Analysis

The changing limits of acceptable tax avoidance

SPEED READ **The Duke of Westminster principle is no longer sacrosanct. The courts increasingly apply a purposive interpretation to defeat artificial tax avoidance schemes, the DOTAS rules gives HMRC early warning of aggressive schemes, and a general anti-abuse rule will be introduced in 2013. The European Commission is also seeking to clamp down on complex and artificial cross-border arrangements. The distinction between tax avoidance and tax evasion has become blurred and, although successful in 1930, the Duke's attempt to reduce his surtax bill would now be regarded by many as unacceptable and morally repugnant.**

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When Hugh Grosvenor, 2nd Duke of Westminster, tried in the 1930s to reduce his surtax bill by paying his staff under seven-year deeds of covenant expressed to be in recognition of past services, on the understanding that they would not claim additional remuneration for future work, the House of Lords decided that this worked. In his famous enunciation of what came to be known as the 'Duke of Westminster principle'), Lord Tomlin confirmed that:

'Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax' (see *IRC v Duke of Westminster* [1936] AC 1 at 19).

Tax avoidance (using tax law to one's own advantage, to reduce one's tax liability by lawful means) has traditionally been distinguished from tax evasion (which involves dishonesty, for example by concealing income or assets or giving false information to the tax authorities). Tax evasion is, and will always remain, illegal.

However, the principle that one is entitled within the law to organise one's affairs so as to reduce one's tax liability is no longer accepted without question. Government ministers have publicly criticised well known entertainers and large multinational corporations, who have acted entirely within the law in seeking to minimise their tax liabilities, with Danny Alexander, chief secretary to the Treasury, describing them as 'the moral equivalent of benefit cheats', prime minister David Cameron describing some of their arrangements as 'quite frankly morally wrong', and George Osborne, chancellor of the exchequer, in his 2012 Budget speech equating tax evasion with 'aggressive' tax avoidance as 'morally repugnant'.

HMRC's working definition of tax avoidance is 'using the tax law to get a tax advantage that Parliament never intended.' It distinguishes this from 'tax planning', which it defines as 'using a tax allowance for the purposes intended by parliament.' Although HMRC acknowledges that, unlike tax evasion, tax avoidance is not illegal, it has obvious distaste for 'contrived artificial transactions that serve little or no purpose other than to produce a tax advantage'.

Judicial interpretation

If legislation appears ambiguous, the courts may look at the *Hansard* record of parliamentary proceedings for a clear indication by the promoter of the legislation as to its intended meaning. However, if the plain meaning of the words is clear, then the courts will generally give effect to it. Tax legislation is often very detailed and specific, and tax planning schemes have often successfully woven a path, sometimes in a highly artificial manner, through the detail.

Of course, the courts have always cast a sceptical eye over contrived tax avoidance schemes, and they have not hesitated to scrutinise the facts to see whether they stand up, or to apply a purposive interpretation to hold that, even though the case appears to fall within the strict letter of the law, it does not in fact do so when the law is properly interpreted to reflect the true intention of Parliament.

In 1982, the House of Lords established, in *WT Ramsay Ltd v IRC* [1982] AC 300, what became known as the '*Ramsay* principle' to defeat a ready-made scheme which sought to establish an allowable loss through a complex, and ultimately self-cancelling, series of transactions. The House decided that its task was to ascertain the true legal nature of the transaction and that, where this had pre-arranged artificial steps which served no commercial purpose other than to save tax, the proper approach was not to look too closely at the individual steps but to look at the effect of the combination of steps as a whole.

The *Ramsay* principle does not only apply to circular or self-cancelling schemes. Two years later, in *Furniss v Dawson* [1984] AC 474, the House of Lords held that steps inserted in a 'preordained series of transactions' should be disregarded for tax purposes if they had no commercial purpose other than tax avoidance; and, four years after that, it further held in *Craven v White* [1989] AC 398 that the same principle applied even if there was no absolute certainty that such steps would be taken, provided they did actually happen in the agreed order and there was at the time no practical likelihood that they would not do so.

However, the courts have been careful to stress that the *Ramsay* case was not intended to signal a departure from the Duke of Westminster principle. In 2001, Lord Hoffman explained in *Macniven v Westmoreland Investments Ltd* [2003] AC 311

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that it was simply a question of ascertaining what parliament meant by using the language of the statute and whether, upon its true construction, the statute applies to the transaction. Tax avoidance schemes either work or they do not; if they do not work, the reason is simply that upon the true construction of the statute, the transaction which was designed to avoid the charge to tax actually comes within it.

In 2004, the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684 unanimously agreed that the essence of the post-Ramsay approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. The House cited with approval a Hong Kong judge who had stated that 'the driving principle in the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts', and that 'the ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.'

However, although HMRC recognises that the courts have developed a more purposive approach, its quibble is that, in seeking to discern 'the intention of parliament' the courts focus on construing the relevant statutory provision in the context of the purpose of the statute as a whole, with only very limited consideration of external materials. It considers this can still produce results which, on a wider view, cannot have been intended by parliament.

Spotlights

The spotlights page on the HMRC website (www.hmrc.gov.uk/avoidance/spotlights.htm) publicises HMRC's views about the types of arrangements and specific schemes which it considers do not work as a matter of law, and is likely to challenge. It also provides some guidance on tax planning to be wary of, pointing out what it considers to be the particular drawbacks of specific schemes which might not otherwise be obvious and listing factors which HMRC consider to be indicators of artificial tax avoidance. The inclusion of one of these features does not necessarily mean that tax avoidance is involved, but the more of them which are present, the more likely it is that HMRC will see the arrangements as unacceptable tax avoidance and challenge the taxpayer's tax return.

The list of tax planning to be wary of reads as follows, and contains no real surprises:

- It sounds too good to be true.
- Artificial or contrived arrangements are involved.
- It seems very complex given what you want to do.
- There are guaranteed returns with apparently no risk.
- There are secrecy or confidentiality agreements.
- Upfront fees are payable or the arrangement is on a no win/no fee basis.
- The scheme is said to be vetted by a top lawyer or accountant but no details of their opinion are provided.
- The scheme is said to be approved by HMRC (it does not follow that this is true).
- Taxation of income is delayed or tax deductions accelerated.
- Tax benefits are disproportionate to the commercial activity.
- Offshore companies or trusts are involved for no sound commercial reason.
- The involvement of professional trustees is claimed to guarantee that the arrangements succeed.
- A tax haven or banking secrecy country is involved without any sound commercial reason.
- Tax exempt entities, such as pension funds, are involved inappropriately.
- It contains exit arrangements designed to sidestep tax consequences.
- It involves money going in a circle back to where it started.
- Low risk loans to be paid off by future earnings are involved.
- The scheme promoter lends the funding needed.
- There is a requirement to take out insurance against the failure of the tax planning to deliver the tax benefits.

TAARs and DOTAS

HMRC believes that most of the marketed schemes now being promoted would fail if challenged in court. Its success rate in challenging such schemes has been very high. The report of the National Audit Office, *Tax avoidance: tackling marketed avoidance schemes* (published on 21 November 2012), reveals that, since April 2010, HMRC has begun litigation in 110 avoidance cases, and has so far won 51 of the 60 (85%) where judgment has been given. However, litigation takes time, as it can take several years to collect the evidence to demonstrate that a scheme does not work, followed by a further wait of over 18 months for the scheme users' tax returns which HMRC need to investigate properly. The NAO report reveals that, as at 31 August 2012, there were 41,000 open avoidance cases relating to marketed schemes used by individuals and smaller companies, of which the majority had been open for between one and five years and the oldest dated back to the early 1990s. However, HMRC has not yet worked out how to measure the effectiveness of its anti-avoidance strategy, and there is no evidence that the use of marketed tax avoidance schemes is decreasing.

Accordingly, the government may choose instead to legislate to change the law.

Each year's budget speech will contain a fair sprinkling of targeted anti-avoidance rules (TAARs) which are designed to counter specific schemes of which HMRC has become aware. Many TAARs provide that they are not triggered if the taxpayer can show the transaction in question was carried out for bona fide commercial reasons and that tax avoidance was not the main purpose, or one of the main purposes, of the transaction.

However, this is a reactive situation and, as fast as parliament legislates to close one perceived loophole, tax advisers soon dream up another. Accordingly, in 2004, parliament introduced the disclosure of tax avoidance schemes (DOTAS) rules in an attempt to gain early warning of the latest thinking on tax avoidance schemes, which HMRC can then challenge or block by TAARs if it considers them to be aggressive and unfair.

Under the DOTAS rules, the promoters (or, in some cases, the users) of tax avoidance schemes containing specified hallmarks must disclose information to HMRC, normally within five days of marketing the scheme or first offering it to clients, explaining how it is intended to work. HMRC will then register the scheme and give it a reference number, which the promoter must give to all clients using the scheme and the clients must include in their tax returns. The promoters must also give to HMRC, on a quarterly basis, the names and addresses of the clients who have implemented the scheme. Since this is often insufficient to enable HMRC to correctly match the clients to HMRC's taxpayer records, the draft Finance Bill 2013, published on 6 December 2012, contains provisions requiring clients to give the promoters details of their unique taxpayer reference number or their national insurance number within 10 days of being given the scheme reference number, or of entering into a transaction pursuant to the scheme if sooner; and the promoter must provide this additional information to HMRC.

The draft Finance Bill also contains clauses which provide that, if HMRC suspects that someone other than the notified clients are likely to be party to the arrangements, it can serve notice on the promoter requiring him to provide, within 10 days of the date he receives the notice or such longer period as HMRC may allow, the names, addresses and UTR or NI number of anyone else the promoter might reasonably be expected to know is or is likely to be a party to the arrangements.

The hallmarks include confidentiality from other promoters, confidentiality from HMRC, a premium fee, off-market pricing of financial products, standardised tax products, loss schemes for individuals, certain leasing arrangements and certain pensions anti-avoidance arrangements.

If HMRC decides the scheme should be blocked, it will usually announce this in a press release, and a TAAR will then be introduced in the next Finance Act, with retrospective effect from the date of the press release. When the tax underpaid as a result of using the scheme is eventually paid, an additional charge is levied to remove the cash flow benefit of using the scheme. Taxpayers can avoid the additional charge by paying the tax upfront.

The schemes featured in spotlights are generally those which HMRC consider has the widest implications and about which there is the greatest need to warn potential users. They will often be schemes that have been disclosed to HMRC under the DOTAS rules.

Since 2004, the DOTAS rules have been progressively tightened to require more detailed disclosure and include a wider variety of schemes, additional taxes, and higher penalties for non-compliance. The November 2012 NAO report found that the scheme has been effective in giving HMRC early warning of avoidance schemes and the scale of tax potentially at risk. Between 2004/05 and 20011/12, a total of 2,289 schemes have been disclosed, with a high number of initial disclosures levelling off to between 118 and 177 in each of the last four years. This has enabled HMRC to act much more promptly in initiating specific changes to the law (93 since 2004) designed to counter them. The NAO report found that changes in tax law had reduced the opportunities for tax avoidance, and the larger accountancy practices were now less active in this area. However, the NAO concluded that, despite the headway HMRC has made in closing legal loopholes and reducing the opportunities for avoidance, this had not prevented between 50 and 100 smaller specialist firms from continuing to sell highly contrived schemes to large numbers of taxpayers, depriving the public finances of billions of pounds. It found little evidence that HMRC was making progress in addressing this problem, and concluded that it needed to be vigorous in seeking more effective counter measures.

GAAR

In December 2010, the government wished to go further, and asked Graham Aaronson QC to consider whether it was possible to draft a general anti-avoidance rule (GAAR) which could deter and counter tax avoidance with sufficient certainty, but without creating undue uncertainty or expense and jeopardising the perceived attractiveness to business of the UK tax regime. His report in November 2011 concluded that it was, though his proposals for a general *anti-abuse* rule were narrower and more specific than the general *anti-avoidance* rules which have been introduced in many other countries. Clauses to implement the Aaronson proposals are contained in the draft Finance Bill 2013.

The GAAR will enable the courts to go beyond the normal law rules of interpretation and look to parliament's original intention, even when the legislation is not ambiguous. It will be targeted at the more 'abusive' tax avoidance schemes which, because they are often complex and/or novel, could not have been contemplated directly when the relevant legislation was drafted, and it is not intended to affect what the Aaronson report described as 'the centre ground of tax planning'.

When the discussion moves from what is lawful to what is morally acceptable, the borderline is not always clear and, indeed, may change over time

In its present form (which may change before the Finance Bill is enacted), it will enable tax planning arrangements to be challenged if:

- having regard to all the circumstances, it would be reasonable to conclude that their main purpose, or one of their main purposes, was to obtain a tax advantage; and
- they are 'abusive', which means they cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances, including the relevant tax provisions and any principles on which they are based (whether express or implied), their policy objectives, and any shortcomings in them that the arrangements are intended to exploit, their substantive results and any other arrangement of which they form part.

The draft legislation indicates non-exhaustive indications of tax arrangements which might be considered abusive, including arrangements which result in income, profits or gains which are significantly lower, or deductions or losses which are significantly higher, for tax purposes, than the corresponding amounts for economic purposes, involve consideration or value which is significantly different from market value, and arrangements which result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid.

If the arrangements are abusive then, subject to compliance with the specified procedural requirements, the draft legislation gives HMRC power to do whatever is just and reasonable to counteract the tax advantages arising from the arrangements. What is 'just and reasonable' would depend upon the facts of the particular case and the tax provisions being exploited, but might include treating an arrangement that has no significant purpose other than to achieve the abusive tax advantage as if it did not take place, or denying relief for any artificial losses that are said to arise.

The European dimension

In March 2012, the European Council of the member states asked the European Commission to 'rapidly develop concrete ways to improve the fight against tax fraud and tax evasion', and the Commission's action plan was published in December 2012 (see *Commission recommendation of 6 December 2012 on aggressive tax planning (2012/772/EU)*, available via www.lexisurl.com/bm7Ht). This will now be considered by EU finance ministers and the European parliament. The Commission estimates that around €1trn a year is lost to tax evasion and avoidance in the EU, and says that, while countries around the world have traditionally treated tax planning as a legitimate practice, structures to shift taxable profits towards states with beneficial tax regimes have become ever-more sophisticated over time, and 'reduce tax liability through strictly legal arrangements which however contradict the intent of the law'.

The Commission wishes to clamp down on 'complex and sometimes artificial' arrangements which taxpayers may use to relocate their tax base to other jurisdictions, or to take advantage of mismatches in national laws to avoid income from being taxed anywhere.

The action plan contains a comprehensive set of measures, which are designed to help member states protect their tax bases and 'recapture billions of euro legitimately due' by taking the same general approach towards aggressive tax planning.

In particular, the action plan recommends harmonising the definition of tax havens and the rules for dealing with them; strengthening double tax treaties to prevent companies active in more than two countries from misusing them to avoid paying tax in either; and tackling tax avoidance (which it says is 'euphemistically known as aggressive tax planning') by introducing common general anti-abuse rules which would allow the tax authorities in all member states to ignore artificial arrangements carried out for tax avoidance purposes and impose tax on the basis of actual economic substance.

The action plan suggests an arrangement should be considered to be designed for tax avoidance purposes if, regardless of any subjective intentions of the taxpayer, it defeats the object, spirit and purpose of the tax provisions that would otherwise apply and, in all the circumstances, any other possible purpose appears 'at most negligible'; and that it should be considered artificial if:

- the legal characterisation of its individual steps is inconsistent with the legal substance of the arrangement as a whole;
- it is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct;
- it includes elements which have the effect of offsetting or cancelling each other;
- it involves transactions which are circular in nature;
- it results in a significant tax benefit which is not reflected in the business risks taken by the taxpayer or its cash flows; or
- the expected pre-tax profit is insignificant in comparison to the amount of the expected tax benefit.

The morality of tax avoidance

An article in *The Times* in June 2012 entitled 'Pay tax according to conscience, not the law' advised that 'instead of asking their accountants if a tax avoidance scheme is legal, the rich should ask themselves: is it moral?', and the paper's leader column a few days later maintained that using a tax avoidance scheme, even if within the law, constitutes 'a form of cheating'.

The European Commission also considers that there is a need to ensure that the burden of taxation is shared fairly, in line with the choices made by individual governments, and believes that aggressive tax planning is contrary to the principles of corporate social responsibility.

In today's era of austerity, there is much emphasis on the need for the better off to pay their 'fair share', whatever that is; and there seems to be a blurring of the traditional distinction between tax avoidance and tax evasion, with the language increasingly distinguishing further between acceptable tax planning and unacceptable tax avoidance.

For example, in his foreword to the March 2011 Treasury discussion document *Tackling tax avoidance*, David Gauke (exchequer secretary to the Treasury) wrote: '... being open for business does not mean being open to tax avoidance ... we expect everyone to pay their fair share. And where we see tax avoidance, we will crack down on it.' For this purpose, he defined tax avoidance as 'reducing tax liabilities by using the tax law to get a tax advantage that parliament never intended'.

In March 2012, Mr Gauke wrote in the *Daily Telegraph* that '... it is unfair that while the vast majority of businesses pay their full tax bill, others seek to avoid doing so. Of course, like anyone, businesses should pay what they owe and get advice to ensure they do not pay more, and my natural inclination is that it should be as little as possible. However, he added 'the government is clear that we will clamp down on tax avoidance where we see *aggressive and abusive attempts to escape paying a fair share*' (emphasis added).

In the July 2012 consultation document *Lifting the lid on tax avoidance schemes* (available via www.lexisurl.com/VHeoX), HMRC went further: 'Tax avoidance involves using the tax law to gain an advantage that parliament never intended and frequently involves contrived, artificial transactions that serve little or no purpose other than to reduce tax liability. And it enables some taxpayers to gain an unfair advantage, undermining confidence in the tax system' (para 2.1).

On 6 December 2012, Margaret Hodge MP, chair of the House of Commons' Public Accounts Committee, declared that promoters of tax avoidance schemes were 'running rings' around HMRC, in ways that the public would consider 'completely and utterly and totally immoral'

As part of its determination to make everyone pay their 'fair share', the government is proposing to introduce in the Finance Bill 2013 a cap of 25%, or £50,000 if greater, on the amount of income tax relief which can be claimed. The cap will not apply to reliefs which already have their own caps, such as pension contributions and enterprise investment scheme relief, but nevertheless it effectively means that anyone earning more than £50,000 a year will pay tax on at least 25% of his income. Whether this is fair if it prevents a businessman who has used his large redundancy pay off to start a business which fails from offsetting the loss against the tax on his redundancy payment, or hits charities hard when their donors find it much less attractive to make large donations, is a matter for debate.

More recently, in December 2012, we have seen coffee chain Starbucks pressurised into agreeing not to claim tax deductions it could lawfully claim for the royalties it pays, the coffee it purchases, the interest it pays on inter-company loans, or for capital allowances and losses carried forward, in order artificially to create a taxable profit in the UK. If it had continued to claim these deductions in accordance with its legal entitlement, it would have continued to make losses, but this would not have satisfied demands from the government, press and public that it should pay its 'fair share'. Whether this arbitrary and illogical solution produces a fairer result than a more intensive review of its transfer pricing policies or a change in the law is also open to debate.

Where does this leave us?

Of course, when the discussion moves from what is lawful to what is morally acceptable, the borderline is not always clear and, indeed, may change over time. However, whilst lip service continues to be paid to the Duke of Westminster principle, it seems fairly clear that, were Hugh Grosvenor to seek today to reduce his surtax bill by paying his staff under seven-year deeds of covenant expressed to be in recognition of past services, this would now be regarded by many as unacceptable tax avoidance and morally repugnant. ■

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