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BENEFICIARIES OF TRUSTS AND FOUNDATIONS

Philip Baker

Foundations are not a new invention. They have a long existence: they were used particularly as structures to hold property for religious purposes in the Medieval period in continental Europe. The Catholic Church, and its various manifestations, existed as foundations. In countries like Austria, Germany and Liechtenstein we have had *Stiftungs*, and, in the Netherlands, we have had *Stichtings*, for many hundreds of years.

Most of those foundations were set up for religious or charitable purposes. The more recent development though – and that is the one that I am focusing on – is the development of private foundations for family members. I suppose that the Ph.D thesis that is latent here is: how far is it possible to develop an institution, which originated for charitable and religious objects, into an institution for private family members?

You can chart this more recent development through the history of recent legislation. Most of this legislation is in the *Private Foundations Handbook*[1]. The starting point is, of course, the 26th January 1926 *Personen und Gellsellschaftsrecht* of Liechtenstein, which introduced the Liechtenstein trust, the Liechtenstein *Anstalt* and, of course, the *Stiftung* – the Liechtenstein foundation. If anybody wants to read a critical appraisal from the early 1990s of foundations, there is an interesting book by an American academic,

Ramati, called *Liechtenstein's Uncertain Foundations*, where he raises queries about the nature and formation of *Stiftungs*.

I put a query against the Cyprus law, because it strikes me that the Cyprus law is more of a law for organisations rather than for private foundations, though it may well be that, in fact, Cyprus foundations have been established for families rather than for a purpose.

I suppose the big lift comes in 1995, when Panama introduced legislation on private foundations, and then it has really picked up in the Caribbean in the last five years – St. Kitts in 2003, the Bahamas and Nevis in 2004, Anguilla, Antigua, and an amendment to the law in Malta in 2006, and, as Nigel Goodeve-Docker and Michael Betley say, Jersey and Guernsey are presently considering introducing foundation legislation, perhaps later in 2007 or in 2008.

I imagine many people will know that the key to a foundation is that it is a separate legal entity: it has separate personality, and it owns assets in its own right; the assets in the fund belong to the foundation. And, just like other companies, it is incorporated by entry on a register – maintained, generally, by the Registrar of Companies, and the Registrar normally issues a certificate with the name, registration number and various other details about the foundation.

A key feature is that, unlike other companies, there are no shareholders: the entity is, in a sense, ownerless. It has a founder who has contributed the assets, though the

existence of "accommodation founders" (people who lend their names to setting up a foundation) is not unusual, and the founder can reserve for himself or herself various powers – powers to revoke, powers to change the by-laws, powers to add or remove beneficiaries, powers to remove the Foundation Council. So, generally, the founder has substantial control - if he wishes it – through the constituent documents. There is a Foundation Council or Board (there is no common terminology as yet), and they have the responsibility of managing the assets and utilising them for the purpose of the foundation - maintaining the beneficiaries or advancing the particular purpose. It is said (and I shall come back to this later) that the duties of the councillors are contractual – not fiduciary, and that they are to be distinguished from the duties of trustees – who are clearly fiduciaries. As I have indicated, the foundation may have a purpose (though it does not have to be a charitable purpose), or it may have named beneficiaries. Or it may have beneficiaries who are members of a class, and it is that type of foundation I am primarily interested in here.

A foundation requires certain constituent documents. It must have a charter, a declaration – something like a company's memorandum and articles combined – which establishes the foundation. Generally, it will have sub-rules, by-laws, rules, articles – variously known: that is not an absolute requirement. Many of the laws say that it must have a charter but does not need to have – though it usually will have – by-laws. These will often contain information about the beneficiaries and the

administration of the foundation. Because they are not generally established in common law jurisdictions, or in those jurisdictions that are common law but do not apply the perpetuity rules, none of the foundations as far as I have seen are subject to a perpetuity period. On the other hand, many of the laws (for reasons I shall come on to explain) provide for the foundation to be under a degree of official control or scrutiny. The Financial Services Commissioner (or his equivalent) has the power to investigate, to appoint investigators, and to look into the affairs of a foundation. Most of the laws require the foundation to have a registered agent and provide that there can be a protector, a guardian or an adviser, who watches over the Foundation Council. Quite a lot of the laws have the rather clever provision that the foundation can continue in another jurisdiction, or move into the jurisdiction from another jurisdiction.

"Why would anyone – given the availability of the trust (the greatest invention of the common law world) – consider ever using a foundation?" I take that quotation from the discussion document in Jersey. In Jersey, the main reason given was that it is believed there is a strong commercial demand for foundations, particularly from clients in civil law jurisdictions, who may not feel comfortable with trust structures. I have heard comments like that made for twenty years or so. I have to say, I am not sure I believe them. My own experience with potential settlors of trusts is that most people contemplating setting up a trust are not that unsophisticated. I bear in mind a particular experience recently in establishing two extremely complicated

structures on behalf of settlors, both of whom came from civil law traditions, but who were very comfortable with the trust concept. I wonder whether high-net-worth individuals these days really are that uncomfortable with the trust structure. I think sometimes they may be rather more uncomfortable with the trustees rather than with the trust structure, but I leave that for separate discussion.

No doubt, among the reasons for creating foundations, is the ability of the founder to retain significant rights. But, of course, that has inherent dangers, including the possibility of a conflict between the founder and the Foundation Council, and the probability of conflict between the founder and those who thought they were to be the beneficiaries of the foundation.

The lack of shareholders is another attraction – the idea of an entity that really is ownerless, so that the only owner of the assets is the entity, and there is nobody above that. I suspect that one of the features that may be seen as attractive is the lack of rights for beneficiaries, which I shall come on to in a moment. But it is worth bearing in mind that, looking at the legislation, it seems to me that there has been a *quid pro quo:* for the lack of shareholders, the lack of rights of beneficiaries, the legislature has said, "Who then is to control the Foundation Council?" There are no shareholders who ultimately own the assets and the beneficiaries have limited rights. The answer has been in the form of public scrutiny and official supervision, and it seems to me that

that is the *quid pro quo*. The founder has the choice. Does he want to have beneficiaries supervising the trustees? Or does he want to have official supervision by the Financial Services Commissioner or his investigator instead?

How would one characterise a foundation? Is it a company? Is it a settlement? The answer, I suspect, is that it can probably meet the definitions of both. It is a body corporate, and so I expect it would come within the definition of a company in any jurisdiction. On the other hand, if you look at the definition of a settlement for UK inheritance tax purposes: a disposition of property, property held for persons in succession subject to a contingency, then – depending on the actual terms – I imagine a foundation could come within that definition as well. It is a concern that I have had with *Anstalts*, and it is certainly a concern I have with *Stiftungs* and other foundations, that some revenue authorities could choose to apply either the provisions dealing with companies, or the provisions dealing with trusts – whichever would give them the best result. That certainly has been my concern in the United Kingdom – that, on capital gains, you could have s.13 TCGA 1992 or you could have ss.86 and 87 applying at the choice of the revenue authority, depending on the actual terms of the particular foundation itself. Are they opaque or transparent? Would the income be seen as flowing through to the beneficiaries? That, I think, must depend upon the actual terms of the foundation itself.

What about the nature of a founder's rights? Would the founder be treated as really having alienated the assets, if the founder has retained substantial control? In particular, might those rights be characterised as a general power of appointment over the assets, which take them back – certainly for inheritance tax purposes – into the founder's estate? Those are a number of issues that would need to be addressed if one was ever contemplating a foundation, and it being viewed from a country like the United Kingdom or the United States.

It is said that the Councillors' duties are contractual. I have a bit of a difficulty with that, because I ask the question: contract with whom? Is it a contract with the founder? Probably, initially yes, but what happens when the founder dies? Who then can enforce the contract? Is it a contract with the entity? Hardly, because the Foundation Council controls the entity. How can they, in effect, control a contract with themselves? I think it is pretty clear that it is not a contract with the beneficiaries, so I am left with this slightly uneasy feeling that it is a contractual obligation, but a contract without a counter-party.

If you look at the laws on foundations, I think you will agree that there is a real paucity of provisions dealing with the rights and interests of beneficiaries. Some laws are, effectively, silent on this point – Cyprus for example, though, as I said, I do not think that really has family foundations in mind. There is one exception: Malta has quite a comprehensive provision, at page 226 of the *Handbook*, dealing with the rights and interests of

beneficiaries. The draftsman was clearly inspired by the concept of the trust, and has adopted many trust ideas. But with those exceptions, generally the provisions for beneficiaries are fairly thin and rather limited. You may, of course, say that if I looked at the 1925 Trustee Act in the United Kingdom, I would find little that talks about the rights of beneficiaries, but, of course, that is set against the context of 400 years of court cases, defending the rights of beneficiaries. You do not have this 400 years of litigation and elaboration as a background to foundations.

Let me take some of these points in some detail. What is the nature of the rights of a beneficiary under a foundation? Is it a proprietary right? Most of the laws say that a beneficiary has no rights in the assets of the foundation until they are actually distributed to the beneficiary. Anguilla is a good example: a beneficiary has no right *in specie*, though Anguilla does provide that a beneficiary can enforce the foundation, but by an action *in personam*, not an action *in rem*. The law in Malta (again in a sense following the trust analogy) says that the rights of a beneficiary are property, and they are moveable property. On the other hand, if you look at the law in St. Kitts, which is a very good example (and a number of other jurisdictions have followed it), that says quite specifically, that the assets of the foundation are not the assets of the beneficiaries until they are distributed.

Many of the jurisdictions have focused on protecting beneficiaries by giving them the right to

information, so the beneficiary is entitled to know about the assets held in the foundation. But, in most cases, that is subject to the terms of the charter or declaration, which I read as saying that if the founder is so minded and so advised, then the beneficiaries will have no right to information. The general rule is that the statutory right to information can be wholly or partially excluded by the foundation's constitution. I would be very nervous about advising a founder to exclude completely the rights of beneficiaries to information: it is an invitation offered by the laws which I would say very strongly should be rejected. And there are exceptions to the rule. In the Bahamas, the Law provides that a beneficiary who has a vested right in the property is entitled to receive accounts and information.

Most of the laws do not give the beneficiary a right to enforce the foundation, and any possible enforcement can be excluded. Again, there are exceptions. In Anguilla, if there is no other provision for removing the Foundation Council, then the beneficiaries can apply to the Court to remove them, but otherwise there is nothing about enforcement. Malta (again perhaps following the trust concept) expressly authorises beneficiaries to enforce. In Nevis, an absolute beneficiary – one who has an absolute vested interest – can require the Foundation Board to meet, but otherwise there is nothing specific about enforcement. Interestingly, Panama has what are probably the strongest provisions, allowing beneficiaries to apply to the Court for removal of the Council, and the right to contest its decisions, but in most of the other laws there is silence or – as we will see in a moment – *in*

terrorem possibilities, which would exclude beneficiaries from enforcing the foundation. It is exceptional to find specific reference to beneficiaries enforcing.

I come now to what I find perhaps the most worrying provisions. I know that – at times – settlors want to exclude the possibility of their beneficiaries contesting the trust. They want to do so, either because they do not trust the beneficiaries, or they hope that by doing so, they will avoid the family becoming embroiled in decades of litigation. But I have a feeling that some of the provisions on foundations go too far. It is not my term – calling them *in terrorem* provisions. It is how they are actually referred to in the Bahamas. If you look at the Bahamas legislation (page 180 of the *Handbook*) you will find a section headed "*In terrorem*". It is the possibility of excluding challenge by the beneficiaries. Anguilla has an understandable provision: if the terms of the charter so provide, a beneficiary who challenges the establishment of a foundation, the transfer of assets, the declaration or the by-laws, can lose his or her claim under the foundation. But, several jurisdictions have then gone further, and said if a beneficiary (or a would-be beneficiary) challenges any decisions of the Foundation Council or the protector, then again, he or she can be excluded by the terms of the charter: Antigua, Nevis and St. Kitts all have that provision. We are looking at an institution that has no shareholders, the founder of which may be dead, or may be in disagreement with the Foundation Council or the beneficiaries, and the beneficiaries – if they challenge the Foundation Council

– will lose their rights. Again, that is an invitation in the legislation that I would recommend people reject. The Bahamas here, I think, has a more acceptable provision. It says, "Beneficiaries can lose their rights if they challenge a decision, but only if it is a decision that does not damage their rights or interests." So, beneficiaries can challenge if the decision harms them, but otherwise they cannot challenge the decision of the Foundation Council, if the charter so provides.

That is a run-through of what the legislation says on the rights of beneficiaries. I emphasise, again, my view that there is a paucity of provisions in the law dealing with the rights of beneficiaries, and I think I have said enough to indicate – from a trust law background – I find significant concerns in the form of *in terrorem* provisions that are offered, and the provisions on supplying information.

Before I leave the rights of beneficiaries, let me perhaps add a dose of realism. There are assets in a foundation: who really owns them? Is it the founder? In theory, no. The founder is supposed to have completely alienated the assets. But I worry that, if the founder does reserve powers of revocation, that he remains – for many purposes – still the owner. Is the entity the owner? As a matter of law, yes, but as a matter of reality, the entity cannot enjoy the assets. The assets cannot benefit the entity; it is not the real, *beneficial* owner. Is it the Foundation Council? Please no. If the members of the Foundation Council start to think that the assets belong to them, then you really have a recipe for problems.

Ultimately, as trust lawyers realised 400 or 500 years ago, it has to be the beneficiaries: they are the people the founder wanted ultimately to benefit. They are the ones who have to be regarded as having ultimately the beneficial ownership of those assets, and I am worried that the foundation ignores that reality.

It is not without reason that we have a beneficiary principle for trusts – the principle that there have to be identified beneficiaries who can enforce the trust. Charities have always been the exception, because the Attorney General can enforce the trust. Another exception today is the purpose trust, because there is always a protector or an enforcer who can enforce it. These exceptions apart, there have to be identified beneficiaries who can enforce the trust. The trust can be enforced by beneficiaries (or on their behalf if they are minors). All beneficiaries have a right to enforce the good administration of the trust, and the Court of Chancery developed a specific remedy for this purpose – the action for account. You do not claim damages against trustees, you claim from them an account of their administration of the trust funds. As a consequence of that right, beneficiaries – either individually or collectively – have been regarded as having an equitable interest in the property. These rules have evolved out of 400 years of case law on this area, and that is what makes the trust such a strong and well-developed institution.

I shall just highlight briefly some of the recent cases on the law of trusts. Interestingly, the first two

cases[2] are a nice contrast, looking at the same question. They are looking at the nature of the interest of a class of beneficiaries under a discretionary trust. Do discretionary beneficiaries have a future interest in the trust property? The question arose for limitation periods under the Limitation Act in New Zealand, and in the Cayman Islands. Though the two Courts do not say exactly the same thing, both of the Courts emphasised – the New Zealand Court of Appeal, the Grand Court in the Cayman Islands – that in the case of a discretionary trust one thing is clear: discretionary beneficiaries have a right to go to courts to enforce the proper administration of the trust against the trustees. Whether that is to be regarded as a future interest or not, the Courts slightly differed, but they emphasised the nature of that right.

Wendt v. Orr[3] is not a massively significant case concerning the profits of share trading, but what it did emphasise is the importance of distinguishing between income and capital in a trust, and the importance of recognising the different interests of life tenants with an interest in income, and remaindermen with an interest in capital. Were the profits of share trading income or capital? In that case, they were income and benefited the life tenant.

CIPC v. Churchill Int. Property Group[4] is a commercial case, but it emphasises the rule in *Saunders v. Vautier*[5] – the rule that beneficiaries, all adult and under no disability, can together agree to end the trust because, ultimately, they are the real beneficial owners, and, even though the trustee had real misgivings, the

Court gave preference to the beneficiaries over the trustee because of the rule in *Saunders v. Vautier*.

Finally, I come to some comparisons: they are not really comparisons, but more points that you should bear in mind when you are thinking about beneficiaries of trusts and beneficiaries of foundations. Consider that with beneficiaries there are conflicting interests between life tenants and remaindermen. Trust law has developed to recognise those interests; I do not see anything in the foundation laws that have recognised that. At times, the trustees need to know who is in the class of beneficiaries: there need to be class-closing rules. Trustees need to know about fiduciary obligations in terms of adding and removing beneficiaries. We have those developing for trusts, not for foundations. Remember who is going to supervise the Foundation Council, and contrast that with supervision of trustees. Remember that the key to fiduciary obligations is the conflict between the duty of a trustee and their personal interest: how does that survive in a contractual environment, rather than a fiduciary one? Consider what might happen to a foundation if there are claims by third parties – ex-spouses, ex-girlfriends, etc. We have trust case law on that, but not yet foundation case law.

If you have a settlor who is absolutely set on creating a foundation (and I think there will be people like this), what should you consider? First of all, I think you should consider drafting very detailed by-laws, foreseeing – if you can – some of these problems, and I suspect that you will find yourself turning, again and

again, to trust precedents when you are drafting them, because you will recognise that these issues have been considered in the trust concepts. Do not be tempted – whatever the founder says – to ignore the rights of the beneficiaries. They are ultimately the ones who will benefit from the fund; their rights need to be more respected. Do not accept some of the invitations that the legislation offers to you. I suspect that it is going to be particularly vital to ensure that there is a protector and, quite probably a professional protector, overseeing the Foundation Council. Finally, and as a litigator myself I smile at this, but I am not certain anybody else should, I foresee that if we do have a growth in foundations, there is going to be in the future an active role for litigators in this area.

I started my consideration of this topic with scepticism: it is the scepticism of a trust lawyer. I end it in the same way. It is not because I feel that something that originated in Liechtenstein via Panama cannot be a good entity – I think it could be, but I have real concerns about this issue of the rights of beneficiaries under foundations as compared with trusts.

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[1] Edited by Milton Grundy, ITPA 2007.

[2] Johns v. Johns (2004) 8 ITELR 287 (NZCA); Lemos v. Coutts (Cayman) Ltd (2005) 8 ITELR 153 (Grand Court)

[3] (2005) 8 ITELR 523.

[4] (2006) 9 ITELR 157.

[5] (1841) Cr & Ph 240.

THE ORDINARY AND EXTRAORDINARY POWER OF THE EUROPEAN COURT OF JUSTICE

David Goldberg

The amount of tax collected by a state or, for that matter, by any taxing authority is a function of two things.

First, it is a function of the rate at which tax is charged and, secondly, it is a function of the amount on which tax is charged. Our incredibly long tax system is mainly concerned with the question of how we measure the amount on which taxes are paid: there are some pages to do with the rate at which tax is charged, but the vast bulk of the legislation is concerned with defining the subject matter on which the charge is levied. That is true in the case of both direct and indirect taxes: determination of the subject matter of the charge is what our legislation is mainly concerned with.

That fact is often overlooked these days in fashionable comments about tax systems, which commend the use of flat rates of tax. I do not mean to suggest by this comment that I am not in favour of flat rate taxation, but what I do intend to suggest is that flat rate taxation will not simplify our legislation hugely, because it is still necessary to define the subject matter of the charge, and the rate at which tax is charged does not necessarily make it easier or shorter to define the amount on which tax is to be levied. In a sense, our corporation tax system demonstrates this: it is a flat rate

tax system, but determination of the chargeable subject matter requires several thousand pages of legislation.

Nonetheless, I do not think that the rate at which tax is charged is unimportant: when a person, whether an individual or a legal entity, is deciding where to establish himself, the rate at which tax is levied is likely to be the first thing at which he looks: indeed, the intricacies of how the tax system works and how the amount on which a person is to be taxed is measured is something that will be far from the mind of most businessmen, who are likely to assume that all systems of measurement are roughly the same. It seems to me, therefore, that, when you look at a tax system, the rate of tax is at least as important and, in some ways, more important than the amount on which tax is payable.

This country retains, broadly, freedom to set its rates of tax. There are some limitations on the rate at which VAT can be set but, as far as the other taxes are concerned, we are free here to choose our rates of tax as we will. But this is no longer entirely so of the system of measurement. To a large extent, we have lost our sovereignty to define the amount on which we are to charge tax. Now that is not at all surprising where VAT is concerned, because every country in the European Community has agreed to adopt, by accepting the 6th Directive, a more or less common basis of measuring the amount on which VAT is chargeable. Accordingly, although cases about VAT can be, and often are, referred to the European Court of Justice – the ECJ – for decision, the Court, when deciding those cases, is

functioning very much as a quite ordinary Court: it is interpreting legislation which we have, more or less, adopted into our national legislation. The legislation is not being interpreted by a national Court and in that respect there is, of course, a difference between purely domestic litigation and litigation which involves an EC element. Nonetheless, what the ECJ is doing in relation to VAT is the sort of thing we would expect judges to do and I think we have all become so used to it that it scarcely surprises us any more that it is happening. But the position is really rather different where direct taxes are concerned. In that area the ECJ has become so powerful that it operates almost as a legislative body without the force of democracy to which a legislative body is usually subject.

The business of a Court is to declare the law. The declaration of law involves, as is now well recognised, the creation of law to some extent. It is, however, to be hoped that extensions of law are created in accordance with principles which have been laid down by previous decisions of Courts, which are then expanded by the new decisions. This is the theory of law with which common lawyers are familiar and comfortable. Civilian systems of law, although having, to a large extent, a different technical basis from the common law, operate in much the same way, although with less regard to the doctrine of precedent than we are used to in this country.

No matter what system of law is being applied, what users want from a system of legal decision making is that it should contain some predictive power. In other

words, as situations arise where it is necessary to determine the consequences in law of what is being done, it should be possible to turn to the decisions of the Courts and say: this is what will happen here. At least, even if we cannot say "this is what will happen", we want to be able to say "this is what is likely to happen". To a greater or lesser extent that is, usually, something that can be done in this country: one looks at the decisions of the Courts and extracts certain principles from them: we then apply those principles to the situation at which we are looking, and determine what the result will be.

The question which, accordingly, arises is whether we can extract any principle from the decisions of the ECJ relating to tax which will enable us to work out what the law is, absent a decision on the precise point by the ECJ. This is something which must be of increasing importance as the years go by, because it seems at least likely, perhaps likely to the point of inevitability, that the influence of the ECJ will grow rather than contract.

So I am going to attempt to extract principles from the ECJ's cases on direct taxation: I have to confess that I find this a difficult task because the Court is not always clear as to why it is reaching a decision. In large measure, this is not to be wondered at: the Court is a large Court and there are many judges with different views. No doubt the Court is quite often able to agree on a result, but not always able to agree on the reasons for it; and this leads to decisions which, while lengthy, sometimes seem to lack coherence. Moreover, the tools

which the Court uses to reach its decisions are relatively new and really rather broad. There are, nonetheless, trends appearing clearly and I shall, accordingly, attempt to extract some principles from what is going on.

First, as far as direct taxes are concerned, there does not, as yet, exist a common consolidated corporate or individual tax base in the EC. In principle, each state is, accordingly, entitled to its own national tax system and can set its own system of measuring taxable income and its own tax rates. But, secondly, if the national system conflicts with the EC Treaty, then, as shown in this country (albeit in another context) by the *Factortame*[1] decision, domestic law is overridden. The question of whether there is or is not a conflict between our domestic tax system and the EC Treaty is, accordingly, one of fundamental importance nowadays both to the operation and to the creation of our fiscal code. The decision as to whether there is a conflict between our national tax system and the EC Treaty is determined (once it has been raised by a taxpayer or by the Commission and, where appropriate, referred to the ECJ) by the ECJ and not by the national Court. It is in this way that decisions of the ECJ have an impact on our domestic legislative framework which means that, in a certain sense, it is acting as a legislative body: once the Court has declared that our national law conflicts with the Treaty, we have to legislate to get rid of the conflict; and we do so because the ECJ has told us that we must.

There are, broadly, seven tools which the ECJ uses in determining whether there is a conflict between our

domestic tax system and the Treaty. They are: first, to fourth, the four freedoms – movement of workers; movement of services; movement of capital and freedom of establishment. Then, fifthly, there are Articles 87 to 89 of the Treaty, prohibiting unapproved state aid. Sixthly, there is Article 293, aimed at the elimination of double taxation. And, lastly, there is the Parent/Subsidiary Directive, which is also aimed at the prevention of double taxation.

Of these tools, the requirement that capital be allowed to move freely is the most broad ranging.

The European Commission has the ambition of creating a co-ordinated European tax base. In other words, the ambition in relation to direct taxes is to achieve what has presently been achieved in relation to VAT. The ambition is that there should be, eventually – eventually not being too far away – a common system of measuring the amount on which tax is charged, which is used throughout the EC or, possibly, within the EEA. Until that has been achieved, the Commission's aim is to ensure that there is, at least, a coherent and co-ordinated tax treatment throughout the EC and this involves:

- removing discrimination and double taxation;
- preventing inadvertent non-taxation and abuse;
- reducing the compliance costs associated with being subject to more than one tax

system.

It seems to me that there are at least five situations in which the seven tools used by the ECJ and the political ambition of the Commission are likely to be relevant to tax. They are:

1. exit taxes: that is where a State seeks to levy a charge on a change of residence by an individual or a legal entity or on the movement of an economic activity from one Member State to another;

2. controlled foreign companies: that is where a Member State seeks to collect tax in relation to the profits of a legal entity established in another Member State;

3. group taxation: that is where what is in reality a single economic grouping is divided among different legal entities which operate in different Member States;

4. taxation of branches: that is where a taxpayer based in one State operates in another State, without establishing a different legal entity there;

5. dividend taxation: that is how a Member State treats a dividend received or paid by one of its residents and whether it makes a distinction between dividends received from or paid to its own residents and those

paid to or received by non-residents, (and, although I have referred here only to dividends, similar issues may arise in relation to cross border interest and it is worth bearing this in mind).

This list is not intended to be exhaustive: other issues arise in relation to individuals – for example the ability or rather, inability, to make investments outside the UK in a way which attracts a tax relief given to UK investments. However, the five areas mentioned are, perhaps, the ones of most significance.

There has already been much litigation in the ECJ in relation to these areas, and I shall make some comments on each of the categories in turn.

It seems to me that in the early days the Court was primarily concerned to prevent discrimination, so that all that it required of a State was that it should treat residents and non-residents, who were, objectively, in the same situation, alike.

But it seems to me to have moved on quite considerably from that position, as the more recent cases show.

Exit taxes

It is apparent from the *de Lasteyrie* decision[2] that it is not permissible to impose an immediate tax charge, or any other burdensome requirement, on a taxpayer in respect of his change of residence from one member

jurisdiction to another. The *de Lasteyrie* decision is, of course, about an individual, but there is nothing in it which limits its operation to individuals: to my mind, it applies equally to companies. However, although there may be no immediate tax charge or burdensome requirement on a change of residence, it seems from the decision in the case of *N*[3], that the State which is being left may make an immediate assessment to tax in respect of the change of residence, although it may not collect the tax due until an actual economic event occurs. This means, for example, that, if X Ltd acquired an asset for 100 and then moves its residence from the United Kingdom to another Member State when the asset is worth 250, the United Kingdom can assess X Ltd to tax on a gain of 150, but it cannot collect the tax unless and until X Ltd actually disposes of the asset.

The *de Lasteyrie* decision and the *N* decision are, of course, not cases about UK tax, but I think we can deduce from those decisions that certain of our domestic provisions about exit charges are in conflict with the Treaty and therefore void. First and most obviously, it seems to me that TCGA 1992 s.185, imposing a deemed disposal on a company ceasing to be resident in the United Kingdom is void, as far as it operates to impose an immediate charge to tax. Secondly, FA 1988 s.130, as far as it requires a company ceasing to be resident in the United Kingdom to secure its liability to tax, is likely to be void if the company is moving to an EEA territory. Thirdly, the restrictions on the operation of TCGA 1992 s.171 (relating to group transfers) and TCGA s.139 ICTA 1988 s.343 (relating to reconstructions), which

limit those provisions so that they only operate to avoid charges to tax when there is a transfer from one UK taxpayer to another UK taxpayer, are also likely to be void as being a form of impermissible exit tax.

In some ways, the last paragraph may sound surprising, particularly in relation to s.171, which has already been amended so as not to discriminate against taxpayers on the grounds of residence. I am not, however, sure that those changes go far enough to satisfy the recent decisions of the ECJ. Until relatively recently, the ECJ seems to have been more willing than it now is to accept that the home state may protect its tax base. To my mind, the *de Lasteyrie* case and the *Marks & Spencer*[4] case show that the ECJ has moved on and will consider illegal (as a breach of the Treaty) any tax charge which arises and becomes immediately payable because of a move from one Member State to another. It seems to me, moreover, that the ECJ would be correct in reaching that conclusion, as exit taxes clearly operate as a restriction on the free movement of capital and on the freedom of establishment.

Controlled foreign companies

In this context we have, of course, the *Cadbury Schweppes* case[5], and there is other litigation about the same topic. Here again, the concepts clearly engaged are the freedom of movement of capital and freedom of establishment.

The *Cadbury Schweppes* case illustrates in a useful way another point which has to be borne in mind about

the way in which the ECJ operates. A decision of the ECJ is a response to the questions put to it by a national court; and it is necessary for a number of people to respond to the decision of the ECJ. First, the national court which made the reference has to apply the decision of the ECJ. This may be more or less easy, according to how Delphic the ECJ has been in its decision: it can, as we shall see, quite often be truly Delphic. Secondly, the taxing authority has to respond to the decision of the ECJ insofar as it has found an aspect of the tax system to be unlawful. And lastly, the Commission may react to the decision of the ECJ if the taxing authority fails to do so.

As we shall see in relation to group cases, our legislature does tend to react to decisions of the ECJ and, although there may be questions as to whether it has reacted adequately or not, the fact that the legislature may react is, on the whole, not particularly interesting. However, the reaction of our domestic Courts to the decision of the ECJ does raise quite interesting issues. In relation to *Cadbury Schweppes*, two questions have to be determined by our domestic Courts as a result of the decision. The first is whether our domestic legislation, containing the motive exemption from liability under our CFC rules, can be interpreted in accordance with the ECJ's decision that, in principle, taxation of CFCs infringes the Treaty. It seems to me quite plain that our domestic legislation cannot be interpreted consistently with the decision of the ECJ and so the second and, in many ways, more interesting issue left to the national court arises. That issue is whether the CFC in question can be regarded really just as a tax scheme rather than as

a genuine economic activity.

It seems to me that this issue leaves considerable scope for differing views. I expect *Cadbury Schweppes* in the end to win its case when the domestic litigation has been finished, but the *Cadbury Schweppes* decision itself may not mean the end of all CFC taxation.

The case, of course, also has implications for individuals, who may be taxable under what was, until recently, ICTA 1970 s.739[6], in respect of income of foreign entities which they have power to enjoy. Where the entity is in a Member State, the UK may not now be permitted to apply s.739. Moreover, the question of how far TCGA 1992 s.13 (imputing gains of non-resident "close" companies to UK resident participators) is valid in relation to EEA entities also now arises.

Group taxation

The *Marks & Spencer* case shows that all members of a group, no matter where they are based in the EC, must, to a large extent, be treated in the same way by each national tax system. Accordingly, it is necessary for this country to give relief for foreign losses. We have reacted very promptly to the decision by amending our group relief legislation in last year's Finance Act, so that, subject to certain limitations, UK companies can now claim relief in respect of overseas losses of non-resident companies which are established in an EEA territory.

What intrigues me about the Court's decision in *Marks & Spencer* is how it can be reconciled with the

decisions which the Court has been reaching in relation to branches, and what those decisions tell us about the principles being followed by the ECJ – a question I return to below. Before I do so, however, I should note one particular feature of the *Marks & Spencer* case, which is that the ECJ has made it plain that a group is only to get relief for losses once: it is not to get relief in more than one jurisdiction or more than once. Accordingly, the ECJ has referred back to the national court, the question of whether non-UK losses of the group can be used more than once. It seems to me that this is quite a firm matter of fact, which the national court can determine by reference to evidence with some ease: the question referred back to the national Court in *Marks & Spencer* is easier to determine than the question of abuse referred back in *Cadbury Schweppes*, which is a much more malleable issue.

Branches

The ECJ has looked at branches from the point of view of the host state and from the point of view of the home state. It has decided that the host state must charge tax on the profits of a branch at the same rate as it charges tax on the profits of a national[7], but it does not have to permit relief, against profits of the permanent establishment, for losses that arise outside the host state and have nothing to do with the activity in the host state[8]. However, the home state must give relief for losses of the permanent establishment against profits arising in the home state[9].

The question which arises is whether these decisions can be reconciled with the decision in the *Marks & Spencer* case. Let me assume an established French group with a profitable UK subsidiary. As I understand that case, losses from outside the United Kingdom can, subject to the limitations in our amended legislation, be surrendered to the UK company. However, if we now assume a French group with a profitable UK branch, the French losses cannot now be used against the profits of the UK branch. It seems to me that this puts the group in a better position than the branch and I find it hard to justify the distinction which the Court is making.

It is this difficulty which makes me wonder what principle the Court is truly following. I find it difficult to believe that, in the area of groups and branches, the Court is truly following principles derived from the four freedoms in reaching its decisions. It seems to me that, if a system of measuring the tax base can constitute a restriction of the freedom of establishment or movement, then, equally, the rate of tax must do so. And if the inability of a group to use foreign losses constitutes a restriction on the freedom of establishment or of movement, then, equally, so must the inability of a branch to use losses constitute a restriction. I do not, myself, find arguments that a branch does not involve an establishment or a movement very convincing, and I do not find the distinctions drawn by the ECJ between subsidiaries and branches convincing either.

So it seems to me that the decisions on branches do raise issues about just what the basis of the ECJ's reasoning is, and this concern is increased when I note that, when the Court says that it is basing its decision on a breach of the four freedoms, it does so only by examining the provisions of the tax system of the referring State. But you can only truly say whether State A is restricting the freedoms by comparing what it is doing – not only internally but also externally – to what every State is doing. The Court is not making that comparison, and, while that is understandable, its failure to do it must impact on the logical integrity of the Court's decisions.

Dividends

There have been a large number of cases about dividends, and these illustrate a number of points about the impact which decisions of the ECJ have on our domestic law. So far as the United Kingdom is concerned, most of them concern or arise out of the now defunct system of ACT, and so, except, of course, to someone directly affected by one of them, they are not of great continuing interest for what they actually decide, but only for the implications that they have for the future. One of the earliest cases about dividend taxation related to the ability of a UK subsidiary to make a group election, when paying a dividend to its foreign parent, so as not to be liable to pay ACT in respect of the dividend. Our domestic legislation did not permit a group election between a UK subsidiary and a foreign parent and the ECJ ruled that illegal. The abolition of the ACT system

in this country means that we are not concerned with legislative amendments to the system to deal with the ECJ's decision, other than the wholesale abolition of ACT back in 1997, itself the subject of considerable debate at the moment. However, the result of the ECJ's decision was that many companies had paid ACT when they should not have done, and this has led to a great deal of litigation about the ability of such companies to recover the tax that they paid. This is not tax litigation as such but is litigation about restitution. It has caused a number of significant developments in our law of restitution and our law relating to periods of limitation – the period within which a claim may be brought. These developments fall outside the scope of this article, but do illustrate the impact which decisions of the ECJ have on what seem to be purely domestic issues.

Then there was litigation in the ECJ about the way in which ACT interacted with the provisions in our tax treaties allowing us to collect a certain amount of tax from non-residents; and these provisions were, to an extent, ruled to be illegal. Next, there has been litigation, in a purely domestic context, about the interaction between our tax treaties and the decision of the ECJ that ACT should not have been paid on dividends paid to foreign parents. As is well known, many of our double tax conventions give a recipient of a dividend a tax credit, largely because of the ACT which had been paid by the dividend-paying company. The *Pirelli* case raised the issue as to whether this tax credit was to be given to a non-resident when the ACT had not been suffered, because of the ECJ's decision that it was illegal to

charge it. The House of Lords, in a rather strained decision, has decided that the tax credit is not to be given. It seems to me that the case illustrates the principle that it does not pay to be too greedy: you cannot expect to have a tax credit if you have not actually suffered the tax that ought to give rise to the tax credit. There is, however, no principle of law that you are not allowed to be too greedy: that is a principle of practice, which it may be relevant to bear in mind when trying to discover what principle the ECJ (or, for that matter, any other court) is actually following in deciding its cases.

The most recent cases about dividends are the *FII* case[10], which is about the ACT payable by a UK dividend paying company in situations where ACT remained payable, and *Test Claimants in Class 4 of the ACT Group Litigation*[11], which is essentially about the ability of the recipient companies to get tax credits under double tax agreements. The decisions are lengthy and they display differences. Essentially, the ECJ has refused to interfere with the agreements made between Member States as to the way in which tax credits were to be given by one Member State to residents of another. In other words, the Court has refused to interfere with the way in which Member States agree to share what may be regarded as a single tax charge between them.

On the other hand, the Court has interfered quite dramatically, in the FII case with the UK's domestic tax system. The ECJ's decision is quite clear about some things, and has referred other things back to the national

court for decision which, I believe, set the domestic court quite a puzzle. I think that four principles can be derived from the *FII* decision. First, the United Kingdom must give an underlying tax credit in respect of dividends received by a UK resident from a non-resident company. It must always do that, even in cases where the UK resident has a less than 10% shareholding in the dividend paying company. This is one point which emerges clearly from the case.

Secondly, the tax rate payable in the United Kingdom by a UK resident company, in respect of a dividend which it receives or is entitled to receive, must be the same, whether the dividend is received from a UK resident or from a non-resident. This equality of taxation can be achieved by a credit method or by an imputation method or by freedom (exemption) from tax. It is for the domestic court to determine whether the rate of tax payable on dividends from residents and non-residents is the same. This seems to be an intriguing question when we, in the UK, do not impose any tax on UK dividends paid to UK companies. The real issue must, accordingly, be whether the underlying tax credit exhausts the liability to UK corporation tax. If so, there has been no illegality in our domestic law; if not, there has been. It seems to me, therefore, that the question of whether there are differences in the rate of tax must vary according to the amount of underlying tax for which credit is available; and so quite interesting issues will arise.

Thirdly, it is not permissible to make a UK resident company pay ACT just because it receives a dividend

from a foreign company. Therefore the principle of freedom of establishment and free movement of capital precluded a UK company from being allowed to pay on dividends free of ACT only because it had received a dividend which has been subject to ACT. Fourthly, surrenders of ACT from one UK resident company to another are not to be permitted if surrenders of ACT to a non-resident company are not permitted. Lastly, the system of foreign income dividends was illegal. Quite what all this means is going to take some working out and the consequences for our domestic law of restitution will, I think, be very interesting.

It is principally our law of restitution which will benefit from this decision and not our tax law, because generally the result of the ECJ's decision is not to free UK taxpayers from undischarged liabilities (most of them will have paid ACT and so on) but to say that they may have paid ACT without being liable to do so. It is, accordingly, necessary to work out how much tax a taxpayer paid without being truly liable to do so and then claim it back in an action for restitution. I should, however, mention here that, where a taxpayer has not settled his tax affairs with the Revenue and has open appeals pending before the Special Commissioners which are affected by an ECJ decision, he must pursue his tax appeal before the Commissioners (and by appeal from them) and may not short circuit the process by going directly to the High Court. It seems to me that, at least so far as surrenders of ACT are concerned, the *FII* decision may be something of a one way street against the taxpayer, because it rather indicates that surrenders

of ACTs should not have been permitted, unless they could also be made to a non-resident company.

I find this an interesting extension of the ECJ's willingness to interfere with a domestic tax system because, so far, while it has been willing to make decisions which erode the tax base of the State which refers the point at issue to it, it has not been willing to do anything which erodes the tax base of another Member State. However, the suggestion that ACT surrenders should have been permitted to non-resident companies does open up the possibility of eroding the tax base of a non-referring State. After all, what is a non-resident company to do with ACT surrendered to it? If the answer is that it is to do nothing with the ACT surrendered to it, what is the point of saying that the inability to surrender ACT to a non-resident is objectionable? The ECJ, in finding a UK resident's ability to surrender ACT objectionable because of the inability to surrender to a non-resident, must have been at least contemplating that the non-resident potential surrenderee could do something with the ACT. The only thing it could possibly do with an ACT surrender is to use it against its own domestic corporation tax or to use it against a liability to UK corporation tax. It is a possible reading of the ECJ's decision that it intended to limit its judgment to cases where the non-resident in question has a liability to UK corporation tax. If that is the correct reading of the decision it is, on this point, relatively limited – in some ways more limited than the *Marks & Spencer* case. On the other hand, if it is not so limited, it would be something of a reach and I am not sure that the ECJ

intended to go so far as that. Nonetheless, the *FII* case does seem to show an even greater willingness by the Court to interfere with domestic systems than previous decisions have demonstrated.

I should also say that, as a matter of pure logic, I find it difficult to justify the dividend decisions by reference to the freedom of establishment or the freedom of movement of capital. After all, in these cases, UK entities had been established and capital had moved, demonstrating the freedom to establish and to move capital.

Something else must be in play, but what?

Let me now try to find a synthesis of what the Court has been doing in relation to tax bearing in mind that, to an extent, the issues raised by the 4 freedoms are economic rather than purely legal. There are, of course, historical analogies which can be drawn. The ECJ functions as the interpreter of the EC Treaty in much the same way as the Supreme Court of the United States operates as interpreter of the US constitution, and the Privy Council (and now the highest domestic Courts) operated or operate as interpreters of the effective constitutions of Canada and Australia. The parallel cannot be taken too far because, of course, there is a difference between the US, Canadian and Australian situations on the one hand and the EC situation on the other. In each of the USA, Canada and Australia, there is a federal government and disputes have arisen as to the respective powers of the federal government on the one hand and the provincial or state governments on the

other. In the case of the EC, there is, of course, no federal government as such.

In the tax cases which are referred to the ECJ, the Court’s task is not to resolve disputes between different levels of government: the dispute in those cases is always as to how the EC Treaty, which has been accepted domestically, impacts on other aspects of domestic legislation which have been enacted by the same legislative body as that which adopted the Treaty. There is the possibility of conflict between purely domestic legislation and the Treaty; and the ECJ determines whether that conflict exists or not. In the cases of federal systems, the interpreting court has usually resolved conflicts in relation to tax in favour of a federal power rather than provincial power. I believe that something similar is going on with the ECJ.

As I have tried to indicate, I do not find a synthesis of the ECJ’s case law based on the four freedoms a particularly convincing basis for the agenda being followed by the ECJ. I do, however, think that the Court is following two principles quite closely. The first is that it is not permissible to discriminate between one person and another or between one economic activity and another on the basis of the place of residence of the person or the place where the economic activity is carried on. The other is that an EC resident should pay tax only once on its profits in the EC so that double taxation should be eliminated. So far, the Court seems more concerned with the possibility that an economic grouping may pay tax on more than its full economic

profit, than with the possibility that it may pay tax on less than its full economic profit. But the essential aim seems to me to be a federal one: tax is to be paid somewhere in the EC, but only once. The rate at which it is paid does not matter very much. It does seem to me that, eventually, even without a consolidated common tax base, this will lead to a federal EC wide direct tax system which will have largely been the creation of the ECJ which will have compelled national legislatures to amend their tax systems. That is the extraordinary power of the ECJ.

It is for consideration whether the ECJ is a satisfactory legislative body, when it is not subject to any democratic checks or balances. The point here is that the decisions of every other court I can think of, which has an interpretative power in relation to a fundamental constitutional document, are subject to review by a legislative body with an amending and reversing power given by some form of constitution. Because the ECJ is a creation of the Treaty and not of a national legislative body and there is no Community Constitution, that is not true of the Court's decisions. If our national legislature – if Parliament – does not approve of an ECJ decision, we do have remedies: we can try to persuade all our Treaty partners to amend the Treaty or we can resile from it. But these remedies are impractical and remote, so that they have no real power; and the ECJ is left with the true power to mould aspects of our tax system as it will. For many, if not most, of us, the Court is a far off institution about which we know little or nothing. I suspect that, instinctively, most British people are opposed to the idea

of a federal structure for the EC; but it may be that something along those lines is needed if we are to retain some form of representative democratic control over the ECJ: without it, that control does not seem to me to exist. At any rate, if there were a constitution, the extraordinary power of the ECJ would be more apparent and transparency is, these days, a prize worth having.

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[1] C213/89
[2] C9/02
[3] C470/04
[4] C446/03
[5] C196/04
[6] [739] See now, *Income Tax Act 2007* s.714 *et seq*
[7] *RBS v. Greek Slate Co* 311/97
[8] *Futura* C250/95
[9] *AMID* C141/99
[10] C446/04
[11] C374/04

THE SMITH STORY

Milton Grundy

Mr. Smith lived in England. His daughter lived in Canada and his son in Australia. They wanted to be partners in the business of commodity-dealing – pork bellies in Chicago, buying long and selling short, hedging exchange risks and that sort of thing. The Smiths did not really understand it all, but that did not matter: they had managers to run it and the managers were not in the United Kingdom, Canada or Australia. They decided to form a partnership together, and they found three nominee companies in the Bahamas, who would form the partnership for them. But when they came to draw up a partnership agreement, they could not agree how the profits were to be divided. Father thought the bulk of the profits should go to the children. He did not need the money to live on, and he would be leaving his money to the children anyway. And he reckoned that rather than pay income tax when he got the money and inheritance tax on what was left when he died, it would be more tax-efficient for the profits to go straight to the children. But the children did not need the money to live on either. Their father would soon be retiring, and they thought he should put aside some money for his old age – for the expensive medical care, the nursing and the sheltered accommodation that an old man might very well need. Wasn't there some way, they wanted to know, in which partnership profits could be put to reserve? Couldn't they wait and see what the future brought, and then decide among themselves – in, say, ten years' time

– how the profits should be divided between them? So the partnership agreement provided for the profits to be divided in such proportions as the partners may unanimously decide, with the proviso that if they had not made a decision at the end of ten years, a person was to be appointed to make a decision for them. Let me call this kind of offshore partnership – just to give it a name – an *Offshore Discretionary Partnership*, and the person to be appointed to make any necessary decisions the *Family Counsellor*.

For many years, the partnership made profits, and the partners resolutely refrained from reaching any decision about how the money was to be divided between them. Please, dear Reader, put yourself in the shoes of those advising each of the partners about completing an income tax return. History does not relate what happened to the daughter's return in Canada or the son's in Australia, but father's advisers saw a parallel with the facts in *Franklin v. CIR* (15 TC 464). The partnership in that case was the banking firm of Samuel Montagu & Co. One of the partners had died, exercising by his will a right under the partnership deed to appoint his son to be a partner. The other partners did not regard the son as a suitable new partner, and there was disagreement – stretching over many years, and including two sets of proceedings in the High Court – between the son and the remaining partners. While all that was going on, what would have been the son's share of the profit, if he had succeeded in becoming a partner, was accumulated in a reserve. It was eventually decided that the partners were entitled to refuse the son

admittance to the partnership and the accumulated reserve was distributed to the partners, so that each of them got the amount he would have received if the income put to reserve had been distributed year by year. What the case tells us is that where a taxpayer's entitlement to income is, as the judge put it, "contingent upon a fact which is going to happen in a future year. It is," he said, "impossible to say that he is entitled to it in the years which passed before that event happens." He is not talking about amounts which are uncertain, but can nevertheless be estimated. An estimate can be brought into an account. This was a case where no estimate could possibly be made: nobody knew at the time whether the partners would succeed in keeping the son of the deceased partner out of the partnership, or whether the son or they would ultimately become entitled to the money placed to reserve. In the light of this decision, the advisers to the father felt able to tell him that he had no income to declare from the Smith partnership. (They did not forget about s.714 of the Income Tax Act 2007: they concluded that the partnership profits were not income of the father's Bahamian nominee and that the only income the father could have power to enjoy would be his own.)

The story has several possible sequels, all of them replete with fiscal puzzles. In one version, the partners do eventually decide how the income is to be divided between them – or the Family Counsellor decides for them. Is each partner's share income of the year in which it is distributed or income of the year in which it was earned by the partnership? In another version of the story, one of the partners has assigned his partnership

interest before distribution is resolved upon. When profits are distributed to the assignee, are they income of the assignee, and if so are they still income of the year in which they arose? An assignee may well say that the distribution cannot be his income for an earlier year, for in that earlier year he did not have that source of income. Suppose – to take an extreme case – the assignee is a newly-incorporated company. Can it be taxed on income which arose before it was incorporated?

In yet another version of the story, the father dies, at a time when some (or all) of the profits are undistributed. How should his partnership interest be valued for inheritance tax? What is its “market value”? Indeed, would anyone buy it at all? It looks at first sight as though what is an offer is something like a lottery ticket – that this is a lottery with three tickets, and the holder of any one of them may hit the jackpot. But the reality is not like that. The son and daughter have power to prevent the purchaser from getting anything, and will have every reason to exercise that power. And when the ten years has gone by and the Family Counsellor comes on the scene, what is he going to say? The son and daughter have between them the majority vote and one can safely assume that they are going to appoint a Family Counsellor who will act in the interests of the family and divide the profits between the son and the daughter, leaving nothing for father’s estate.

Here we have an asset which is assignable, but yet valueless. And yet again, it may become valuable, when circumstances require. It is like the Cheshire cat:

sometimes it is all cat, and sometimes it is just the smile. When it is the cat, it can provide medical treatment, education, travel – whatever is required, and perhaps even without a tax charge. When it is just the smile, it has an obvious role in estate planning – in the context of inheritance tax, gift tax, estate tax and the like. But it also has a role in relation to income and capital gains taxes, as well as to exit taxes and wealth taxes – roles which, as far as I have been able to ascertain – remains wholly unexplored.

Adapted from part of a talk to be given to the ITPA at its meeting in Vienna.

ABUSE OF RIGHTS – EUROPE'S LEGAL ELEPHANT[1]

Hui Ling McCarthy

Following the ruling of the European Court of Justice in *Halifax v Customs and Excise Commissioners* (C-255/02) [2006] STC 919 on 21 February 2006 (which applied the doctrine of abuse of rights to the VAT regime) there has been much speculation as to the extent to which the doctrine can be applied to strike down planning arrangements designed to mitigate VAT. Soon after the release of the judgment, HMRC issued a statement in their Business Brief (27/02/06) that, of the 175 or so cases then stood over pending the ECJ's ruling, they foresaw the vast majority of their disputed decisions would be maintained. HMRC have subsequently relied on the doctrine at almost every opportunity, not just on substantive issues, but also in the course of interim proceedings to obtain disclosure from traders. However, far from being the answer to HMRC's prayers for an outright prohibition on tax planning, the ECJ was clear that the doctrine was not a general anti-avoidance principle, nor could it be used to invalidate all structures where tax mitigation comprised merely one of a number of components. Instead, it is a principle of interpretation that must be considered in conjunction with other well-established concepts of Community law, such as legal certainty and fiscal neutrality.

This article examines the development of the doctrine and the emergence of general principles for its application. It goes on to address the interaction of the

ECJ's test in *Halifax* with other Community law principles and the evidence the courts will consider when assessing whether abusive practices exist, before concluding with a summary of potential VAT planning opportunities[2]. So far, the VAT and Duties Tribunal has considered abuse in four decisions post-dating *Halifax*[3]. Where relevant, this article reviews the transposition of the doctrine into the UK system of VAT to date.

The Purpose and Scope of the Doctrine

"Abuse of rights" is evolving into a bit of a legal elephant. By which, I mean that the term still has no precise definition, yet we reckon we know it when we see it (albeit your elephant looks somewhat different if you are viewing it through the eyes of tax collector rather than tax payer). The body of EU case law dictating the circumstances in which abuse may be present is continually refining. In the absence of a national abuse provision prescribing those circumstances, the purpose of the doctrine is to catch cases where either -

(i) a person is attempting to rely on a European legal right to circumvent or displace national law, or

(ii) a person is looking to gain a financial or other advantage by way of an abusive use of Community law.

The former situation arises in relation to direct tax, where taxpayers seek to rely on a fundamental Community freedom to influence the domestic tax

treatment arising thereon (see, for instance, *Cadbury Schweppes plc* (C-196/04) [2006] STC 1908 on the interplay between the freedom of establishment and the UK CFC legislation). The latter arises in the context of VAT via the purported recovery of input tax or the reduction of liability to output tax by mitigating the effect of non-deductible VAT in circumstances which are directly contrary to the purpose of the provisions of the Sixth Directive. However, far from catching all transactions obtaining tax advantages, the unequivocal language used in decisions of the ECJ suggests that forfeiture of a taxpayer's rights cannot be justified on a whim, but only where the taxpayer's actions are so extreme that the purpose of Community law would otherwise be severely frustrated.

ECJ Case Law

Cases such as *Diamantis* (C-373/97) determine there may be abuse where taxpayers seek to rely on Community law to derive "an *improper* advantage, *manifestly* contrary to the objective of that provision" which "will cause *such serious* damage to the legitimate interests of others that it appears *manifestly* disproportionate." The Advocate General in *Halifax* echoed what he referred to as the "consistent pattern" in the existing case law and stated that a person's right to rely on a provision could be limited only where it is "*manifestly beyond* the aims and objectives pursued by the provision abusively relied upon". (*Emphases added*).

Member States' Established Concepts

Member States' own national provisions tackling abuse are also emphatically worded. For example, Article 281 of the Greek Civil Code (approved by the ECJ in *Diamantis*) provides that, "the exercise of a right is prohibited where it *manifestly exceeds* the bounds of good faith, morality or the economic or social purpose of that right." (*Emphasis added*) Similarly, continental European legal systems with their own established notions of abuse (that have existed before the doctrine was adopted by Community law and apply to all their domestic laws, not just to tax) do not recognise the principle as a first resort to frustrate tax planning. The French tax administration is faced with a presumption that agreements are real and that reciprocal or multi-party transactions are deemed to be economically balanced. This places the question of *abus de droit* within a series of rebuttals, such that it does not answer the administration's prayer for an absolute right to state that a taxpayer may not use a legal right in a manner for which it may not have been designed. The equivalent Dutch doctrine of *fraus legis* is considered the *ultimum remedium* and can only be applied if other methods of interpretation have been exhausted.

The European Commission

The European Commission appears to concur: in its previous submissions to the ECJ, the Commission has sought to restrict the scope of the doctrine, to prevent excessive curtailment of traders' rights. In *EC Commission v Italy* (C-129/00), the Commission argued

that, "… the principles of effectiveness would be observed only if cases of rejection of repayment claims were exceptional and maintains that the exercise of rights derived from the Treaty cannot be impeded by general measures based on a presumption of abuse of rights." Accordingly, it is clear that only extreme and aggressive tax planning is caught, not merely the structuring of commercial transactions in a way that simply falls outside *the range of transactions* contemplated by the draftsman when Community law was transposed into the UK system of VAT.

Evolution of the Abuse Test

The key European authorities responsible for formulating the doctrine show a shift from a subjective to an objective approach. Earlier cases[4] (although not expressly addressing abuse) considered the *bona fide* nature of commercial transactions in order to determine whether those transactions had been effected for the sole purpose of wrongfully securing an advantage under Community regulations. This was superseded by the test in *Emsland Stärke* (C-110/99), which examined, firstly, the objective circumstances in which, despite formal observance of Community rules, the purpose of those rules had not been achieved, and secondly, whether there had been the subjective intention to obtain an advantage by the artificial creation of the conditions for obtaining it.

Greater significance was placed on the objective nature of the doctrine in *Halifax*, where Advocate General Poiares Maduro emphasised that the doctrine

was a principle of interpretation, to be employed in deciding whether or not the Community law provision at issue conferred the right so claimed. Both the Advocate General and the ECJ restricted the subjective element of the test in *Emsland Stärke* by elaborating the objective nature of the second limb: the state of mind of the taxpayer was no longer considered relevant. Only if the "essential aim" of the transactions (which must be apparent from a number of *objective* factors) is to obtain a tax advantage will the prohibition of abuse be relevant - a far higher hurdle than the "main purpose" test for which HMRC had been hoping.

The result of the ECJ's deliberation in *Halifax* was the two-stage test for abuse. Readers will be familiar with the objective and subjective limbs respectively:

> "… first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.
>
> Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. … the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages."

The Court's retreat from the consideration of purely subjective factors such as motive and intention should be

encouraging for tax planning.

It appears that the Advocate General and the ECJ advanced the *Halifax* test a stage further in *Cadbury Schweppes*, notwithstanding that the case did not concern VAT, but the application of the UK's CFC legislation in the context of freedom of establishment. Both the AG and the ECJ placed the emphasis on *genuineness*: provided that the companies involved had real substance and were more than just 'letter-box' companies, then even an "avowed purpose of benefiting from [a] favourable tax regime" was insufficient to constitute abuse. However, I do not think the *Cadbury Schweppes* formulation is precisely interchangeable with the *Halifax* test, such that (for VAT purposes) the sole question is one of genuineness, with only wholly artificial arrangements falling foul of the objective limb of the test: it is more far-reaching than that. The ruling of the ECJ in *Halifax* itself states that there can still be an abuse of the Sixth Directive, notwithstanding that, as a matter of European law, the disputed transactions *actually* constituted supplies and an economic activity. The distinction arises from the relevant Community rights at issue: in the context of direct taxes, the taxpayer is seeking to invoke some fundamental freedom of Community law (staunchly upheld by the ECJ), from which the tax advantage is merely a national law consequence. However, in the context of VAT, the tax advantage itself is the Community right at issue. The *Cadbury Schweppes* analysis fits in determining "place of supply" questions under the Sixth Directive, insofar as freedom of establishment may fix the geographic

location of a purported supplier. For entitlement to a particular VAT advantage, it must still be shown that there *was* a supply *from that place* and that that supply was not an abuse. Artificiality may be the only bar to claiming a freedom, but it is not necessarily the only bar to deriving a VAT advantage.

General Principles in applying the Doctrine

Halifax resolved the previous uncertainty as to whether abuse of rights applied to VAT. The VAT Tribunal in *Redcats* subsequently held that the doctrine is not confined to Community law provisions that themselves directly confer tax advantages, but also to those with a neutral purpose (for example, Article 5 defining “taxable transactions”, Article 11 defining “taxable amount” and Article 13 defining the exemptions). However, there still remains some residual uncertainty as to the precise extent of its application.

Deferral Schemes

In principle, a tax advantage derived from an outright VAT saving is no different from timing or cashflow advantages created by deferral schemes, to the extent that both should be subject to the prohibition of abusive practices. In view of the Advocate General’s clear statement in *Halifax* linking deferral schemes to abuse, there is no reason why such schemes cannot be abusive. Indeed, the question in one of the joined cases (*University of Huddersfield*) involved a deferral scheme, albeit in one sense it was not a true deferral scheme, because the VAT Tribunal had found as a fact that the

intention of the University was to create an absolute VAT saving (by terminating various leases comprising the VAT arrangements early, as opposed to letting them run their course). However, simply choosing to lease an asset rather than purchase it outright is not in itself abusive: exempt traders need not bear the immediate burden of input tax and are not precluded from spreading irrecoverable VAT over a period of time, provided that the leases in question are on commercial terms and are not themselves artificial in nature (for example, at an artificially low rent or with a predetermined early termination as in *University of Huddersfield*).

Domestic legislation v. Community rights

It is still uncertain whether the doctrine can strike down planning arrangements deriving their tax advantage from purely domestic legislation, as these are national measures permitted by way of derogation, rather than being Community rights *per se*. Three measures that have been the focus of recent authority (albeit not necessarily in the context of abuse) are

(i) zero-rating (permitted by way of derogation under Article 28.2(a) of the Sixth Directive),

(ii) the election to waive exemption for buildings and land permitted under Article 13C; enacted in Schedule 10, para 2 VATA 1994), and

(iii) Commissioners' directions to use the open market value of a supply in certain cases (permitted under Article 27; enacted in Schedule 6, para 1 VATA 1994).

(i) Zero-rating

Taxpayers have no directly enforceable right to zero-rating under EC law. In the absence of national measures precluding abuse, therefore, it might seem these provisions fall outside the ambit of the doctrine. At first sight, this argument is an extremely attractive one, especially since the judgment of the ECJ in *Talacre Beach Caravan Sales Ltd v Customs and Excise Commissioners* (C-251/05), where the Court held that national legislation decisively determined the scope of the supplies for which the Sixth Directive allows an exemption. Indeed, in that case, it had been HMRC themselves that had argued that zero-rating gave rise to no form of Community law right. However, it is my view that this argument is restricted to a fairly narrow range of cases, where the *classification* of subject matter is in dispute, not whether there has been a zero-rated supply of that subject matter.

VAT Tribunal *dicta* in *Redcats* partially illustrates this analysis: the appellant was a mail order company, selling clothing and household goods advertised in bi-annual catalogues. The catalogues were originally supplied to customers free of charge; however, the company amended its trading conditions by purporting to introduce a zero-rated charge for each catalogue and making a commensurate reduction in the price of the

mainly standard rated goods ordered from it. The taxpayer argued that the principle of abuse could not apply here, as the advantage sought arose from the zero-rating legislation. The Tribunal did not flatly reject this proposition. However, it commented that the case was founded on other provisions of the Sixth Directive and on principles of Community law, including Articles 2 and 11(A)(1)(a) of the Sixth Directive (on supply and construction), neutrality and distortion of competition. A case for abuse could be founded on those Community rules as the dispute centred on the transactions comprising the *supply* of the catalogues to customers.

(ii) Election to Waive Exemption

HMRC have chosen not to make submissions on abuse of rights in the *Newnham College* case[5] (postdating *Halifax*), a recent challenge to a VAT deferral scheme involving an election to waive exemption. In this case, the College decided to renovate its library, but was concerned that, given it was exempt from VAT, it would not be able to recover input tax on the cost. It therefore set up a company wholly-owned by the College, whose directors were College members and granted the company a lease of the library. The College then sold its books and seconded its library staff to the company, before hiring back the assets and paying the company a fee for the provision of library services. The issue for the Tribunal was whether the College could be said to be in "occupation" of the library, in which case, it would be precluded from opting to tax pursuant to Schedule 10; both parties accepted that the only purpose

of the scheme had been the recovery of VAT. HMRC won in front of the VAT Tribunal on the basis that it was clear the intention had been to mitigate VAT, and it would be an abuse of the legislation to allow the election to waive exemption to stand as the conditions for VAT recovery had been artificially created. Curiously, HMRC expressly disclaimed a case for abuse on appeal to the Court of Appeal. Accordingly, the Court did not consider *Halifax*, but, in his judgment, Chadwick LJ was clear that any right of election pursuant to para 2(1) arose purely from domestic legislation: Article 13C of the Sixth Directive made it plain for each Member State to decide whether to allow a right to opt for tax in cases of letting and leasing immoveable property and how, if at all, that right was to be restricted.

(iii) Open Market Value

The VAT Tribunal in *Weald Leasing* considered whether the introduction of an unconnected company (yet one which was set up by the group's VAT consultant and used for the purposes of the scheme) prevented HMRC from making directions under Schedule 6, paragraph 1, to substitute open market value resulted in the accrual of tax advantages contrary to the Sixth Directive and to the domestic legislation. The Tribunal acknowledged that this would involve a widening of the *Halifax* test in order to encompass national legislation enacted by way of derogation. However, since HMRC neither made submissions nor adduced evidence in this respect, the point was not analysed further.

In light of the VAT Tribunal's comments in *Weald Leasing*, it will probably not be too long before HMRC attempt to extend the abuse doctrine to domestic legislation enacted in this way.

Interaction of the *Halifax* Test with Established EC Principles

The *Halifax* test cannot be applied in isolation: each limb operates alongside existing principles of EU law – predominantly those of fiscal neutrality and prevention of the distortion of competition, legal certainty and legitimate expectation.

The "Contrary to VAT Purpose Test"[6] *- the First* Halifax *Limb*

(i) Fiscal Neutrality

Fiscal neutrality dictates that VAT should be neutral as regards the tax burden on a business: the deduction system is meant to relieve a trader entirely of the burden of VAT payable or paid in the course of his economic activities, and Member States should not adopt any measures that would have the effect of undermining that neutrality. That is not to say, however, that commercially equivalent transactions must be afforded the same VAT treatment: traders may not choose one set of transactions, yet avail themselves of the tax consequences of the other[7]. This works both ways: conversely, HMRC cannot recharacterise a set of transactions simply because a commercially equivalent route exists with less beneficial VAT consequences for a

trader; neutrality does not require economic decisions to be taken independently of tax considerations. Whilst the courts will not invalidate an arrangement simply because it affords a trader the most favourable tax treatment, the transactions comprising the arrangement must be properly characterised in the context of the trader's normal commercial operations. However, if a disputed arrangement arises out of a change in business practice, the relevant question is whether the new practice standing alone is commercially justified, not whether there was a commercial justification for making the change. Furthermore, restrictions cannot be placed on traders according to their status as fully taxable, exempt or partially exempt: this would conflict with fiscal neutrality and distort competition (*Weald Leasing*). However, although it is open to a trader, in ordering its affairs, to choose between exempt and taxable transactions, artificially portraying standard-rated transactions as zero-rated would be abusive (*Redcats*), because the final consumption of goods would not be taxed in a neutral manner.

(ii) Legal Certainty and Legitimate Expectation

Legal certainty limits the doctrine from being extended so far that it affects legitimate trade: taxpayers must be entitled to know in advance what their tax position will be and to rely on the plain meaning of the words used in the VAT legislation. Community legislation must be certain and foreseeable, especially where rules entail financial consequences. A procedure for advance clearance would, to a certain extent, reduce

uncertainty over the application of the doctrine. The procedure in France, for example, presumes automatic clearance if the tax authorities do not reply within 6 months. However, in the absence of the introduction into UK legislation of an indirect tax GAAR, it is unlikely such a procedure will be adopted, because the abuse doctrine as it currently stands is no more than a principle of interpretation.

Under this limb of the test, legal certainty and legitimate expectation dictate that, (provided there is a commercial purpose for embarking on a series of transactions – to be determined by the "essential aim" test), the *manner* in which those transactions are performed is a matter for the individual taxpayer and should not be called into question. Intention and motive are irrelevant, and abuse does not arise simply because transactions have been constructed in a different and economically effective way. This impacts in two ways on the evidence a court will consider when determining the objective limb of the *Halifax* test.

(i) Where a commercial purpose is plainly apparent on the face of an arrangement, the tax advice received by a trader is irrelevant. In *RBS*, the tribunal refused HMRC's request for disclosure of various advice and records on the grounds that preliminary discussions and the thoughts of the company's board members and professional advisors were irrelevant. It was equally irrelevant whether there was a perceived tax

advantage as the transactions in question had economic reality (compared to *Halifax* where the artificiality of the transactions spoke for itself).

(ii) "Unusual" particulars of transactions are also irrelevant when determining the "contrary to VAT purpose" test, unless they are so unusual that they can be said to be, in fact, artificial. In *RBS*, the Edinburgh Tribunal rejected as "startling" HMRC's submission that a lease of vehicles for "an unusual duration" (namely, 2 years) could show an abuse of rights.

The "Essential Aim" Test – the Second Halifax *Limb*

If an arrangement falls foul of the "contrary to VAT purpose" test, it will only be abusive if, additionally, its "essential aim" is to obtain a tax advantage. It must be the "essential aim", assessed objectively, of the whole series transactions viewed collectively, not just of one particular step, included to make the arrangement technically viable. If there is another explanation or economic justification for an arrangement, there is no abuse, and HMRC have no discretion to inquire whether the transactions were *predominantly* motivated by tax avoidance. However, "essential" may not simply mean "sole", otherwise why did the ECJ not express the test in these terms? There may be some scope for saying that the test is equivalent to a "but for" test: if it is the case that, but for the potential tax advantage, the trader would in any event

have embarked upon the series of transactions, then there has been no abuse. Accordingly, any commercial justification for a particular arrangement must be of sufficient significance that it is more than merely ancillary. Indeed, the second limb of the *Halifax* test has led to uncertainty as to its precise meaning: a reference for a preliminary ruling was lodged on 16 October 2006 in *Part Service* (C-425/06) as to whether the "essential aim" test is satisfied by *transactions carried out for no commercial reasons other than a tax advantage*, or is broader or more restrictive. It is in relation to *this* limb that tax advice received becomes relevant, as does evidence of collusion or personal or commercial links between the parties involved. These factors will either illustrate the purpose of a scheme, or shed light on the objective circumstances in the context of which the decision to enter into the scheme was made.

The Tribunal in *MMO2* allowed HMRC's request for disclosure under Rule 20(3) of various classes of documents relating to tax advice. It held that the obtaining of advice, the nature of that advice and the circumstances in which it was given were all objective factors, on which *essential aim* could be assessed, given that there was no apparent commercial purpose for adopting the arrangements in question. Similarly, any unusual particulars of a scheme constitute objective evidence of its *essential aim*. For example, it would be difficult to justify the commercial purpose of a lease of a building for a single day. Although the lease may be genuine, in the sense that it is *factually* real (if it is properly executed and not a sham), it is not easy to see

how it is *economically* real, because (without intending to rewrite the *essential aim* test into something it is not) the lessee would not gain any commercial use or benefit from it.

VAT Planning post-*Halifax*

Although, in the context of VAT, the definition of abusive practices may not be restricted only to wholly artificial arrangements, there remains scope for VAT planning in certain circumstances, even if a trader may be taking advantage of a *lacuna* in the legislation:

- in the absence of a national provision prohibiting abuse, it is arguable that the doctrine does not extend to domestic legislation, such as zero-rating, opting to tax or the open market value rules;
- post-*Cadbury Schweppes*, place of supply planning opportunities may be available;
- deferral schemes involving the use (by exempt or partially-exempt traders) of genuine leases on proper commercial terms at a commercial rate should fall outside the ambit of the first limb of *Halifax*, even if the arrangements are between connected parties with the essential aim of obtaining tax advantages;
- deferral schemes involving third party leasing arrangements are likely to result in immediate financing and cashflow benefits

as well as VAT advantages and accordingly, neither of the *Halifax* limbs will be satisfied;

- for the same reason, intra-group leasing arrangements involving foreign subsidiaries should not fall foul of the abuse doctrine, even though there may be immediate cashflow and withholding tax benefits (depending on the financing in place), as well as the deferral of VAT;
- inserting a 'true' third party such as a bank into a chain of transactions may prevent HMRC from making directions under Schedule 6, para.1, to substitute open market value, provided that the third party is more than a mere conduit;
- if an arrangement affords significant mitigation of direct or stamp taxes, as well as a VAT advantage, then arguably the VAT advantage is not 'essential', because, due to other tax savings, the arrangement would have been entered into in any event, so the second limb of *Halifax* is not satisfied; and
- since the *Halifax* test requires the courts to consider an arrangement in its entirety, not just one or two particular steps, it seems likely that VAT planning as an element of a company reconstruction will also fall outside the *essential aim* test.

Those involved in VAT mitigation can take heart from recent judgments of the ECJ to the extent that VAT planning is not synonymous with abuse. Provided the arrangements are *economically* real or fuelled by a commercial objective, they should be immune from attack – though, doubtless, HMRC will persist.

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[1] *A longer version of this article appeared in the second edition of the 2007 British Tax Review published by Sweet & Maxwell at [2007] BTR 160*

[2] Readers should be aware that, if an arrangement comes before the VAT Tribunal, as well as deciding whether or not abuse exists (the focus of this article), an equally fundamental part of determining a trader's eventual liability is the redefinition of the disputed transactions in the event abuse is found. A finding of abuse does not guarantee a "windfall" for HMRC. Submissions as to how transactions should be redefined should not be neglected and can often be as complex (if not more so) as the question of whether abuse exists at all. Due to space constraints, it is not possible to provide a meaningful analysis here. However, paragraphs 152 – 172 of the VAT Tribunal decision in *Weald Leasing Limited* (Decision 20003) provide an interesting starting point, as well as summarising the VAT Tribunal's current thinking.

[3] Chronologically, these decisions are *RBS Deutschland Holdings GMBH* VAT Decision 19055*, MMO2 Plc* VAT Decision 19514*, Redcats (Brands) Limited* VAT Decision 19648 and *Weald Leasing.*

[4] For example, *General Milk Products* (C-8/92).

[5] *Principal and Fellows of Newnham College in the University of Cambridge v Revenue & Customs Comrs* [2006] STC 1010, CA.

[6] The VAT Tribunal in *Redcats* referred to the two limbs of the test as "the contrary to VAT purpose test" and "the essential aim test" respectively. I adopt these definitions in the following analysis.

[7] See *BLP Group plc* (C-4/94) and *Cantor Fitzgerald International* (C-108/99).

SECTION 75A FA 2003: THE DEATH OF SDLT PLANNING?

Michael Thomas

Section 75A, the new general anti-avoidance rule for SDLT, was first introduced by the SDLT (Variation of the FA 2003) Regulations 2006 (SI No. 3237) with effect from 6 December 2006. A slightly revised version (which will have retrospective effect to 6 December 2006) is being enacted as clause 70 of the 2007 Finance Bill and it is that version which forms the basis of this note.

The striking feature of s.75A is that it is very widely drafted. It is therefore a very effective weapon available to HM Revenue at Customs ("HMRC") and, is likely to succeed in countering the SDLT planning arrangements against which it is designed to be used if it is deployed before the courts. To a large extent it is thought that s.75A will indeed mark the end of SDLT "schemes". The introduction of s.75A will accelerate the trend towards bespoke planning which is of more limited application. The potential width of situations in which s.75A might apply gives cause for concern that it may catch innocent transactions. However, it is thought that difficulties should not arise provided that both HMRC and the courts give s.75A a sensible interpretation.

Conditions for s.75A to apply[1]

Section 75A adopts the approach of "following the land". It applies where a vendor ("V") disposes of a

chargeable interest (i.e. land) and a purchaser ("P") acquires either that interest or an interest deriving from it. A number of transactions must be "*involved in connection with the disposal and acquisition*"; these are referred to as "the scheme transactions". The final condition for s.75A to apply is that the total SDLT payable in respect of the scheme transactions must be less than "*the amount that would be payable on a notional land transaction*" under which P acquires V's chargeable interest. The conditions for s.75A to apply will now be considered in more detail.

What is a scheme transaction?

Section 75A(2) and (3) contain further details on the kind of "scheme transactions" at which s.75A is aimed. "Transaction" expressly includes "a non-land transaction", "an agreement, offer or undertaking not to take specified action", "any kind of arrangement whether or not it could otherwise be described as a transaction" and "a transaction which takes place after the acquisition by P of the chargeable interest".[2] Although the term "transaction" is not expressly defined it is apparent that it is to be construed very broadly and that s.75A(2) is designed to achieve this. An example of a non-land transaction is the sale of shares in a company which owns the relevant land.

A list of six examples of scheme transactions is provided in s.75A(3). The purpose of this is to ensure that both taxpayers and the courts are in no doubt that Parliament has stopped certain schemes in accordance with HMRC's recommendations. Two of the examples

given are a sub-sale and the carving out of a lease from a freehold. The remaining examples all relate to the right to terminate a lease and comprise the grant of such a right to terminate (whether as part of a new lease or by the variation of an existing lease), the exercise of such a right and an agreement not to exercise a right to terminate a lease or to take some other action.

"In Connection With"

The scheme transactions must take place "*in connection*" with both the disposal and the acquisition. The interpretation of this phrase is crucial to the scope of s.75A. The statute does not qualify the term "*in connection with*" and this suggests that it is intended to have the broad interpretation for which HMRC would no doubt contend. However, there are problems with having a concept which is so potentially broad at the heart of s.75A. One is that innocent transactions, where there is no question of the taxpayer trying to avoid SDLT, are potentially caught. It is suggested that if this issue does ever come to court then a sensible interpretation will be given to s.75A to ensure that it only catches the kind of "*schemes*" at which it is clearly aimed. At least, that is what should happen but there are no guarantees in litigation. The result is needless uncertainty, which is the second problem.

Uncertainty wastes the resources of taxpayers, whose advisers will have to consider the risk that s.75A might apply. Moreover, the uncertainty works against HMRC because it encourages those who design schemes to save SDLT to speculate what limits the courts might

set on the relevant connection and to try and circumvent s.75A using that limitation. This is of course inherently a very dangerous exercise because when confronted with aggressive planning intended to circumvent a mini general anti-avoidance rule the likelihood is that the courts will find that no such limitation exists. However, if there are no other downsides to adopting the planning, then there may be taxpayers who are prepared to take the risk and make HMRC fight and win the point. For example, it might be argued that the relevant connection is lacking if the vendor is unaware of the scheme transactions which are to follow, such as where the first step involves a "*double completion sub-sale*". The problem for any taxpayer seeking to argue this is that there is nothing in s.75A to require all the parties to have a subjective intention for the scheme transactions to take place. All that is required is for the scheme transactions, looked at objectively, to take place in connection with one another. In practice the result is to a large extent a matter of impression: if a court finds the transactions to be the kind of planning which should be struck down then it is likely to find the requisite connection and if it regards the transactions as innocent then the opposite will follow.

It is much more strongly arguable that the requisite connection is lacking is if the scheme transactions are undertaken by the vendor before any purchaser arrives on the scene. SDLT is a purchaser-orientated tax and if the steps taken to save tax do not involve him, especially if there is a long gap before his involvement, then s.75A should not apply as the requisite connection will be

lacking. To take a simple example, if V creates a special purpose vehicle company in advance of marketing that company and in the future the company is then marketed and ultimately acquired by P then s.75A should not apply. Indeed this appears to be expressly accepted by s.75C(1). Of course, creating an SPV is difficult owing to the anti-avoidance legislation aimed at preventing this. However, there are situations where it is possible, such as where other assets are transferred out of a company which also owns land in order to create an SPV[3] or if land is transferred to an unconnected company.

The Notional Land Transaction

The notional land transaction fulfils two functions. First, it forms a key part of the test to determine whether or not s.75A applies. Secondly, if s.75A does apply then the charge is computed by reference to it as discussed further below. As mentioned above, the notional transaction involves the acquisition of V's chargeable interest by P. The consideration under the notional transactions is the larger of the aggregate amounts either given by way of consideration by any one person for the scheme transactions or received by V or a person connected with him. Scheme transactions which are also land transactions are disregarded for the purposes of SDLT. The chargeable consideration on the notional transaction includes deemed chargeable consideration arising under s.53 FA 2003, the SDLT partnerships regime and the rules on exchanges.[4]

The Effect of Section 75A Applying

When section 75A applies, then two consequences result. First, any scheme transactions which are also land transactions are disregarded for SDLT purposes. Secondly, tax is then charged on P by reference to the notional transaction, the effective date of which is the earlier of the last date of completion for the scheme transactions or the last date on which a contract in respect of the scheme transactions is substantially performed. The result is a kind of statutory *Furniss v Dawson* where inserted steps are disregarded and tax is charged according to the end result. However, on closer inspection, s.75A is almost certainly wider than *Furniss*, for example because of the width of the term "in connection with".

Exceptions to Section 75A

The revised statutory wording in the Finance Bill provides for several circumstances when s.75A will not apply. However, what is most striking is the absence of any statutory motive test or clearance procedure for transactions which do not have tax avoidance as one of their main purposes. The author's view, as stated above, is that the courts will interpret s.75A to achieve this result but uncertainty still remains. HMRC are similarly of the view that s.75A exists to prevent abusive avoidance but of course that is no comfort when a taxpayer and HMRC disagree as to what is abusive.

The statutory exceptions to s.75A will now be dealt with in turn.

First, s.75A does not apply where the SDLT payable in respect of the scheme transactions exceeds that payable on the actual transactions only by reason of either the reliefs for alternative financing arrangements under ss71A to 73 or the social housing provisions contained in Schedule 9. This exception applies where tax is reduced "only" by the relevant provisions. Accordingly, it is not possible to have, for example, a prior sub-sale combined with an alternative finance relief provision as a basis for planning and then claim that s.75A does not apply.

Secondly, in calculating the chargeable consideration on the notional transaction the consideration for what would otherwise be a scheme transaction is ignored if it is "*merely incidental*" to the transfer of the land from V to P under s.75B(1). It is doubtful whether s.75B really adds anything because if a transaction is "*merely incidental*" to the land transfer, then it is highly arguable that it lacks the relevant connection with it in any event. Moreover, it is expressly provided[5] that a transaction is not incidental if it "*forms part of a process, or series of transactions, by which the transfer is effected*", "*the transfer of the chargeable interest is conditional on the completion of the transaction*" or if it is of one of the specific scheme transactions listed in s.75A(3). So, it is difficult to imagine scenarios where the exception for incidental transactions will make a difference in practice. Nevertheless, it is provided that a transaction may be incidental if it is undertaken only for a purpose relating to the construction of a building, the sale or supply of

something other than land or a loan to P to enable him to acquire the property[6]. As stated above, these kind of transactions lack the relevant connection with the land transfers in any event.

Thirdly, a transfer of shares is ignored for the purposes of s.75A if it would otherwise be the first in a series of scheme transactions[7]. This ensures that a straightforward sale of a land owning company followed by a liquidation is not caught by s.75A; although it is doubtful whether it would have been caught in any event.

Fourthly, the notional transaction under s.75A attracts any “relief” as if it were an actual transaction. The term relief is not defined so that there may be some uncertainty as to what is a relief: for example strictly this would not cover any exemption within Schedule 3. More fundamentally, this does not assist in the situation where there is a series of innocent transactions, each eligible for individual reliefs for which the notional transaction would not qualify. For example, land might be transferred up to a Newco with group relief claimed prior to a liquidation reconstruction on which reconstruction relief is claimed. This arrangement cannot be intended to be caught by s.75A but the notional transaction would qualify for neither relief. An attempt seems to have been made to address this very point in s.75C(3) but it does not solve the problem because it merely provides that the notional transaction satisfies the statutory purpose test if any of the scheme transactions do. This provision needs

amending and this may happen during the passing of the Finance Act.

Fifthly, no account is taken of any consideration paid in respect of certain transactions which qualify for specified reliefs[8]. This means that even if the notional transaction does not of itself qualify for relief, then some or all of the consideration may not be chargeable.

Finally, on a practical note, HMRC has issued a so-called "White List" on transactions which will not be caught by s.75A. The examples given are clearly outside s.75A in any event, so the White List has little practical use. However, it is worth noting that *Prudential* planning (see below) involving separate sale and build contracts is expressly not caught.

What is Caught by s.75A?

As stated at the outset, s.75A is a widely drafted mini general anti-avoidance rule. It catches several planning arrangements which were popular prior to December 2006. These include the more aggressive planning based on sub-sale relief under s.45(3) designed to ensure that little or no tax was paid when there was no genuine commercial sub-sale, the various ideas based on terminating a lease to radically alter its value without an SDLT charge and the idea of the purchaser paying if the vendor failed to exercise some right, such as the right to terminate a lease. Schemes involving partnerships are also caught although the flaws in the legislation on which the planning was typically based are dealt with in their own right, as discussed further below. Nevertheless,

s.75A prevents individual vendors from using partnerships to avoid SDLT being payable on a sale.

Are Innocent Transactions Caught?

The short answer to this is that innocent transactions should not be caught. However, the position is not as clear as it could be owing to the width of the scope of s.75A. The result is that there is some uncertainty. However, in the author’s view very often it will not be too difficult to form a firm view that s.75A does not apply when there is no question of any planning.

What Planning Survives s.75A?

Perhaps the biggest question in practice is what planning survives s.75A. It is possible to identify various arrangements which clearly do.

One is a *Prudential* arrangement where the purchaser acquires bare land from a vendor and at the same time enters into a building contract with the vendor so that SDLT is payable on the land value alone.

Another is a sale of shares in a land owning company or units in a unit trust. Creating a special purpose vehicle for sale is a more difficult exercise of course. Prospective corporate vendors should consider creating SPVs more than three years in advance of any prospective sale to avoid any clawback of relief. SPVs can also be created by hiving out other assets to create a clean company where the other factors permit this.

A third kind of arrangement which should be immune from s.75A is for a developer to not acquire any interest in land but instead to be paid as a builder and also as marketing agent for the landowner-vendor. Section 75A has nothing to bite on provided that the developer does not acquire any interest in land. The key to ensuring the success of this kind of arrangement is to ensure that the developer does not acquire any interest in land whilst balancing this against the commerciality of the deal and the vendor's needs. These kind of arrangements might well become very popular over the next few months.

A fourth group of arrangements comprise what might be termed "bespoke planning". In some transactions there will be particular facts which mean that the SDLT charge can be reduced without the need for a contrived arrangement. Put another way, if there is no series of transactions, then s.75A cannot apply. One example of this is for a tenant to swap a 999 year lease for a new lease rather than a freehold to take advantage of the rules on surrenders and regrants. Another is the rule that no SDLT is chargeable on the incorporation of a partnership, as discussed further below.

Finally, there may be scope for more aggressive arrangements. However, the most likely key to achieving this is to break the "connection" test. It is considered that there will be good arguments that the connection test is broken if the vendor sets up the planning prior to the purchaser arriving on the scene. The longer the time gap between the setting up of an arrangement and an ultimate

sale, the harder it is to argue that the requisite connection is present. The *Furniss v Dawson* case law is relevant in this regard. If no consideration passes at the first stage then there is nothing for s.75A to bite on at that time. However, if there is to be a significant time gap, it must be recognised that in many cases it may not be worth all the effort, risk and commercial inconvenience in order to save SDLT at 4% and it might be simpler to create an SPV and wait 3 years. There may be scope for other arrangements which exploit the s.75A rules for the basis of planning, such as by taking advantage of the rules on deemed consideration to achieve an SDLT saving. One such arrangement along these lines is currently available but will be blocked when the Finance Bill receives Royal Assent.

HMRC's hope is clearly that s.75A will mark the end of "one size fits all" SDLT planning schemes. To consider whether this is likely to be the case it is necessary to understand HMRC's approach to SDLT planning. HMRC has up to now been slow to attack SDLT planning arrangements through the courts. Instead the approach has been to amend the legislation. Not all of the legislative amendments have been unqualified successes as more than one has failed to stop the intended target and others have been unnecessary and only caused further confusion. It is also important to understand that not every arrangement which s.75A targets necessarily worked anyway. HMRC would have had strong arguments against more than one of the schemes against which s.75A is targeted. Who would have prevailed before the courts is inherently uncertain

but it is very unlikely that HMRC would have failed in every challenge.

Conversely, HMRC's failure to challenge SDLT schemes encourages taxpayers who wish to adopt them. If HMRC accepts that a scheme works then that is its result. If no other tax apart from SDLT is at stake then more aggressive taxpayers may be prepared to undertake planning on the basis that little will have been lost if it fails. Any statutory provision is open to interpretation and by using such broad charging concepts s.75A lends itself to possible interpretations which radically restrict its scope. In short, if HMRC wants to stop the next round of SDLT schemes, then it is likely that it will need to actually use s.75A. The author's view is that s.75A will indeed be used, in particular because there is no basis for HMRC to ask Parliament for anything wider!

So, whilst it may not be impossible to plan aggressively around s.75A that exercise will be both very difficult and very high risk. Before any arrangement is adopted then those risks will need to be spelt out in full to any client. Almost certainly full details will need to be disclosed to HMRC to prevent disclosure assessments, penalties and any accusations of impropriety. Expert advice will need to be taken in individual issues.

Conclusions

Section 75A is a widely drafted and very powerful mini-general anti-avoidance rule. Provided that HMRC actually uses it, then it is likely to spell the end of most if not all "one size fits all" SDLT schemes. The future of

SDLT planning is will be towards bespoke ideas and planning of which HMRC approves. When undertaking it should not be overlooked that aside from s.75A it needs to work as a matter of the general SDLT code, not fall foul of *Ramsay* and fit with both other taxes and the commercial deal.

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[1] See s.75A(1)
[2] See s.75A (2) (a) to (d)
[3] It might be argued that the stripping out of the other assets from the SPV does not qualify as a scheme transaction because it takes place before any land is disposed of. In any event, the present issue is when s.75A might apply.
[4] See s.75C(5) and (7)
[5] By s.75B(2)
[6] See s.75B(4)
[7] See s.75 C (1)
[8] See s.75C (4)