THE RULE OF LAW, TAX AVOIDANCE AND THE GAAR

by Patrick Way QC

INTRODUCTION

On the 20th November 2013 the Bingham Centre for the Rule of Law is holding a one-day public conference on the subject of "Do Our Tax Systems Meet Rule of Law Standards?". The title is something of a hot topic, and the purpose of the article is to consider why this might be and why tax practitioners and others are concerned that, currently, what might reasonably be called, the "rule of public opinion" as voiced by the Press and MPs has to some extent usurped the "rule of law". That this is the case can be seen by reference to the outcry against companies such as Google, Amazon and Starbucks, none of which has broken the law, and yet each of which has faced widespread criticism from MPs, journalists and the Press. Indeed, Starbucks announced on 6th December 2012 that it would make a voluntary payment of £20m. to HMRC in reaction to the apparent public mood against its tax stance. As it happens, Starbucks' most recent accounts reveal a world-wide rate of tax of 31%, which seems relatively high. Further, Goldman Sachs felt the weight of public opinion upon its shoulders to such an extent that it abandoned plans to defer bonus payments to the 6th April 2013 (when the top rate of tax was reduced to 45p) and paid the bonuses before that date, employees suffering the top rate of income tax at 50p instead. The effect of that was to incur a total marginal rate of income tax and national insurance on the bonuses of 57.8%, rather than the still considerable 53.4%. As some commentators

have observed, adjusting the time of bonus payments is just the sort of routine advice which many small accountants give to their small company clients. Nevertheless, Sir Mervyn King, the departing Governor of the Bank of England, was amongst those critical of Goldman Sachs, and he said:-

> "I find it a bit depressing that people who earn so much seem to think it's even more exciting to adjust the timing of it to get the benefit of a lower tax rate, knowing this must have an impact on the rest of society."

OBSERVATION

The writer should say that the comments in this article are his own and are, for example, entirely independent of the Bingham Centre's views.

THE RULE OF LAW AS AGAINST THE RULE OF PUBLIC OPINION

What is the rule of law?

As will be seen from sources such as the website for the Constitution Society, the concept of the "rule of law" is an ancient principle but nevertheless somewhat elusive. As the Society says, the phrase is universally used but not comprehensively defined. They also say that it is commonly understood to mean that "every member of society is bound by and entitled to the benefit of laws which are publicly made and publicly administered and which do not have retrospective effect". The Society goes on to say, as one of its general rules, that "The judiciary are often regarded as the guardians of the rule of law, as it falls to an independent and fair judiciary to enforce that rule of law, especially when invoked by citizens to protect themselves from the excesses of the state or the executive."

Equally relevant in the writer's opinion is the following definition of "tax" taken from Black's Law Dictionary:-

> "A tax is a "pecuniary burden made upon individuals or property owners to support the government ... a payment exacted by legislative authority." It "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority." And it is "any contribution imposed by government ... whether under the name of toll ... custom, excise ... or other name" (Black's Law Dictionary page 1307, 5th edition 1979)

The following is the writer's attempt to provide a definition of the "rule of law":-

> "The rule of law requires that the government of the day exercise its powers, including its powers to collect tax, by reference exclusively to its rules, regulations and legal practices as laid down in statute and built up through case law. The law is sacrosanct, and an individual is entitled to govern his or her affairs exclusively by reference to the law in force, particularly so far as is concerned the citizen's obligation to pay tax."

The Bill of Rights of 1688 established that "the levying of money to or for the use of the Crown without grant of Parliament was illegal". Put it another way (as the writer would put it), "tax may be raised only pursuant to the rule of law and not otherwise."

As we all know, the authority for imposition and collection of tax is by reference to enactments of Parliament, and, of course, Parliament is responsible for approving new legislation. Indeed, before legislation becomes enacted, both the House of Commons and the House of Lords must debate and vote on the proposals. As a result of this we have a fundamental principle of statutory construction, which is that, in seeking to give meaning to legislation, the requirement is to find "the intendment of Parliament" which underscores the legislation in question. Accordingly, when one looks at one of the leading

textbooks on statutory construction, *Statutory Interpretation* by Francis Bennion, published by Butterworths, 4th edition, one finds, in his introduction at pages 9 and 10, the following:-

> "Statute law is the will of the legislature; and the object of all judicial interpretation of it is to determine what intention is either expressly or by implication conveyed by the language used, so far as necessary for the purposes of determining whether a particular case or state of facts which is presented to the interpreter falls within it."

So the rule of law overrides any "moral" aspect relating to construction of legislation and in particular concerning the construction of tax statutes and, it follows from that, that the rule of law reigns sovereign over public opinion.

That there is no morality in relation to tax law, and certainly no morality in construing tax law, has until recently been relatively well-accepted. After all, as most readers will know, in respect to morality and tax legislation, we have the well-known judgment of Rowlatt J. in *Cape Brandy Syndicate v. The Commissioners of Inland Revenue* (12 TC 358):-

> "Now of course it is said and urged by Sir William Finlay that in a taxing Act clear words are necessary to tax the subject. But it is often endeavoured to give to that maxim a wide and fanciful construction. It does not mean that words are to be unduly restricted against the Crown or that there is to be any discrimination against the Crown in such Acts. It means this, I think; it means that in taxation you have to look simply at what is clearly said. **There is no room for any intendment; there is no equity about a tax: there is no presumption as to a tax; you read nothing in; you imply nothing, but you look fairly at what is said and at what is said clearly and that is the tax.**" [emphasis added]

That is not to say, of course, that in the modern world commercial enterprises may take no account of public opinion. Indeed, it is critical that they are aware that they cannot, from the point of view of promoting and retaining their image, simply rely upon having adopted a strictly legalistic approach, especially in relation to the management of their tax affairs. If the public deems them to have acted outside the perceived morality of the day then the business will suffer, particularly if their brand is one of utmost integrity.

In this article, the writer considers how public opinion in relation to tax matters has changed dramatically and also queries the role of Parliament – including, in particular, that of the Public Accounts Committee in relation to its attack (so it would seem) on businesses which have done nothing more than adopt and comply with the rule of law. In a nutshell, in the writer's view it is not for the Public Accounts Committee to chastise companies that save tax within the law. On the contrary, if Parliament finds such an approach objectionable, then it should change the law. Parliament, after all, is the law-maker in the first place.

Further, as Lord Hoffmann has said, in "Tax Avoidance" [2005] BTR 197:-

> "… tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by statute that means such a tax is to be imposed. If that is what Parliament means, the courts should be trusted to give effect to its intentions. Any other approach will lead us into dangerous and unpredictable territory."

So, this illustrates one of the difficulties when trying to pin down what avoidance is, since on *one* analysis any scheme that works is by definition not avoidance: it complies with the intention of Parliament as expressed within the statutory language.

See, for example, the paper entitled "Interpreting Tax Statues: Tax Avoidance and the Intention of Parliament" by

Professor Judith Freedman, Law Quarterly Review, January 2007 for a commentary on this area of law. In that paper Professor Freedman cites the following view which was expressed in the Institute of Fiscal Studies Green Budget in 2006:-

> "There will have been no avoidance if the judges decide that Parliament misfired, so that arrangements fall within the letter of the law – however much it may appear that Parliament may not have intended its language to cover the particular arrangements entered into by the taxpayer. As a matter of law, that is what Parliament has prescribed and a taxpayer does not avoid tax by limiting his or her liability to what the law prescribes." (S Bond, M Gammie and J Whiting, Institute for Fiscal Studies Green Budget (2006), at page 174)

So, pausing here, the writer repeats that it seems to him that it is not for Parliamentarians to chastise persons who act within the law to reduce their tax from what those Members of Parliament might have wished for. On the contrary, as already mentioned, it is his view that those Parliamentarians, if they object, should change the law, and it is certainly within their power, of course, to do so.

The rule of law in practice

Applying the rule of law, surprising as it may seem at first glance to some commentators, can produce both benefits and disadvantages for taxpayers: morality does not come into it.

In the case of *HMRC v. D'Arcy* (ChD 2007, [2008] STC 1329), we find planning involving the accrued income scheme and the sale and repurchase of gilts resulting in the taxpayer being able to access a significant tax advantage with no corresponding economic expense, in circumstances where Henderson J said:-

> "In short, this is in my view one of those cases, which will inevitably occur from time to time in a tax system as complicated as ours, where a well-advised taxpayer has been able to take advantage of an unintended gap left by the interaction between two different sets of statutory provisions."

Or to put it another way: "The rule of law holds sway in this case whether I like it or not (*and I probably don't like it*)".

Similarly, in the case of *Mayes v. Revenue & Customs Commissioners* [2011] EWCA Civ 407, [2011] STC 1269; *affg* [2009] EWHC 2443 (Ch), [2010] STC 1 we find a tax avoidance scheme involving surrenders of insurance policies producing a loss by reference to a prescriptive interpretation of the statute (*application of the rule of law*), in circumstances where the taxpayer in question suffered no similar economic loss. As will be seen in the analysis below of the *Lobler* case, the courts held, in effect, in *Mayes*, using the writer's own language rather than the court's, that the rule of law had to be observed, however unsavoury that might appear to the judge applying the law. Consequently, the taxpayer's avoidance scheme had to be found to be successful since it fell fairly and squarely within the legislation which directed, in effect, that a significant tax benefit accrued. One might even say, based upon some of the comments mentioned above, that it was therefore not avoidance at all; but the writer does not adhere to that principle. Rather, in his view, the taxpayer's attempt to pay less tax than might otherwise have been the case (certainly less than the amount which Parliament would have considered to be the case had it addressed the point and covered it properly) was successful after all. The avoidance fell within the prescriptive rules on the statute, however odd the result which those prescriptive rules produced.

But the rule of law cuts both ways and can produce outcomes which are very much to the detriment of the taxpayer. In the case of *Orsman v. HMRC* ([2012] UKFTT 227 (TC), a case involving stamp duty land tax (SDLT), Miss Orsman bought a

house for a total consideration of £250,000. The SDLT on that amount would have been £2,500 only, since the consideration fell within the 1% threshold. Unfortunately, Miss Orsman also acquired some other items including some fixed units in the garage which had a value of £800. These fitted units counted as *fixed chattels* as if they were part of the house itself, and as a result their value increased the total consideration for the house, chargeable to SDLT, from £250,000 to £250,800. This resulted in the whole of the increased consideration moving from the 1% band into the 3% band for SDLT purposes. This is because SDLT operates on a "slab" basis, meaning that as you cross from one threshold to another (here from 1% to 3%) you "take with you" the *whole* of the consideration and not just the extra amount (here £800) which pushed you into the higher band in the first place. This meant that Miss Orsman had to pay a total of £7,524 SDLT for the house (an extra £5,524) and this additional amount of £5,524 arose exclusively because of the effect of Miss Orsman's buying the cupboards for £800. In other words, it would have been cheaper for Miss Orsman to have asked the vendors to remove the cupboards completely, and she could then have bought new cupboards with the tax saving, as well as a small car to put in the garage.

Now, you may ask, did HMRC apply the rule of law here, or did they seek to recover only what public opinion so freely talks about: Miss Orsman's "fair share of tax"? Of course, HMRC applied the rule of law and helped themselves to additional tax worth nearly ten times the value of the cupboards.

Or, how about the case of *Joost Lobler v. HMRC* ([2013] UKFTT 141 (TC)? This involved, like *Mayes*, partial surrenders of life policies involving taxable income arising under ITTOIA 2005 Chapter 9 Part 4, only this time the legislation applied to the great disadvantage of the taxpayer. Indeed, in the opening paragraph of the judgment, Judge Charles Hellier acknowledged, so it would seem, with some remorse and frustration, that this was a case which produced a remarkably unfair result as a consequence of the application of prescriptive legislation (*the writer would say as a result of the application of the rule of law*), together with, unfortunately – so continued Judge Hellier – Mr. Lobler's ill-advised actions: i.e. Mr. Lobler had not checked the legal position before he took various steps. The facts involved Mr. Lobler moving to England and putting all his life savings into a life insurance policy with Zurich Life and topping that up with a loan from HSBC, such that the insurance policy at one time had a value of over $1.4m. Having put the money into the policy, he then began to withdraw sums from the policy, once in the United Kingdom, taking out sufficient first to repay the HSBC loan and then the balance, more or less, was taken out to enable him to buy a house and to engage in works of renovation in the United Kingdom. So it might be said that all that Mr. Lobler had done was to put money into the policy and then take it out again, and he assumed that there would be no tax to pay, and certainly not on virtually the *whole* amount of the money which went in and out of the policy.

Broadly speaking, however, because of the way the legislation worked, *all* of the amounts that came out were fully taxable. And by applying the rule of law in this way (to the disadvantage of the taxpayer), the judge here was simply adopting a similar analysis as was adopted in *Mayes v. HMRC*. There, as already mentioned, the judge (Proudman J) had held in the Chancery Division that a *planning* scheme that utilised this legislation to the advantage of the taxpayer, was successful because of the prescriptive way in which the legislation worked in each case.

As Proudman J had said in *Mayes*, in *favour* of the taxpayer, and as was repeated in *Lobler*, *against* the taxpayer, the relevant legislation "is legislation which does not seek to tax real or commercial gains. Thus it makes no sense to say that the legislation must be construed to transactions by reference to their commercial substance ... [the legislation] adopts a

formulaic and prescriptive approach. No overriding principle can be extracted from the legislation ...".

So you can see that the writer is not saying that the rule of law is perfect and produces fair results. What he is saying is that at least you know where you are with the rule of law, particularly if the courts apply a literal and prescriptive meaning to it, adopting the rule set out by Rowlatt J in the *Cape Brandy* case.

Public opinion and Starbucks, Amazon and Google

So now we come to the impact of public opinion. As we all know, the Public Accounts Committee and much of the Press have whipped up a furore in relation to anybody who does not pay what they see as their "fair share of tax". The problem with using the expression "fair share of tax" is that it is thoroughly subjective. You may be different, but the writer has come across very few people who say, "Do you know what? I personally should be paying more tax." What he has come across is people saying others should pay more tax. Anyway, the point is that we have seen that as *a legal matter* there is no equity in a tax statute, and therefore it seems to the writer to be inappropriate to try and identify fairness in tax: the law can be unfair, but – as already said – at least you should know where you are with it if you stick with the rule of law. And Parliament can always change it.

Anyway, if you want an example of how the law is not fair then look at *Orsman* above. Or, look at the rates of tax in 1979 when the government was charging a top rate of earned income of 83% and was taxing unearned income at the rate of 98%. Can you believe that? You earned £100 of deposit interest, kept £2 for yourself and gave £98 to the government. But in the writer's view fairness of tax is not something for the Public Accounts Committee. As his colleague in chambers, David Goldberg QC has said, "It is beyond the competence of the Committee to determine whether a particular taxpayer has paid the "right" amount of tax; the proper job of the Committee is to examine against the standards of good administration, whether HMRC is doing its job." Further, as David Goldberg QC said, "A company which pays tax on its profits, computed by deducting from its receipts the expenses incurred to earn them, cannot be said to have avoided tax." A stand needs to be made for "principle" not "demotics" in the view of David Goldberg QC. The writer agrees with him.

More particularly, if Parliament does not like the tax results that are achieved by a taxpayer within the law, then the simple remedy is for Parliament to change the law. They should stop "grandstanding" about tax avoidance; rather they should change the law and remember that they introduced the law in the first place.

Films

The Public Accounts Committee grilled two members of the film industry on 6th December 2012. It is to be recalled that in 1997 the government of the day dramatically changed the benefits to individuals of investing in films. Cutting a long story short, if an investor put money into a film, typically via a partnership, then the new rules produced quite extraordinary benefits. In the first place, the legislation provided that payments for a film would be treated as trading expenditure and not capital expenditure. Also, the entirety of the payment was treated as falling within one year, even if it was paid on, say, the 5th April. Finally, to the extent that a loss arose as a result of the acquisition of the film (as would be bound to be the case in the first year, because of course the expenditure from the film inevitably exceeds the income on a film which has not yet been released), then the whole of that loss could be offset against the investor's general income. Now, in the spirit of this debate, that amounts – in the writer's view – to "government-sponsored tax avoidance". You are converting

capital to income; you are ignoring accountancy practice – which would otherwise spread the payments over some years (the lifetime of the film as it were), and you are then allowing that loss to be offset against all your other income: all thanks to the relevant statute. In other words, the government was asking for trouble in my view. Of course, the aim was that as and when the films produced royalties then these would be taxed at that stage. So the government at that time saw no real mischief: just a deferral until tax fell in. And that, after all, is the whole point of the 1997 legislation. So people could hardly be criticised for following along the path set for them by the government which introduced that legislation. In a nutshell, it was to encourage film investment by accepting that there would be large up-front costs but giving those large up-front costs helpful tax treatment (one might say tax avoidance) on the basis that in due course when the film produced profits (if it did) those would be fully taxable.

The two representatives of the film industry who appeared before the Committee on the 6th December tried to make this point but the Committee were having none of it.

Nevertheless, one does not want to be too naive. One of the problems with films and tax avoidance is that *some*, maybe *many*, have utilised these government-sponsored reliefs in a way that was simply not intended and was frankly not allowable – as a matter of *law*. For example, the payments made by way of investment in the first place were "ramped up" in favour of the investors by loans and in some cases the chance of those loans ever falling to be repaid were slim to say the least. Now that *is* abusive, and that is the area which HMRC are focusing on and, in the writer's view, are being successful. But these are two separate aspects, which the Committee should have addressed differently. There is, if you like, benign avoidance on the one hand, which is, as the writer calls it, government-sponsored avoidance (i.e. following the rules as set down by the 1997 legislation). And then there is aggressive avoidance, which would probably fall within the GAAR anyway, as we will see shortly. That involves the artificial increase of investment sums in circumstances where the investor would be unlikely ever to "incur" that expenditure in any real sense of the meaning of that word. Even absent the introduction of the GAAR that approach would fail; with the GAAR it is unlikely even to get "to the starting blocks".

Starbucks, Amazon and Google

Perhaps at this stage we should just briefly look at what the so-called mischiefs are which were adopted by Starbucks, Amazon and Google. Sadly, very few facts have emerged in the Press, but, by and large, the cases have arisen because modern business practices, particularly in the digital age – where transactions take place "in the ether" rather than on paper in an office – have accelerated beyond legislation that was formulated to a very large extent in the late 19th Century and early 20th Century. That ("old") legislation is simply not equipped to deal with modern business methods. In particular, the legislation and case law that remains with us is rooted in the days when a transatlantic crossing might take a week or so; whereas nowadays a transatlantic transaction, of course, can take place in less than a second. Further, the rules that govern modern business practice are not equipped to deal with current global business structures, under which many companies operate with subsidiary companies located all over the globe – including locations such as Guernsey, Switzerland or wherever else they might be, which have their own tax laws, more benign than those of the United Kingdom.

More particularly, there are two aspects of modern life that we need to look at. The first is the *place of contract*, and in relation thereto we should also look at the *place of a permanent establishment*, in both situations where transactions take place cross-border.

And the second situation is by reference to the transfer

pricing rules, particularly as they apply in relation to payments for intellectual property – such as for the use of a brand, or for the purchase of a product in respect of which the organisation involved may be one of the world's leading buyers (here, the writer is thinking of Starbucks and coffee).

What Google and many others seem to have done, entirely legitimately, is to arrange for contracts which might otherwise be treated as taking place in the United Kingdom to be executed elsewhere, typically in Ireland, where the rate of corporation tax is much lower than the UK and US rates of tax. The mechanism for achieving this would be based on long established law, being the "*law of offer and acceptance*" by reference to a case such as *Erichsen v. Last* (CA 1881, 1 TC 351). That case involved a Danish telegraph company operating in the 19th Century, which had an agency and office in the United Kingdom dealing with calls received in the United Kingdom using its wires. The relevant contracts were made in the United Kingdom (where acceptance took place) not in Denmark (where the offer took place). From this you can determine the place of business: where *acceptance* of a contract occurs. Similarly, most of us will know the champagne case of *Grainger and Son v. Gough* (HL 1896, 3 TC 462). This involved one Monsieur Louis Roederer, the well-known champagne merchant, whose chief place of business was at Rheims in France. He appointed an English firm as his representative in the United Kingdom for the sale of champagne, and those English agents obtained orders in the United Kingdom, but they were transmitted back to France, and it was in France not in the United Kingdom that the French wine merchant exercised his discretion as to whether to execute the orders or not. Once that had been done, the champagne was then forwarded from Rheims direct to the purchasers at the expense and risk of the latter. It was held by the courts that in that situation the contract for the purchase of the champagne was not made in the United Kingdom: it was made in France, where it was *accepted*. And essentially that is what is happening in modern transactions: care is taken to ensure that the contracts are made by acceptance in the country (say Ireland) where the rate of tax is less than elsewhere (say in the United Kingdom or the United States).

In turn this means that great care must be taken by multi-national groups in relation to the application of the relevant double tax treaty, such as the UK:Irish double tax treaty (SI 1976 No.2151). In particular, care would have to be taken in relation to the definition of *permanent establishment* found in Article 5 of that treaty, to make sure that the Irish company did not have a permanent establishment in the United Kingdom through the use of any agents acting on its behalf in the United Kingdom. This involves taking notice of the provisions of Article 5(4) which reads as follows:

> "(4) A person acting in a Contracting State on behalf of an enterprise of the other Contracting State ... should be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise."

Accordingly, the relevant Irish company could have individuals operating in the United Kingdom "on its behalf", as long as those individuals had no authority to conclude contracts on behalf of the Irish enterprise and did not do so. This is just the same as we have seen as the circumstances within the *Grainger v. Gough* case.

The second area upon which multi-national companies have been relying involves transfer pricing, and it can be said in relation to the companies in question mostly to be in respect of intellectual property rights or the purchase of specific goods such as coffee in the case of Starbucks.

The reality is that these companies do have very valuable

intellectual property rights, and this can be demonstrated on the basis that if they were to allow a third party to use their own name (looking at intellectual property), they would charge such third parties (as franchisees) a full market rate. So, under the current principles of transfer pricing the company that owns the intellectual property rights, of course, is entitled to charge all the other companies within the group a full market rate for using the brand name in question. Under transfer pricing rules, missing much out, the price paid within the group has nevertheless to be acceptable on a comparative basis. If therefore, as the writer understands it, the companies in question do indeed have separate franchisees to whom they do in fact charge an arm's length fee for the use of the company's name – as is frequently the case – then there seems nothing to prevent the company in question charging precisely the same fee to its own group members, which the paying company can then deduct the consideration in the computation of its profits. By definition, the fee charged will be acceptable as a matter of law if it is the same as the amount charged to arm's length third parties anyway. The difficulty with this approach (paying fees cross-border for intellectual property rights and other rights) is that what this usually does, (perhaps, *inevitably* does) of course, is to "suck out" large amounts of money from a high-tax jurisdiction into a low-tax jurisdiction where, of course, the rights are based.

The same can be said in relation to the purchase of coffee, for example. Starbucks must be one of the biggest coffee purchasers in the world. It, presumably, buys its coffee in one or more jurisdictions where the rates of tax are low and then charges other entities within the group where the rates of tax are high a market rate for that coffee.

In each of these cases the companies are within the rule of law but, of course, are not within what the current mood of the majority of the public deems to be morally acceptable. I deal with a solution to this problem subsequently.

Finally, there is one point to add in relation to steps involving US companies. Unlike our own code, the United States has a relatively benign controlled foreign company regime. This means that the monies in question which are earned in Ireland, for example, can be left there at low rates of tax with no incentive or requirement for them to be remitted, or treated as remitted, to the United States, where higher rates of tax are paid. So the answer here (and this is not a UK issue) is for the United States to introduce more stringent controlled foreign company rules, that would tax, say, the monies sitting in an Irish group company as if they had been received back in the United States.

A VIEW FROM 1994

The Labour Party's solution to avoidance

Let us now look at the position concerning how the Labour Party thought, back in 1994, they might deal with the question of avoidance. In relation thereto the writer considers a booklet which the Labour Party published in 1994, entitled "Tackling Tax Abuses – Tackling Unemployment". In the booklet are included a number of quite interesting comments, some of which are repeated here. Indeed, the points which are now listed below are ones which the Labour Party identified as being problems in the area of tax avoidance as long ago as 1994:-

"• offshore loopholes: taxation of non-residents, non-domiciles and those with offshore accounts should be overhauled in line with the recommendations of the Inland Revenue. It is not fair that a wealthy few should be allowed to work or live in the UK without making a fair contribution through taxation;
- trusts: the taxation system must be reformed to prevent the abuse of trusts for tax avoidance;

- inheritance tax: this must be made effective and less easy to avoid particularly for those who come to regard it as a voluntary tax;
- offshore tax avoidance – the abuse of offshore trusts and companies continues. The head of foreign claims at the Inland Revenue has stated he does not know how much tax is lost through money going offshore but "there could be substantial sums involved" (BBC 6 O'Clock News, 27/7/94);
- loopholes using trusts – the use of trusts to avoid tax is widely publicised by the tax avoidance industry. In a recent publication, one financial adviser stated under the heading "Why are trusts used?";
    - to avoid and/or reduce inheritance tax;
    - to avoid and/or reduce income tax;
    - to avoid and/or reduce capital gains tax."

"David M Aaron Partnership, The Small Investor's Guide to the Use of Trusts"

What is clear is that billions of pounds are held in trust principally for tax avoidance purposes.

Inheritance tax: the voluntary tax – it is unacceptable that inheritance tax can be operated by tax planners as a "voluntary tax". If society is to have inheritance tax, it must be operated fairly. At present, whilst the very wealthy avoid the tax, many others are being drawn into it.

It is not the very wealthy who pay most of the inheritance tax; they are very effective at exploiting loopholes to avoid it.

Among the loopholes now used are ... deeds of variation"

So, it is fair to say that any structure that involves any element of offshore activity, trusts and inheritance tax avoidance must be at the top of the list of the things that the Labour Party regarded as unacceptable avoidance, as must the use of deeds of variation and inheritance tax planning.

The Labour Party and the GAAR

Perhaps more interesting still, however, is the view of the Labour Party in 1994 in relation to the introduction of a general anti-avoidance rule. The writer should say before we look at this that they were considering a GAAR when it meant a general anti-*avoidance* rule; whereas the rule to be enacted very shortly is a general anti-*abuse* rule. Nevertheless, on page 4 of their booklet in 1994, this is what the Labour Party said:-

> "We have rejected a general anti-avoidance provision for two reasons. Firstly, experience elsewhere reveals that it has severe limitations in its success. Secondly, as a matter of principle we believe that the citizen is entitled to know where he or she stands before the tax law. A catch-all provision that came into play when all else fails is unacceptable in a fair tax system."

This seems to the writer to be absolutely right. A general anti-abuse provision seems to him to be unacceptable in a fair tax system for all the reasons that are mentioned in the booklet and in this article. More particularly, it seems to him that a GAAR breaches the rule of law because it is so uncertain that no-one can know where they are with it.

THE GAAR

Rationale for the GAAR

Paradoxically, the proponents of a GAAR considered that it would restore the rule of law. They felt this, it seems, because they had identified that the courts, in their desire to do down distasteful ("egregious") schemes, were at best "bending" the rule of law to find against a tax avoider, and at worst ignoring the rule of law entirely. So the aim seems to have been to introduce a GAAR (within the rule of law, therefore), to allow judges better to dispense the rule of law rather than ignore it because of their moral repugnance of the avoidance involved.

As will be seen, the writer considers it unlikely that the GAAR will achieve this result (of bringing cases involving avoidance back within the rule of law), because the GAAR is too vague and unclear and leaves too much open to debate and uncertainty. In other words, the judges will not be able to follow a *clear* statement of the law in respect of the GAAR but will be left to their own subjective devices. This leaves the citizen unclear as to what the law will be from time to time.

The GAAR's wording

If we now look at the wording of clause 204 in the current Finance (No.2) Bill, we will see why, in the writer's view, the Labour Party was right to be against a GAAR, even when their objection was "just" in respect of avoidance, rather than abusive avoidance:-

> "**204. Meaning of "tax arrangements" and "abuse"**
>
> (1) Arrangements are "tax arrangements" if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements.
>
> (2) Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot **reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions**, having regard to all the circumstances including –
>
> (a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,
>
> (b) whether the means of achieving those results involves one or more contrived or abnormal steps, and
>
> (c) whether the arrangements are intended to exploit any shortcomings in those provisions."
>
> **(emphasis added)**

So, pausing here, what an earth does the above wording mean? In particular, what does the wording which the writer has put in bold mean? In answering this he looks at the words in bold in two parts.

Dealing with the first part, many commentators have questioned the so-called "double reasonable test". It seems to be included so that one cannot simply say, "Well *I* thought it was reasonable to avoid tax, so *you* can't stop me." On the contrary, you have to ask yourself whether a third party would think that you were being reasonable in thinking that your avoidance was not abusive. But the writer personally still does not really know how this would operate in practice. More precisely, who is to say, in a court, precisely what that means? Different judges have different views, and long may it continue. But how does this help the citizen to know where he or she stands and how does this help the citizen's adviser to advise?

The writer understands that those driving the GAAR consider that the purpose of the double reasonable test is to find out, if you like, what the "reasonable man" considers is abusive. In other words, you are looking to see, so it might be said, what the man on the Clapham Omnibus would think. The difficulty with that is that this moves us away from the pejorative expression, "abusive" to some extent, to the more benign word "reasonable". These are two different concepts and should not be muddled together. The key behind the word "abusive" is, of course, that the legislation is *abused*: this is a strong word and it means that the taxpayer uses the legislation (abuses the legislation) in a way that simply cannot have been intended. Reasonableness does not come into it.

Then let us look at the second part of the wording which the writer has put in bold, where it talks about "in relation to the relevant tax provisions". What does that mean? Does that simply mean that you are caught, *in relation to a particular statutory provision*, if you say, "Ah, right, there's a flaw in *that* wording. Let me exploit that." An example where, it seems to me, that

the GAAR would definitely apply, and of course this case is mentioned in the GAAR paraphernalia anyway, would be the *Mayes* case, where the extraordinary rules relating to insurance policies were utilised to the advantage of the taxpayer. It seems to the writer obvious that if one were looking at the GAAR now in relation to *Mayes*, one would say that it cannot be the case, in relation to the relevant tax provisions which produce the mismatch, that they are consistent with any policy objective, but involves some contrived or abnormal step.

But would the GAAR stop Starbucks, Google, Amazon and film schemes?

It may come as a surprise to some politicians (and maybe the writer is wrong) but he does not think for one minute that the GAAR would stop the arrangements involving Starbucks, Google and Amazon. This is borne out by HMRC's GAAR guidance of 15th April 2013 where they say, at para.B5.2 as follows:-

> "... many of the cases of the sort which has generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the GAAR cannot be dealt with by the GAAR."

After all, so far as the planning involving Starbucks, Google and Amazon is concerned, none of those arrangements may be said, in relation to particular tax provisions, to be inconsistent with the intended result of those provisions, nor do they involve any particular abnormal or contrived step, nor any shortcomings in the provisions. On the contrary, they fall full square within the particular provisions. Further, it is "normal" for a multi-national company, for example, to choose to acquire its goods in one central location and also to have its intellectual property similarly located in one jurisdiction; otherwise the exercise of spreading these activities across many companies would be extremely expensive. By putting them in one single location, it makes perfect commercial sense. Accordingly, it can hardly be said to exploit the provisions (i.e. to find a loophole in the provisions) if one uses the statutory provisions to reduce tax because one jurisdiction has a lower rate of tax than another.

What about films?

The position in relation to films is more difficult. If a taxpayer has simply utilised the legislation without any abuse (of course), then it is hard to see how the GAAR could apply. The difficulty arises, as already mentioned in this article, in that some film promoters have exploited the legislation by artificially increasing the amounts invested into films, in such a way that the legislation is unlikely to have been intended to apply to it; or those promoters have introduced extraordinarily high rates of interest or extraordinary amounts of debt and then exploiting legislation as it applies to that. So there must be some areas where the GAAR would apply in relation to films.

Examples produced by the GAAR Advisory Panel

The Interim GAAR Advisory Panel produced, with effect from 15th April 2013, various examples of situations which might or might not fall within the GAAR. This was done pursuant to the provisions of the Finance (No.2) Bill 2013 Clause 208 and the examples do repay very close reading. It seems that these examples will be taken into account in due course by courts in ascertaining whether a particular set of circumstances falls within the ambit of the new GAAR and it is to be observed, therefore, that this is a somewhat dramatic extension of the *rule of law*. After all, it means that Parliament has afforded to third parties being the members of the Advisory Panel (rather than to Parliament itself), the opportunity, in effect, to determine what the rule of law underlying the GAAR may in fact be. In the writer's view this is too great a departure from the rule of law: these powers are best reserved exclusively to Parliament, not to third parties.

Incidentally, the Panel, in their examples, endorse the actions taken by Barclays Mercantile Business Finance Limited, as reported in the case of *BMBF v. Mawson* (76 TC 446). On the one hand it is understandable, given the judgment of both the Court of Appeal and the House of Lords in the case. On the other hand, however, it is to be observed that in the High Court (which judgment was of course overturned) it was held that "The transaction was really about creating a complex and sophisticated structure which enabled [an entity] every year to receive payments representing its share of tax savings ... from the capital allowances [involved]." So this might seem to be abusive on one level, further highlighting the problems which the GAAR may produce: its wording is *not* clear enough.

Equally, the Panel held that use of the main residence election (by which you can choose which of two residences is your main one for capital gains tax purposes) was not abusive. This might be a relief to those politicians who claim that the same property is both their *second* residence for the purposes of claiming allowances from Parliament but also their *main* residence so far as claiming capital gains tax relief is involved. If it were not for the view given by the Panel, then the writer's view would have been that claiming a property was *both* a second and a main residence was abusive. We can now rest assured that that is not the case.

POTENTIAL SOLUTIONS

The writer now deals with the solutions that have been put forward in respect of the problem which in this article, perhaps unfairly, we are describing as the problem relating to Starbucks, Google and Amazon. In other words, how do we get the rule of law to match the undoubted moral indignation?

These answers are, first, a *unitary* solution, i.e. one which relates to the particular country that suffers a shortfall in tax, and the other is a *global* solution which requires the assistance of a large number of nations pursuant to suggestions put forward by the OECD. The writer deals with each of these in turn.

Unitary solution

The following has been suggested to the writer, and no doubt to many others, as being a way in which one might address the situation from the point of view of United Kingdom based solution. What we are looking for here is to find a way of bringing back into the UK nets profits which have "properly" arisen in the United Kingdom. In essence, what would happen under the suggested unitary solution, would be that the UK legislation would produce some sort of a formula by reference to which the "UK part" of the world-wide business of a group, could be attributed to the United Kingdom on a fair and reasonable basis. Accordingly, the formula would probably involve, as a numerator, the assets, employees and the sales which took place solely in the United Kingdom, and the denominator, of course, would have the same features, but would be in relation to the world-wide group. This would then enable a percentage of the world-wide business, so far as it might be said to relate to the United Kingdom, to be computed, and that amount would then be taxed at the UK's corporate rate of tax. This therefore would ignore any of the deductions which have caused the problems including, therefore, deductions for payment for royalty rights and payments for materials.

There are objections to this, of course, and it may be that it would be counter-productive to "UK Plc" particularly in relation to large UK-based multi-nationals where significant overseas sales are generated. The effect would be to suck profits out of the United Kingdom rather than bringing them back into the United Kingdom. Also a unitary solution would work to the disadvantage of the United Kingdom if other "competitor countries" did not adopt a similar solution and it

would be a brave Chancellor of the Exchequer who would introduce it independently of other jurisdictions.

Global solution

The global solution is one that looks more likely to succeed, although it will take some time, and this is one that is recommended by the OECD. Indeed, on the 19th April 2013 the OECD's Secretary General, Angel Gurria, presented a report to G20 finance ministers and central bank governors which was intended to ensure that all taxpayers pay their "fair share of tax". The report included a reference to:-

- a progress report about a global forum on transparency and exchange of information for tax purposes, including the up and coming ratings of jurisdictions' compliance with the global forum's standards on exchange of information on request;
- efforts by OECD to strengthen automatic exchange of information;
- latest developments to address tax base erosion and profit-shifting;
- a practice that can give multi-national corporations an unfair advantage over domestic companies and citizens.

In relation to this, there were proposals to develop:-

a. instruments to put an end to or neutralise the effects of hybrid mismatch arrangements and arbitrage;
b. improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. The current work on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules;
c. updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services. These solutions may include a revision of treaty provisions;
d. more effective anti-avoidance rules, as a complement to the previous items. Anti-avoidance measures can be included in domestic law as included in international instruments. Examples of these measures include general anti-avoidance rules (GAARs), controlled foreign companies (CFC) rules, limitations on benefits (LOB) rules and other anti-treaty abuse provisions;
e. rules on the treatment of intra-group financial transactions, such as those related to the deductibility of payments and the application of withholding taxes;
f. solutions to counter harmful regimes more effectively, taking into account factors such as transparent substance.

Perceived disadvantages of this global approach have been highlighted by some commentators. One objection is that by having a single over-arching international body such as the OECD leading the change and making the fairly dramatic amendments which need to be made, you remove competition from within jurisdictions. There have been fairly dramatic articles about how Ireland has suffered as a result of being at the centre, so it would seem, of tax avoidance, but this is not to say that if all of the Irish offices involved in managing royalty rights and so on were to disappear, as they would do, presumably, pursuant to the OECD recommendations, that the Irish economy would improve. Indeed, the United Kingdom at the moment is going through an exercise of reducing its corporation tax rate, in order to encourage international companies to set up their headquarters in the United Kingdom, and this seems to be successful. So, tax competition, which

exists in the current regime, produces some benefits as well as some disadvantages.

CAN AN ADVISOR IGNORE AVOIDANCE?

Hossein Mehjoo v. Harben Barker & Another

The above case is relevant to the debate as to whether the rule of law, on the one hand, or some sort of morality, on the other, holds sway. Broadly speaking, the case involved a negligence case where a non-domiciled individual, missing much out, contended that he should have been advised to enter into a tax avoidance scheme involving offshore bearer warrants. The judge in that case held, broadly speaking, that the advisers were negligent in not advising the non-domiciliary to use such a scheme and held that any reasonably competent accountant holding himself out as having expertise in advising non-UK domiciles should have recommended the planning.

The Times of 6th June 2013 has run a story on this article, starting with the somewhat sensational comment that "The accountancy profession was "*thrown into turmoil*" yesterday after a High Court judge appeared to rule that practitioners had a duty to advise wealthy clients to avoid tax." In the writer's view, journalists should not mix up fact and comment (*Comment is free but facts are sacred* – CP Scott). After all, it is not a *fact* that the accountancy profession was in turmoil on the evening of the 5th June when the article would have been written, given that only a handful of accountants would have known about the judgment at that time.

Nevertheless, the case does illustrate the difficulty which advisers face. Would, for example, the advisers to multi-national companies have been *negligent* (in the light of *Mehjoo*) had they *not* recommended the possibility of locating valuable rights in low-tax jurisdictions? The Public Accounts Committee would say, presumably, that they should have ignored any such obligation to give tax avoidance advice. But a judge might find them to be negligent. So the position is difficult to say the least.

The short answer is that this case demonstrates again that, in the writer's view, the important point is to have regard to the *rule of law* and to the extent that the rule of law is perceived by Parliament and the public to be unacceptable and/or immoral then Parliament should change the law. The legislation affording the benefits in relation to the bearer warrant scheme, after all, was amended after the time that Mr. Mehjoo could have utilised it. So, Parliament did stop a scheme in this situation that was perceived to be wrong. Consequently, we all know where we are in relation to overseas bearer warrants and non-domiciliaries but otherwise, in the writer's view, the most acceptable course is to allow the judges to construe the law as it is absent, any morality, and for Parliament to change the law if the weight of opinion is that a particular law is unacceptable, perhaps because of its immorality.

Equally an adviser must put before a client all the *legal* options as a matter of good practice including proposals for reducing (avoiding) tax. A good adviser will also alert a client to the fact that that avoidance is very much frowned upon, of course, by the public, by the Press, by HMRC and by the courts themselves. The client should then factor all of this information, received from the adviser, into his own decision-making process together with any moral repugnance which he may reasonably feel for tax avoidance. In this way, it is most unlikely that any adviser could be sued for negligence: he would have discharged his obligations to "put the client in the picture fully", and by so doing would allow the client all the information that he needed to make an educated decision.

CONCLUSION

By way of conclusion, it seems as if at the end of all this, there will be significant changes in the law relating to global businesses.

There may well be some form of unitary tax as described, and more likely, in due course, the OECD will produce global policies which presumably will be adopted by members of the OECD and will operate across the globe. The end result will be therefore a new rule of law in this area and it is to be hoped that in these circumstances the new rule of law will be sensible and certain and will be upheld by governments in the future so that citizens and businesses know where they are.

So far as a GAAR is concerned, the writer rather doubts its necessity, given, for the reasons already mentioned, that he doubts it would have any effect on world-wide business practices (because it is aimed at abusive exploitation of statutory provisions, and there seems to him to be no such activity), and in his view it has the significant disadvantage of introducing just the sort of uncertainty which the Labour Party predicted would be the case back in 1994, albeit in relation to a general anti-avoidance rule rather than a general anti-abuse rule.

In a nutshell, Parliament should trust the rule of law given that it is Parliament which has the power to change it wherever it perceives abuses. That is to be preferred, in the writer's view, to responding to moods of public opinion particularly where so little specific information is in the public domain at any time.