Equity in Tax—All Change after 1873?

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Abstract
Until the late 19th century, equity and common law courts were separate. Tax courts emerged from equity, and today equitable principles and maxims govern the tax legislation, as well as His Majesty's Revenue & Customs guidance and the tribunals. Even though the equity and common law courts "fused" in 1873, there has only ever been one law: common law tempered by equity. Only the courts, remedies and procedures were different prior to 1873 (though a unified Court of Exchequer with equity and common law jurisdiction existed before 1841). The law was already a single entity by the late 19th century. There was no fusion of actual laws in 1873, only of courts and procedure. Equity already moderated tax law, with beneficial ownership being all that mattered for tax purposes then and today.

Keywords: equity; common law; fusion; tax; beneficial ownership; Supreme Court of Judicature Act 1873.

[A] INTRODUCTION

Of equity courts and equitable principles, one may think of dimly-lit Dickensian courts, *Bleak House* and prolonged will disputes—all consigned to history. However, even though such courts might seem to be Dickensian, the tax laws embedded in statute[1] are not. These same principles, now administered through modern tax tribunals, stem from those medieval courts of equity. Indeed, just beneath the surface—lightly bedecked by modern legislation, titles and practices—the equitable principles are still there today. The Supreme Court of Judicature Act 1873 (the 1873 Act) swept away the courts and replaced them with one Supreme Court of Judicature, consisting of the High Court and civil Court of Appeal. However, the laws themselves were not merged—equity and common law were always one. Equity has always been the conscience of common law; it was just the courts and procedures that were unified. This

[1] At more than 10 million words, the UK has the world's longest tax code (Hammond & Collins 2021).

poses the question: did the 1873 Act make any difference to substantive tax law? Did it actually fuse equity and common law whence modern tax laws stem?

This article suggests not; the 1873 Act made no difference with respect to merging law and equity. They were always one—with equity acting as a moderator over the law. The modern tax courts are, and always have been, courts of equity. The equitable principles of good conscience and tools (such as constructive trusts) are recognized and enforced by the tax courts; the best and most common example is that the courts (as well as much of the legislation and His Majesty's Revenue & Customs (HMRC)) recognize beneficial ownership as being that of the taxable person—not necessarily that of the legal owner. Beneficial ownership is a creation of equity and is at the cornerstone of tax law. After the 1873 Act, the procedures and courts simply caught up.

[B] COURTS OF CONSCIENCE

Prior to 1873, the equity courts consisted of the High Court of Chancery (or Chancery Court) and, until it lost its equitable jurisdiction following the Administration of Justice Act 1841, the Exchequer of Pleas (or Court of Exchequer). Both courts arose, and eventually split, from the medieval Curia Regis[2] and were based upon the premise of good conscience. Yntema quotes a description of equity as being the "conscience of the law" (1966-1967: 69). The common law has *rules*, whereas equity has *maxims and principles*. Prior to the Reformation, the Lord Chancellors were priests rather than lawyers, applying the principles of canon law and conscience where the common law would not reach (Neuberger 2012).

The common law courts consisted of the Court of Common Pleas and the King's/Queen's Bench, with their Serjeants-at-Law. The precedence and ridged procedure from those courts, observing the strict wording of the law, along with the Acts of Parliament, applied *in rem*, that is, to everyone. Equity, on the other hand, was to provide a just remedy to the case before (primarily) the Chancery Court when the inflexible common law provided no remedy. It was presided over by the Lord Chancellor (also known as the "Keeper of the King's Conscience", per Haydn 's 'dictionary of dates' (1871) because "the office of the Chancellor is to correct men's consciences" (*Earl of Oxford's case* (1615: 486)); it was essentially the Lord Chancellor's personal court. The rules of equity are applied *in personam*, that is, with a tailored obligation imposed as a specific solution to a specific

[2] The King's Council – the effective governors of the Kingdom who evolved into the modern Executive and Parliament.

problem onto the conscience of specific parties, for "the Chancellor will frustrate and set it aside, not for any error or defect in the judgment, but for the hard conscience of the party" (*Earl of Oxford's case*: 487). Critically though, in the event of any confliction, section 11 of the 1873 Act placed equity above common law. Even though the equity courts disappeared, the spirit did not.

[C] COMMON LAW AND EQUITY AS ONE?

Throughout the centuries, the common law and equity courts ran in parallel, as "two streams running side by side and do not mingle their waters" (Ashburne 1902: 22-23). As Taylor put it:

> Equity follows the law, so it is said, but the way it follows it is to prevent its being put into operation. This is illustrated in the case of equitable estoppel which does not convey the title but prevents the legal title from being used as such (1917: 24).

After the 1873 Act, the two different streams were arguably "fused", with equity and common law becoming one and being administered together in one court with one set of laws. Lord Diplock put forward that argument succinctly in the case of *United Scientific Holdings Ltd v Burnley Borough Council* (1978: 925) when he said:

> by 1977, this metaphor of two streams running side by side has, in my view, become both mischievous and deceptive. The innate conservatism of English lawyers made them slow to recognise that by the Supreme Court of Judicature Act 1873, the two systems of substantive and adjective law – formerly administered by the Courts of Law and the Courts of Chancery – were fused.

This view was also favoured by Wilkinson LJ in *Tinsley v Milligan* (1993: 28): "the equitable principle has become elided into the common law rule" and "the reality of the matter is that English Law has one single law of property made up of *legal and equitable principles*" (1993: 22, emphasis added).

Another argument is that common law and equity law remained distinct—they just happened to be administered in the same courts after 1873—a procedural/administrative fusion only with no mixing of the rules of equity and law themselves (Babafemi 1971). If, as the law now states (in section 49 of the Senior Courts Act 1981, being the modern version of section 11 of the 1873 Act), equity prevails over common law, that is surely proof that equity is still distinct from common law. Otherwise, why state that one prevails over another if they are now a single entity? (Neuberger 2010). However, despite being separate, the two laws/principles were not

in competition; indeed, the rules of equity worked with the common law, refined and shaped it—medieval common law lawyers would have been influenced by the rules of equity. As Bryson puts it:

> Thus, did equity supplement and complement the common law? Equity does not compete with the common law but tunes it more finely. The common law is, in theory, a complete system; equity is not a system within itself but rather relates to the common law and aids the common law. English justice came to consist of both common law and equity and would be defective without both. This was recognised as early as the fifteenth century (2001: 41)

This quote introduces a third possibility, which is that even before the 1873 Act, the two laws were *already* one, and had become greater than the sum of their parts. Common law is *the* law, with equity acting merely as a moderator, a means of interpretation and an overriding corrective principle that ensured that those laws were applied according to good conscience in spirit as well as in word. This is essentially what courts do today—they take a "purposive" rather than "literal" approach to the legislation, seeking what was the intention behind the legislation when it was formed, rather than simply what it says. In ancient times, Aristotle had written in his *Ethica Nichomachea* (cited by Baker 2018: 114) :

> "Aequitas" as a means of correcting general laws, which in their nature could not provide for every eventuality and to him it meant interpreting written laws according to the intention rather than the letter.

This concept of *aequitas* (or *epieikeia* in the original Greek) was simply "denoting what is fair and reasonable"; equity "which previously was contrasted with strict law, is a necessary adjustment, an epiphenomenon, of legal justice" (Yntema 1966-1967: 5). This followed through to ancient Rome, where the phrase "*summum ius summa iniuria*"[3] (penned by Von Stroux 1926) encapsulated the principles of equity from which the legal rules are interpreted.

This was essentially the foundation of the modern purposive approach (Thorpe 2021) and was cemented into United Kingdom (UK) law following the House of Lords case *Pepper v Hart* (1992, 1993) which allowed the admission of Hansard into court to help determine the intention of lawmakers (this was a tax case!). However, even as far back as the *Earl of Oxford's case*, the verdict by the Lord Chancellor Thomas Egerton was that equity guides common law—the two are rooted in separate courts with different procedures, but are essentially one:

[3] "The greatest right is the greatest injury."

> law and equity are distinct, both in their courts, their judges, and the rules of justice; and yet they both aim at one and the same end, which is to do right; as justice and mercy differ in their effects and operations, yet both join in the manifestation of God's glory (*Earl of Oxford's case*: 486).

Holdsworth (1915) reminds us that even the development of the common law was influenced by canon law in its development of the doctrine of consideration.

We could take what Lord Diplock said in *United Scientific Holdings Ltd* (ie "by the Supreme Court of Judicature Act 1873, the two systems … were fused") to mean "by [*the time of*] the Supreme Court of Judicature Act 1873 the two systems were fused". By 1873, the laws were already fused, the Act did nothing to change that. Until 1841, the Court of Exchequer held both common law and equitable jurisdiction, so the concept of a single body of law within a single court was nothing new (something the Master of Rolls, Sir John Romilly, had pointed out during the debates concerning the 1873 Act—as pointed out by Patrick Polden (2002)). All the 1873 Act did was unify the courts, allow procedures to be administered concurrently and allow suits for equitable remedies to be heard in courts of law and *vice versa*. There has only ever been one system of law, written as common law but tempered by the principles and maxims of equity and good conscience in the vein of *aequitas* of Aristotle's day. Taylor makes a similar analogy saying that suits should be neither in law nor equity, "but merely actions where the rights of the parties are to be determined by the law of the land" (1917: 11). The rules and principles are, and always have been, distinct, but they act as one body of law pulling in one direction for the greater good. Even whilst the 1873 Act was being considered, the Lord Chief Justice Sir Alexander Cockburn had no issue with equity prevailing over common law but wanted to ensure that once defects in the law had been identified and corrected, even the name "equity" should disappear, leaving only common law visible (essentially as it is now). His concern was simply over the transfer of power from the common law courts to a new High Court of Justice, which he regarded as simply being the Chancery Court "under the new and high-sounding name" (Polden 2002: 5). This too would suggest that there was no argument over the dominance of one principle over another, no denial even that there was one body of law; it was the merging of courts and consequential loss of power and patronage which was in the minds of many.

The application of the *in personam* jurisdiction of equity applying to specific individuals only could therefore also be brought into question. If equity and law are essentially one and the same whereby the law is

tainted, coloured and influenced by equity, then arguably equity now acts *in rem* (Hohfeld 1913; Durfee 1916) in the same way that rights and rules are respected and observed by everyone according to the manner in which they affect the common law. The application of equitable rules being applied *in personam* (Cook 1915) is just as valid for tax law. When a "wrong" is committed by an individual trying to divert income to someone else to avoid paying the necessary tax, equity will right that wrong by placing the beneficial (and taxable) ownership back onto that individual. A dishonest individual with ill-gotten financial gains is left with only *in personam* trusteeship obligations. The tax rules are applicable to everyone as much as any branch of common law so are applied *in rem*, but so too are the benefits and powers of restitution within equity. Equitable obligations are imposed *in personam* against a named individual, but they can equally be aimed at anyone who chooses to engage in dishonest activity—so the laws of equity are also arguably applied *in rem* as much as under the common law.

How does this all fit with modern tax rules?

The Exchequer Court began life as the first tax court by virtue of collecting revenue with only the King being able to bring cases; the defendants were debtors to the Crown, namely, taxpayers. The formal head of the Court was the Lord High Treasurer who worked alongside the Chancellor of the Exchequer, whence the modern post derived. Tax was therefore part and parcel of the Exchequer Court from its very beginning and it evolved into becoming another equity court. As Bryson puts it:

> The revenue function of the Exchequer remained its primary characteristic, and from this humble origin as a tax collector, it answered the call to administer equity. Like St Matthew, the Exchequer rose and went on to bigger and better things (1975: 33)

Equity expresses itself through the tax laws by its recognition of beneficial ownership's taking priority over legal ownership. The beneficial owner is the "real" owner, namely, the person who can benefit from the asset; the legal owner is merely the person whose name is on the title/deed. Beneficial ownership is a product of equity, the laws of conscience recognizing intent rather than the form. In most instances, the legal and beneficial owners are one and the same, but the separation of legal and beneficial ownership defines and creates a trust—another creation of equity. The common law courts would only ever recognize legal ownership: the strict letter of the law. Equity looks through this to recognize the existence and rights of a beneficial owner, and the equity courts would be the resolution to those injustices meted out by the inflexibility of the common law

courts. Today, it is the Senior Courts Act 1981 which places equity above common law. HMRC acknowledges this and its internal manual points out that: “Taxation of income is based on beneficial ownership, not legal ownership”[4] and:

> Capital Gains Tax is charged under TCGA92[5]/S1(1) on the disposal of assets, but it is important to bear in mind that the legal owner of an asset is not necessarily its beneficial owner and that it is beneficial ownership (not legal ownership) which the tax principally follows.[6]

The beneficial owner of an asset is also the person who provides the funds to purchase the asset—the legal owner will be the person in whose name the asset is purchased (and recognized as such by the common law), but the “real” owner is the person who provided the means to buy it—thus creating a resulting trust. Eyre CB, in the case of *Dyer v Dyer* (1788: 42) reminded us of who the beneficial owner is:

> the trust of a legal estate, whether freehold, copyhold, or leasehold; whether taken in the names of the purchasers and others jointly, or in the names of others without that of the purchaser; whether in the one name or several; whether jointly or successive – results to the man who advances the purchase-money.

Elsewhere in the tax statutes, the importance and primacy of beneficial ownership can be found with inheritance tax as per section 5 of the Inheritance Tax Act 1984: “For the purposes of this Act a person’s estate is the aggregate of all the property to which he is *beneficially entitled*” (emphasis added).

1930s anti-avoidance

The settlements legislation and Transfer of Assets Abroad (TOAA) rules are contained within sections 624-648 Income Tax (Trading and Other Income) Act 2005 (ITTOIA) and sections 714-751 Income Tax Act 2007 respectively. These rules essentially impose the beneficial ownership of an asset back on its original owner when that person attempts to transfer it to someone else—with the income tax following suit. The two sets of legislation trace their existing forms back to 1936 and, whilst they are different, with different mechanisms and aimed at different scenarios, they essentially do the same thing—reassign beneficial ownership back to the donor and impose a settlor-interested implied trust for income tax to follow (Thorpe 2021).

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4 HMRC Manual TSEM9305.

5 Taxation of Chargeable Gains Act 1992.

6 HMRC Manual CG11700P.

The settlements legislation concerned gifts of income to a settlor's spouse or minor unmarried child—theoretically a simple way for an individual to reduce their taxable income yet keeping it within the family. As far as spouses are concerned, the settlements legislation made little practical impact before 1990 as a wife's income was taxed as part of her husband's income anyway. After 1990, when "aggregation" ceased and the UK adopted independent taxation, the availability of a spouse to receive income and utilize their personal allowance and/or basic rate band made the settlements legislation more relevant. The rules essentially impose a settlor-interested trust on the person who now legally owns the income only as a trustee, as the beneficial ownership has been returned to the settlor. Gifts can be made to spouses without being caught by these rules if they include the underlying capital behind the income. In the *Arctic Systems case* (the colloquial name for *Jones v Garnett* (2007), this spousal "get out" saved Mr Jones from being taxed on his wife's share of their company's dividends from her equal shareholding following the artificial inflation of the distributable reserves (by his taking a small salary) due to his being creator/settlor of the company's income.

The TOAA rules likewise effectively impose a settlor-interested trust on the original settlor of the income (Thorpe 2021). When an asset is transferred to a non-UK-resident or domiciled person such that the UK resident still has the power to enjoy the resulting income, that resident is subject to income tax. The imposition of trusteeship onto a new legal owner, with beneficial ownership remaining with the original/real owner, is done through the mechanism of implied (resulting) trusts. In a similar vein, constructive trusts are also used by the equity courts to ensure that those who unjustly enrich themselves hold the legal title of their dishonest gains for the victims who are the beneficiaries. Unlike the settlements legislation, however, the TOAA rules are subject to an express "motive" exemption to ensure genuine commercial transactions are not caught. Only someone attempting to "commit" tax avoidance would be subject to the TOAA rules—a clear conscience will not invoke the intervention of equity.

As well as equity's recognizing the beneficial owner over the legal owner, it will also recognize what is right and just; the tax courts, with equity running through them like rock, will overturn the letter of the law if good conscience demands it.

[D] EQUITABLE PRINCIPLES IN THE TAX COURTS

Not only does the tax legislation put equitable principles at the forefront, beneficial ownership is cited in and enforced by Acts of Parliament, but the tax courts are also courts of conscience. Although the courts will obviously interpret the legislation and recognize the beneficial ownership bestowed therein, there are instances of the tax courts' applying the rules of equity with an inherent jurisdiction to correct a moral wrong, even though the case at common law seems "clear cut".

One example is the case of *Rebecca Vowles v HMRC* (2017). Miss Vowles was subject to a COP9 investigation by HMRC for dividends and benefits-in-kind (a company car) received by her but not declared. She was shareholder and director of the company in question (which was subsequently liquidated and investigated for fraud); so, on the face of it, she was liable for the income tax. However, it transpired that she was subject to physical abuse from her partner to whom in reality this business actually belonged; her legal ownership of the shares and directorship was a façade (as her partner was also disqualified from being a director). He was behind all correspondence and actions within the company and all of her finances; she was purely a figurehead acting upon his command. She did not, in reality, receive any dividends nor have any use of the company car. This argument was made in an appeal against the assessment which found favour with the First Tier Tribunal who said:

> Our finding is that while in law she was the shareholder, in equity it is clear that she held that share on trust for Mr Walker, even though neither party, not being lawyers, would have thought about the matter using such terminology. But the situation Ms Vowles described was clearly one where her name was used, but she had no beneficial interest in the company … We do not consider her the beneficial owner of the share in her name …
>
> In short, we find that Ms Vowles was not the person liable for the tax on the dividends. While we think s.385 (of ITTOIA 2005)[7] must be read as giving liability to a single person, in any event our finding is that whichever test in s.385 is applied, Ms Vowles was not the person liable to the tax. The dividend was not paid to her, it was not received by her and she was not in equity entitled to it (*Rebecca Vowles v HMRC* 2017: paragraphs 84-86)

[7] Sub-section 1 reads: "The person liable for any tax charged under this Chapter is— (a) the person to whom the distribution is made or is treated as made or (b) the person receiving or entitled to the distribution."

These paragraphs lay bare that the judiciary will call upon equitable principles which will take priority over any legal titles and procedures if good conscience demands it. The tribunal recognized that Ms Vowles's ownership of the share capital was as a trustee and that the beneficial (and thus taxable) ownership was elsewhere with the partner. Thus, the tribunal imposed a form of implied (constructive) trust—"*it is clear that she held that share on trust*" and that she was not "*in equity entitled*" (2017: paragraph 86, emphasis added) to the dividend. In addition, the tribunal effectively overlooked the fact that, for income tax purposes, Ms Vowles was a director—a *de jure* officer of the company and registered as such at Companies House. Whilst directors would normally be subject to income tax by having private use of a company car, and whilst Ms Vowles was a director, the tribunal held that this did not reflect reality and so she should be relieved from this legal obligation. The spirit of the medieval chancery courts is alive in an administrative tribunal of first instance.

Another example of the courts' role as a judge of conscience is the case of *David Patmore v HMRC* (2010) whereby the First Tier Tribunal imposed a constructive trust despite no invitation by either party to do so. HMRC sought to invoke the settlements legislation with respect to the transfer of a small number of "B" shares in the family company from Patmore to his wife and from which dividends were subsequently paid. HMRC argued that this was a settlement with the dividends on those "B" shares being taxed upon the "settlor", namely Mr Patmore. However, the First Tier Tribunal refused to agree—it held that there was an insufficient level of bounty by virtue of the fact that Mrs Patmore was still jointly liable for the debts which were incurred to buy the shares in the first place. Instead of finding that the beneficial taxable ownership of the "B" shares was on Mr Patmore, the tribunal found that Mrs Patmore was somehow the victim of an injustice by holding so few shares yet jointly responsible for the total debts behind the entire shareholding. The tribunal found that Mr Patmore held half of the "A" shares on constructive trust for his wife. The judge stated: "Mrs Patmore was entitled to half of the 85 "A" shares but in fact received only two "A" shares and the promise of almost valueless "B" shares" (2010: paragraph 59).

The judge also stated that:

> Either she (Mrs Patmore) intended to give up her entitlement in favour of her husband or she did not. I have found as a matter of fact that she did not intend a gift. This led me to conclude that Mr Patmore held some of the shares on constructive trust for her and that her receipt of the B shares and dividends up to 42.5% of the dividend paid did not therefore involve an element of bounty on his part (*David Patmore v HMRC*: paragraph 85).

What makes this case interesting from a perspective of examining the role of equity is that the imposition of a constructive trust occurred where neither party made any submissions regarding equitable remedies. The constructive trust is an equitable tool of restitution, traditionally imposing trusteeship upon the commissioner of a crime of dishonesty. However, the "new model" constructive trust[8] does the same with equitable wrongs—placing beneficial ownership in the hands of the wronged person; the person who committed an equitable, but not legal, wrong retains only their legal ownership of the asset. The tribunal judge, Barbara Mosedale, invoked this entirely on her own initiative based upon the inherent equitable jurisdiction of the courts. The tribunal, in rejecting HMRC's submissions of beneficial ownership remaining with Mr Patmore via the settlements legislation, could simply have respected the legal title of the shares. However, the judge didn't like the situation with the wife having so few shares yet half the liabilities, so she imposed the constructive trust to reassign Mrs Patmore greater degrees of beneficial ownership. This case demonstrates the inherent jurisdiction of the courts and shows that even without any prompting or argument, and without needing legislation to empower them, equitable principles are a ready weapon for the tax courts to combat any unconscionable behaviour.

[E] CONCLUSION

Whilst the 1873 Act seemingly placed equity ahead of common law, equity had already been prevalent in the tax courts long beforehand. The first tax court was an equity court; the principles of conscience and canon law guided and supervised the common law. The 1873 Act simply confirmed what had always been the case. Centuries on, equity still prevails within the tax courts by virtue of beneficial ownership—that "progeny of equity" (to quote Lord Denning)[9] which is the basis of taxation whereby any attempt to avoid tax by transferring the legal title of an asset is met by long-standing legislation which keeps the beneficial ownership with the real owner. By following the beneficial ownership, the tax courts are showing that equitable principles are all-important and that they are courts of equity which will overturn the letter of the law if good conscience demands it. The tax courts are, and always have been, courts of equity. The 1873 Act did nothing to change that; it only brought the courts and procedures together, or rather back together, thus resembling the pre-1841 Court of Exchequer as much as any new modern High Court.

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8 A phrase he used to describe "new model" constructive trusts when saying that "equity is not past the age of childbearing" in *Eves v Eves* [1975] EWCA Civ 3, [1975] 1 WLR 1338, 7.

9 Ibid.

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