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TAXATION AND HUMAN RIGHTS

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Some would say that taxation and human rights is an oxymoron. An oxymoron is, of course, the conjunction of two otherwise apparently irreconcilable concepts. I personally do not believe that taxation and human rights are in any way irreconcilable or conflicting; I think human rights are a fundamental aspect of taxation. Human rights limit what governments can do to their citizens - to people affected by their decisions. I think at the moment we are at a very exciting stage, where we are seeing the extension of human rights principles into the tax field, to provide limits to what governments can do to taxpayers. It is part of the balance between the powers of the state and the rights of taxpayers.

The European Convention – its full title is "The Convention for the Protection of Human Rights and Fundamental Freedoms" - was concluded in Rome in 1950. The Convention was introduced and produced by the Council of Europe, which has 41 members – broader membership than the European Union – so that it extends from Cork to Vladivostock and from the Arctic Circle to Limassol.

Within those confines, 41 countries are members of the Convention, and all of them are subject to supervision by the European Court of Human Rights, which sits in Strasbourg. The Strasbourg Organs are the bodies that supervise the European Convention, and in the last fifty years the Strasbourg Organs have heard a surprisingly large number of tax cases. When I did some research a year ago, I found 240 tax cases had gone to Strasbourg. In the last twelve months there were about another 36.

This is a regular tax court, hearing cases about the rights of taxpayers anywhere from these 41 countries. They hear cases, because all 41 states allow taxpayers to challenge the actions of revenue authorities to Strasbourg. They recognise a right of individual petition to the Court in Strasbourg.

Very similar protections exist under the UN Convention – the International Covenant on Civil and Political Rights (“the ICCPR”) - which is available to all member states of the United Nations: there are 145 states parties to the ICCPR. It is a younger instrument than the European one. It entered into force only in the early 70s. It also has a supervisory body, called the Human Rights Committee, which sits either in New York or Geneva. The Human Rights Committee very often looks at the jurisprudence of Strasbourg in deciding cases, but so far only a few tax cases have gone to the Human Rights Committee. Not all 145 states allow taxpayers to challenge the government; in fact only 95 allow a challenge, and so fewer cases have gone to New York or Geneva than have gone to Strasbourg. Nevertheless, there is a small but growing tax jurisprudence of the Human Rights Committee. The 95 states are listed in the Appendix below.

The two Conventions have broadly similar Articles, which are of particular relevance to tax. There is the right to a fair trial and to a fair proceeding if one is challenging a tax assessment, the right to respect private and family life, prohibition of discrimination and protection of property. Those are the four main Articles of the European Convention. There is no equivalent provision in the ICCPR for the protection of property.

The most important of these provisions in the tax context is the right to a fair trial. This is to be found in Article 6 of the European Convention (and there is a parallel provision in Article 14 of the ICCPR), which begins

> 1. In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law.

That applies to civil and criminal cases. In criminal cases there are some additional guarantees - presumption of innocence in paragraph 2, right to legal aid in paragraph 3 – additional guarantees which apply only to criminal matters.

Do these guarantees apply to tax proceedings? In tax matters, do we enjoy the right to a fair trial and to all the rights that Article 6 encompasses? That turns on those first words of Article 6, "*In the determination of civil rights and obligations or of any criminal* *charge…"*. I guess that most of us – as tax lawyers – would say at first blush that in a tax matter we are concerned with civil obligations; we are not concerned with criminal charges. We would be wrong, because the Strasbourg Organs have said that this phrase has to be given an "autonomous convention meaning" – a meaning which has to be common from Cork to Vladivostock. In particular, they have noted that in many continental European countries, which do not have the advantage of the common law, tax is an area of administrative or public law: it is not a civil law matter. A French lawyer for example would say that tax is not a civil matter but an administrative one and therefore does not come within Article 6. But he would add that administrative penalties, like tax fines, are criminal matters. And that is broadly what the European Court has said – that Article 6 does not apply to ordinary tax proceedings, but it does apply to penalty proceedings or fines.

On the first point, there is a long line of cases, going back to the early 1960s, where the Strasbourg Organs have said that the right to a fair trial does not apply to ordinary proceedings for the determination of a tax liability. To say that an individual challenging tax does not have a right to a fair trial, sounds ridiculous. The conclusion follows from the autonomous Convention meaning. Partly because it sounds so ridiculous, the European Court reconsidered its position on this point in the case of *Ferrazzini v. Italy*. In this case a Grand Chamber of the European Court reviewed the jurisprudence. It is understood that *Ferrazzini* was one of 2,000 Italian delay cases, where the tax appeal has taken more than ten years to come to Court, and even in Italy that is a very long time. The Court decided not to change its position and held that in a case concerning a dispute about a tax assessment, the Convention does grant the right to a fair trial.

Social security appeals, however, are an exception: Article 6 *does* apply to them.

There are also many cases in which the Court has found that serious tax penalties are criminal for Article 6 purposes. The leading case is *Bendenoun v. France*. It is a case about the French penalty for "*manoeuvres frauduleuses*". The taxpayer complained of the lack of a fair trial and the Court said that since this was a serious penalty the taxpayer had all the criminal guarantees. There was a similar finding in the *AP, MP and TP v. Switzerland* case. In Switzerland, if a taxpayer is involved in tax evasion, there is a maximum 400% penalty. The Court said that this was clearly criminal. In *JJ v. The Netherlands* there was a 100% maximum penalty and this was deemed as criminal. A recent UK case – *King v. Walden* – said the same thing. The conclusion is that substantial tax penalties for negligent or fraudulent submission of tax returns are regarded as criminal and all the criminal protections apply.

What are these protections that apply sometimes in social security cases and otherwise in criminal cases? There is a basket of protections for fair trials. The taxpayer has the right to a court. There is a Hong Kong case which decided that if a taxpayer is required to pay his tax before he can appeal to the Court, that requirement deprives him of his right to a court, and it breaches the equivalent provision in Hong Kong to the Convention. There is a right to an independent and impartial tribunal; most tax courts are probably independent and impartial, and no challenge has ever been successful on this issue.

Perhaps the most important right for taxpayers in practical terms is the right to a determination within a reasonable time, and it is evident from decision in a number of cases that the Court regards anything over five years as unreasonable. It would have been very attractive to taxpayers if Article 6 had been extended to ordinary tax cases: a lot of cases, including all those Italian delay cases, would have been thrown out on the grounds that the taxpayer did not have a fair trial. The right to a public hearing may not be so attractive to many taxpayers who, one may suppose, would prefer to have a right to a private hearing, and there has been some debate as to whether Article 6 affords such right as well.

There is an important right to the presumption of innocence: the onus falls on the tax authority, wherever there is a serious penalty, to prove the facts. There is also a right to legal aid, though that may not be so relevant in many cases. An area where there are important developments coming is the right of silence. Where there is a serious tax penalty involved, the taxpayer has a right not to answer any questions and not to supply documents. There is a very recent case on this called *JB v. Switzerland*. In this case the Swiss authorities were investigating somebody for potential tax evasion. They asked him to produce documents and he refused, so they imposed a fine of Fr.2000 on him. He still refused, and further fines were imposed. When this reached Fr.8,000 he went to Strasbourg. The Strasbourg Court said he was merely exercising his right to silence and could not be penalised.

The last, and rather interesting, development is non-heritability of tax fines. The *AP, MP and TP* case was a case where it was the deceased's father who had evaded tax. He died, the evasion was discovered, and the Swiss tried to impose penalties on his heirs. The Court did not permit this: tax penalties are criminal and criminal liability dies with the offender. I believe the practice in the United Kingdom at the moment, is that accountancy firms are refusing to pay any tax penalties after the taxpayer has died, on the grounds that the penalties cannot be enforced against the heirs of the estate.

Article 1 of the First Protocol protects the right to property. In case somebody might have argued that taxation is theft - on the basis that tax interferes with his right to property - the draftsman added a second paragraph preserving the right of states to impose tax. Even so, taxation is *prima facie* an interference with the enjoyment of property, for if one did not have to pay tax, one would have more property to enjoy. Taxation is authorised by the second paragraph, but the second paragraph is an exception to a fundamental principle, and exceptions are narrowly construed. So, the Strasbourg Court can scrutinise taxes on various grounds. They can be scrutinised on the grounds that the government is not pursuing a legitimate aim, that they are not proportionate, but disproportionate provisions, or that there is a failure to keep a fair balance between the interests of the community and those of the individual. In a number of cases, taxpayers have tried to challenge taxes on the grounds that they imposed an excessive and invidious burden, but none have been successful so far – and it seems unlikely that they will be in the future, for in one of the cases – a case from Germany, 100% tax was held not to be excessive!

A more promising area for challenge lies in the rule that tax has to be subject to law. If tax rules are not adequately published or not adequately clear so the taxpayer can see what is due from him, there is potential for a challenge. *Spacek* was an attempt to challenge tax rules that had not been adequately published. It failed, but there is a clear indication that if tax rules are not made sufficiently public, or they are too unclear, there is a breach of the rule of law and the tax would be attackable.

There have been some cases attacking substantive tax provisions but none of them have been successful so far. Slightly more successful have been attacks on procedural tax provisions - rules for the enforcement of tax. A good example is *Lemoine v. France*. In this case, the taxpayer owed Fr.80,000 and the French authorities put a charge over property worth Fr.8m. The Court found that charging Fr.8m. to secure Fr.80,000 was disproportionate, and struck down the action of the French authorities.

Where taxpayers have been a little more successful has been in challenging discriminatory tax provisions. Article 14 of the European Convention guarantees the enjoyment of rights in a non-discriminatory fashion. Some taxpayers have challenged tax rules on the grounds that they were discriminatory. One of these cases was *Van Raalte v. The Netherlands*. There used to be a rule in the Netherlands that a lady over the age of forty-five with no children did not have to pay child contribution but a man did. Mr. van Raalte was a gentleman over forty-five with no children and he challenged this. He said that if he were a woman he would not have to pay the tax and that he was being taxed because he was a man. The Strasbourg Court held that the rule was discriminatory and unacceptable. Mr. van Raalte's success was short-lived: the Dutch changed the law, and now everybody pays the contribution!

The right to privacy is provided by Article 8. Everyone has a right to privacy, though the second paragraph, again, provides an exception, which permits the state to interfere with an individual's right to privacy and seek information. The relevance in tax matters is that where the revenue authorities seek information from an individual, they are interfering with his right to privacy and they have to justify that interference. The leading case here is *X (Hardy-Spirlet) v. Belgium*. The Belgian tax authorities were not satisfied with Mr. Hardy-Spirlet's tax return and required from him a statement of all his income and expenditure for the relevant period. Mr. Hardy-Spirlet objected, on the grounds that such a statement would disclose intimate details of his personal life. The Strasbourg Organs said that he was, in principle, right: seeking information interferes with his right to keep his financial affairs private, but the state can justify this interference if it is in accordance with the law, in the interest of collecting tax and not disproportionate. There are very few cases where a breach of Article 8 has been found but many areas where the facts have not amounted to a breach – search of the taxpayer's house and office, search of the taxpayer's ex-wife's house, search of bank premises, requirement of a statement of personal expenditure and, interestingly, exchange of information between revenue authorities.

There are also articles of subsidiary relevance. There are those relating to the right to life and the prohibition of torture. They do not look as though they have much relevance to tax, but at least one taxpayer has raised Articles 2 and 3 in a tax context: this was Mr. Stephan Lewandowski of Posnan in Poland. He argued that the visit of the tax inspector to his house killed his wife. There was actually no evidence of any causal link between the visit of the tax inspectors and the death of the late Mrs. Lewandowska some time later and the Court in Strasbourg so found.

Article 4 prohibits slavery and forced labour. In the 1970s four Austrian companies argued that having to operate a Pay As You Earn system, deducting tax from their workers, was forced labour. What they did not notice was that the Convention allows forced labour if it is part of normal civic obligations, and operating PAYE is a normal civic obligation. There is a slightly serious point here. There has been some discussion as to whether some tax obligations carried out without payment are normal civic obligations. If, for example, a bank is required to undertake excessive expenditure simply to deduct tax or is required to supply information without being paid for the work by the Revenue, there is a question as to whether that goes beyond a normal civic obligation. This may be tested in the coming years.

What about freedom of thought, conscience and religion? Can an individual say that paying tax is against his religion? Someone has tried it in, actually, a fairly serious context. *C v. United Kingdom* is one of a number of cases where Quakers have said it was against their religion to fund military expenditure: they were prepared to pay their tax but wanted the part which goes to the military to be paid into a separate fund for non-military purposes. One may have a lot of sympathy for that view, but the Court in Strasbourg and the Human Rights Committee in New York has both said that religion has nothing to do with tax: whatever a taxpayer's religion is, he has the ordinary obligations to pay tax.

Is the obligation to put a particular figure in his tax return an interference with a taxpayer's freedom of expression? A decision – not particularly relevant to tax – is to be found in the case of *APEH Uldozottel-nek v. Hungary*. This case concerned the association of those who have been persecuted by the Hungarian revenue authorities. It was an association set up by a number of professionals in Budapest. They wanted to register that name, but the Court in Budapest ruled that they could not register the name because it implied that there was some association with the revenue authorities. The accountants argued that their right to freedom of expression allowed them to register whatever name they wish, but they were unsuccessful.

This is very much a developing area. A start has been made on the extension of human rights rules to the tax field. There are some existing protections, but what is really interesting is what is to come.

APPENDIX

Countries from which an individual may petition the UN Human Rights Committee

Algeria, Angola, Argentina, Armenia, Australia, Austria, Barbados, Belarus, Belgium, Benin, Bolivia, Bosnia-Herzegovina, Bulgaria, Burkina Faso, Cameroon, Canada, Cape Verde, Central African Republic, Chad, Chile, Colombia, Congo, Costa Rica, Cote d'Ivoire, Croatia, Cyprus, Czech Republic, DR Congo, Denmark, Dominican Republic, Ecuador, El Salvador, Equatorial Guinea, Estonia, Finland, France, Gambia, Georgia, Germany, Greece, Guinea, Guyana, Hungary, Iceland, Ireland, Italy, Jamaica, Kyrgyztan, Latvia, Libya, Liechtenstein, Lithuania, Luxembourg, Madagascar, Malawi, Malta, Mauritius, Mongolia, Namibia, Nepal, Netherlands, New Zealand, Nicaragua, Niger, Norway, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Rep Korea, Romania, Russian Federation, St. Vincent & Grenadines, San Marino, Senegal, Seychelles, Sierra Leone, Slovakia, Slovenia, Somalia, Spain, Sri Lanka, Suriname, Sweden, Tajikistan, FYR Macedonia, Togo, Trinidad & Tobago, Turkmenistan, Uganda, Ukraine, Uruguay, Uzbekistan, Venezuela, Zambia.

SALVAGING SECURITIES[1]

Felicity Cullen

Since the introduction of taper relief in 1998 practitioners have raised concerns as to the way in which the term "security" would be interpreted for the purposes of the relief. The Inland Revenue has acknowledged these concerns and some months ago announced that it would issue guidance as to the meaning of "security" for taper relief purposes in Summer 2001. The June 2001 issue of the Tax Bulletin contains the promised guidance.

In summary the guidance states that:

(a) a security within the meaning of s.132 TCGA 1992 is a security for the purposes of taper relief;

(b) a debenture possessing the characteristics of a "debt on a security" will be a security for taper relief purposes;

(c) a debenture which is only deemed to be a security by s.251(6) TCGA 1992 is not a security for taper relief purposes.

The issues that arise in determining whether a debt instrument is a "security" in the broader capital gains tax ("CGT") context are well known and will not be discussed at length. In the context of the meaning of "debt on a security", the most recent authority is *Taylor Clark International v. Lewis* [1998] STC 1259, where, in short, it was held that in order to be a "security" a debt had to be a marketable investment. The courts have not produced any definitive statement as to what is meant by a "marketable investment" but, inevitably, there are debt instruments in issue which, though intended to be securities for taper relief purposes, will not be regarded as "marketable investments" and will not fall on the right side of the line. It is, for example, not infrequently the case that, for various commercial reasons, securities are not freely transferable; and this may, depending on the terms of the instruments as a whole, cause them to fall outside the definition of securities for taper relief purposes. The context in which securities (as opposed to shares) and issues concerning them most frequently occur for taper relief purposes is takeovers, i.e. where loan notes (whether or not together with shares) are issued in exchange for shares on the occasion of company acquisitions. In this context, the loan notes will often have substantial gains (deriving from the former shareholdings) inherent in them and the holders will want to maximise their taper relief by ensuring first, that the loan notes are indeed "securities" which are eligible for taper relief and secondly, that the crystallisation of the gains is deferred as long as necessary or desirable. The question addressed here is whether, in the light of the guidance on the meaning of "security" for taper relief purposes, the terms of debt instruments issued or to be issued on exchanges (and which do not or may not constitute securities as that term is now to be interpreted by the Inland Revenue) can be amended or varied so as to fall or fall more clearly within the Inland Revenue's interpretation of "security".

Existing Loan Notes

It may be possible to amend an existing loan note so as to improve (where necessary) its status as a "security". For example, a loan note which does not include a provision permitting assignment could, in the light of the Inland Revenue's interpretation of security, be amended so as to include such a provision. There are, however, at least two problem areas in the context of amending existing loan notes. First, an amendment which is regarded as essential so as to convert a loan note which is not a "security" into a security in future cannot retrospectively improve the position. If the loan note under consideration does not (in accordance with the Inland Revenue's interpretation) constitute a "security" (and, as such, an asset eligible for taper relief at the business assets rate), and it is converted into a security which is eligible for relief at the business assets rate, the apportionment rules will apply to attribute different rates of taper relief to different periods of ownership (see para.3 Schedule A1 TCGA 1992). Accordingly, although the taper relief position would be improved for the future, amendment or variation would not be a complete solution - unless the unamended loan note can, contrary to the Inland Revenue's published position, be successfully argued to be a security. Secondly, the sort of amendments which may be necessary to ensure that a given loan note is treated as a "security" for taper relief purposes may be alleged by the Inland Revenue to be so fundamental as to constitute a disposal of the original loan note in consideration of a new loan note. If the effect of an amendment is indeed to convert a debt instrument which is not a security into a security – an instrument of a different nature – it may be difficult to resist an argument that the amendment is fundamental. If the argument that there were such a disposal were sustained, the gains inherent in the loan note would be realised: the disposal would not fall within s.126 TCGA (reorganisation of *share* capital) or s.135 TCGA 1992 (exchanges) and would, in my view, be difficult to bring within s.132 TCGA 1992 (equation of converted securities and new holding) so as to avoid the crystallisation of gains on it. In conclusion, it is not possible to improve the status of loan notes for the past, and it is likely to be difficult to "improve" existing loan notes so as to ensure that they fall within the Inland Revenue's interpretation of "security" for the future without creating undesirable side effects.

Earn-out Loan Notes

The position concerning earn-outs giving rights to future issues of loan notes is more promising. Section 138A TCGA 1992 is, essentially, designed to give rollover treatment to earn-out rights and their satisfaction (where rollover would not otherwise apply), but is of interest in the present context. Where, under s.138A TCGA 1992 (the statutory successor to Extra-statutory Concession D27) an earn-out right given on a share exchange "consists in a right to be issued with shares in or debentures of another company" and the conditions of s.138A TCGA 1992 are otherwise satisfied, the earn-out right is assumed to be a security of the issuing company for the purposes of TCGA 1992. More particularly, where an earn-out right is granted in the prescribed circumstances “this Act shall have effect, in the case of the seller and every other person who from time to time has the earn out right, in accordance with the assumptions specified in subsection (3) below”: s.138A(2) TCGA 1992. Subsection (3) provides as follows:

> “(3) Those assumptions are –
>
> (a) that the earn-out right is a security within the definition in s.132;
>
> (b) that the security consisting in the earn-out right is a security of the new [purchasing] company and is incapable of being a qualifying corporate bond for the purposes of this Act; …”

The effect of subsection (3) read in combination with subsection (1) of s.138A TCGA 1992 is that an earn-out right to “debentures” (subsection (1)) which may not, on their terms, constitute “securities” in accordance with the Inland Revenue interpretation, will constitute a “security” of a purchasing company for the purposes of TCGA 1992[2], which must include the taper relief provisions of Schedule A1 TCGA 1992. (Almost all loan notes will constitute debentures – a term of wide meaning – even if they do not constitute “securities”). Accordingly, during the earn-out period, the earn-out right should accrue taper relief at the business assets rate. (This assumes, of course, that the purchasing company is either a trading company or the holding company of a trading group and that the individual eligibility conditions for taper relief are met.)

Eligibility for taper relief at the business assets rate at the end of the earn-out period will be governed by (amongst other conditions) whether or not the loan notes issued pursuant to earn-out rights are “securities”. If, because the loan notes to be issued pursuant to the earn-out rights are not (in the light of the Inland Revenue’s interpretation) themselves considered to be “securities” for taper relief purposes, arrangements are made for the terms of the loan notes to be “improved”, it is possible that the Inland Revenue would allege that the existing earn-out right has been extinguished and replaced by a new earn-out right. Subsection (4) of s.138A TCGA 1992 provides for the roll over of one earn-out right into a replacement one, so an argument from the Inland Revenue that there has been a disposal of an earn-out right and the acquisition of another is not necessarily problematic. In the case of an earn-out right which is maturing shortly, however, there may be a problem in achieving the s.138A(4) TCGA 1992 rollover, in that one of the conditions of s.138A(4) is that:

> “(c) the new right is such that the value or quantity of the shares or debentures to be issued in pursuance of the right (“the replacement securities”) is *unascertainable* at the time when the old right is extinguished”.

The value or quantity of loan notes to be issued under a maturing right may be ascertainable so that the s.138A(4) TCGA 1992 rollover could not, if necessary, be relied upon. I have added the words "if necessary", because it is just possible that the variation of the terms of loan notes to be issued pursuant to an earn-out right may not necessarily involve a disposal of that right; but I would not recommend reliance on this point. It may be that the "unascertainable" point can be dealt with by, for example, deferring the maturity of the earn-out right and ensuring that the value or quantity of the debentures to be issued in pursuance of it (albeit ascertainable by reference to the old right) is unascertainable by reference to the new right. In conclusion, it may be possible to amend the terms of loan notes to be issued under earn-out rights so as to salvage the status of the loan notes as "securities" and rely on s.138A(4) TCGA 1992 to prevent premature crystallisation of gains.

As a final point, subsection (4) of s.138A TCGA 1992 is clearly intended to provide for the rollover of earn-out rights, and the Inland Revenue ought not, in practice, to suggest otherwise. The drafting is, however, somewhat imperfect; and this will need to be drawn to the attention of the client.

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[1] First published in *The Tax Adviser*, July 2001

[2] This analysis assumes that something which is a security for s.132 purposes will be a security for taper relief purposes: a different conclusion (i.e. that "security" for taper relief purposes is narrower than for s.132 purposes) is, in my view, highly improbable. Indeed, the Inland Revenue has now said, "Although this matter is not free from doubt we accept that such earn-out rights count as securities for taper relief purposes."

ANTI-AVOIDANCE

David Goldberg

Introduction

Some scientists spend their time trying to find a unified theory which will explain, all in one go, the weak and the strong forces at work in the universe. I once thought that there might be one theory of law which explained every case the Courts had ever decided. My idea was that the Courts were always trying to remedy perceived inequalities between the parties to a dispute, and, in some ways, I do not think this theory was too far wrong. Indeed, a theory of this sort can be seen at work in contract law and in questions of estoppel and in tort law and, even more explicitly, in the field of administrative law, where the Courts have said that an administrator has the overriding duty to be fair. There is, however, a problem with a theory which says that the overriding attempt of the judge is to remedy inequalities or to be fair. What do we mean by the concepts of inequality and fairness? The concept will have different meanings to different people, and the content of any duty of fairness or to remedy inequality will vary according to the viewpoint of the observer: the plaintiff in litigation will have one view of what is fair, the defendant another and the judge a yet different view which may not coincide with that of either of the parties.

Indeed we see in tax cases how different people will regard the concept of inequality. Most taxpayers, I would assume, believe that the Revenue are in the dominant position and the taxpayer in the weaker position. We look to the Courts to protect us from an overbearing executive. The Revenue would not think themselves overbearing – might not really think in terms of inequality at all. And, in my experience, the judge in a tax case tends to think of the Revenue as the weaker party, burdened by the duty to carry out a difficult job against the opposition of a strong, well-advised, and often cunning opponent, who has command of the facts.

The Concept of Avoidance

This is an article about tax avoidance, about the approach of the Courts to tax avoidance and about the recent case of *MacNiven*, so I must begin by defining terms. When we come to consider the concept of avoidance, we find that, just as it is difficult to define fairness and inequality, so it is difficult to define avoidance. When we say that something is avoidance, we imply both a statement of fact – that no tax has been payable, and a statement of opinion – that tax ought to have been payable or, perhaps, that, without making the moral judgement implied by the word "ought", we would have expected it to be paid. The statement of fact – that tax has not been payable – will not occasion much controversy; but the statement of opinion – that tax ought to have been payable or that we would have expected it to be paid – is inevitably going to be controversial and different people will hold different opinions.

The cases show that judges use the expression "tax avoidance" in at least three different ways. The first way is to refer to tax avoidance as a purely moral concept:

when tax avoidance is referred to in this way, it is a statement by a judge that he does not like what has been done. When used in this way, the expression “tax avoidance” has no legal content whatever; it is a conclusion based on facts, but little help in guiding us as to what is or what is not tax avoidance. Secondly, judges sometimes use the phrase “tax avoidance” to distinguish between acceptable tax mitigation and transactions which, while legal, are unacceptable in the sense that they do not achieve the purpose of reducing taxes that they were intended to achieve. In this context, the distinction is often said to be between transactions which have real economic consequences and transactions which do not have real economic consequences. Everybody knows that, in the days of the window tax, the tax was avoided by blocking up a window; and it can be seen that a person who blocked up his window suffered the consequences, because he got less light coming into his house: window blocking worked as a device for mitigating that tax. Interestingly – this is a bit of an aside, but I found it interesting - some people did not wish to suffer the consequences of window blocking. In 1757 one taxpayer fixed a short glass connection between two windows, and claimed that he had made them into one window; and won before the Commissioners. But on appeal, the Court of Kings Bench decided that “this is a manifest evasion of the Act, therefore the determination of the Commissioners is wrong”. Presumably this was because the short glass connection did not have the real consequence of turning two windows into one, with perhaps difficult problems of draft control. And while a distinction between acceptable tax mitigation and unacceptable tax avoidance may, at times, seem useable and useful, it again evaporates upon examination: what, after all, are real consequences and what not? What is it that makes the avoidance unacceptable? We find ourselves back at a purely moral view.

A third judicial commentary on the meaning of tax avoidance is to be found in the context of statutory references to tax avoidance, and here, as exemplified by the *Willoughby* decision, a distinction is made between transactions which accept statutory invitations (which are not avoidance) and those which are doing something other than accepting statutory invitations – which are, or may be, avoidance. But here again the formulation of what is and of what is not tax avoidance leaves an unanswered question: when is a statute making an invitation? The taxpayers in *Furniss v. Dawson* might well have thought that they were accepting a statutory invitation, though they found out that they were not.

The Relevance of the Concept

I could go on identifying the difficulties that lie in the way of an attempt adequately to define tax avoidance but, even without doing that, it is possible to conclude that the concept of avoidance is elusive and is, to a large extent, a matter of opinion, not susceptible of precise analysis. Nonetheless, some of our recent case law appeared to suggest that the correct way of approaching a tax case was to consider whether it involved "avoidance" and that there were rules which applied only where there was avoidance. However, if avoidance is a difficult concept, it is unlikely to be a useful analytical tool; and it will not be helpful to have rules which only apply where avoidance is found to exist.

Happily, the *MacNiven* case has exploded what may now be seen as the myth that there are special judge-made rules which apply to cases of tax avoidance. As Lord Hoffman has lucidly explained in the *MacNiven* case, the concept of avoidance is or, rather, ought to be, at most a conclusion arrived at after analysis and not an analytical tool; and it is as well that this should be so, because, if the term "avoidance" cannot be fully defined, it cannot usefully be employed in determining the outcome of a tax case. On a true analysis then, the concept of avoidance should, as a matter of law, tell us nothing about how we approach the analysis of a transaction in tax terms. The tax consequences of a transaction should not, in the absence of a special statutory provision making it relevant, vary according to whether we characterise the transaction as avoidance or not. And, indeed, as the *MacNiven* case has reaffirmed, a taxpayer is entitled to choose the way in which he structures his transaction. If he has a choice between carrying out a transaction in a way which reduces tax and a way which leaves it unaffected, he can legitimately and effectively choose the way which reduces or avoids tax.

Nonetheless, we all know that judges will react unfavourably to transactions which they feel are avoidance. This is an emotional, not a rational, response but we cannot pretend that it does not exist. A judge will be unfavourably disposed to a transaction if he feels that tax is not being paid where it is fair that it should be paid; and in part this is due, I think, to a judge's belief that, in a tax matter, where a taxpayer has actively taken steps to reduce his tax bill, there is inequality, and that it is the taxpayer – the person who strove to reduce his tax - who is in the stronger position. When a judge will feel that it *is* fair for tax to be paid and when not is unpredictable; and one of the huge changes which has been brought about by the *MacNiven* case is that it should no longer be relevant as a matter of law. Until *MacNiven* it was intellectually respectable for a judge to say "this is tax avoidance and therefore I shall apply special principles which the courts have devised to counter tax avoidance". That sort of approach is no longer permissible in law. The question of whether something is tax avoidance is not any more the key to the application of some separate set of principles: it is no more than a moral expression of indignation. Thus, although I have begun by commenting on the definition of the phrase tax avoidance, I do not think that it is any longer of legal significance, save in cases where a statute expressly refers to the concept. But it is still a concept of practical significance. As I have said, on an emotional level, judges – at least some judges – will react differently and unfavourably to cases which they consider to be avoidance; and we need to take this reaction into account in advising clients; and for that reason, if for no other, the concept of what is avoidance remains relevant. In the days when men went to barbers rather than hairdressers, the man with the scissors would, as is well known, ask, at the end of the procedure, whether there would be "anything for the weekend sir" and, at the beginning, he would quite often ask "Are they treating you alright sir?" When I refer in what follows to tax avoidance I am referring to something which the "they" of the barber's question would disapprove of; and I now turn to the question of how they – in this context legislators and judges – have responded to avoidance.

The Beginnings of Avoidance

As is well known, income tax has been around since 1799, but nobody seems to have been terribly bothered about avoidance until the beginning of the 20th century. In part, this was because low rates of income tax meant that it was not worth avoiding, and in part it was because, with a less intrusive system of administering tax than we have now, evasion was an easy and the principal way of reducing taxes. My researches suggest that the phrase "tax avoidance" does not appear at all until 1906 or 1907. Austin Chamberlain, in a debate in Parliament in 1907, drew a distinction between evasion and avoidance and said that: "evasion was an illegitimate denial of the imposition of the tax. The Honourable Gentleman spoke of avoidance as if it were a refusal to recognise a moral obligation. I do not think there is any moral obligation on the part of any taxpayer to pay more taxes than he was legally liable to pay". And as late as 1927, Mr Churchill as Chancellor of the Exchequer said, in remarks which find an echo in the Duke of Westminster's case, that "the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes enforced by the

Crown so far as he can legitimately do so within the law". Indeed, it seems that it was only after the First World War, when excess profits taxes were enacted to deal with wartime profits, that taxpayers first became interested in structuring or managing their affairs so as to reduce taxes; and it is only then that we see Parliament becoming concerned with tax avoidance as distinct from tax evasion, so that legislation designed to counter what was perceived as avoidance was included in the Acts relating to these excess profits taxes. I think the only legislative example we have in this country of something approaching a general-anti avoidance rule is to be found in the excess profits tax enacted by the Finance Act 1941. Under s.35 of that Act, the Revenue could counteract transactions, the main purpose of which was the avoidance or reduction of liability to excess profits tax. Legislation had, of course, by then already been enacted to prevent the avoidance of tax by transfers of assets abroad and by the creation of settlements, and the Courts were already familiar with Estate Duty planning.

So there has always been concern with the evasion of taxes, but what might be called tax avoidance did not play any significant role in economic life until after the First World War and remained at a relatively low level until after the Second World War. Indeed, it was not until the 1960's and 1970's, when tax rates were penal, that tax avoidance seems to have been regarded at an official level as a really serious issue. The problem began with dividend stripping in the late 1950's and spread with the introduction of what might be called the mass marketed tax avoidance schemes of the 1970's, which were designed to reduce both income tax and capital gains tax.

The Approach of the Courts

It is then only in the late 1970's that the Courts had to wrestle to any significant extent with cases about avoidance and four comments may be made about the Courts' approach. First, Courts have always been kinder to arrangements designed to mitigate taxes on inherited wealth than they have been to transactions designed to mitigate taxes on earned money. I cannot explain this phenomenon. It is, of course, economically absurd: we should encourage earning and be more relaxed about taxes on inheritance, but the Courts have not behaved that way. It may be that a judge subconsciously feels that, as he has to pay tax on his earnings, everybody else should have to as well, but I don't quite see how this explains the favour shown to inherited wealth. Secondly, while neither of these things are dispositive, it helps to have a title and to be protestant rather than catholic (the Vesteys usually win their tax cases, the De Waldens usually lose theirs). Thirdly, the Courts usually feel more favourable to taxpayers with earnings when the economy is in a healthy state than they do when the economy is suffering a downturn, and again this seems to me in some ways economically the wrong way round, because, again, you would think that we ought to be encouraging people to earn all the more when times are economically bad. And, fourthly, the Courts here have always done the job of limiting tax avoidance for the legislature by the way in which they have decided the cases before them.

Thus there has been no need here, as there has been in other countries, for the legislature to introduce a GAAR: the response of the Courts to avoidance has been adequate to deal with the problem.

I make these comments both light-heartedly and seriously: I make them seriously because they represent observable facts; and I make them light-heartedly because, obviously, points like this cannot be taken too far as a guide to what a Court will do. However, up until 1981, the Courts had one guiding and overriding principle: regard could not be had to substance but only to form; and this cardinal principle was derived from the *Duke of Westminster* case, decided in 1936.

The Duke of Westminster's Case

It is, perhaps, useful to remind ourselves what the issue was in the *Westminster* case. The Duke had a large staff and he paid them wages which were not deductible in computing his income. In those days, all charges on income – annuities and the like – were deductible in computing taxable income, so somebody came up with the wizard wheeze of the Duke agreeing to pay annuities to his staff while they went on working for him at, it was expected, a reduced wage, though there was no obligation to take a reduction in wages. The question was whether the annuities were really annuities or whether they were really wages. A number of features suggested that the annuities really were annuities and not wages: they would stop if the Duke died, even if the employment continued; they would continue to be paid for their stipulated duration even though the employment terminated; and the Crown's primary argument was that there was really a contract, not written down but to be implied, which made the annuities wages and not annuities. If that argument had been accepted – and the issue was largely one of fact - then, of course, the annuities would have been wages and not annuities. But it was not accepted by the majority of the judges who heard the case. Faced with that problem, the Crown also argued that, even in the absence of any contract, the annuities were, in substance, wages and so, as a matter of law, ought to be taxed as wages. But in the absence of the alleged contract, which was found not to exist, the annuities were not wages. And what the Court was saying was that there is no principle in our law that enables something to be treated as wages when they are not wages. This is what Lord Tomlin meant in *Westminster* when he said that "there could be no appeal to the substance of the matter". It is worth noting that this is, in effect, a decision that a payment which has one character cannot be recharacterised as another type of payment by appealing to the substance of the matter. This is a rule against recharacterisation, and nothing more extravagant than that.

The New Approach

And so the law seemed settled until, in 1981, there was the explosion – the nuclear explosion – of *Ramsay*, setting off a chain reaction, leading through *Burmah*, *Furniss v. Dawson* and *Ensign Tankers* to *McGuckian*. These cases seemed to proclaim a new approach – sometimes called an emerging principle, and they rightly caused a good deal of disturbance in the dovecotes inhabited by tax advisers. The problem was not so much what the cases were actually deciding – that is the actual outcome of the case, looking only to its own facts – but, rather, with the way in which the decisions were expressed.

I think exception can be taken to three particular features of the judgments before *MacNiven*. First, there was an appeal to jurisprudence derived from the United States. This was dangerous and uncertain. It was dangerous because, although there are many features common to all tax systems, there are very considerable differences between the US and the UK tax systems, and principles developed in the context of US statutes cannot easily be applied to our domestic law. And it was uncertain, because the American Courts seem to have adopted at least four different approaches to tax avoidance cases. They are:

(a) a sham doctrine, which is unobjectionable and broadly the same as we have here and which nobody will get very excited about;

(b) a no business purpose doctrine, that a transaction may be disregarded if it has no commercial purpose;

(c) a step doctrine which is that, where a transaction is carried out in several steps, the steps may be disregarded; and

(d) a substance over form doctrine, which is that one looked to the substance and not to the form.

Before *MacNiven*, the English Courts appeared to be creating a doctrine which was an amalgamation of the step doctrine with the no business purpose doctrine, but the *McGuckian* case suggested that we might be adopting a substance over form approach which is, of course, a different thing altogther. It did, however, appear that we were developing a distinct UK doctrine, rather than just importing a US doctrine; and *MacNiven* shows that, while there remains some universality in the common law (so that we do not altogether disregard what common law judges in other jurisdictions are doing), nonetheless, the doctrines applied here are UK doctrines and not doctrines imported from the United States.

The second feature of the judgements before *MacNiven* to which exception can be taken is that many of the judges were putting forward a moral principle as if it were a legal principle. There were, undoubtedly, some judges who were, in effect, saying that the principle was “if we do not like it, it is not going to work”. Lord Templeman was, of course, chief amongst these judges, but he was not the only one. This is not the way to run a legal system: this is to substitute discretion for law and we should not do that. It is right to say that the judges who took this moral view were very much in the minority, but they were there and were not without influence; and the worry was that their view might spread. We can see from *MacNiven* that it has not done so.

The third feature is that some of the remarks made by some of the most respected judges in these cases were excessively extravagant. Lord Diplock's well-known, if slightly nauseating, remark in *Burmah* that "it would be disingenuous to suggest and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume that *Ramsay*'s case did not mark a significant change" is one of these rather extravagant remarks. A friend of mine was once going to write an essay called "Lord Doplick's Ligoc"; and remarks of this sort explain why. Another extravagant remark was Lord Scarman's map-making analogy in *Furniss v. Dawson*, where he says that it will be in an "area of judge made law that our elusive journey's end will be found". Pausing here, then, and looking at the dicta in these cases up to *McGuckian*, it would or might appear that we had developed a doctrine that tax avoidance cases were to be decided by some principle of judge-made law, which might depend to some extent upon decisions of the US courts, and which could also turn heavily on the degree of indignation and repugnance felt by the judge who was deciding the case in question. If that is what had happened it would, of course, have been very unsatisfactory: judges are supposed to decide cases in such a way as to provide a guide to the result of future cases: they ought to be providing a degree of certainty and a doctrine of this sort certainly did not do that. Happily, however, what is important in our system of jurisprudence is the point which is actually decided by a case rather than the peripheral commentary which surrounds the decision. When each of these individual cases up to *McGuckian* is analysed, it will be found that what it actually decided was something very much narrower than the commentary suggested: we would have been looking after our blood pressure better if we had concentrated on the actual decision rather than on the extravagant remarks, although it does have to be said that the remarks were, at the least, worrying.

And then came *McGuckian*.

McGuckian

McGuckian was and is an interesting and important case for three or four reasons. First, two of the judges who decided the case were trained in non-domestic jurisdictions, Lord Steyn in South Africa and Lord Cooke in New Zealand, so that they brought to the case a different, non-UK and non-US perspective. Secondly, the case suggests that there is a rule of substance over form, which is to be applied in tax cases while, thirdly, it emphasises that the principle being dealt with is one of statutory construction and not something else. The second and third aspects of *McGuckian* are somewhat contradictory: if the question is one of statutory construction what is the scope of a rule about substance over form, which is a fact related rule? It appears from *MacNiven* that the substance over form aspect of *McGuckian* does not exist; so, while it is undoubtedly a feature of the *McGuckian* decision, I think we can put it into the extravagant remarks compartment. The fourth aspect of the *McGuckian* case is that it is not entirely clear what it actually decided. Did it decide that capital could be treated as income or did it decide that the taxpayer's vehicle got income? I want to come back to this in a moment when I have considered the *MacNiven* decision in a bit more detail.

MacNiven

Although recent, it is not the latest word on the story because we have, since it was decided, had the decision in the *DTE* case, but it is, I think, the most important case we have had on tax at least since *Ramsay* and *Furniss*. Why is it so important? The answer is because it has swept away all the clutter and has left us with a rule and, although neither the content of the rule nor the result of the rule may yet be absolutely clear, the rule itself *is* clear. There is no moral content to a tax case: as Rowlatt J said all those years ago, "there is no equity about a tax"; and a taxpayer is entitled to arrange his affairs so that he pays the least possible tax. Where the statute does not mention tax avoidance, the question of whether there has been tax avoidance is irrelevant to the analysis; and it does not matter whether the factual background can be described as a device or a stratagem or just as a transaction. None of this has any impact upon the analysis. The only thing which has any impact is the wording of the relevant statute. This is the rule. It is all a matter of looking at the statute and seeing whether the taxpayer falls within it or without it. So the case is important because it has swept away a lot of the clutter and all of the extravagance and taken us back to the right place, which is the wording of the statute itself.

It is, I think, even more important because of the instruction which it gives us as to how we should approach the issue of statutory construction. In every case it is necessary to ascertain with precision the question being posed by the statute; and, in determining what the statutory question is, a purposive approach is adopted to the construction of the statute. This is, I think, the absolutely key and fundamental point. It is always necessary to identify the statutory question. In *Ramsay* and *Burmah*, the statutory question was, “Has the taxpayer realised a loss?” The analytical error made at the time the transactions were being considered in the 1970’s was to think that the statutory question was, “Did the taxpayer make a loss on this particular asset?” and to fail to realise that, implicit in that question, was the issue of whether the taxpayer made a loss at all. A taxpayer can only make a loss on a particular asset if he suffers a loss: if he does not have a loss at all, he cannot realise a loss on a particular asset. The statute posed the question, “Does the taxpayer as a matter of fact have a loss?” and the Courts were able, by analysing the facts, to see that he did not. In *Ensign Tankers* the question was, “Did this taxpayer incur expenditure?” and a factual analysis enabled the Court to say that it had not. In *Furniss* the question was, “To whom was this disposal made?” and the Court was again able to analyse the facts and find that there was a disposal to the ultimate purchaser, rather than to the intermediate company. And it can be seen from an analysis like this that nothing in the cases up to *McGuckian* at least, infringes the rule laid down in the *Duke of Westminster* which is that there can be no recharacterisation by reference to substance.

What we learn above everything else from *MacNiven* is that identification of the statutory question is absolutely key. Now, for reasons to which I shall come, I do not think *MacNiven* is a very useful guide, when it comes to identifying what the statutory question is in each case: indeed, in one respect at least, I think it may be rather unhelpful on that point, but what is quite clear is that we do need in every case to identify the correct statutory question. All that *MacNiven* actually decides is that, as Westmoreland discharged its debt for interest, it had a charge on income for the purposes of s.338 ICTA 1988, because it paid the interest. That is all that it actually decides: it decides something, now no longer relevant, in relation to s.338 ICTA 1988. It does not decide anything more and it does not decide anything less. And it does not tell us very much about how that decision was arrived at. I think everybody recognises that, using the same analytical theory as expounded in *MacNiven*, the conclusion that Westmoreland had not discharged its debt could have been arrived at just as easily as the conclusion that it had. Now, because that is so, I do not think that *MacNiven* is a very good guide to the result in future cases: it tells us what approach to take, and it is highly important for that reason, but it does not actually point to the outcome of any future case, and I should make five points here.

First, although I have emphasised the absence of moral content in the making of any analysis, it is, perhaps, worth noting that it is not wholly absent from this decision itself. The House of Lords has said that the feature objectionable to the Revenue was the ability of the pension scheme to recover tax; but I rather doubt if that is what was objectionable to the Revenue. What was objectionable to the Revenue was that Westmoreland was put in a position to claim tax relief while being, economically, in exactly the same position as it was in when it could not obtain tax relief. However, a point to note here is that Westmoreland really did have a loss: it really had lost money, so that *MacNiven* is not a case where relief was being obtained for something unreal.

Secondly, in some ways, *MacNiven* has created rather than eliminated uncertainty. Before *MacNiven* it appeared that a particular set of circumstances had to exist as a matter of fact before a *Ramsay* approach could be adopted. There had, for example, to be pre-ordination - and this is no longer the case. A rule like that – that certain facts had to exist before *Ramsay* applied – was obviously inconsistent with an approach which gives the guiding role to the meaning of the statute and looked uncomfortably like judicial law making. However, the removal of any such rule means that the facts alone cannot now determine the applicability or non applicability of the *Ramsay* approach.

Thirdly, there is a good deal in *MacNiven* about the distinction between legal and commercial concepts. I do not believe this is going to be important in other cases. The Court says the point was important in *MacNiven* but I have to say I am not quite clear why: even if commercial concepts were relevant, would not a businessman, if told that Westmoreland had discharged its debt for interest, say that Westmoreland had paid its interest? Some commercial concepts are dependent on or interlinked with legal ones. The point which I have made and that I want to emphasise is that the actual decision is only that Westmoreland had paid its interest, given the terms of s.338 ICTA 1988. The reasoning as to *why* Westmoreland is treated as having paid its interest belongs in the commentary category, not in the class of the truly important, and, while there is much commentary on it, it will be a mistake to focus on the distinction between legal and commercial concepts when the real issue is, "What question is being posed by the statute?"

Fourthly, because it is a mistake to pay too much attention to the distinction between legal and commercial concepts, I do not myself think that the *DTE Financial Services* case in the Court of Appeal is incompatible with *MacNiven*. I do think that there are a number of objections to that decision, partly because the interpretation which it puts on the word "payment" is inconsistent with the provisions about "trading arrangements", and partly because the Court's approach to the application of *Ramsay* principles is somewhat out of line with the approach indicated by *MacNiven* itself. This in a way goes to illustrate how the *MacNiven* concepts can create uncertainty. Indeed any purposive approach inevitably brings uncertainty, because the perceived purpose of a statute will vary with the degree of knowledge and familiarity of the person doing the construing. But I fully accept that the statutory question asked in the *DTE* case is, "Was there a payment by the employer to the employee?" And for my own part, on the facts of the case, I do not think it too difficult to say that the answer was, "Yes" in the context of the particular statutory provision in issue.

And this brings me to my fifth and last point on *MacNiven*. As I have been at some pains to expound, I believe that its importance lies in emphasising the paramount role of the statutory question, and, on the whole, I do not have too much difficulty with the way in which the statutory question has been identified by Lord Hoffman in relation to *MacNiven* itself, or in relation to the earlier cases, save for *McGuckian*. I do, however, have a little difficulty with the way in which Lord Hoffman has identified the statutory question in *McGuckian*. Lord Hoffman has said that the statutory question in *McGuckian* was, "Was this receipt income or capital?" And the answer to the question was that it was income, because the sale of the dividend did not work the alchemy of turning income into capital. I have difficulty with this. If the statutory question really is, "Was this receipt income or capital?" it is necessary to look at the receipt itself as sale proceeds and to characterise it as income or capital. On its face, the receipt, being sale proceeds of a right to a dividend, is capital, and it follows that a conclusion that the receipt is income involves treating the sale proceeds as a dividend. This is to recharacterise the receipt in a way which is prohibited by the *Duke of Westminster*'s case, the paramountcy of which has been re affirmed yet again by *MacNiven*. Now if that is what *McGuckian* has decided – that sale proceeds can be taxed as income it does more than interpret the statute: it would have gone so far as to recharacterise what is essentially capital as income; and this would go further than any case before *McGuckian* and further than *MacNiven* suggests it is permissible to go. The problem I think is caused because Lord Hoffman had slightly mis-stated the statutory question posed in *McGuckian*. I do not think the question was, “Is this receipt capital or income?” I think it was, “Who received the dividend?” And, on the facts of the case, the answer to that question was the apparent vendor, because, as a matter of fact, it got the dividend.

Somewhere in Four Quartets, T S Eliot has some lines to the effect that in the end is our beginning. *MacNiven* has got rid of a lot of extravagant stuff, and it has taken us back to the paramount role of the statute, while emphasising the modern approach of purposive construction – which is not new, but which is more greatly emphasised today than it once was. Is it the end of the journey to which Lord Scarman referred in *Furniss v. Dawson*? The answer is no for two reasons.

First, as Lord Hoffman, with a, to me, welcome lucidity, points out, we are not always on the same journey. Indeed, I suspect each case takes us on a different journey, so that, just as you cannot step into the same river twice, you cannot end the journey more than once. But, secondly and more crucially, I think we still have a great deal to learn about how to identify, in the context of modern and elaborate transactions, what the statutory question is. But I am quite sure that correct identification of the statutory question is critical to the analysis of any tax case, and clarification of that point is a significant analytical avoidance.

Some years ago I had the privilege – it was, I think, then a privilege – of advising the Conservative Party, and, afterwards, Mrs Thatcher wrote to me to thank me for my help in what she called "the battle against the Inland Revenue". Some of us think of tax practice as a war, if not of arms at least of wits, and so it may be appropriate for me to finish with Mr Churchill's famous remark after the Battle of El Alamein had been won by General Montgomery:

> "Now, this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

OPTIMUM STRUCTURES FOR OVERSEAS COMPANIES: INVESTING IN UK LAND

Patrick Soares

Introduction

The UK taxation regime is very attractive for non-resident companies which invest in UK land.

A fairly common structure is for a trust to be set up outside the United Kingdom by an individual, who is not resident, not ordinarily resident and not domiciled in the UK, with the trust owning a non-UK company, such as a Jersey company, or a BVI company, which in turn holds the UK investment land.

Note that if UK based persons are behind the overseas structures or are beneficiaries under the trust then specific anti-avoidance provisions will have to be taken into account as well as the provisions dealt with below.

Tax free Capital Gain

The first main advantage is that when the property is sold one should be able to ensure that the capital gain (which could be chargeable at the top rate of 40%) is free of all UK tax. This is because gains made by persons who are not resident or ordinarily resident in the United Kingdom (the Jersey company) are free of UK capital gains tax unless the assets are used for the purposes of carrying on a trade in the United Kingdom (and the letting of property is a "business" and not a "trade").

There are also anti-avoidance provisions to be watched out for in particular TA 1988 section 776 which taxes certain artificial land transactions. Also it is important that the land was not acquired as trading stock.

Valuable Capital Allowances

If there is any plant or machinery in the building such as lifts and central heating systems one can generally use the apportioned part of the expenditure (i.e. the part of the purchase price apportioned to the machinery) as a deductible expense against the rent. The amount which can be deducted is 25% of the expenditure on the reducing balance basis.

Tax relief for the rent

Under general principles the rental profits will be chargeable to income tax at the basic rate of 22% (TA 1988 ss21 and 21A).

Part of the profit as mentioned can be reduced for tax purposes under the capital allowances provisions. Also if there are expenses, such as estate agency fees, and these are of a revenue nature, they can be offset against the rent to reduce the tax charge.

The primary procedure, however, used in the United Kingdom to reduce or eliminate the tax charge on the rent is to take out a borrowing possibly from a connected offshore company or trust.

Obtaining the Maximum Interest Relief

The amount of interest which can be deducted from the rent is subject to the UK transfer pricing regime (TA 1988 schedule 28AA) which generally means that a borrowing to buy 85% of the property or fund 85% of the expenditure on improvements can give rise to deductible interest.

That is a figure which the writer has been able to obtain in a number of cases in practice. The final determinant is what an unconnected person would have charged. If, of course, the lender is unconnected with the taxpayer and there is a straightforward loan made to the taxpayer which is charged on the land there will be no problems at all. If they are connected then the 85% or thereabouts figure may well be appropriate.

Note that if the company has other assets, e.g., a portfolio of shares, which it can use as security for a borrowing, then it may even be able to offset the interest on a 100% borrowing against the rent.

It is also vital to ensure that the company directors take the borrowing out wholly and exclusively for the purposes of the company's business (and appropriately minute this) and not, for example, to benefit the lender or the shareholders. That is an area the Revenue have been known to closely scrutinise.

Finally one will want to ensure that the interest can be paid gross. There will not normally be problems if a bank is the lender. However, if a connected company or family trust makes the loan and a mortgage is taken against the property (this should invariably be done for transfer pricing purposes) then the mortgage must be in a special "Inland Revenue approved" form if the interest is to be paid gross.

Avoiding Stamp Duty

Stamp duty at up to 4% is chargeable on the purchase price of land in the UK. It is also chargeable if land is given to a company (market value is substituted) (FA 2000 s119). There are many plans available in the UK to try to mitigate this charge to stamp duty.

One involves putting the nominal legal title to the property at an early stage into the name of a subsidiary company of the landowner (that subsidiary company will hold the legal title as nominee for the landowner); the landowner then contracts to sell the property to the purchaser and receives the purchase price but instead of vesting the legal title to the property in the name of the purchaser the purchaser buys the subsidiary company for a nominal sum and thus effectively controls and owns the company which holds the legal title.

Avoiding or Reclaiming Value Added Tax

Value added tax can be chargeable with respect to UK land transactions at 17 ½% if the landowner has elected that VAT shall be charged (VATA 1994 Sch 10 para 2). Often the foreign purchaser when buying land is charged VAT because the vendor has elected that VAT shall be charged.

This means he must pay over the VAT but he can reclaim this if he also elects to charge VAT on the property. In addition, unless some planning route is used, he must pay stamp duty at up to 4% on the VAT.

Very often, however, the going concern relief will apply (VAT(SP)O 1995, 1995/1368 at 5). What this means is if the vendor, for example, has let property and is receiving rent and he has elected for VAT to apply and the purchaser also elects for VAT to apply and the purchaser carries on the same letting business as the vendor no VAT is charged to him.

Using a Company to avoid Inheritance Tax

Inheritance tax is chargeable after a nil rate band of £242,000 at a flat 40%.

This tax can be charged on UK land if the land is held by a trust or by an individual.

However, if the land is held by an overseas company inheritance tax will nearly always not be in point. Thus it is not normally prudent for UK land to be held by an individual or an overseas trust direct but to have an offshore company which is owned by the trust (created by an individual who is not domiciled in the UK) with that offshore company then owning the property.

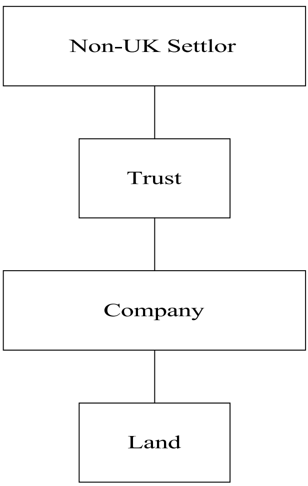
Conclusion

It is clear that one should be able to make the capital gain tax free and also shelter from UK income tax virtually all or a major part of any rent.

In addition VAT should not present a problem either because the going concern relief applies or if VAT is charged on the purchase one should be able to reclaim that VAT if the offshore company purchaser also elects for VAT to be charged on the land.

With regard to stamp duty this can normally be avoided but it depends on the circumstances of each case.

Inheritance tax can be avoided by ensuring that one holds the investment property through a company which is usually in turn owned by a non-UK trust.



SWAPS AND SCHEDULE A

Michael Thomas

In the present climate of economic uncertainty, borrowers may be attracted to enter into various types of contract to hedge against fluctuations in interest rates. A standard interest rate swap agreement involves two parties, usually at least one being a bank, agreeing to make payments to one another calculated by reference to variations in interest rates; which party is liable to make payments and their amount will depend on whether rates are above or below a particular level. There are many varieties of interest rate contract but this article focuses on swaps.

Where the taxpayer is a company, the tax treatment is set out in Part IV Chapter II of the Finance Act 1994. But where the taxpayer is not a company, the position becomes less clear. What is the tax treatment of an interest rate swap entered into by a partnership of individuals carrying on a Schedule A rental business, in order to hedge against interest payments on loans taken out to purchase its investment properties? The short answer is that the Inland Revenue treat payments made or received under the swap as Schedule A expenses or receipts. The Revenue's practice is set out in *Tax Bulletin 25* (October 1996). This treatment is premised on the interest itself being deductible in accordance with s.74(1)(f) ICTA 1988.

As a matter of common sense the Revenue's approach is correct: payments received by the borrower under the swap are netted off against the interest payments it makes, producing the same economic effect as if the borrower had taken out a new loan with different interest payments. But while the tax system should produce common sense results, the legal basis on which it does so should also be clear. Here we have a receipt under an interest rate swap agreement being labelled as income arising from the exploitation of land. This is equivalent to labelling a giraffe as an elephant and demonstrates that the schedular system must rely on fictions and twisted logic in order to produce sensible results.

The Revenue's approach to swap contracts entered into by Schedule A businesses follows, in accordance with the rule that Schedule A profits are computed in the same way as those of Schedule D Case I, their treatment of swaps entered into by traders, as set out in Statement of Practice 14/91. But the conclusion that receipts under swap contracts are trading income from the underlying activity which the swap was protecting is difficult to reconcile with *Nuclear Electric v Bradley* [1996] STC 405 where the House of Lords took a narrow view as to when investment income could amount to a trading receipt, albeit that their Lordships did recognise that it could. *Nuclear Electric* decided that investment receipts providing against future trading payments were not trading receipts, but unfortunately their Lordships gave little further guidance on the question of when investment income will be a trading receipt. Perhaps the best reconciliation is to say that receipts under interest rate contracts are receipts from the underlying activity, when they are used to set off against deductible interest payments which are costs of that activity in the present year.

In Statement of Practice 14/91, the Revenue give guidance as to when a payment made or received under an interest rate contract will be treated as a trading outgoing or receipt, notwithstanding that the taxpayer has no trade in interest rate contracts. Essentially they say that payments made under interest rate contracts taken out to reduce the risk of trading transactions will be treated as trading profits or losses. This is treatment is undoubtedly helpful in that it allows profits and losses under the swap to be set off against interest payments and trading profits respectively. But of course a Statement of Practice is not a statute, and to rely on it a taxpayer must show a legitimate expectation of being allowed the treatment it affords. It could be argued that Statement of Practice 14/91 does not apply to interest payments hedged against capital borrowings, because there is no trading transaction, although the better view is that where the borrowings are related to a Schedule D Case I trade the Statement of Practice applies: that would make economic sense. More fundamentally, the Statement of Practice does not deflect the central criticism that the schedular system only arrives at sensible results by labelling payments received under swap contracts as trading profits or income arising from the exploitation of land.

If an individual, or for that matter an investment trust, takes out a swap purely as a speculative investment, rather than to hedge or as part of a trade in swaps, the question arises, into which case of Schedule D the income falls. The Revenue's original view, as expressed in Extra-statutory Concession C17, was apparently that such receipts were Schedule D Case III annual payments. But it is difficult to see how swap payments are pure income profits, especially where payments fall to be made by both parties during any year. The better view is that the net annual payments made and received under the swap should be within Schedule D Case VI. What is clear is that without legislation, such as that which applies for corporation tax purposes, the schedular system cannot adequately cope with interest rate contracts.

The above analysis ought to be academic and sterile. Unfortunately, it has practical relevance, because the general rule remains that profits and losses arising under the different Schedules and the different Cases of Schedule D must be segregated, notwithstanding the difficulties of classifying income in the first place. Our tax system is undeniably complex, but complexity should be the cost of precision and not the result of distorting concepts and twisting logic. Taxpayers should be able to undertake transactions with knowledge of the law that will apply, rather than have to rely on the Revenue to apply its Statements of Practice. The schedular system is unnecessary historical baggage; it should be scrapped and replaced with a business profits tax.

STAMP DUTY PLANNING

Patrick Way

Introduction

This article sets out some rules to assist practitioners in their stamp duty analysis of commercial transactions.

Rule 1

Think carefully whether the transaction needs to be documented. If it must be documented, can a contract falling outside paragraph 7 Schedule 13 Finance Act 1999 be utilised and then assets passed on completion by delivery? Alternatively, can a written offer be utilised, to be accepted by conduct? In any event, be careful of receipts if they operate to document the transaction in a critical fashion. If it were always intended that the written record would form part of the transaction then, it is likely to be stamped on its merits, typically as a conveyance on sale.

Note the following taken from *Carlill v Carbolic Smoke Ball Company* (1892) 2QB 484, when Hawkins J stated:

> "The mere fact that a document may assist in proving a contract does not render it chargeable to stamp duty... A mere proposal or offer, until accepted, amounts to nothing. If accepted in writing the offer

> and acceptance together amount to an agreement."

It is from this case that one technique of offer and acceptance has evolved.

Rule 2

Consider (if you want to be bullish) not stamping a document at all.

The case of *Marx Estates and General Investments Ltd* (1975) 3 ALL ER 1064 is authority for saying that a document need not be stamped. In that case the chairman of a meeting was entitled to accept the votes of a proxy, notwithstanding that the proxy form ought to have been but was not stamped. It was held that the proxy form although unstamped was not void.

Sometimes, however, a document cannot be avoided. For example, the following sets out situations where a written instrument must be utilised:-

- S88 of the Companies Act 1985 provides that a return of allotments must be accompanied by the contract or the particulars thereof "duly stamped" – consider using an unlimited company.

- S103 of the Companies Act 1985 requires written instruments for the transfer of shares and debentures in a company (although there may be avoidance schemes available).

- The Law of Property Act 1925 requires many land transactions to be in writing (see for example s53(1) dealing with equitable interests in land).
- Section 2 of the Law of Property (Miscellaneous Provisions) Act 1989 requires contracts relating to land to be made in writing .

Note, however, that the practice in this area is in a state of flux, as the time honoured convention that barristers may not object to unstamped documents in court has recently been disavowed by the Bar Council.

Rule 3

Consider removing assets from the terms of a transaction and recording them in documents in respect of which no stamp duty arises. For example, it may be possible to extract foreign assets from a conveyance on sale and to organise for those assets to pass by reference to documentation executed and kept outside the United Kingdom.

Rule 4

Non-chargeable assets which can pass by delivery should not be included in a conveyance.

It is acceptable for a contract for the sale of goods to provide that completion will take place by means of delivery. The Stamp Office accept (as they should do) that there is no transfer by instrument of the goods necessarily in these circumstances and if as a matter of fact the goods do pass by delivery then the fact that there has been a preceding contract will not produce a charge to stamp duty.

Rule 5

Remember that if the purchaser takes over debts and liabilities then the quantum of these will increase the stampable consideration. This rule can extend to unlikely situations.

A dividend *in specie* falls outside the stamp duty charge since no consideration is involved. If, however, the members take their *specie* dividends in consideration of taking over liabilities then s57 Stamp Act 1891 will apply in respect of the liabilities.

Accordingly, do not create a liability and then discharge it by a dividend *in specie*.

Example - wrong way

1. A company agrees to pay a dividend of £1m.

2. In satisfaction of the obligation to pay £1m the company agrees to transfer an asset worth £1m – stampable.

Example - right way

A company agrees to pay of a dividend of £1m to be satisfied by the transfer of an asset worth £1m –not stampable.

Rule 6

Stamp duty in respect of shares is ½% and in respect of other assets is 4%. Accordingly where there is a choice it may be sensible to acquire a company rather than the assets. The value of the consideration could be further reduced if the purchaser wishes only to acquire certain assets within the company. The non-required assets could be stripped out within s42 Finance Act 1930 beforehand (but watch s27 FA 1967), and the company then sold to the purchaser without the unwanted assets. The use of a company reduces the impact of s57 as well, since the total value of liabilities and assets within a company are "netted off" in computing the price of the shares to be sold, to produce a smaller consideration for stamp duty purposes.

Alternatively, if the transaction is relatively small, it may be sensible to try to dispose of assets (rather than shares) where a certificate of value is available.

It may be possible, with care, simply to transfer property which amounts to an undertaking from one company to another in circumstances where relief under s76 Finance Act 1986 is available. This reduces the charge to ½%. The transferee company can then be sold on with duty at a further ½% only.

Rule 7

Watch goodwill, as this is a chargeable asset under paragraph 7 Schedule 13 Finance Act 1999 (*West London Syndicate v CIR* CA [1898] 2 QB 507).

However, if the goodwill attaches to a business carried on entirely outside the United Kingdom, the agreement will be exempt from stamp duty, since it will in respect of property locally situate outside the United Kingdom.

In order for goodwill to be located outside the United Kingdom, it must be the case that both the business and the customers are abroad (*Benjamin Brooke & Co v CIR* QB (1896) 2 QB 356 and *Muller & Co's Margarine Ltd* HL (1901) AC 217).

Rule 8

Make use of all available exemptions and reliefs wherever possible, such as those available under section 42 Finance Act 1930 (intra-group transfers), section 75 Finance Act 1986 (relief for reconstructions), section 76 Finance Act 1986 (sales of undertakings) and section 77 Finance Act 1986 (interposition of a holding company).

Conclusion

It is hoped that these eight rules will serve as a useful foundation when considering stamp duty matters.

INFORMATION: COMPLIANCE v CONFIDENTIALITY

John Walters

In this presentation, I consider the relationship between compliance and confidentiality in the context of the UK tax system. The question essentially is – how does legal privilege square up against Revenue investigation powers? Although I look at the topic from a specifically English law perspective, I am sure that what I say will have resonances with experts from other jurisdictions, as the subject of compliance and confidentiality is, of course, of general world-wide significance and topicality.

The three main heads of privilege recognised by the law of England and Wales are, first, the privilege against self-incrimination, second, the privilege for *without prejudice* correspondence. Neither of these has much relevance to my topic. The last head of privilege is what is generally called "legal professional privilege", although this name may confuse, because it is not the privilege of the lawyer but of the client; this is the head of privilege with which we are especially concerned when we consider the power of the Inland Revenue to obtain documents pursuant to s.20 of the Taxes Management Act, 1970. The section itself is part of an elaborate series of provisions to be found in eight sections of the Taxes Management Act which are generally referred to together as "section 20". These eight sections deal with power to compel the production to the Inland Revenue of documents and the furnishing of particulars (that is the giving of evidence) by taxpayers and others – in particular, by third parties often referred to as “innocent third parties”, such as banks and professionals. The documents and particulars in question must be “such as in the reasonable opinion of the Inspector of Taxes issuing the notice” under section 20 or, in some cases, in that of the Commissioners of Inland Revenue themselves, “contain or may contain or are information relevant to a tax liability to which the taxpayer may be subject” (the taxpayer being the person under investigation). These provisions constitute a detailed code regulating to whom, by whom and subject to what threshold requirements, both procedural and substantive, such notices may be given. They are a labyrinth of detailed regulations which govern more or less every aspect of the exercise of this investigatory power. The powers include a power to raid, contained in the section which is called s.20C. This power is usually exercised at 7 o’clock in the morning. The power to raid under s.20C is arguably the most intrusive power: it is a power to enter and search specified premises, if necessary by force, where there is reasonable ground to suspect serious fraud, and evidence of it is likely to be found on the premises. The least intrusive power is, perhaps, the power under subsection (1) of s.20 – the power to call on a taxpayer himself to deliver documents.

What documents attract privilege? There is a distinction between cases where litigation is contemplated and those where it is not, and in the context of section 20, and in most investigation powers, we are most likely to be concerned with the head of privilege which applies where litigation is not contemplated. Where litigation is not contemplated, only communications passing between a client and his lawyer and vice versa are protected, and then only when the lawyer is acting as such and is advising or taking instructions from his client. This is advice privilege. The lawyer does not have to be an English lawyer. One of the recent cases in the United Kingdom is the case of *ex parte Tamosious* [1999] STC 1077. Alwyn Tamosious is a US lawyer practising in the United Kingdom, and there was never any doubt that the documents in his possession were documents held by a lawyer and *prima facie* the subject of legal professional privilege, notwithstanding the fact that he was not a barrister, advocate or solicitor. The privilege extends to communications between the lawyer or his agent acting as such and the client or his agent, but for this privilege to attach to documents the relationship of client and lawyer must have been established or at least have been contemplated when the communication in question came into existence, and it must be referable to that relationship. In general, communications to be privileged must be for the purpose of, or related to, the giving or obtaining of legal advice. The privilege attaches to communications within an organisation where one party is the employed lawyer of another, or of the organisation as such. The privilege does not attach, in the absence of contemplated litigation, to documents provided by third parties to a lawyer to enable him to give an opinion. Those documents have not come into existence for the purpose of the advice, and so they are not generally privileged unless there is contemplated litigation. But, on the other hand, advice privilege does attach to correspondence from a lawyer to his client where he reports, in giving advice, a conversation that he has had with third parties, and it attaches to documents sifted and selected by the solicitor in the exercise of his own judgment, because that is all part and parcel of what has been called the continuum of the giving and receiving or obtaining of legal advice. Litigation privilege – as it is sometimes called – is rather wider than advice privilege. Where litigation is contemplated, documents created by third parties are privileged so long as the dominant purpose of their being brought into existence was possible or existing litigation. It does not have to be the sole purpose, but it must be the dominant purpose.

There are five other points to make about the scope of privilege. First, it appears to protect an entire document even if part is and part is not privileged. Secondly, it does not protect communications intended to facilitate crime or fraud. This is an important exception and the Inland Revenue rely on it wherever they can, when they are investigating suspected tax fraud. So when you make a claim for privilege, the first thing they will say is, "We have to be satisfied that the document wasn't intended to facilitate crime or fraud." Thirdly, privilege can be lost, either by waiver or by the document coming into the hand of a third party, no matter how the document gets into a third party's hand – whether by accident or fraud or however, and that is the reason for the familiar rubric on all lawyers' fax sheets, that *this information may be privileged and if it has got* *to the wrong place it must be returned without being looked at*. Fourthly, privilege is that of the client; the lawyer has a duty to claim it, unless instructed not to do so, but it is his client's privilege and not his. A lawyer's duty to his client to claim privilege may conflict with his *prima facie* obligation under section 20 to give disclosure to the Inland Revenue. When a section 20 notice is served on a third party with legal professional obligations of confidentiality to his client, the recipient is caught in a nutcracker between his obligation to give disclosure to the Inland Revenue in accordance with the requirements of section 20, and his obligation not to give disclosure because it is his client's privilege, which he cannot waive unless instructed to do so – and generally he will only be instructed to do so if he has first advised the client to give the instructions.

Lawyers in that situation are in a difficulty and that is the difficulty in which clients of mine found themselves in the firm of Davies Frankel & Mead. They were served with a widely-drawn notice under s.20(3) to produce most – but not all – of the documents they held relating to a particular client whom the Inland Revenue were investigating. In order to deal with that, they brought judicial review proceedings, which were heard by Mr. Justice Moses in June of last year, in order to try to get a resolution of the problem with which they were faced. The judicial review failed, but permission to appeal to the Court of Appeal was obtained and that brought sufficient pressure on the Inland Revenue to effect a settlement.

The last point to make about the scope of privilege is that under the general law it is given only to communications with lawyers, though by statute it has been extended to certain others such as licensed conveyancers and trademark and patent agents. But it does not extend to someone acting as a legal adviser who is not actually a lawyer. That means it does not protect communications with an accountant, even though the accountant holds the papers subject to an implied duty of confidentiality.

Let me now consider the nature of the rule, and ask whether it is procedural or substantive. It is only if it is a substantive rule, rather than a procedural rule, that it can be of help in resisting the exercise of the Inland Revenue's investigation powers. We all tend to believe that privilege is such a fundamental right that its existence must go back into pre-history, but this is not true. Until comparatively recently, it was regarded as a purely procedural rule relating only to the production of evidence in the proceedings of a judicial or quasi-judicial nature. In proceedings, the other side was prohibited from seeing the instructions that the client had given to his lawyer, and this prohibition was regarded as a procedural rule. This was certainly the view of Lord Justice Diplock as recently as 1969, in the case of *Parry-Jones v. the Law Society* [1969] 1 Ch. 1.

That was a decision that the Law Society – not being party to any litigation – could look at solicitors' clients' privileged documents for certain regulatory purposes. On this view of privilege, it could never be a defence to any exercise of any statutory power, and the fact that privilege started as a rule of evidence in judicial proceedings is the source of the practical difficulty that there is no obvious solution to the problem of finding ways to resolve disputes as to whether privilege applies to any particular document in the context of an Inland Revenue investigation. This is a problem, I imagine, in other jurisdictions; it was first addressed in the United Kingdom in the context of direct tax, in the *Tamosious* case in 1999. Latterly, it has received legislative attention in the amendments to section 20 introduced by the Finance Act 2000.

In the 1970's and 1980's a movement began in the Commonwealth which decided, in effect, that privilege was a fundamental rule giving substantive rights, and not just a procedural protection in the context of litigation. In England – as well as the rest of the Commonwealth – privilege is now recognised as a substantive rule of law and not merely a procedural one. It is indeed a fundamental right. It was described in 1994 as both an important auxiliary principle serving to buttress the cardinal principles of unimpeded access to the Court and to legal advice, and also a fundamental common law right, which will only be abolished by the words of a statute if that is required by necessary implication from the statutory language.

However, that abolition is required by necessary implication to be derived from statutory wording in section 20: this was precisely what the Court of Appeal held in the *Morgan Grenfell* case [2001] STC 497. It held that the terms of section 20 generally abolish legal professional privilege in the context of the exercise of tax investigation powers, and that is why the case is such a controversial one. Where there is no abolition of it by express words or necessary implication, privilege can, of course, be a defence to the exercise of a statutory power of investigation.

How does privilege apply to statutory powers of investigation? The simple answer to this question is that privilege applies when the statute permits it to apply. In the context of section 20, it is only expressly available where lawyers are involved – where the notice requiring disclosure is served on a lawyer, or where, in the context of a raid, it is a lawyer's premises that are being raided: there is specific reference in the statute to lawyers in these two contexts. However, there was an amendment in the Finance Act 2000, which amended section 20 and introduced a new procedure, giving a wider privilege defence against a notice to produce documents. Where a notice under this new procedure is issued, the privilege does not just apply to lawyers. In the old section 20 it specifically did just apply to lawyers, and that is why the Court of Appeal said, quite simply, that if the statute says that privilege applies to lawyers only (and the Court was looking at the pre-2000 legislation in that case), then, by necessary implication, it does not apply to anybody else. In the *Morgan Grenfell* case, what the Inland Revenue were asking was for documents containing legal advice which were not, in fact, held by lawyers. So the Court of Appeal said, "In those circumstances, although the right to privilege is indeed a fundamental common law right, you can't refuse to produce this legal opinion because the document in question wasn't held by a lawyer". And there is a necessary implication that because the statute says the defence only applies where the document is held by a lawyer, it does not apply where the document is not held by a lawyer. With that decision we have reached the position that legal professional privilege is *prima facie* a defence to the exercise of a statutory power of investigation, unless the terms of the power demonstrate expressly or by necessary implication that it is not to be, and that by conferring expressly on a limited class of persons (in this case, lawyers) the defence of privilege to an exercise of a statutory power, Parliament has demonstrated that it does not intend anyone outside that class to have the benefit of the defence. It is a decision that the fundamental right to legal privilege should yield to the other right in play – the public interest in the prompt, fair and complete collection of the public revenue. But it does, nonetheless, seem distasteful that a man should generally be compelled to produce his legal advice. Is this in accordance with sound policy? Also, it is an odd reflection that if the section 20 code had been silent about privilege altogether, instead of giving it expressly where the documents were held by lawyers, then the Court of Appeal's reasoning in the *Morgan Grenfell* case, based on what it called the "principle of legality" that is the fundamental nature of the right to privilege, would have led it to the conclusion that privilege was a defence against any exercise of the investigatory power. So you get the ironical – and almost paradoxical – situation that because Parliament has expressly mentioned privilege as a defence for lawyers, it has diluted the efficacy of the right – confining it to the situation that is expressly mentioned, rather than leaving it to apply generally, which would have been the case if it had not been mentioned at all!

Our rule about privilege stems from the conflict, in an adversarial system, of two principles of law. The first is that the tribunal or the court seized of the matter must have the whole truth, and the second is that the client should be able to get untarnished advice, and, in order to do that, he must be able to tell his lawyer the whole truth, without fear that the lawyer will ever say what he has been told. The balancing act between these two principles was done long ago, and it was decided, as Lord Taylor said in *R v. Derby Magistrates Court e ex p. B.* [1996] AC 487 once and for all, that privilege is the dominant principle, so that even at the expense of not providing the whole truth to the tribunal, a person must not be compelled to reveal what he has said to his lawyer or what his lawyer has said to him. One may ask why, as a matter of policy, that general principle should not apply also to the exercise of Revenue investigation powers, because, of course, the consequence of the Inland Revenue getting privileged material is that they know what has passed between a taxpayer and his lawyer. It is a very controversial policy area.

In the United Kingdom, the law in this area is being influenced by the adoption into our law of the principles of the Human Rights Convention. On the 23rd May 2001, the House of Lords gave judgment in the case of *R v. The Home Secretary ex. P. Daly* [2001] UKHL 26, a case on prisoners' rights. The Home Secretary lost, and one is tempted to think that judges are nowadays more anxious to protect prisoners' rights than taxpayers' rights. Perhaps they should reflect on where their salaries come from! The appellant, Mr. Daley, is – still – a long-term prisoner, and he challenged the policy regulation which required prison staff to examine legal correspondence during a cell search in the absence of the prisoner whose cell was being searched. Mr. Daley was well-advised and, for the purposes of appeal, he accepted the need for random searches of prisoners' cells. He accepted also that such searches might properly be carried out in the absence of the resident prisoner. And he also accepted the need for prison officers to examine legal correspondence held by prisoners, to make sure that it was legal correspondence and that that correspondence was not used as a convenient hiding place to secrete drugs or illicit materials of any kind or to keep escape plans or records of illegal activity. He accepted all those things: he limited his complaint to the claim that the examination of legal correspondence should ordinarily take place in the presence of the prisoner whose correspondence it was. He just wanted to be there when the prison officers examined the correspondence.

The Home Secretary's evidence, on the other hand, was that examination of prisoners' legal correspondence had always to be carried out in the absence of the prisoner in order to "discourage prisoners from using intimidatory or conditioning tactics to prevent officers carrying out a full search of possessions." What was meant by “conditioning tactics” was action by which prisoners seek to influence the future behaviour of prison officers. The Home Office evidence went on, “For example, a prisoner might create a scene whenever a particular item was searched intending to cause prison officers not to search it in future on the ground that searching it was more trouble than it was worth” and one can well understand and imagine what might be going on in those circumstances.

The House of Lords decided that the prison policy did indeed infringe the prisoner’s common law right to the confidentiality of his privileged legal correspondence. This is for the reason I refer to above – that it inhibited the prisoner’s willingness to communicate with his legal adviser in terms of unreserved candour, and that there was a risk, if the prisoner was not present, that officers would stray beyond their limited role in examining legal correspondence. Lord Bingham accepted – and I think this is important – that in an imperfect world there will necessarily be occasions when prison officers will do more than merely examine a prisoner’s legal documents, and apprehension that they may do so is bound to inhibit a prisoner’s willingness to communicate freely with his legal adviser. At this point one might reflect that if prison officers can be fallible in this respect, cannot tax officials also fail to adhere strictly to their duty to respect the confidentiality of the material they see? The House of Lords then considered the Home Office’s justification for the policy, and it objected to its blanket nature. It held that the Home Office should discriminate on a reasonable basis between those prisoners who were likely to be intimidatory or disruptive or both, and those who were not, and only to search in the absence of prisoners when they reasonably considered them to be disruptive or intimidatory. They had to take a prior reasonable decision as to whether this prisoner was likely to be intimidatory, and only then did they have the justification to override his fundamental right to confidentiality in this way. And on this ground the blanket policy regulation which the Home Office was arguing was declared unlawful in the sense of being *ultra vires* the enabling primary legislation which was s.47 of the Prison Act 1952.

The reason I have discussed this case at such length is that it seems to me to exhibit a radically different judicial attitude from that which we in England have been accustomed to expect in cases of alleged abuse by the Inland Revenue of their section 20 investigation powers. It is also more realistic: its scepticism on the question of whether one can always assume unimpeachable integrity on the part of government officials is quite refreshing. What a change from the tone of the famous dictum routinely cited in judicial reviews cases involving the Inland Revenue that they themselves are in the best position to judge the fairness of their own actions. That comes from the 1985 case of *Preston* [1985] STC 282. And what a change from the attitude of the House of Lords in *TC Coombs* [1991] STC 97, where it held that an inspector seeking to serve a section 20 notice must be presumed to act reasonably, unless it can be positively proved that he could not possibly be acting reasonably. The House of Lords in the *Coombs* case was willing to take this stance, even though it acknowledged that the pre-condition it was setting could, in practice, never – or hardly ever – be fulfilled. On that basis, the presumption was in practical terms irrebuttable. Incidentally, the very inspector concerned in the *TC Coombs* case was later convicted for accepting bribes and was sent to prison himself.

In considering the right to respect the correspondence under Article 8 of the Human Rights Convention in the *Daly* case, Lord Steyn commented that there was an overlap between the English law approach on judicial review and the Convention approach, and that most cases would be decided the same way whichever approach was adopted. But he did say that the Convention approach, with its emphasis on the need for any infringement of human rights not only to be objectively justifiable on a recognised basis, but also proportional to the needs of the public policy justification, did mean that "the intensity of review is somewhat greater under the proportionality approach". In other words, the threshold for finding abuses is lower under the Convention approach, so you are more likely to get home under the Convention approach than under the traditional English administrative law approach laid down in the old 1948 *Wednesbury* case [1948] 1 KB 223, where the Court has to find that a decision is capricious or absurd before it can intervene.

All of this suggests that the tide may yet turn – at any rate in England – in this field, where hitherto the

Inland Revenue have been left very much to their own devices. I believe we are moving away both from blanket defences and from blanket investigatory powers, towards something much more tailored to the specific case in hand. In the *Tamosious* case in 1999, the Court was faced with the problem of what to do when a lawyer who was being raided by the Revenue made a blanket claim saying that all his papers were privileged and protected from seizure. He put up a blanket defence. How was that claim to be tested? The High Court held that the existing section 20 code on raids permitted the Revenue to take with them an independent counsel, who would be on the premises for the purposes of making an on-the-spot adjudication of any privilege issue. The disputed items could properly be taken away, even if a claim for privilege was still maintained in relation to them, provided they were kept in an embargoed state until the person raided had the opportunity to apply to the Court for a binding adjudication. The principal amendment made to section 20 in 2000 was the statutory introduction of a new Revenue power to apply to a judge for a production order, requiring documents to be produced within a specified short period, and there is an express protection from this power for items subject to legal privilege, wherever they may be found – that is, in a lawyer's possession or otherwise. In this way, but only in relation to the exercise of this new power, one of the historical illogicalities of the privilege defence is removed, and this is a very significant policy change in favour of the taxpayer.

Another interesting policy change introduced in 2000 is that before the Inland Revenue can get one of these new production orders from the judge, they must give the person affected the opportunity to appear and be heard at the hearing before the judge when the application for the order is made, so that this is an *inter-partes* hearing rather than the *ex parte* hearing we have traditionally had, where only the Inland Revenue is there before the judge. Although the Inland Revenue have always had certain duties to present a fair and balanced approach, the taxpayer was not there to make sure that this duty was carried out, and in any event the judge only had the Revenue before him. Admittedly, under the 2000 rule this provision for an *inter-partes* hearing can be challenged, and the judge can refuse to hear the taxpayer, but only if the investigation would be prejudiced by his being there.

We might say – in the Revenue's favour – that the 2000 change includes a new provision for the resolution of disputes as to legal privilege, very much along the lines foreshadowed in the *Tamosious* case. The position on the resolution of privilege disputes which applies in relation to the new production order has now also been applied to Revenue raids – not by way of Revenue regulations, but instead by primary legislation in the form of the Criminal Justice and Police Act 2001, which was rushed through Parliament before the recent General Election. Section 50 of that Act expressly empowers the Revenue, under a s.20C raid, to take away material which may or may not be privileged and keep it embargoed. There is a duty to notify the occupier of what has been taken away, and there is a duty to have procedures in place to get any real disputes as to whether or not any particular documents are privileged before a judge as soon as possible.

The trend which emerges from the recent case law and the legislation passed in reaction to it, is that there is much more awareness that investigation powers which override legal professional privilege cannot be in such blanket terms as have traditionally been regarded as acceptable. It seems to be coming to be recognised as unacceptable, at any rate in theory, for the Inland Revenue to be able to use their powers against anyone and in any circumstances without the possibility of any opposition being voiced, except in reaction to the exercise of the power. There is an awareness in the legislation that any infringement of fundamental rights must, in order to satisfy Human Rights Act requirements, be proportionate for the purposes justifying the infringement, and must therefore be a good deal more fine-tuned.

But on the other hand, the new approach, while recognising the fundamental nature of the rights on legal professional privilege, will not allow privilege to be asserted on a blanket basis, without any comeback from the Inland Revenue. The law now is saying that procedures must be put in place which are appropriate and proportionate, in order to test the claim of privilege and at the same time preserve the confidentiality inherent in privilege documents. The up-coming House of Lords appeal in the *Morgan Grenfell* case (if it happens, and I hope it will) will therefore be interesting because it will examine and – with luck – rectify the approach of the original section 20 legislation. That legislation dates from 1976, before privilege was recognised as a fundamental common law right in the way that it now is recognised. This case will – with luck – be a resolution of an interesting jurisprudential conflict, but it will be interesting to see whether it does rectify the approach of that original legislation – the Court of Appeal having held in a blanket way that it abolishes the right to privilege except in stated exceptional circumstances, and having also refused, in a blanket way, any opportunity to the person affected to be heard on the matter. That opportunity is now belatedly being recognised by the law as an appropriate and proportional protection against abuse, where Revenue investigatory powers conflict with the fundamental right to privilege.

Members of Chambers

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