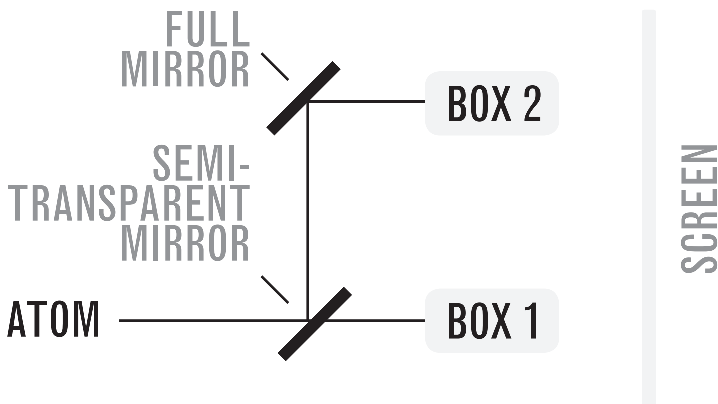
# TAX SUPERPOSITIONS

## by Michael Firth

INTRODUCTION

Ask a physicist with access to the right equipment and he (or she) will be able to prove to you that the same electron of atom can be simultaneously in two places at once – in other words, in a superposition.

First,[1] he would direct a source of atoms at a semi-transparent mirror. The point of the semi-transparent mirror is that it reflects part of a wave but allows the rest of the wave to go through. Second, he would direct (using full mirrors) the path of what passes through the semi-transparent mirror into one holding box (Box 1) and the path of what is reflected by the semi-transparent mirror into another holding box (Box 2). Note that both boxes have a narrow slit that points at the same screen and which can be opened and closed at will:




Now he asks you which box you want to look in. You choose one box (Box 1), look in it, and the atom is there. You then open

the other box (Box 2) and find nothing. The physicist then repeats the experiment a number of times. Each time, you choose a box and sometimes the atom is in the one you chose and sometimes it is in the one you did not choose. So far, so ordinary.

Recall, however, that Boxes 1 and 2 are parallel and each has a slit that can be opened and that points at a screen. The physicist carries out the same experiment, but instead of letting you choose to look inside one box, he opens both slits on the boxes at the same time. The first time he does this, a single atom appears on the screen. He then repeats this many more times and you start to see a pattern build up of alternating bright vertical lines (where atoms are hitting the screen) and dark vertical lines (where no atoms are hitting the screen).[2]

By this point, you would be starting to think that something unusual was going on, but the physicist says there is more. He moves the two boxes slightly further apart (although still pointing at the same screen), and repeats the exercise of watching a pattern build up on the screen (which has been replaced with a fresh screen). The same pattern of alternating bright and dark lines builds up, but this time the dark lines are noticeably narrower.

The only thing that changed between the first screen demonstration and the second screen demonstration was the distance between the boxes. If there was a single atom in each box during each run of the experiment, the area over which the pattern was shown might be expected to wider when the boxes are further apart, but one would not expect the pattern itself to change. It appears to follow that when the physicist opens both boxes at the same time, "something" of the single atom is coming out of both boxes at the same time and those "somethings" are interacting with each other on the way to the screen in a way that depends on how far apart they were when they started.

Finally, the physicist repeats the screen demonstration and allows you to look in one of the boxes before he opens both

slits at the same time. This time, there is no pattern on the screen; instead the distribution of atom hits is broadly uniform.

The explanation of the above given by quantum theory is that until the atom is observed, it can be represented by a wave of probabilities. Thus, a wave crest represents a higher probability that the atom would be measured in that location, and a wave trough represents a lower probability. This is not simply an abstract wave, however, because as the experiments above imply, the wave is split at the semi-transparent mirror, each separate wave then travels to one of the boxes and, when released, the waves interfere with each other on the way to the screen to cause the pattern seen.

However, when you open one of the boxes before releasing the waves, you observe the atom and thus collapse its wave from a range of possible locations into the single location that you observe.

In what is probably a very ill advised step, the purpose of this article is to (roughly and inexpertly) translate this concept that something can be in two states at once (i.e. in both boxes at the same time), into a tax context.

The premise is that in the same way that, before it is observed, the location of an atom can be represented as a wave of probabilities as to where the atom would be found if an observation was made, so too, the uncertainty in the UK tax code is such that tax charges can be represented as a wave of probabilities that a particular action will be found to have a particular tax consequence when the Courts get round to "observing" or measuring it.

The idea is that, rather than simply accepting such uncertainty as an unavoidable fact of life, taxpayers can entangle their tax affairs with whatever the correct tax analysis of a proposed action is later observed to be. Thus, in a greatly simplified example, if T believes that there is a 50% chance that a disposal of property to X will qualify for a tax relief and a 50% chance that it will result in a tax charge, T will make the answer to the

question of whether he has disposed of the property to X depend directly on whether the tax relief is available.

Once the property rights have been entangled with the tax analysis in this way, until the tax position is looked at by an authoritative adjudicator, the disposal will exist in a superposition between the states of having happened and not having happened. The benefit is that when the tax analysis is established, whichever way the uncertainty is resolved, the superposition of the property rights will collapse in a way that means there is no tax charge. Thus, if the relief is found to have been available, it will follow that T made the disposition, but if the relief is found not to have been available, it will follow that T made no disposition.

It can be seen, therefore, that tax superpositions are an approach to the tax code in general rather than a self-contained tax planning tool. They do not create tax advantages; instead they allow taxpayers to hedge any uncertainty as to whether an actual relief (for example) is available where the non-availability of that relief would have stopped the transaction taking place or caused it to take a different form, if the taxpayer had known about it. In essence, tax superpositions allow taxpayers to say "I think that this is the tax position, but I am not prepared to take the risk that it is not".

The structure of this article is as follows:

(a) Tax superpositions explained
(b) Tax superpositions as a matter of law
(c) Tax superpositions justified

***(a) Tax superpositions explained***

Tax superpositions are all about dealing with uncertainty in the tax code in a constructive way. Uncertainty may arise in three main (and, to an extent, overlapping) ways:

1. It is not clear what the legislative words mean;
2. It is not clear what the facts are; or
3. It is not clear how the legislation applies to the facts.

Such uncertainty becomes especially problematic in two scenarios. The first is where an opportunity is available to a taxpayer, but it is not clear what the tax consequence of taking that opportunity will be. On one view of the tax code, the tax consequences of the opportunity are acceptable. On another view, the tax consequences are unacceptable. Not wishing to risk the possibility that the unacceptable tax consequences are the actual consequences, the taxpayer decides to do nothing.

The second scenario is similar: an opportunity is available to a taxpayer but there are different ways of taking advantage of the opportunity. The tax consequences of each structure can only be described in terms of probability rather than certainty. According to the standard view, the taxpayer must choose between the approaches according to the potential benefit and likelihood of that benefit.

Both of these problems can be cured with a tax superposition. In the former, the tax superposition would create a situation where determining whether the taxpayer has taken the opportunity depends upon whether the tax consequences of that opportunity are favourable or not. If the opportunity has favourable tax consequences, the taxpayer has taken it. If the opportunity does not have those tax consequences, the taxpayer has done nothing (or something with certain, and acceptable, tax consequences).

In the latter scenario, the tax superposition means that whether the taxpayer has used the first choice structure or the second choice structure depends upon whether the taxpayer's tax analysis of the first choice structure was correct.

***How to establish a tax superposition***

The best way to understand how a tax superposition may be established is through an example. Take a set of facts in which a taxpayer (T) carries on a lettings business, and the additional services provided by T are more substantial and wide-ranging

than those provided in *HMRC v. Pawson* [2013] UKUT 050 (TCC) (for example, T also delivers meals to residents), but not so substantial and wide-ranging as to put it beyond doubt that the business does not consist mainly of holding investments.

If business property relief from IHT is available, T would like to place the business into a discretionary trust for the benefit of his children and grandchildren. If not, he will think about other possibilities. One option is to apply for non-statutory clearance from HMRC, but let us assume that, contrary to the view of T's advisers, HMRC have said relief is not available. T thus faces the dilemma posed in the preceding section: take the risk of tax uncertainty or do nothing.

The tax superposition is created by drafting the principal trust of the settlement as follows:

1. Principal Trust
    - 1.1. If the condition specified in Clause 1.3 is met at the time that this deed is executed, the Trust Property is held on the Trusts specified in Clauses 2 – 4.
    - 1.2. If the condition specified in Clause 1.3 is not met at the time that this deed is executed, the Trust Property is held on the Trusts specified in Clause 5.
    - 1.3. The condition is that the Original Trust Property is relevant business property within the meaning of Chapter 1 of Part V of the UK Inheritance Tax Act 1984 as that Chapter stands at the time that this deed is executed.

Clauses 2 to 4 would then set out the discretionary trusts and Clause 5 would set out a trust that did not involve any risk of inheritance tax, for example, a bare trust in favour of the Settlor.

From this it can be seen that who the beneficiaries are and what rights they have depends entirely upon the tax law definition of "relevant business property". If T's advisers are correct that the Original Trust Property is relevant business property, T has created a discretionary trust but, for the same reason, IHT relief is due. Conversely, if HMRC were correct

that the Original Trust Property is not relevant business property, then T has created a bare trust for himself and there is no loss to his estate.

Until it is established who is correct, however, it cannot be known with certainty who the beneficiaries are – the property rights in the Trust Property are in a superposition between the two possible trusts, and it is only when a Court "measures" the location of the property rights that the superposition will collapse into one of the possibilities.

Having created the superposition, T has two options. He can either seek to have the superposition authoritatively collapsed or he can allow the superposition to persist and plan around it.

One way of collapsing the superposition would be via the taxation of the income from the Trust Property. Assuming that the settlement anti-avoidance provisions do not apply, then the correct taxable person in respect of the income depends on who is the actual beneficiary of the trust. It follows that HMRC's decision (and, if necessary, a Tribunal's decision) as to who is taxable in respect of the income will depend on whether the Original Trust Property was relevant business property. Once that issue has been litigated and resolved a first time, it is unlikely that HMRC would want to re-litigate it (and, in any event, it may be an abuse of process).

Alternatively, if T wishes to let the superposition persist, both he and the trustees will need to hedge each transaction with the discretionary beneficiaries in terms that it is either a disposition by the trustees or else a gift (and thus a PET) by the Settlor. Failure to do so would mean that the dispositions could potentially be found to be breaches of trust if it is subsequently held that the Trust Property was held on bare trust for the Settlor, with the result that the property is held on constructive trust for the Trustees (and, in turn, the Settlor).

One final issue in relation to this example is that until the superposition is collapsed, there is the possibility that the

Trust Property is in the Settlor's estate. This can dealt with by having the "not relevant business property" trust as a trust to hold absolutely for a specified person or persons – perhaps the main discretionary beneficiaries, if they can be trusted not to seek to collapse the superposition in favour of the absolute trusts. In those circumstances, the IHT analysis would be a superposition between business property relief and a potentially exempt transfer. On the other hand, the Settlor could retain the bare trust in favour of himself and dispose of that potential interest at some later point by a potentially exempt transfer.

The above is offered as proof of principle, and tax superpositions may applied to many other reliefs and tax problems, for instance:

- Corporate re-constructions
- Rollover relief on incorporation of a business
- The GAAR.

In all cases two important, but general, points should be noted. The first is that it is vital to make sure that the superposition depends on the state of affairs at or before the time one purports to create it. Only in those circumstances can the superposition depend entirely upon a legal uncertainty, rather than, for example, something that may happen in the future. The aim is to make the location of the property rights certain from a legal perspective from the outset, even if for all practical purposes, there is no certainty until the question has been authoritatively resolved.

Second, tax superpositions are not the same as the doctrines of mistake or the rule in *re Hastings Bass*. Whereas those rules aim to undo or void transactions after they have been carried out, the tax superposition makes what the taxpayer actually did or did not do in the first place dependent on the tax analysis. It does not seek to undo something that at least appears to have been done.

***(b) Tax superpositions as a matter of law***

In legal terms, the objection that tax superpositions may face is that the trusts or contracts creating them are void for uncertainty. From a contractual perspective, there is the rule that the courts will not generally make the contract for the parties – it is for the parties to make their contract and they must express their agreement in a form that is sufficiently certain for the courts to be able to enforce it.

Similarly, from a trusts perspective, it is well known that there must be certainty in relation to the objects of the trust, although precisely what is required depends upon the type of trust. Thus, for fixed trusts it must be possible to draw up a complete list of the objects of the trust, whereas for a discretionary trust it must be possible to say of any given person that he or she is or is not an object of the trust.

Neither doctrine provides a problem for tax superpositions, as long as the uncertainty in relation to the tax position is due to uncertainty in interpreting the legislation or applying the legislation to the facts and not in determining the primary facts.

In the first place, from the law's (and thus the Court's) perspective there is no uncertainty. Whilst to mere mortals, such as taxpayers and their advisers, there can be uncertainty as to whether, for example, a particular business qualifies for business property relief as relevant business property, there is only one correct legal answer to that question and that answer will be handed down by a Court, when asked. Of course, in reality, judges have to go through the same mental processes as tax advisers to decide what the answer to a question is. The difference is that when a judge hands down the answer, he or she does not say "this is probably the answer – I am 80% sure it is", he or she says, "this is the answer", and subject to appeals, it is the answer for those parties.

In the second place, even if one did accept that as a practical matter there is (at least) a degree of uncertainty in interpreting

the tax code, it would be nothing short of absurd for the Courts to hold that whilst it is permissible for Parliament to promulgate inherently uncertain rules, it is impermissible for private citizens to incorporate those same provisions into their drafting. Putting this another way, if the tax provision is certain enough that the Courts can make sense of it (or will make sense of it) when called on to do so, there is no reason why the scenario in which they are called upon to make sense of it ought not to be in deciding who has particular property rights.

Essentially, one can think of the Courts as the third person appointed to resolve the ambiguity, not unlike the Chief Rabbi in *Re Tuck's Settlement Trusts* [1978] 2 WLR 411. Indeed, in *Re Leek* [1969] 1 Ch 563 Harman LJ held that a class of beneficiaries defined by reference to whether the trustees considered the person to have a moral claim was upheld because the condition was not whether the person had a moral claim, but whether the trustees considered the person did (and see, to similar effect, *Dundee General Hospitals v. Bell's Trustees* 1952 SLT 270).

As confirmation of the legal validity of tax superpositions, one can note that there are a number of circumstances in which it is already the case that the true effect of an agreement or trust can only be established by reference to concepts in the tax code.

***Registered pension schemes***

As part of the process for a pension scheme obtaining registered pension scheme status, HMRC are entitled to require (and do in fact require – RPSM02101010) that the scheme administrator declares that the "instruments or agreement by which [the pension scheme] is constituted do not entitle any person to unauthorised payments" (FA 2004, s.153(3)).

In practice, what many pension scheme trust deeds do to be absolutely sure of this is they expressly state that no member or beneficiary is entitled to any payment or benefit that would

amount to an unauthorised payment within the meaning of s.160 of FA 2004. Thus, the whole pension trust is circumscribed by a restriction that is defined expressly by reference to the tax definition of unauthorised payment. It has never, to the author's knowledge, been suggested that such a provision is in any way ineffective, and the consequence is that if the trustees make a payment believing it to be an authorised payment, but it is in fact an unauthorised payment, that payment is in breach of trust and must be returned to the trustees (thereby avoiding the unauthorised member payment charge – see *Thorpe v. HMRC* [2009] EWHC 611 (Ch)).

***Drafting trusts generally***

Two examples in relation to drafting trusts generally may be given. The first can be found in paragraph 3 of the STEP Standard Provisions for will trusts, 2nd edition:

> "If the existence of any powers conferred by these provisions would be enough (without their exercise) to prevent a Person from being entitled to an interest in possession (within the meaning of the Inheritance Tax Act 1984) then those powers shall be restricted so far as necessary to avoid that result."

It can be seen that this provision can operate to create a superposition in relation to the existence of a power. If there is a power, and it is not clear whether it is administrative or dispositive, then whether that power exists will depend upon how the courts would approach that question in the context of the Inheritance Tax Act 1984. By drafting the trust in this way, the drafter takes the uncertainty out of the tax status of the trust and substitutes uncertainty as to the existence of a power. Such uncertainty is far more acceptable, because even if the trustees make the wrong decision, the effect is that one has to undo the purported exercise of the power, rather than interest in possession status being lost. In a sense one has "tax-proofed" the trust.

Another example of tax-proofing is in the drafting of non-relevant person trusts. Non-relevant person trusts are those drafted to ensure that only persons who do not fall within the definition of "relevant person" in ITA 2007 s.809M (e.g. the Settlor's parents) can benefit. If such a trust brings remittance basis income or gains of the settlor to the UK, there is no taxable remittance. The definition of "relevant person" is rather long and complicated, with numerous cross-references to other definitions in the tax code, such as "close company" and "participator". Instead of painstakingly recreating these elements of the definition, it is far simpler to include them by express reference. One way of doing this is to set out the list in s.809M and include the definitions of the defined terms by reference. Another way is to simply exclude:

> "any person falling, for the time being, within the definition, for the time being, of "relevant person" in the United Kingdom Income Tax Act 2007, s.809M, relative to the Settlor."

It has been observed that such tax-proofing clauses are no substitute for properly analysing the statutory provision and framing the trust accordingly.[3] This is especially true when drafting the trust administrative powers – one wants to provide as much guidance to the trustees as possible in relation to what they can and cannot do. On the other hand, however, careful drafting, even copying the legislation out, is no substitute for making it absolutely clear that the trust is to be read by reference to the relevant part of the tax code. If one does not do so, there is at least a risk that the statutory provision and the trust provision will be interpreted differently (for example, if some other part of the tax code forces the Courts to adopt an unnatural interpretation of the relevant tax definition). The author's preference, therefore, is for the provision to be drafted in a helpful but succinct way (for the trustees' benefit), with the tax-proofing clause added on at the end (to be sure).

***Wills***

In *RSPCA v. Sharp* [2010] EWCA Civ 1474 the deceased, by a professionally drafted will, purported to give to certain beneficiaries:

> "the amount which at my death equals the maximum which I can give to them by this my Will without Inheritance Tax become payable in respect of this gift…"

The issue that arose was whether this clause entitled the beneficiaries to a gift equal to the full amount of the nil-rate band or only so much of the nil-rate band as was not used up by other specific gifts in the will. In the event, the Court of Appeal agreed with the RSPCA to the effect that the clause was a gift of the nil-rate band less other specific gifts made in the will. What is important for present purposes, however, is that the Court was more than willing to engage in technical analysis of the underlying tax legislation to establish exactly what the testator intended:

> "The phrase "the maximum which I can give to them by this my Will without Inheritance Tax becoming payable in respect of this gift" seems to me to contemplate (as it must) a calculation of the nil rate band by reference to all transfers of value made "by this my Will". Those words are not superfluous or accidental. They are an accurate recognition of how IHT works." (§23 per Patten LJ).

***Tax Covenants***

It hardly needs explaining that tax covenants are drafted with extensive reference to the tax code of one or more States. For example, the covenant may provide that the purchase price will be reduced by:

> "an amount equal to any Tax Liability of the Company arising as a result of any Event which occurred on or before Completion…"

And Tax Liability will be defined by reference to a whole host of taxes, subject to specific exclusions.

***VAT***

VAT provides the most common example of drafting by reference to the tax code: prices exclusive of VAT. Normally there is no doubt as to whether the supply is subject to VAT at the standard rate, but in some cases there is, and if it later emerges that, for example, the supply was exempt or zero-rated, as the customer has agreed a VAT exclusive price, any amount paid as VAT can be recovered (via an action for unjust enrichment based on mistake).

This is particularly interesting given the insistence in *May & Butcher v. King*, The [1934] 2 KB 17 on certainty as to contractual prices:

> "'Certum est quod certum reddi potest.' Therefore, you may very well agree that a certain part of the contract of sale, such as price, may be settled by some one else. As a matter of the general law of contract all the essentials have to be settled. What are the essentials may vary according to the particular contract under consideration. We are here dealing with sale, and undoubtedly price is one of the essentials of sale, and if it is left still to be agreed between the parties, then there is no contract." (per Viscount Dunedin).

In relation to VAT exclusive prices, that third person must be the Tribunals and Courts.

***(c) Tax superpositions justified***

Whilst tax superpositions are legally entirely different from the so-called *Hastings-Bass* principle (see the end of section (a), above), there might be an inclination to direct some of the same criticisms as were directed at that doctrine, at the tax superposition doctrine. For example, Lord Neuberger said, extra-judicially ("Aspects of the law of mistake: *Re Hastings Bass*", Trusts & Trustees, Volume 15, No.4, June 2009):

> "Let me pursue the get-out-of-gaol free aspect a little

> further. Consider a case where trustees casually exercise a power and take an action, without taking any advice believing that it will have no disadvantageous tax consequences. If their belief is correct, the action stands; but, if the action gives rise to a charge to tax, they can, effectively as of right, have the action reversed. The position is equally good, if the trustees get expert advice that the action will, albeit only probably, work in terms of tax consequences. It would seem that they could confidently proceed to take the action. If it works well and good, and, if it does not, they believed it would, so they can bring themselves within the principle.
>
> Indeed, it gets better. Say that trustees are told that a particular action has a 10 per cent chance of saving tax, and a 90 per cent change of increasing tax liability, and they take the action in the belief that, if it does not work, they can unscramble it by relying on the principle. If they go ahead, the principle seems to result in heads the trust wins, tails the Revenue loses. If the 10 per cent chance eventuates, tax is avoided and trebles all round. If it does not, the trustees may at first sight be in difficulties because they cannot have believed the action would work, on the balance of probabilities, in the light of the advice they got. Accordingly, no mistake and so no application of the principle.
>
> But hang on a moment: if the trustees cannot rely on the principle, they should nonetheless be able to undo the action under the principle, because they made a mistake when taking the action, namely that they could rely on the principle if it did not save tax." (at p193).

With respect there is one key error in this reasoning and one key omission. The key error is the suggestion that it is "heads the trust wins, tails the Revenue loses". That is absolutely not what tax superpositions (or the *Hastings Bass* principle) achieve.

Instead, what they achieve is "heads the taxpayer obtains a benefit provided for in the tax code, tails nothing happens".

In other words, if the taxpayer obtains the tax benefit, he must have satisfied the conditions set out by Parliament to obtain that benefit and thus has not "won" vis-à-vis the Revenue. Conversely, if the tax benefit is not obtained, so the end result is essentially that nothing has happened, the taxpayer is in no better position as a result of having tried and failed to obtain the tax benefit. In particular, unlike cases of tax avoidance, the taxpayer has not obtained a tax advantage without incurring the economic consequences that Parliament intended to attach to that advantage. He simply has not changed his position and thus his tax position has not changed.

One can only see the Revenue as losing out if one sees the uncertainty and complexity of the UK tax code as a deliberate trap set up by the Revenue to catch people out and result in unpredictable tax charges. The author has never heard a UK government or HMRC express this view, and the establishment of the Office of Tax Simplification suggests that complexity is not regarded as a virtue.

This leads on to the key omission: the cause of the 10:90 chance of a tax benefit versus a tax charge that Lord Neuberger refers to is a horrendously complicated tax system that was not designed by, and thus is not the fault of, the trustees. Essentially, what tax superpositions allow the taxpayer to do is say: "I want to do X, but only if there are no adverse tax charges".

I cannot see how this is at all unreasonable. Having created a monstrosity, it does not lie in the mouths of the Revenue or the government to object to taxpayers seeking to reduce the uncertainty that they face. The rule of law requires a legal system to be made up of laws that are intelligible, clear and predictable. Where a legal system falls short of this ideal, no criticism should be levied on persons who take matters into their own hands, rather than becoming serial gamblers.

## CONCLUSION: "I LIKE TO THINK THAT THE MOON IS THERE EVEN IF I'M NOT LOOKING AT IT"[4]

In an ideal world, or at least one that showed more respect for certainty and predictability than the one we inhabit, tax superpositions would be unnecessary. The truth, however, is that many tax charges are not "there" until the relevant legislation has been placed before the relevant Tribunals and Courts, and an authoritative observation has been made.

Unless the taxpayer would have entered into the particular transaction in question irrespective of the tax analysis, a tax superposition allows the taxpayer to make his actions entirely dependent on what the tax analysis turns out to be. If the taxpayer's tax analysis is falsified by later experimental observations (or "cases" as they are otherwise known), then so is the existence of the corresponding transaction.

From the perspective of an adviser, a tax superposition offers a form of insurance policy, because it removes the risk that a disappointed client will turn around and say "I would rather have done nothing than be left with the tax bill I now face" (and it is in precisely that sort of case that the client may be able to recover damages that include the tax bill).

*Endnotes*

1 This description is based on the particular way of presenting the double-slit experiment set out in Rosenblum and Kuttner, "*Quantum Enigma*", 2nd edition, which is highly recommended for those seeking an accessible way of reading more about approaches to interpreting quantum theory.

2 See the video at http://www.hitachi.com/rd/portal/research/em/doubleslit.html

3 Kessler and Sartin, *Drafting Trusts and Will Trusts*, 11 edition, §16.17.

4 Albert Einstein