certainly correct. On the other hand, a strategy which does not involve the offshore company having any enforceable rights at all would not involve a transfer of assets. It might arguably involve a "settlement" for the purposes of the income tax settlement provisions. This would depend on the true *ratio* of the *Hayley Mills* case.[7]

His Lordship continued, at page 538j:

> "Second, the Special Commissioners said that the rights acquired by Drishane were not created by the taxpayer because they came into existence under a contract to which he was only one party. This, too, is in my view an unduly restrictive construction. The contract of employment is no doubt a bilateral transaction by which each party undertakes obligations and thereby confers rights on the other. In the context of section 478, and in particular the extended meaning of 'assets' contained in sub-section (8), it seems to me appropriate to describe the rights of one party under the contract as having been created by the other."

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6 See p 527b.

7 49 TC 367.

This is rather more questionable. Where the contract is onerous to the alleged transferor, one can see the force of the argument that by creating valuable rights in the recipient he has transferred an asset. Yet where the alleged transferor has given full consideration, it seems absurd to consider the rights conferred on the non-resident under the contract in isolation from his duties. Suppose a beneficiary under a discretionary will trust resident in Guernsey contracts to purchase from the trustees a house which he occupies rent-free. The effect of the contract and its completion is that he will have transferred an asset to the trustees, the cash, and as a result income will become payable to the trustees. Can it be supposed that the beneficiary thereby becomes a transferor, even though he has added no value to the trust fund?

One apparent solution to this problem would be for the courts to hold, as they did in the case of the income tax settlement provisions,[8] that one could not be a transferor unless the transfer involved bounty on one's part. Yet that would fail to catch some cases which clearly ought to be caught; for example, where I transfer investments to an offshore company in return for shares in it which I retain myself, allowing the income from the investments to accumulate within the company.[9]

Another solution, in appropriate cases only, would be for the beneficiary to prove that he was not a transferor because he did not have any tax-avoidance motive.[10]

4 Was Income "payable to" the Offshore Company?

The Special Commissioners also found that income had not "become payable" to Drishane as a result of the contract. Drishane had merely become entitled to trading receipts. They relied upon *Latilla v IRC*, particularly the speech of Lord Porter at pages 119-120. The ratio of the case was that where a foreign company was a member of a foreign *partnership*, that company's share of the partnership profits was "payable to" it within the meaning of Finance Act 1936 section 18, the original ancestor of Taxes Act 1988 section 739. Lord Porter said:

> "No doubt, it is true to say that an individual cannot pay himself, if "pay" be used in its strict sense, but no question of an individual's ability to do so arises here."

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8 See *IRC v Plummer* [1977] STC 440.

9 Cf *IRC v Levy* [1982] STC 442.

10 See now Taxes Act 1988 section 741 and *IRC v Willoughby* [1995] STC 143.

Thus, the question as to an individual trader was expressly left open. The same would apply to a corporate sole trader.

Hoffmann J also disagreed with the Special Commissioners' view that the trading income did not become payable to the company:[11]

> "Third, the Special Commissioners said that the contract did not result in income in the sense of the profits or gains of the trade of business consultancy becoming payable to Drishane within the meaning of section 478. All that became payable was the receipts of the trade: the profits arose in the hands of Drishane as a result of carrying on the business. The Commissioners distinguished *Latilla v IRC* ... on the ground that in that case there was a partnership which constituted a distinct fund out of which the taxpayer was entitled to a share of profits. Although there are references in the speeches to the income having been paid out of partnership funds, I do not think that this was an essential element in the reasoning. A partnership is not, after all, a separate legal entity. The receipts of the partnership belong to the partners immediately they are received, and the profits of the partnership arise to the partners in exactly the same way as in the case of a sole trader. What the House of Lords did in *Latilla* was to reject the submission that it was not conceptually possible for anything other than the receipts of the trade, as opposed to its profits or gains, to become 'payable' to the trader, and that therefore section 478 could not apply to trading profits. The judgment of Lawrence J ... which was approved by the House of Lords, seems to me to deal with this argument on the quite general basis than in the context of section 478 the words 'income becomes payable to' are wide enough to include not only the case in which the payment to the non-resident has in itself the quality of income but also the case of payments to a non-resident trader from which, after deduction of expenses, the income will arise."

This is a very curious interpretation of *Latilla*. With respect, it is quite clear that their Lordships were deliberately abstaining from deciding the general point as to whether trading profits arising to a sole trader were within section 478. By abstaining, they were giving a strong hint that they had considerable doubts as to whether they were. While it is true that the judgment of Lawrence J is so short and scanty on reasoning that one could speculate he decided against the taxpayer on any one of a number of grounds, the ratio of the House of Lords is crystal clear. Viscount Simon, in whose opinion Lords Atkin and Russell concurred, referred to the passage in the judgment of the Court of Appeal, delivered by the Master of the Rolls, Lord Greene, "which I would respectfully adopt as expressing with the greatest clearness and precision the true view of the application of section 18 to the facts of the case". Lord Greene's view was that "The share of the profits

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[11] At p 539a onwards.

of the partnership to which the company is entitled is that share which comes to it in accordance with the terms of the partnership. ... In the partnership's accounts, the company's undrawn share of profits would appear as a debt owing to the company. If the profits were under the control of the other partner, the company could, by appropriate proceedings, compel him to pay over its shares. If this is not income "payable" to the company, we do not know what is."

The *Latilla* point is therefore in my view still an open one, notwithstanding the judgment of Hoffmann J.

5 Power to Enjoy

His Lordship then went on to consider whether the taxpayer had "power to enjoy" any of the income of Drishane. Before Hoffmann J, the Crown relied only upon two heads, contained in section 478(5), namely:

> "(b) the receipt or accrual of income operates to increase the value to the individual of any assets held by him or for his benefit, or
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> (c) the individual receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income ..."

His Lordship noted section 478(6) which provides:

> "In determining whether an individual has power to enjoy income within the meaning of this section, regard should be had to the substantial result and effect of the transfer in any associated operations, and all benefits which may at any time accrue to the individual (whether or not he has rights at law or in equity in or to those benefits) as a result of the transfer and any associated operations shall be taken into account irrespective of the nature or form of the benefits."

His Lordship said, at page 540a:

> "In my judgment it is clear that the substantial result and effect of the transactions was that the taxpayer received benefits provided out of a tax-free fund accumulated by Drishane in Jersey from its exploitation of his services under the contract of employment. These benefits were the provision of liquidity, first in the form of cash payment for properties which could not be sold on acceptable terms in the open market; second, in the provision of money for repairs, which the taxpayer could not

> otherwise at the time have afforded to undertake; and, thirdly, in payments of salary and also in discharge of the taxpayer's moral obligations, which were constantly in his mind, to provide for [his common law wife] and his children. The taxpayer was therefore deemed to have power to enjoy income of Drishane under section 478(5)(c)."

This passage is extremely suspect. Some of the judge's remarks are contrary to established principle. Let us consider firstly the provision of liquidity. It was established by the House of Lords in *Lord Vestey's Executors v Commissioners of Inland Revenue*[12] that even where a transferor has a power to direct the trustees of an offshore trust to purchase investments from himself, it does not follow that trust income is "payable to or applicable for the benefit of the settlor". As Lord Simonds put it, at page 83: "I think that these words contemplate an out-and-out parting with the trust property or income by payment to the settlor in money or money's worth." Thus, the mere "provision of liquidity" does not involve power to enjoy.[13] How, then, did Hoffmann J make such a blunder? Quite simply because the authority was not cited to him. While it decided very many useful points in favour of the taxpayer, most of which are still good law, it is 123 pages long and extremely heavy going. It is consequently known only to a very small core of specialists.

Even more startling is the judge's conclusion that the taxpayer had power to enjoy income of the company which could be used in discharge of the taxpayer's moral obligations to provide for his common law wife and his children. Many settlements are set up under which the settlor and any spouse of his are excluded from benefit. The taxpayer will very often be making provision for children or other dependants to whom he feels he owes a moral obligation. It has always been supposed that the existence of a moral obligation is immaterial. The short technical answer is that nothing in the definition of "power to enjoy" justifies the judge's interpretation.

6 Branch or Agency

The Revenue had in the alternative assessed Mr Brackett on the basis that Drishane was carrying on a trade in the United Kingdom and was doing so through Mr Brackett as a branch or agency. Hoffmann J, in remarking *obiter* that he would have upheld the assessments, continued to astonish:[14]

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[12] 31 TC 1 (1949).

[13] The situation would, of course, be different, if the offshore trustees or company purchased an asset from the settlor/transferor at above its market value.

[14] At p 540h.

> "I find it difficult to imagine how a non-resident company which carries on a trade with any degree of continuity in the United Kingdom can do so otherwise than through a "branch or agency" ..."

Not one case was cited to him on this area. It is just as well that his remarks were mere *obiter dicta*.

7 The Moral

The first moral to be drawn from the case is: Offshore tax planning is not for the little man. Mr Brackett appears to have been but a small-time tax avoider. If you cannot afford counsel to fight your case who is rather more learned in tax law than the Revenue's counsel, then there is not much point in trying. In the current climate, you will find that as the judiciary is not well disposed to you, it is not enough to be as good as the other side: you need to be better.

Admittedly, it is by no means certain that Mr Brackett would have won if he briefed competent counsel. (He would have had a much better chance if he had instructed counsel to advise him on his initial arrangements.) Yet his chances would have been greatly improved.

The second moral is that this anti-taxpayer authority is not so daunting as it at first looks. While some of the judgment is sound, some is questionable, some suspect and some pure heresy.