HOUSE OF LORDS

Lord Nolan Lord Mustill Lord Hoffmann
Lord Clyde Lord Hutton

OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT IN THE CAUSE

COMMISSIONERS OF INLAND REVENUE
(APPELLANTS)

v.

WILLOUGHBY
(RESPONDENT) (FIRST APPEAL)

COMMISSIONERS OF INLAND REVENUE
(APPELLANTS)

v.

WILLOUGHBY
(RESPONDENT) (SECOND APPEAL)
(CONSOLIDATED APPEALS)

ON 10 JULY 1997

LORD NOLAN

My Lords,

In this appeal the Commissioners of Inland Revenue seek to uphold five assessments to income tax, four of which were made on the respondent Professor Willoughby for the years of assessment 1987/8 to 1990/1 inclusive and the fifth of which was made on his wife, the respondent Mrs. Willoughby, for the year of assessment 1990/1. The assessment upon Professor Willoughby for 1987/8 was made under section 478 of the Income and Corporation Taxes Act 1970. The remaining assessments were made under section 739 of the Income and Corporation Taxes Act 1988, which replaced and re-enacted section 478 of the Act of 1970 without material alteration. The origin of these sections is to be found in section 18 of the Finance Act

1936, a section whose provisions, either in their original or in their re-enacted form, have been considered by your Lordships' House on previous occasions. It will be convenient, and sufficient for all relevant purposes, if as a general rule I refer to these provisions in the form in which they appear in the Act of 1988.

Section 739 is the first section in Chapter III of Part XVII of the Act, which is concerned with the transfer of assets abroad. The purpose which the section is intended to serve appears from subsection (1) which reads as follows:

> "(1) Subject to section 747(4)(*b*), the following provisions of this section shall have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets by virtue or in consequence of which, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled outside the United Kingdom."

The charging provision upon which the Commissioners of Inland Revenue rely is subsection (2), which is in these terms:

> "(2) Where by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled outside the United Kingdom which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise, that income shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts."

By virtue of section 742(9)(*a*), the reference in section 739 to an individual is to be deemed to include the wife or husband of the individual. Section 742 also contains definitions of a number of the other words and phrases used in section 739, such as "transfer", "power to enjoy" and "associated operations," but fortunately it is unnecessary to consider any of these definitions because it is common ground between the parties that by virtue or in consequence of transfers of assets to Royal Life Insurance International Ltd. ("Royal Life"), a person resident or domiciled outside the United Kingdom, Professor and Mrs. Willoughby had power to enjoy income of Royal Life at a time when they were ordinarily resident in the United Kingdom, that is to say during the tax years for which the disputed income tax assessments were made upon them.

More specifically, the facts upon which the claim for tax is based are these. In 1973 Professor Willoughby took up employment as Professor of Law at the University of Hong Kong and he and Mrs. Willoughby became resident there. The University had a Provident Fund Scheme of which Professor Willoughby was a member, but he wished to make additional provision for his retirement. This additional provision included the taking out of three offshore personal portfolio bonds with Royal Life. The first bond (No. 1121) was taken out by Professor and Mrs. Willoughby jointly in August 1986, with funds provided by Professor Willoughby on his retirement as Professor of Law at the University of Hong Kong. The second bond

(No. 2387) was taken out by Mrs. Willoughby in March 1989, and was funded by the proceeds of an earlier offshore policy taken out by Professor and Mrs. Willoughby in 1979 with Save and Prosper International Insurance Ltd, ("Save and Prosper"), a Bermudan Insurance Company. The third bond (No. 3343) was taken out by Mrs. Willoughby in March 1990, and was funded by the proceeds of two further policies which had also been taken out by Professor and Mrs. Willoughby with Save and Prosper, in 1981 and 1982 respectively. There is no dispute that the payments of premiums on the taking out of these policies were transfers of assets to Royal Life for the purposes of section 739, nor is there any dispute about the amount of income arising from the investments comprised in the bonds which is the subject of the various assessments. The premium on the first bond was, however, paid on 8 August 1986 when both Professor and Mrs. Willoughby were still resident outside the United Kingdom. They contend that for this reason alone no liability to tax can arise upon the income of the first bond, because they say section 439 only applies to transfers of assets by individuals who are ordinarily resident in the United Kingdom at the time of the transfer.

The Special Commissioner accepted this contention. So did the Court of Appeal. My Lords, so do I. It has now been made clear, by the decision of your Lordships' House in *Vestey v. Inland Revenue Commissioners* [1980] A.C. 1148, reversing the first part of its decision in *Congreve v. Inland Revenue* [1948] T.C.30 163 that the charging provisions of the section can be applied only to the individual (or the wife or husband of the individual) who has made the relevant transfer of assets. At pp. 1174-1175 Lord Wilberforce described the section as being:

> ". . . directed against persons who transfer assets abroad; who by means of such transfers avoid tax, and who yet manage when resident in the United Kingdom to obtain or to be in a position to obtain benefits from those assets."

He added: "For myself I regard this as being the natural meaning of the section."

Mr. Henderson Q.C., for the Commissioners, pointed out that Lord Wilberforce, with whose speech Lord Salmon and Lord Keith of Kinkel agreed, expressed himself in terms which did not support the respondents' case but which were perfectly consistent with the Commissioners' case. Lord Wilberforce did not indicate that the individual to be charged had to be ordinarily resident in the United Kingdom at the time of the relevant transfer: on the contrary, he confined his references to the case of individuals who avoid tax "when resident in the United Kingdom."

This submission had not formed part of the Commissioners' written case, and was, I suspect, put forward by Mr. Henderson in argument to ward off the reliance placed in the written case of the respondents upon other passages in the *Vestey* speeches, in particular those of Viscount Dilhorne at p. 1183A-C and again Lord Keith of Kinkel at p. 1197F-H implying or assuming that liability depended upon the individual being ordinarily resident in the United Kingdom at the time of the transfer.

My Lords, I am satisfied that no useful purpose would be served in the present case by comparing these various passages in the *Vestey* speeches. Their Lordships in *Vestey* were simply not concerned with the particular question which arises in the present case. The transferors in *Vestey* had been ordinarily resident in the United

Kingdom at all material times. If I were to read anything relating to the present issue into the words used by Lord Wilberforce, it would be merely that he was leaving the matter open.

Leaving *Vestey* aside Mr. Henderson submitted that the suggested restriction of liability to individuals who were ordinarily resident here at the time of transfer was unwarranted by the statutory language, and would give rise to anomalies. It would not be sensible, he argued, to distinguish between the cases of an individual intending to take up residence in the United Kingdom, who made a transfer of assets with a view to the future avoidance of United Kingdom tax and who settled here a few days after the transfer, and another individual acting with precisely the same intention who settled here a few days before making an identical transfer. The sensible time at which to consider the question of residence, Mr. Henderson submitted, was the time at which the income from the transferred assets arose, and the avoidance of tax would (but for the section) take place. He reminded your Lordships that in the second part of its decision in *Congreve* this House had held that this latter approach should be adopted in relation to the residence of the transferee. In consequence of *Congreve* it matters not, for the purposes of the section, if the transferee was resident in the United Kingdom at the time of the transfer. It suffices if the transferee is non resident at the time when the relevant income arises and the avoidance of tax would otherwise take place. This part of the *Congreve* decision was unaffected by the subsequent decision in *Vestey*.

Finally, Mr. Henderson invoked the persuasive authority of a decision by the Court of Appeal in Northern Ireland, in the case of *Herdman v. Commissioners of Inland Revenue* 45 T.C. 394. One of the issues raised in *Herdman* was precisely that now raised before your Lordships, and it was resolved by the Court of Appeal in favour of the Commissioners of Inland Revenue. The Commissioners appealed unsuccessfully to your Lordships' House on another aspect of the case but there was no appeal by Mr. Herdman against the decision of the Court of Appeal on this point now in dispute.

Before considering the *Herdman* decision I must return to that part of the *Congreve* decision which was reversed by your Lordships' House in *Vestey*. In *Congreve* the Commissioners of Inland Revenue had successfully contended that for the purposes of liability under section 18 of the Finance Act 1936 the identity of the transferor of the assets in question was immaterial. I mention in passing that this contention ran directly counter to what the House of Commons had been told by the Financial Secretary to the Treasury when the Finance Bill of 1936 was being debated. The Financial Secretary had made it plain that, for liability to arise under the section the transfer of assets must have been made by the individual who was to be assessed. Indeed the Financial Secretary went further and said that "there has to be a transfer of assets abroad by an individual resident in this country": Hansard (H.C. Debates), Vol. 313 col. 685. That, of course, was long before the decision of your Lordships' House in *Pepper v. Hart* [1993] A.C. 593, and the possibility of referring to statements in Parliament as a guide to the intentions of the legislature was not considered. Even if it had been considered, it seems that no such reference would have been permitted under *Pepper v. Hart* principles, because your Lordships' House detected no ambiguity in the section. The leading speech was given by Lord Simonds, and at p. 205 he said:

> "The language of the section is plain. If there has been such a transfer as is mentioned in the introductory words, and if an individual has by means of such transfer (either alone or in conjunction with associated operations) acquired the rights referred to in the section, then the prescribed consequences follow."

This was the state of the law when the case of *Herdman* came before the Court of Appeal in Northern Ireland. In March 1951, Mr. Herdman while resident in the Republic of Ireland had transferred assets to a company which was also resident in the Republic. In October 1953 he became resident in the United Kingdom. Like Professor and Mrs. Willoughby in the present case, he contended that the section did not apply to him because he had not been ordinarily resident in the United Kingdom at the time of the transfer. Not surprisingly in the light of *Congreve*, the contention failed. After citing the speech of Lord Simonds in that case Lord MacDermott C.J., said at 45 T.C. 405:

> "The individual, accordingly, at whom section 412 is aimed is the person who seeks to avoid liability to charge, irrespective of whether he was or was not a participant in setting up the scheme for avoidance. This explains the reference to 'ordinarily resident in the United Kingdom,' for that points to those who would gain by the avoidance rather than to those who may have contrived it--perhaps in some earlier year. There seems no reason why the section should make such residence necessary for those who play a part in the scheme for avoidance at the time they do so, and I do not think the language used provides for such a requirement."

Mr. Henderson accepts that in so far as the *Herdman* decision was thus based upon the reasoning in *Congreve* it cannot avail him. He submits, however, that the reversal of *Congreve* by *Vestey* does not of itself lead to a conclusion that *Herdman* was wrongly decided, and he relies upon a passage in the judgment of Lord MacDermott immediately following that which I have quoted. In this passage Lord MacDermott said that "it would be surprising if Parliament had left such a large loophole open as would be the case" if the taxpayer's argument were correct, and that neither the wording of the section nor its underlying purpose seem to call for such "an anomalous distinction" as would arise if an individual who was resident in the United Kingdom at the time of the relevant transfer was caught by the section, but one who was non-resident at that time escaped liability. These, then, are the grounds upon which Mr. Henderson bases his case that the contention put forward by Professor and Mrs. Willoughby gives rise to anomalies, and is, he submits, unwarranted by the statutory language. I now return to that language.

The crucial words, as it seems to me, are those in subsection(1) which state that the section is to "have effect for the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfer of assets," coupled with the identification, in subsection (2), of "such an individual" as the subject of liability. What can the words "such an individual" refer to save for an individual of the kind described in subsection (1), that is an individual ordinarily resident in the United Kingdom seeking to avoid liability by means of transfers of assets? Although the point was not determined in *Vestey*, the view there taken that the individual to be charged must be the individual who made the transfer

seems to me to lead inevitably to the conclusion that the individual concerned must be the only type of transferor with which the section is concerned, and that is a transferor ordinarily resident in the United Kingdom. At the risk of seeming over confident in expressing an opinion about language which has been construed in diametrically opposite senses by your Lordships' House in the past, I would say in the light of *Vestey* that this is the natural and plain meaning of the words used.

I accept that in consequence the immigrant tax avoider who makes his dispositions before taking up residence in this country would escape liability under the section. I would for my part find it fruitless to speculate whether this consequence was foreseen and accepted, or arose through inadvertence. I would not, in any event, regard it as sufficiently astonishing in itself to cast doubt on what I have described as the natural meaning of the words used, and I do not believe that Lord MacDermott's remarks in *Herdman* were intended to go so far. As I read them, these remarks were made by way of comment upon what Lord MacDermott regarded as a satisfactory result of the *Congreve* decision rather than as an independent ground for his own decision.

I accept also that, at first sight, there appears to be something of an imbalance in a statutory requirement that the transferor must be ordinarily resident at the time of the transfer, but not the transferee. But the appearance of imbalance is, to my mind, little more than superficial. So far as the words used are concerned, it is to be noted that it is sufficient that income becomes payable to the non-resident person "by virtue or in consequence" of the transfer, either alone or in conjunction with associated operations. This wording is apt to cover the case where there has been a lapse of time between the transfer and the accrual of income to the non resident person. It is scarcely surprising that the legislature should have contemplated and provided for such a case. Otherwise it would have been too easy, as the facts of *Congreve* show, for liability under the section to be escaped by means of the relevant transfer being made to a resident person who thereafter became non resident.

I therefore conclude that the income from Bond No. 1121 does not fall within the embrace of subsections (1) and (2), because Professor Willoughby was not ordinarily resident in the U.K. when he purchased it. I would only add by way of postscript that Parliament, has now, by section 81 of the Finance Act 1997, changed the law in respect of income arising on or after 26 November 1996.

In the case of Bonds No. 2387 and No. 3343 which were taken out after Professor and Mrs. Willoughby had become ordinarily resident in the United Kingdom, section 739 is plainly applicable unless it is displaced by section 741 which reads as follows:

> "Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either -
> (*a*) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or
> (*b*) that the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation."

The Special Commissioner, Mr. Shirley, found that Professor and Mrs. Willoughby had discharged the burden of proof thus imposed upon them under both paragraph (*a*) and (*b*) in relation to all three policies, although strictly, of course, the exemption under section 741 was not required for the first policy.

I have mentioned that the first of the Royal Life bonds was taken out with the funds arising from the Hong Kong Provident Fund Scheme, and the second and third with the proceeds of three policies taken out by Professor and Mrs. Willoughby with Save and Prosper in Bermuda. I note in passing that each of these policies was certified by the Revenue under paragraph 1(1) (a) of Schedule 2 to the Finance Act 1975 as a "qualifying policy." The effect of such certification, under the law then in force, was that the profits of the policy on maturity would be entirely free of United Kingdom tax.

On 17 November 1983 the Revenue published a press release entitled "Offshore and Overseas Funds; Life Assurance Policies issued by Non-Resident Life Offices" The press release made clear the Government's intention to introduce legislation in the 1984 Finance Act which would:

> (i) In general prevent new policies of Life Assurance issued by Non-Resident Life Offices from being qualifying policies;
> (ii) Change the rules for computing the tax charge on profits received by U.K. resident policy holders from non-qualifying policies issued by non-resident life offices, so that on the maturity of the policy, and in certain other events, the holder would be liable to both basic and higher rate income tax on the profits.

Thus the total freedom from tax accorded to the benefits derived by Professor Willoughby from policies such as his Save and Prosper policies would cease to be available. The general rule for the future was that profits from policies issued by non-resident life offices would carry with them a liability to income tax on the benefits received at the time when they accrued. Until that time, however, the income and capital gains arising from the funds comprised in the policy could be accumulated free of United Kingdom tax. The new legislation bringing about these results was enacted in 1984 and is now incorporated in sections 539 to 554 of the Income and Corporation Taxes Act 1988.

In 1985 Professor Willoughby decided to take early retirement from the University and in July of that year he gave one year's notice accordingly. On retirement he was due to receive a lump sum payment from the University's Provident Fund. He sought advice from Personal Financial Consultants Limited ("PFC"), a company which he had earlier consulted before taking out his Save and Prosper policies. He accepted their advice to put his money into a single premium personal portfolio bond taken out with Royal Life.

It is common ground that Professor Willoughby's sole concern in consulting PFC was to provide for his ultimate retirement and to have an arrangement which would be flexible and also simple for his wife to deal with in the event of his death. At the time the first bond was taken out Professor Willoughby had made up his mind to return to live in the United Kingdom. The avoidance of United Kingdom tax was not in his

mind, although he was well aware of the tax aspects of the policy. He could hardly fail to be, because they were naturally stressed in the Royal Life advertising material. Professor and Mrs. Willoughby were, of course, resident in the United Kingdom when the second and third bonds were taken out. It was not suggested that there is any difference between the three bonds as regards either their inherent nature or the purposes for which they were acquired.

The principal feature distinguishing a personal portfolio bond from other bonds issued by Royal Life was that the purchaser of the personal portfolio bond retained the ability to choose, switch and manage the investments comprised in the fund to which the bond was linked. Personal portfolio bonds amounted to some 2 per cent of the total of bonds issued by Royal Life, the remainder being bonds linked to what was described as a fixed menu of investments, selected by Royal Life. It was only the personal portfolio bonds which were regarded by the Commissioners as falling foul of section 739. The remainder, it was accepted, were exempt by reasons of the provisions of section 741(*a*).

In order to understand the line thus drawn, submitted Mr. Henderson, it was essential to understand what was meant by "tax avoidance" for the purposes of section 741. Tax avoidance was to be distinguished from tax mitigation. The hall mark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hall mark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. Where the tax payer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax.

My Lords, I am content for my part to adopt these propositions as a generally helpful approach to the elusive concept of "tax avoidance", the more so since they owe much to the speeches of Lord Templeman and Lord Goff of Chieveley in *Ensign Tankers Leasing Ltd. v. Stokes* [1992] 1 A.C. 655 at 675C-676F and 681B-E. One of the traditional functions of the tax system is to promote socially desirable objectives by providing a favourable tax regime for those who pursue them. Individuals who make provision for their retirement or for greater financial security are a familiar example of those who have received such fiscal encouragement in various forms over the years. This, no doubt, is why the holders of qualifying policies, even those issued by non-resident companies, were granted exemption from tax on the benefits received. In a broad colloquial sense tax avoidance might be said to have been one of the main purposes of those who took out such policies, because plainly freedom from tax was one of the main attractions. But it would be absurd in the context of section 741 to describe as tax avoidance the acceptance of an offer of freedom from tax which Parliament has deliberately made. Tax avoidance within the meaning of section 741 is a course of action designed to conflict with or defeat the evident intention of Parliament. In saying this I am attempting to summarise, I hope accurately, the essence of Mr. Henderson's submissions, which I accept.

Proceeding on this basis Mr. Henderson contrasted the position of a United Kingdom resident who directly owned the underlying investments, and one who profited from the investments through the medium of the personal portfolio bond. The former would be liable to income tax at both basic and higher rates on the income from the investments, and also to capital gains tax on chargeable gains realised on disposal. The latter, under the tax regime applicable to overseas life policies, would pay no tax on the income or capital gains until the maturity of the bond or the occurrence of one of the other specified chargeable events.

In these circumstances, submitted Mr. Henderson, the underlying reality of the matter is that the holder of the Royal Life personal portfolio bond continues to manage and benefit from his own portfolio of investments, but by the insertion of the bond structure he escapes tax on the income and gains from those investments as they arise. Parliament cannot sensibly have intended the statutory taxation regime for offshore life policies to apply in such circumstances, so the purpose of an investor in such bonds cannot be characterised as mere tax mitigation.

My Lords, there is a basic fallacy in this argument. It lies in the proposition that the "underlying reality" is that the holder of the bond continues to manage and benefit from "his own portfolio of investments."
As my noble and learned friend Lord Hoffmann pointed out in the course of argument, so far from the underlying investments being owned by the bond holder, he has no legal or equitable interest in them whatever. As Clause 12 of the Policy makes clear the allocation of investment units to the bond for which the policy provides is purely notional. Units are referred to solely for the purpose of computing benefits under the policy. The reality in truth is that the bond holder has a contractual right to the benefits promised by the policy, no more and no less. It is therefore quite wrong to describe the bond holder as having, in the words of the appellants' printed case "in substance all the advantages of direct personal ownership without the tax disadvantages." The significance of this misdescription would become all too apparent if--perish the thought--Royal Life were to become insolvent and unable to meet its obligations to the bond holders.

This fallacy goes to the heart of the Commissioners' case. For the attack which they have launched against Professor and Mrs. Willoughby and other Royal Life bond holders is limited as I have said to those who hold personal portfolio bonds, that is to say bonds under which the bond holder has effective control of the investment policy, the Commissioners accepting that the remaining offshore bonds issued by Royal Life do not involve the avoidance of tax.

Like the Special Commissioner and the Court of Appeal, I am unable to follow the reasoning of the Commissioners. The personal portfolio bond holder may fare better or worse in terms of benefits by reason of his control over investment policy than does his fellow bond holder with the standard type of bond, but the difference between them seems to me to have nothing to do with tax or with tax avoidance. I can see no reason why Parliament should have intended to distinguish between them in fiscal terms.

It follows that, in agreement with the Court of Appeal, I would affirm the clear and carefully reasoned decision of the Special Commissioner upholding the

respondents' claim for exemption under section 741(*a*). It is therefore unnecessary to decide whether the Special Commissioner was equally entitled to hold that the respondents had established their claim to the protection conferred by section 741(*b*) on "bona fide commercial transactions . . . not designed for the purpose of avoiding liability to taxation." At first sight the point seems a straightforward one, but the precise scope of the phrase "bona fide commercial" as it occurs in the related context of section 703(1) of the Act, which also deals with tax avoidance, has given rise to dispute in a number of cases of which *Commissioners of Inland Revenue v. Goodwin* [1976] 1 W.L.R. 191, a decision of your Lordships' House is an example. In the instant case your Lordships did not think it necessary to call upon counsel for the respondents, and in company with the Court of Appeal I think it better to defer consideration of section 741(*b*) until a case arises in which it is crucial to the decision.

For these reasons, I would dismiss the appeal.

LORD MUSTILL

My Lords,

I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Nolan. For the reasons he gives I would dismiss the appeal.

LORD HOFFMANN

My Lords,

I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Nolan. For the reasons he gives I would also dismiss the appeal.

LORD CLYDE

My Lords,

I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Nolan. For the reasons he gives I would dismiss the appeal.

LORD HUTTON

My Lords,

I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Nolan. For the reasons he gives I also would dismiss the appeal.