RECENT TAX CASES
by David Goldberg

I have spent the last few years thinking that the practice of tax law and the study of quantum physics had much in common: in both disciplines, if you look at something hard enough, it does something different from what it does if you don't look at it, so that – for example – shares and debentures, which are certainly there when you don't look at them, disappear – like observed particles – into another part of the multiverse, when you do look at them.

As we approach the Christmas Season[1], perhaps I might be permitted the additional reflection – a recent addition to my thinking – that the practice of tax law also has religious and evangelical aspects.

These thoughts are, despite what Professors Hawking and Dawkins might think, not wholly antagonistic, one to the other: as religion is an attempt to explore the mystery of creation and to make sense of the physical world, it can be seen as a form of physics – which is, of course, what it was in the beginning.

A number of faiths believe that the universe was created by the speaking of words, which is why the first line of the St. John's Gospel is, "In the beginning was the Word and the Word was with God and the Word was God".

Some mystical traditions have it that, when the word was spoken, its letters got torn apart – which is why the world is fractured, and the business of human beings is to put it together again – to reassemble the word, so that the world is healed and has a unity to it.

If we acknowledge those faiths and traditions, then tax and the creation of the world have something in common: tax is, after all, created by words written down in a statute, and, without those words, there would be no tax.

Any act of creation has something of the sacred to it; and the thought that the words of tax statutes, which create our tax law, have something of the sacred to them, is what might be called the religious aspect of the practice of tax law.

The evangelical aspect – which is, I think, antagonistic to the religious aspect – is that some judges and academics perceive, within the sacred words, an unexpressed underlying principle, which is that the words must be fractured if they lead to the opportunity not to pay tax, when, by appeal to some higher but – again – unexpressed reason, it would be expected that tax should be paid.

Some have adopted this underlying principle with an unswerving crusading zeal in an endeavour to bring what is believed to be healing to what they see as our fractured tax system.

That zeal has given us what used to be called the emerging *Ramsay* doctrine

and is now described as an ordinary principle of statutory construction, the so-called purposive approach.

My concern at the moment is that, in an endeavour to slay the devil of so-called tax avoidance, we are not bringing healing to the system, but are aggravating the fractures which inevitably exist in it.

The problem is that we are not – or some of us are not – paying sufficient attention to the words of the sacred texts which create our tax law.

In order to illustrate this theme, I have chosen four cases which, in a conscious effort to parody Elizabeth Schwarzkopf's choice of desert island discs, are all, as it were, recordings of my own.

The four cases are:

Sun Life

Davies & James

MJP

Schofield

The first case I will look at is *Sun Life Assurance Company of Canada (UK) Ltd v HMRC* [2010] STC 1173.

In broad terms, in order to calculate the corporation tax payable by a life assurance company, its profits are divided into two parts, one of which is called the policyholders' share of the profits (because, as its name implies, it will ultimately accrue to the benefit of the policyholders) and the other of which is called something different: it can conveniently be called the shareholders share of the profits.

The company's tax bill is then worked out by applying to an amount equal to the policyholders' share a lower rate of corporation tax than the normal rate and by applying the normal rate to an amount equal to the shareholders' share.

The difference in rates was originally introduced, at the height of the Battle of Britain, to encourage saving and, perhaps, the use of those savings in funding Spitfires; and it appears from the results to have been successful in its object.

The important point here is that matters like the rate of tax have a significant impact on the success of an economy; and the need for this relief may suggest that lower tax rates are economically more beneficial than higher ones, no matter what the political imperatives may be. Markets soared when Mr. Obama kept low income tax rates for high earners: Mr. Osborne please take note.

In order to find the policyholders' share of the profits, the first thing you do is to make the usual I-E computation of the life company's profits and the usual Case I computation, often wrongly called the notional Case I computation – wrongly called that because it is, in every way, an actual Case I computation.

Having made those computations, you take the Case I profit away from the I-E profit and the result is the policyholders' share of the profits.

It follows that, the smaller the Case I profit, the larger the policyholders' share of the profit and the lower the amount of tax which the life company must actually pay.

For the purposes of making this division, however, Case I profits are specially defined, by what was FA 1989 s.89(7), as:

> "profits computed in accordance with the provisions of the Taxes Act 1988 applicable to Case I of Schedule D".

That definition was changed by FA 2003 Schedule 33 paragraph 7 which added, at the end of the sub-section I have just quoted, the words:

> "and adjusted in respect of losses in accordance with section 76(2C and (2D) of the Taxes Act 1988".

And then there was a sub-paragraph which appears, on a first careless reading, to imply that only losses accruing in an accounting period ending after 31 December 2002 could be carried forward in computing Case I profits.

Now Sun Life had Case I losses which had accrued before 2002 and it wanted to carry them forward, in accordance with the usual Case I loss relief rules in ICTA 1988 s.393, to periods after 2003, in making the computations needed to find the policyholders' share of the profits.

The Revenue said they could not do that for any year, and so two questions arose:

(i) was s.393 a provision "applicable to Case I of Schedule D?"; and

(ii) if so (so that the original wording of s.89(7) meant that pre 2002 losses could be carried forward in computing Case I profits for the purposes here in issue) was the ability to do that taken away by the amendments made to s.89(7) by FA 2003?

Now, to my mind, it is quite obvious that s.393 is a provision applicable to Case I of Schedule D. The contrary argument is that it is a provision of the

Corporation Tax Acts and gets applied after a Case I profit has been established, not as a provision applicable to Case I of Schedule D but as a rule applicable to corporation tax.

However, the fundamental point is that what s.393 does, when it applies, is to reduce the Case I profit and (leaving aside the almost impossible example of a Case V corporate trade) nothing else.

It seemed to me that, when there are brought forward losses, s.393 is applied to determine the Case I profit; and if it is applied to determine the Case I profit then it must be a provision applicable to Case I of Schedule D.

The Special Commissioner and the Court of Appeal both accepted that view and held that s.393 was a provision applicable to Case I of Schedule D.

But victory on that point was meaningless unless we could also win the argument that the FA 2003 amendments did not take away the ability to carry forward pre 2002 losses.

In order to see that that was so, it was necessary to make a precise linguistic analysis of FA 2003.

In summary, the point was this: if s.89(7) in its original form gave the right to carry forward losses, that existing right could not be taken away by the addition of a new and, on analysis, slightly extended relief given for 2002 and later losses.

The Special Commissioner decided against us on that issue and, in value terms, the victory as to the original meaning of s.89(7) was worthless without winning the point about 2003.

On appeal to the High Court, the judge, unlike the Special Commissioner and the Court of Appeal, held against us on the basic s.393 point and so did not have to make a decision about 2003.

However, he indicated that he would have been in our favour in relation to 2003 if he had been with us on the basic s.393 point; but those favourable remarks were of no value without a win on the s.393 point, so we soldiered on to the Court of Appeal which, happily, decided both points in our favour, so we won.

Now there are three reasons why I have started this talk with a summary of this case.

First, this is the only one of the four cases I shall mention which has finished its ascent up the curial ladder. Unlike the other cases about which I shall speak, this is a victory which has been banked, while it is pending in the others; it's nice to think about a victory which is not just in prospect, but has been banked.

Secondly, arguing this case gave me a fascinating insight into why a life company makes two computations.

If you set up a pension fund with a manager, the fund will pay the manager a fee and the manager and the fund will, separately, compute their own profits for each period.

A life company, in effect, combines the pension fund and the management in one business and in one entity, with the policyholders being interested in the results of their investments less the charges levied by the manager for managing them and less claims, and with the shareholders benefitting from the fund management business and being interested in its results.

A life company appears, on the surface, to have one entire business but, on analysis, it is really two intermingled, but distinct, businesses, a trade of managing investments and a separate investment activity.

And it turns out that, if you subtract the Case I result from the I-E result, you make precisely the division needed to ascertain the profit of the shareholders trade of managing the investments (which is the Case I profit) and the profit of the investment activity.

It is actually extraordinarily elegant and precise – and, to my mind, fascinating, to discover that this weird dual computation system has such a sound rational foundation.

However, in answering the questions posed by this case, the elegance of the system does not tell us much about what the right answers are.

In some cases, some people at least, will have a view that there is a morally right or economically right, or another adjectivally right answer, but *Sun Life* is not a case like that.

Sometimes when you look at it, it seems fair that the losses should be carried forward in computing the policyholders' share, but at others it doesn't seem like that. The difficulties in judging what the "right" answer is are compounded by the inevitable periodicity, both of accounts and of tax liabilities; and issues arising from these periodic aspects of the matter confuse things.

To my mind, there is no morally or even economically right answer to the question of whether the losses should be carried forward and that is the third – and, indeed, main – reason I have chosen to start with this case.

If there is no morally or economically right answer to the questions raised by this case, the only way – the only way – of judging what the right result is, is to read the words of the statute and, without any preconceptions, to determine what

they – and they alone – say. To use a rather weathered phrase, there is no equity about a tax: you do not read anything in and you do not leave anything out; you take no account of any unexpressed purpose or of any intendment; you just read the words.

In the end, that is what the Court of Appeal did in this case. So this was an example of the religious aspect of tax practice.

But will the Court of Appeal take that approach when the last two cases I am going to talk about get to that Court? Will the Supreme Court take that approach when the next case gets there?

The honest answer is that that it all depends on which judges compose the Court when those cases get there – some judges being more wedded to a literalist approach than others, and the question which arises is whether there is – or can be – any justification for adopting a different approach to statutory interpretation in different cases.

I suggest that, if there is no morally, economically or otherwise adjectivally right answer to a case like *Sun Life*, there is no such answer to any tax case.

That is not surprising: tax is, after all, adjectivally and, perhaps, adverbially, neutral. (For those who nodded sagely when I said that, don't ask me what adverbially neutral means: I don't know; I wrote it down for fun and found that it made a sort of intellectual sounding noise, which I rather liked when I spoke it, so I left it in, especially because it allows me to make the point that it is a mistake to think that things which you don't understand are profound).

The knowledge that some judges believe that, in tax, there is a morally right answer – a point that is illustrated by the next three cases – troubles me. I value the certainty of law: the concept of the adjectivally right answer in tax, recently embraced by protestors at Top Shop and Vodafone, literally frightens me.

Davies & James, my next case, is an administrative law case.

I can sum up the whole of administrative law while I stand on one leg: the administrator must behave fairly.

But what is fair and what is not fair?

In IR20 Section 2 §2.9, the Revenue told taxpayers that, if they did not have evidence that they had "left the UK either permanently or to live outside the UK for three years or more" but:

> "have gone abroad for a settled purpose ... you will be treated as not resident and not ordinarily resident"

so long as you keep your visits to the UK to an average of less than 91 days a year.

Now, the first question which arises here is whether the Revenue are bound by that sort of statement.

In answering that question, one issue which can arise is whether the Revenue had authority to make the statement.

The point is that they might not be bound by statements which they did not have authority to make.

Now, in general terms, HMRC have power to manage the tax system but not to change the law.

So if the representations made in IR20 amount to a promise to treat a person who is, undoubtedly, resident as non-resident, it might be arguable that the Revenue had no power to make them and would not be bound by them.

It is, accordingly, important that the putative taxpayers in this case have not been held to be resident: we do not know whether they are resident here or not and, in those circumstances, it seems to me beyond doubt that the Revenue are bound to apply their IR20 promises to these claimants if the factual requirements set out in IR20 are satisfied.

The Court of Appeal has agreed with that and has added, which I consider very doubtful, that the Revenue would be bound by their IR20 promises even if they did not have the power to make them.

So the question then is what promises HMRC have actually made.

On the face of it, Section 2 of IR20 does not raise any difficult questions of interpretation: the words “if you go abroad, you will be treated as not resident” do not seem to me to be at all ambiguous.

The Revenue argument was that the words “go abroad” and phrases like that elsewhere in Section 2 of IR20 mean “if you go abroad so as, in law, to become non-resident”.

The Court of Appeal rejected the Revenue’s argument in that form, but, although it accepted that IR20 contained promises and not just guidance, held that, given the whole context of IR20, the promises only applied to people who had become non-resident in law.

To my mind that is obvious nonsense: if the promises only say that a person who has become non-resident in law will be treated as non-resident, they are not promises at all.

The conclusion that they are promises but do not apply to people who fall precisely within their wording comes from the Humpty Dumpty school of interpretation which gives the administrator power to say what the words he uses mean.

To my way of thinking, this interpretation fractures the words of IR20, but there is time yet to put them, if not Humpty Dumpty, together again.

Another issue which arises in the case is whether the Revenue's practices in relation to IR20 had been changed without any public announcement of that fact.

In a sense, the question here is whether the Revenue's conduct amounted to a representation that they would take a very relaxed attitude to IR20.

The issue is evidence intensive, and I cannot explore it here; but, for myself, I have no doubt that there was an unannounced change of practice.

The case goes to the Supreme Court next July. I shall not tempt fate by predicting the outcome, but I will say that, in litigation as in war, victories are won by a combination of perseverance and good handling, both of which are, I like to think, being demonstrated in this case.

One other point emerges from the case. It took seven applications just to get permission to bring this judicial review, five of which involved oral hearings and ten different judges were involved.

It was only the last three of those ten who were willing to acknowledge that permission for the application should have been given without any question at the beginning and so awarded the costs of all those hearings to the applicants.

There are two lessons to be drawn from this.

The first is that you cannot always rely on a judge to apply the law: there is too much of the personal brought to bear in the quality of judgment these days; the quality of objectivity is being lost.

Secondly, it is very difficult to rely on promises made by the administrator.

When we rely on concessions or practice statements, and – even more so – when we rely on statements in the manuals, the only remedy is judicial review, and it is difficult to get.

The next case to talk about is *MJP* [2010] STD FTT 683 and, again, there are two questions in it.

The first is whether there was a loan relationship between two companies in a group.

The evidence consisted largely of the cash books of the two companies and an audit trail.

The cash books showed payments of cash by the lender to the borrower, but HMRC argued that the payment of cash by the lender might have been to a third party for the benefit of the borrower and might have been recorded in the cash books of the borrower, even though it was not actually a cash payment.

That argument was contrary to the evidence of the audit trail, but the Tribunal took no proper account of that, preferring to raise, of its own motion, the suggestion that the absence of bank statements, in supposed infringement of the VAT regulations, was – of itself – sufficient to prevent MJP from proving the existence of the loan relationship.

It seems to me that, on the balance of probabilities – the relevant standard here, the cash books and audit trail do establish the loan of money here.

I am, moreover, concerned that the Tribunal has, of its own motion and without putting the point to MJP's witnesses or asking for comment on it, taken into account a supposed infringement of the VAT regulations about record keeping.

As it happens, HMRC did not raise this point about loan relationships until more than the 6 years for which the VAT regulations require records to be kept had elapsed, so the Tribunal was wrong about the supposed breach of the VAT regulations.

I rather think that, once that is realised, the weight of the evidence is such that a loan relationship will be found to have existed.

Moreover, even if that is wrong, why is there not a loan relationship, if A pays money to the benefit of B and the parties acknowledge (as happened in this case) that there is a loan relationship between them?

It seems to me that, where there is an advance of cash from A to B or an expenditure of cash for B's benefit by A, there is, so long as the parties document the matter as involving a loan, a loan relationship; and I am astonished that the revenue have argued to the contrary.

I am not a great fan of the loan relationship legislation and, if the Special Commissioners are right, there is a very easy way out of it.

The other issue in the case is this.

On the assumption that there is a loan relationship, MJP released part of the loan relationship, but the loan relationship continued to subsist as to the remaining part.

The question which arose is whether MJP was entitled to a debit in respect of the part of the loan relationship which it had released.

Whether it was or not depended entirely on whether it had departed from the assumption "that every amount payable under the relationship will be paid in full".

The question arose under the old form of FA 1996 Schedule 9, paragraph 6(3).

At all times, as it seems to me, MJP assumed that every amount payable under its loan relationship would be paid in full: at one point the amount due under the loan relationship changed; and MJP recognised the change, but that does not mean that it has departed from the assumption that every amount payable would be paid in full.

The argument to the contrary derives from Schedule 9, paragraph 5(1)(c), which suggests that recognition of the release of a liability does involve a departure from the assumption that every amount would be paid in full.

However, the words in paragraph 5 are capable of applying to a case where a loan relationship is released *after* the accounts date, but *before* the accounts are drawn up, so that, when the accounts are drawn up, they reflect an amount less than that actually outstanding under the loan relationship at the accounts date; and in that situation there is, indeed, a departure.

It is, thus, possible to think of an explanation for paragraph 5 which does not contradict the argument being put, in relation to paragraph 6(3), in a case where the release takes place *before* the date to which accounts are drawn.

On a literal reading of the statute, there is, in that situation, no departure from the statutory assumption, and it follows that, if MJP is to lose the case, the words of paragraph 6(3) must be construed purposively or in some other way to mean something which they do not say.

The Tribunal has, of course – and as is to be expected at that level – adopted a broad purposive approach to interpretation, but, in my view, the meaning that they have attributed to paragraph 6(3) cannot be tortured out of the words by any process.

The question which the case, accordingly, raises is how far purposive construction can produce a meaning which is flatly contradictory to what the words of the statute say.

When words are difficult to construe, when there is ambiguity, where the words do not tell you what the answer is, there is, of course, not only room, but

also the necessity, for some form of interpretation.

But where, as here, the words are clear, how much room is there for purposive construction?

A similar issue arises in the case of *Schofield*.

Schofield involved a clever scheme where two pairs of options were, in effect, exchanged for each other.

Each pair consisted of a put or call over the FTSE and a put or call over gilts.

The grant of the options relating to gilts should not give rise to any charge to capital gains tax, nor should their exercise give rise to any chargeable gain or allowable loss.

On the other hand, the grant of the options over the FTSE could give rise to capital gains tax and to chargeable gains or allowable losses as the case may be.

The taxpayer paid for the options over the FTSE and was paid for the options over gilts; and the idea, of course, was that, in many cases, the options would expire unexercised and the taxpayer would make an allowable loss on the FTSE options which he had purchased and would realise non-chargeable gains on the grant of the gilt options.

In Mr Schofield's case, however, the FTSE moved remarkably and there were profits and losses on all of the options.

In one tax year he closed out the option over the FTSE which was at a loss and the option over the gilts which was standing at a profit and, looking at the matter on a literal construction of the legislation, made an allowable loss on the FTSE option and a non-chargeable gain on the gilts.

He then emigrated and became non-resident for the next and succeeding tax years.

In the next tax year he exercised the FTSE option which stood at a profit and the gilt option which was at a loss and, had he been resident and the matter were looked at on a literal basis, he would have made a chargeable gain and a non-allowable loss.

The Revenue argued that nothing had happened in this case, and the Tribunal appears to have agreed with them – saying, at one point, that it was applying a doctrine of fiscal nullity.

At the time, I did not, and I still do not, understand this argument: things did

happen and there is no doctrine of fiscal nullity.

Moreover, the options were granted – and this has been found as a fact – at market value.

Accordingly, even if we ignore the payments of cash supposedly made for the options, the taxpayer will have base cost for the FTSE options: if the cash is ignored (which, on a proper view of the law, it should not be) the FTSE option was acquired for a gilt option of an equal value.

There is, accordingly, no doubt that the FTSE option which the taxpayer disposed of at a loss did have a base cost.

As it seems to me, the proper question is not whether something happened or whether there is a doctrine of fiscal nullity, but whether the taxpayer realised something that is recognised as a loss for the purposes of the capital gains tax legislation.

In some ways, then, the case raises a straightforward *Ramsay* issue.

In the Revenue's case for the pending appeal, they now put the case on the basis that transactions which had a commercial unity should be treated as a whole and that, on that basis, no loss arose.

I, of course, do understand the commercial unity approach, but I do not believe that the commercial unity approach allows you to ignore what the legislation says, and the legislation here is very prescriptive: it mandates a precise tax treatment for each of the 4 options which are here in issue.

Unlike *Scottish Provident*, there is a conflict here between a bland commercial unity approach and the wording of the statute: even given that the four options have a commercial unity, that does not mean that there are not four options, each of which has prescribed tax consequences.

The only proper issue to my mind is whether, given the supposed commercial unity of what happened, there was a loss.

I have said the *supposed* commercial unity, because one of the essential parts of the Revenue's analysis is that Mr Schofield's emigration was a foregone conclusion.

Now, I do not know of any case which shows that something like a planned emigration can be part of a preordained scheme or a commercial unity, and I am a bit surprised by a decision which is postulated on the proposition that Mr Schofield's emigration was so certain that what happened in this case, including his successful emigration, had a commercial unity.

Moreover, there can be no doubt that, if Mr Schofield had not emigrated successfully, HMRC would have taxed the gain that arose on his later exercise of the second FTSE option.

But leaving that aside, is it right that when the statute treats these 4 options as distinct assets with particular consequences on grant and exercise, the commercial unity approach allows the Court to say there was no loss.

According to *Ramsay* itself, the difference which is important is the difference between a real loss and an arithmetical difference.

But it has to be borne in mind that, in *Ramsay*, there was value shifting: the taxpayer put up one sum for shares and the money put up was, as it were, moved into non-taxable debt.

Nothing like that has happened here: there are separate assets, each capable of producing a gain or a loss.

If the loss on the FTSE option is not a real loss because there is a gain on the gilt option, is the gain on the FTSE option next year not a real gain?

And, if the loss on the FTSE option is not a real loss because of the gain on the gilt option, why are there losses when there have been hedging transactions?

The case seems to me very important, because it will help to define the limits of the purposive and commercial unity approaches.

A pessimist will say that the purposive approach is so in the ascendancy that loss, in the sense of not winning this case rather than in the sense of allowable loss, is inevitable.

Indeed, *Schofield* and *MJP* are examples of the evangelical aspect of tax practice.

But I have detected that some judges are unhappy at the extent to which the purposive approach has been taken.

Ten days or so ago, there was a case – *HMRC v Holland* – reported in The Times.

B was the corporate director of C. A, an individual, was a director of B.

Was A, who was a director of the director, a shadow director of C?

The Supreme Court, by a majority, has said that he is not.

To my mind, that rather demonstrates that a strict approach is coming back

into fashion.

Like the tide, fashions in statutory interpretation ebb and flow, and, at the right time, what were once the dangerous shallows of tax avoidance may yet turn out to be the safe deep waters of tax mitigation.

But if there are to be riots about whether Top Shop and Vodafone have paid enough tax, what the law says may be a bit immaterial. I despair of the belief that there is a proper amount of tax to pay, which is reflected in the ECJ's concept of arrangements intended to escape the national tax "normally payable".

Happily, I did not draft the tax statute but, if I had, I might, as God is sometimes supposed to do about the creation of the world, wonder if it was worth it.

If there is an automatically right amount of tax to pay, what is the point of the statute?

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[1] The text of this article is that of a talk given by the author on the 9th December 2010 – Ed.