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*Editor: Milton Grundy*

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# THE WORLD-WIDE RESPONSE TO THE HARMFUL TAX COMPETITION CAMPAIGNS (UPDATED TO APRIL 2004)[1]

**Philip Baker**

The thinking behind this paper is this: I thought I would like to find out what had actually happened as a result of the harmful tax competition campaigns up to date. After all, we have had the campaigns for roughly five years, and when they started, people were saying, "This is the end of the world of international tax planning as we know it." I was interested to see whether the world had come to an end.

In looking at what has happened, I am focusing on changes to tax systems, and am using a very broad-brush approach. I am not looking at changes that have come about at the same time due to other campaigns. For example, I am not looking at changes to financial regulation which have come about as a result of the focus on money-laundering – changes that have been brought about by the work of the Financial Action Task Force. I am focusing just on tax system change.

I am also not interested in criticisms of the underlying policy of the harmful tax competition campaigns. One can get almost daily e-mails from the Centre from Democracy and Apple Pie, with trenchant criticisms of the underlying policy. I am not interested in that. What I am interested in here is what has actually happened by way of tax system change, and analysing whether these changes are good or bad.

## Background to the Campaigns

Let me turn to the background. There are two principal campaigns – the EU campaign and the OECD campaign.

The EU campaign started in December 1997, with the European Council Conclusions, which proposed a tax package. The tax package was finally adopted in June 2003, after the Council had sorted out the final problem of the Italian milk quota. There are three main elements to the tax package. The one I want to focus on first is the Code of Conduct for Business Taxation, which is sometimes referred to as the *Primarolo Committee Code*, because it involved the establishment of a Committee, originally under the chairmanship of Dawn Primarolo, to examine harmful tax practices within the EU Member States and their dependent and associated territories. That Committee, in 2000, published a list of sixty-six potentially harmful tax regimes (which is reproduced in Appendix II). The Code of Conduct had, in a sense, to wait in the wings for the rest of the package to be agreed. Once the package was agreed, decisions of the Primarolo Committee need to be implemented.

The other campaign is that of the OECD, which was initiated in 1996, but first became public in April 1998 with the publication of the first of four reports, entitled “Harmful Tax Competition: A Global Issue”. There are two aspects of the OECD campaign. One aspect focuses on the thirty OECD-member countries, and entailed a process of identifying potentially harmful preferential tax regimes, and there were some forty-seven identified by 2000. The other aspect of that campaign was the listing of tax havens and the obtaining of commitments from these tax havens. For that, some forty-seven jurisdictions were originally examined to see whether they were tax havens. To date, of the forty-seven, nine have been excluded and are ruled to be non-havens; thirty-three are havens which have made commitments to the OECD; there remain five uncooperative tax havens[2] that have still not made commitments to the OECD. The cooperative havens have now been christened Non-OECD Participating Partners – "NOPPs" – and have been encouraged, under the banner of the Global Forum on Taxation, to develop work on international standards for transparency and effective exchange of information. An Informal Contact Group has been established between representatives of the NOPPs and OECD Member Countries. Meetings have been held in Ottawa in October 2003 and London in February 2004 to develop the notion of a global level playing field.

Mention should also be made of the Savings Income Directive[3], which – strictly speaking – is part of that EU tax package. In many senses this has taken on a life of its own, because it was perceived very early on that the Savings Income Directive would only work if neighbouring countries, major countries elsewhere in the world, and dependent territories signed up to equivalent measures. What started off as an internal directive has taken on a world-wide dimension, in the rush to try and make certain that other countries were also signed up to the same types of measures.

Of those campaigns, it is worth reminding oneself about the original timetable, though it has slipped somewhat. The European Union was planning to roll back harmful regimes within five years from the 1st January 1998, and that deadline has been passed. The OECD had two points of time: the member countries were to end their harmful features by April 2003, and after the end of 2005 there were to be no benefits obtained. By then, the tax havens were to have ended their harmful features. All that has slipped, and we are now looking at 2010 or 2011 – certainly within the European Union – for the ending of benefits from some existing tax practices.[4]

What has also changed has been the focus of the campaigns. One criticism which can be made of the campaigns is that they never assessed precisely what aspects of tax regimes actually were harmful. They identified harmful tax competition, without saying what really were the harmful elements. For example, the EU Code of Conduct has only one paragraph (paragraph B) that talks about what is harmful and it refers to:

> "Tax measures which provide for a significantly lower effective level of taxation … than those levels which generally apply in the Member State in question …"

The OECD's report has only five paragraphs which consider what may be harmful, and it is very hard to see from these what they really had in mind.

What has made matters somewhat worse is that, as the work has proceeded – particularly the OECD work – there has been a shift: ring-fencing was dropped as a criterion for tax havens, and the whole campaign shifted towards transparency and exchange of information, so that what became harmful was lack of transparency and the lack of willingness to exchange information. Because there was uncertainty as to what is "harmful", there was also uncertainty as to what states had to do in order to comply with the demands of the campaigns.

## The Impact of the Campaigns

What have the campaigns actually made states do, and what has the impact of this been on the campaigns themselves? There is a very simple comment that one can make at the beginning: the campaigns have subjected different jurisdictions to different degrees of pressure to change. That is not a simplistic, "lack of level playing field" comment; it is rather a recognition of the fact that some jurisdictions were subject to both campaigns, and some to neither. The seventy-or-so jurisdictions affected fall into six groups, which have been under varying degrees of pressure, and have responded in different ways.

### Group 1: *The EU and OECD Member States*

In the first group are those states that are <u>both</u> members of the European Union and members of the OECD. All of the present fifteen EU states are members of the OECD, and so these countries were subject to both of the campaigns. At the same time, because they are members of the European Union, they are also subject to review under the *state aid* provisions of the Treaty of Rome, and they are subject to the increasingly perverse jurisprudence of the European Court of Justice on direct taxes. So there is a lot of pressure coming on these states, from different directions, to change their tax systems.

Of the fifteen, three have not felt much pressure. The United Kingdom, for example, has not been cited by the European Union or the OECD; Italy, through not having implemented the Trieste regime, has not had a particular problem; and Sweden has not particularly faced a problem either. But Austria, Belgium, Denmark, France, Germany, Ireland, Luxembourg, Netherlands, Portugal and Spain have all had regimes identified by the European Union or the OECD or both.

Ireland is crucial in identifying what has happened, because, very early on, the Irish - recognising that the Dublin and Shannon schemes would have to give way under this twin pressure - looked at the wording of the Code, and saw that what was defined as harmful was any regime with a significantly lower rate of tax than that generally applied. As you know, the Irish said, “Let’s just have a generally low tax rate for everybody. We’ll get rid of Dublin and Shannon, and we’ll just have a generalised low rate of tax at 12.5%” – which they have had since 2002. And, of course, that does comply with the words of the OECD and the EU campaigns, because it is a generalised rate, and there is no regime with a significantly lower rate than the one generally applicable. So Ireland has led the way by saying that you can get out of this problem by having a generalised low regime. Most recently Ireland has announced (in December 2003) a new holding company regime intended to be the most attractive of similar regimes in virtually all the EU, OECD states.

The other country I want particularly to mention is the Netherlands. One may say that it was the winner of the EU competition: of the forty-seven regimes judged potentially harmful, ten of them belonged to the Netherlands. Of those ten, five were old ruling practices, and the Netherlands responded to that in 2002 by introducing new types of ruling practices. The Netherlands, again, has pointed the way by saying that you can have a ruling practice, provided that it is one of two types – an advanced pricing agreement ("APA"), because, in the transfer pricing world, APAs are very acceptable; or an advanced taxation ruling ("ATR"), which tells you how particular legislation will impact on a particular transaction. Both of those are acceptable types of rulings, and the Netherlands has brought those in to replace the old type of rulings.

Group 2: *The non-EU, OECD Member States*

In the second group of jurisdictions are the other fifteen OECD-member countries, who are not EU members, and who, because they are not, have not been subject to the Primarolo Committee, though some have been part of the attempt to expand the Savings Income Directive. Countries in this group have not been under the same sort of pressure as countries in the first group.

Switzerland abstained on the original OECD report, so there must be a question mark whether Switzerland is subject to either of the campaigns, and certainly whether it is subject to any OECD requirement to change its practices. Swiss regimes have, though, been examined as part of the OECD campaign. As at April 2004, the Swiss 50/50 regime is still under scrutiny, largely it seems because no one quite understands what the regime means. What has also happened with Switzerland is that it has become a key country for the Savings Income Directive; in the recent draft agreement Switzerland agrees that it will implement equivalent measures to the Savings Income Directive.[5]

There is also a big question mark as whether anybody can make the United States carry out any changes, but the one tax practice of the United States which was identified was the foreign sales corporation, and for these the WTO litigation lies in the background. That has driven the United States to abandon foreign sales corporations and to move towards an extra-territorial income exclusion and then possible subsequent legislation. So the United States, in a sense, is subject to slightly different pressures from the OECD and European Union.

Group 3: *The EU candidate countries*

In the third group are the ten countries due to join the European Union in May 2004. You might have thought that they would be under a lot of pressure, because these countries – as a condition of joining – have to show that their tax systems will comply with the *acquis communautaire*, which includes the Code of Conduct, state aid provisions and the Directives. In fact, some of these countries have taken the opportunity, when joining the European Union, of making their tax regime both EU- and OECD-compliant and even more attractive than it was before.

The classic example here is Cyprus. The Cypriots realised that the old 4¼% offshore regime could not survive joining the European Union, so they followed Ireland. Cyprus has gone for a generalised low corporate tax regime – a 10% rate, which will apply to all Cyprus companies. But they have added further "whistles and bells" – an exemption for foreign income, a participation regime based upon a minimum 1% shareholding, an exemption for capital gains and a 50% interest exclusion. Cyprus has taken the opportunity of joining the European Union to introduce a more attractive tax regime than it had previously, and one more attractive than anywhere else in the European Union (other than perhaps Estonia, with its 0% corporate tax rate).

Group 4: *The dependent and associate territories*

In the fourth group are the dependent or associated territories of the EU and OECD member states. Both the Code of Conduct and the OECD campaign required that similar principles should be applied to these territories, and they have come under a fair degree of pressure.

Gibraltar is, of course, *sui generis*. It is within the European Union for most purposes, and so it is subject to the state aid provisions and ECJ jurisdiction. It has had challenges brought to its special regimes for qualifying companies and exempt companies, and it is now talking about following Cyprus and Ireland – or, more exactly, Estonia – by having a generalised corporate tax rate of 0%. But Gibraltar wanted local utility companies and local financial services companies to be excluded from the 0%, and the European Commission has recently ruled that this would fall foul of the state aid provisions. No doubt Gibraltar will need to find other sources to replace its lost revenue if it moves to a zero rate of corporate tax.

Aruba and the Netherlands Antilles have had to comply, and they have done so by dropping their offshore corporate regime in favour of a generalised rate, though they have not gone for a low rate: they have adopted a generalised higher rate, but with a participation exemption and a ruling system similar to that of the Netherlands.

Jersey, Guernsey and the Isle of Man have decided upon a general 0% corporate income taxes, so that there will no longer be any exempt companies or any need for them. The issue they then face is how to match the loss of revenue from other sources: Jersey is considering a 5% sales tax and cuts in personal income tax allowances.

The Caribbean jurisdictions of Anguilla, British Virgin Islands, Montserrat and the Turks & Caicos Islands have been under less direct pressure; they seem to be biding their time to see what changes they need to make to their tax system in general.

Group 5: *The tax havens*

That is largely true also of the penultimate group, the identified tax havens. Most of the thirty-three cooperative jurisdictions have so far only made their commitment. Some of them – like the Cayman Islands – have concluded tax information exchange agreements, but otherwise they are waiting to see what are the non-harmful tax regimes and then they will make the changes. Recently several have signed up to measures equivalent to those in the Savings Income Directive.

As to the uncooperative havens – Andorra, Liberia, Liechtenstein, Marshall Islands, and Monaco – I think it is fair to say that they are coming under increasing pressure to make changes, at least initially by making a commitment, but also by changing their tax system. So, for example, Monaco has negotiated a new tax treaty with France, with greater exchange of information. Liechtenstein is one of the jurisdictions that has to be signed up to the Savings Income Directive before it goes ahead. We have the extreme case in Liberia, where the Americans engineered a regime change.

Group 6: *The non-havens*

At the other extreme of the spectrum, the last group is composed of the non-havens – the jurisdictions that were not characterised as havens by the OECD. There were nine jurisdictions which were on the original list of forty-seven, but proved they were not havens; they have been under no pressure to change, and I do not think any of them have had significant changes to their tax system.

Then, of course, there are others, who were never on the list at the beginning – Hong Kong, Labuan and Singapore. These countries have been completely off the hook. Singapore, for example, has been introducing new preferential regimes for financial service companies and for expatriate employees, making themselves more attractive because they have been outside of the whole process completely.

## The OECD 2004 Progress Report

There is an air of self-congratulation about the OECD's 2004 Progress Report. While the public attention has largely been focused on the tax haven aspect of the OECD campaign, this report focuses more on the aspect that relates to OECD Member Countries. The Report notes that, in 2000, 47 preferential tax regimes had been identified in 9 categories. Of these 47, 18 have been abolished, 14 have been amended so that the potentially harmful features have been removed, 13 have been found not to be harmful, and two regimes – the Swiss 50/50 practice and the Luxembourg 1929 companies – are still being assessed (see Appendix C). Taken by itself, this looks very impressive. However, in some jurisdictions – Ireland for example – the regimes which have been abolished have simply been replaced by the generalised, low tax rate.

Published alongside the 2004 Progress Report is a bulky, composite document, entitled the Consolidated Application Note: this contains guidance on the application of the 1998 Report to preferential tax regimes. This Consolidated Note represents work which has been taking place within the OECD, and essentially identifies what aspects of a tax system, and of certain particular regimes, are potentially harmful. A tax system, even if it contains certain preferential regimes, but which successfully avoids these harmful elements, will not be regarded as involving any harmful tax practice.

The Note discusses four general aspects of tax systems: transparency and exchange of information, ring fencing, transfer pricing, and a rulings regime. It then considers three specific regimes: holding company regimes (and similar preferential tax regimes), fund management regimes, and shipping regimes. Most of the comments on these seven areas are fairly bland and general, largely repeating the aspects of the 1998 Report. The content is clear, however: a tax system can have a rulings practice, it can have a holding company regime, a regime for fund management, and a special shipping regime – provided it avoids the elements identified in the Note, it will not be criticised.

**What then is a non-harmful tax regime?**

So, having surveyed with a pretty broad brush what has happened to different groups of countries, and outlined the 2004 Progress Report, can one finally identify what is a non-harmful tax regime?

We can see that it seems acceptable to have a generalised, corporate tax rate which applies to all companies, even if it is at a low rate – 12.5% in Ireland, 10% in Cyprus, and even down to 0% in Gibraltar, Estonia, the Channel Islands and the Isle of Man. It does mean, of course, that those jurisdictions have to look for other sources of revenue, and they are looking to sales taxes or VAT, property taxes and employment charges to raise government revenue to make up for the shortfall from corporate income tax. To that extent, they are shifting the tax base to less mobile targets.

Alongside a generalised regime, can a state still have a special regime for certain categories of companies or certain activities? The answer seems clearly to be, yes, for some regimes. Shipping is the clearest example. Many jurisdictions have a special shipping regime, generally a tonnage tax, and that seems to be unassailable. The Consolidated Application Note generally approves a shipping regime which avoids certain elements. Similarly, a special regime for fund management is acceptable, so long as it avoids certain harmful features. What about a special regime for local financial services or local utilities? Gibraltar tried that, but has found problems with the state aid rules in the EU.

Holding company regimes seem also to be acceptable, so long as they avoid certain features. Most EU countries and many of the OECD, non-EU countries have such regimes, and one would expect them to be allowed, because the regime often has a number of aspects which are clearly acceptable. For example, participation exemptions are now so widely available that it is hard to see those as in any way being harmful regimes. In Cyprus, the participation exemption even comes down to a 1% holding, and, if I have understood it correctly, the new Italian regime has no minimum holding for its participation exemption. It is necessary to avoid harmful aspects: you cannot exempt dividends and gains where the subsidiary is not engaged in real trading activities and paying real tax - an exemption for holdings in tax haven subsidiaries would not be acceptable.

The exemption method of relief for double taxation is also acceptable. Though there is a view that it is only the credit method that is really non-harmful, the exemption method is so widely practised that is unlikely that that would ever be regarded as harmful.

Absence of tax on capital gains can be perceived as part of the general tax system, and so if you exempt all capital gains, even gains on land or shares, that would be non-harmful. No-one has suggested that there is any requirement that you need to tax capital or tax estates in order to be non-harmful, so regimes that do not tax capital or estates are certainly within the acceptable parameters.

Turning to individual taxation, can you have a special regime for expatriates or non-domiciliaries – taxing them only on 50% of their income or only on local source income? The jury is out on those, but so many countries have those regimes that it is doubtful that they would ever be characterised as harmful, at least if they are limited in time. Then one wonders what is an acceptable time limit – maybe five or seven years. But perhaps lifetime preferential treatment for non-domiciliaries is going to be regarded as harmful and unacceptable.

Of course, you can have a special tax regime for real trading and industrial activities. Industrial development zones have always been regarded as in a separate category.

Following the Netherlands, the Antilles and Aruba, you can have a rulings practice provided it is limited to issues like arm's length pricing and advanced tax rulings. Again, the Consolidated Application Note gives guidance on what elements a ruling regime must avoid.

The one key factor you have to have in your tax system is effective exchange of information and transparency. So it is clearly harmful if you do not enter into tax information exchange agreements. Increasingly, the world is moving to recognise an actual active duty to gather information for purposes of exchange. Until recently, the OECD was split on this. The United Kingdom and Japan did not recognise that duty, so the rest of the OECD was isolated. Now the United Kingdom and Japan have fallen in line, and all OECD countries recognise a duty to gather information for the purposes of exchange. Banking secrecy must also give way both to criminal and civil tax investigations by other states.

## Analysis and Conclusions

Does it all make sense? Of course not. If you start without a clear idea of what is harmful, what have you got? You have got 0% corporate tax rates being regarded as not harmful, whereas if you have different systems for different types of companies (except shipping, fund management etc), that is regarded as harmful. Some elements make sense – transparency and exchange of information. Increasingly, people are recognising that other elements do not make sense, and one is beginning to hear talk within the European Union of a need for a minimum effective corporate tax rate, with which places like Ireland, Cyprus, Estonia and Gibraltar would have to comply.

Where are we going? One view of the facts is that the campaigns have accelerated the race to the bottom rather than prevented it. The campaigns have also sanitised certain preferential regimes – removed their worst elements – while sanctioning their continued existence. We may start seeing some serious questions coming out of the Commission and the Primarolo Committee about where we are going.

Our timetable has changed. We are now looking at 2010 and 2011 for the full effect of these campaigns to be felt, though that again may be pushed later. But it does mean that the next five years are going to be crucial. Once the self-congratulation is over, one may see the European Commission and OECD summing up in the same way as I have on what has been achieved so far, coming to the same conclusion that it does not make sense, and looking again at what is going to be regarded as acceptable tax competition.

# APPENDIX I

## CONCLUSIONS OF THE ECOFIN COUNCIL MEETING

on 1 December 1997
concerning taxation policy
(98/C 2/01)

The Council held a wide-ranging debate in the light of the Commission communication entitled “A package to tackle harmful tax competition in the European Union”, which takes stock of a discussion initiated by the Commission at the informal meeting of Ministers for Economic Affairs and Finance in Verona in April 1996 and given more substantial shape at the informal meeting in Mondorf-les-Bains in September 1997.

That discussion concerned the need for coordinated action at European level to tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment-friendly way.

In the light of that debate and in a spirit of comprehensiveness of approach, three areas were particularly highlighted: business taxation, taxation of savings income and the issue of withholding taxes on cross‹border interest and royalty payments between companies.

Following that debate, the Council and the Representatives of the Governments of the Member States, meeting within the Council, agreed to the Resolution on a code of conduct for business taxation set out in Annex 1;

The Council also:

- approved the text on taxation of savings set out in Annex 2,

- considered that the Commission should submit a proposal for a Directive on interest and royalty payments between companies,

- took note of the Commission's intention to submit rapidly two proposals for Directives on the subjects referred to in the first and second indents above,

- called on the Commission to submit to it each year, together with the report provided for in paragraph N of the code of conduct for business taxation, a progress report on work concerning taxation of savings and interest and royalty payments between companies,

- took note of the Commission's undertaking on fiscal State aid,

- called on the Commission to take forward its work on taxation, continuing to draw on the assistance of the Taxation Policy Group,

- took note of the following statements for the Council minutes:

1. re Annex 1 (code of conduct)

   Certain Member States and the Commission consider that special tax arrangements for employees could come within the range of problems covered by the code. They accordingly consider that this question needs to be discussed within the Taxation Policy Group with a view to a possible extension of the code under the review procedure laid down in paragraph N.

   The Council and the Representatives of the Governments of the Member States, meeting within the Council, as well as the Commission note that standstill and rollback are closely inter-related and stress the need for a balanced application to comparable situations, without this delaying the implementation of standstill and rollback. They also consider that a period of two years, as a general rule, should be sufficient for rollback. As from 1 January 1998 the actual rollback will have to take place within five years although a longer period may be justified in particular circumstances following an assessment by the Council.

   The German delegation, like other

delegations, understands point B (3) as including, *inter alia*, the targeted granting of advantages for international mobile activities, where they are not granted for non-mobile activities.

The Commission points out that the authorization granted in 1987 and extended most recently in 1994 for the arrangements for international financial services centres in Dublin expires in 2005 and that, under that authorization, no new institutions may benefit from those arrangements after 2000.

2. re Annex 2 (taxation of savings)

The Member States state that, if they were to change their legislation, they should be guided by the points set out in Annex 2 to these conclusions.

The United Kingdom delegation considers that such a Directive should not apply to Eurobonds and similar instruments.

The French delegation considers that the Directive on the taxation of savings should not lay down a rate of withholding tax of less than 25%.

The Netherlands delegation notes that it will assess the proposals in the light of the principle of taxation of savings in the country of residence.

The Luxembourg delegation considers that a Directive on taxation of savings should be accompanied by a Directive on business taxation covering general arrangements for business taxation in the Member States.

The Belgian, Italian and Portuguese delegations state that they will not agree to the Directive on interest and royalty payments between companies before the Directive on the taxation of savings is adopted.

3. The Commission notes the Netherlands delegation's request concerning problems relating in particular to taxation of pensions and insurance benefits; it undertakes to consider the matter with the assistance of the Taxation Policy Group with a view to possibly drawing up a proposal for a Directive.

4. The Commission notes the Belgian delegation's request concerning VAT treatment of cross-border motor vehicle leasing and undertakes to look into it with an open mind. It will in particular consider to what extent the proposals already planned to modernize and streamline the present VAT arrangements can provide a suitable solution.

# ANNEX 1

## RESOLUTION OF THE COUNCIL AND THE REPRESENTATIVES OF THE GOVERNMENTS OF THE MEMBER STATES, MEETING WITHIN THE COUNCIL

of 1 December 1997
on a code of conduct for business taxation

THE COUNCIL OF THE EUROPEAN UNION AND THE REPRESENTATIVES OF THE GOVERNMENTS OF THE MEMBER STATES, MEETING WITHIN THE COUNCIL,

RECALLING that a comprehensive approach to taxation policy was launched, at the Commission's instigation, at the informal meeting of the Ministers for Economic Affairs and Finance held in Verona in April 1996 and confirmed at the meeting in Mondorf-les-Bains in September 1997 in the light of the consideration that coordinated action at European level is needed in order to reduce continuing distortions in the single market, prevent significant losses of tax revenue and help tax Structures develop in a more employment-friendly way,

ACKNOWLEDGING the major contribution made by the Taxation Policy Group to the preparation of this Resolution,

NOTING the Commission communication to the

Council and the European Parliament of 5 November 1997,

ACKNOWLEDGING the positive effects of fair competition and the need to consolidate the competitiveness of the European Union and the Member States at international level, whilst noting that tax competition may also lead to tax measures with harmful effects,

ACKNOWLEDGING, therefore, the need for a code of conduct for business taxation designed to curb harmful tax measures,

EMPHASIZING that the code of conduct is a political commitment and does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty,

HEREBY ADOPT THE FOLLOWING CODE OF CONDUCT:

Code of conduct for business taxation tax measures covered

A. Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community.

Business activity in this respect also includes all activities carried out within a group of companies.

The tax measures covered by the code include both laws or regulations and administrative practices.

B. Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of, *inter alia:*

1. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or

2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or

3. whether advantages are granted even without any real economic activity and substantial economic presence within the

Member State offering such tax advantages, or

4. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or

5. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.

Standstill and Rollback

*Standstill*

C. Member States commit themselves not to introduce new tax measures which are harmful within the meaning of this code. Member States will therefore respect the principles underlying the code when determining future policy and will have due regard for the review process referred to in paragraphs E to I in assessing whether any new tax measure is harmful.

*Rollback*

D. Member States commit themselves to re-examining their existing laws and established practices, having regard to the principles underlying the code and to the review process outlined in paragraphs E to I. Member States will amend such laws and practices as necessary with a view to eliminating any harmful measures as soon as possible taking into account the Councils discussions following the review process.

Review process

*Provision of relevant information*

E. In accordance with the principles of transparency and openness Member States will inform each other of existing and proposed tax measures which may fall within the scope of the code. In particular, Member States are called upon to provide at the request of another Member State information on any tax measure which appears to fall within the scope of the code. Where envisaged tax measures need parliamentary approval, such information need not be given until after their announcement to Parliament.

*Assessment of harmful measures*

F. Any Member State may request the opportunity to discuss and comment on a tax measure of another Member State that may fall within the scope of the code. This will permit an assessment 10 be made of whether the tax measures in question are harmful, in the light of the effects that they may have within the Community. That assessment will take into account all the factors identified in paragraph B.

G. The Council also emphasizes the need to evaluate carefully in that assessment the effects that the tax measures have on other Member States, *inter alia* in the light of how the activities concerned are effectively taxed throughout the Community.

Insofar as the tax measures are used to support the economic development of particular regions, an assessment will be made of whether the measures are in proportion to, and targeted at, the aims sought. In assessing this, particular attention will be paid to special features and constraints in the case of the outermost regions and small islands, without undermining the integrity and coherence of the Community legal order, including the internal market and common policies.

*Procedure*

H. A group will be set up by the Council to assess the tax measures that may fall within the scope of this code and to oversee the provision of information on those measures. The Council invites each Member State and the Commission to appoint a high-level representative and a deputy to this group, which will be chaired by a representative of a Member State. The group, which will meet regularly, will select and review the tax measures for assessment in accordance with the provisions laid down in paragraphs E to G. The group will report regularly on the measures assessed. These reports will be forwarded to the Council for deliberation and, if the Council so decides, published.

I. The Council invites the Commission to assist the group in carrying out the necessary preparatory work for its meetings and to facilitate the provision of information and the review process. To this end, the Council requests Member States to provide the Commission with the information referred to in paragraph E so that the Commission may coordinate the exchange of such information between the Member States.

State aid

J. The Council notes that some of the tax measures covered by this code may fall within the scope of the provisions on State aid in Articles 92 to 94 of the Treaty. Without prejudice to Community law and the objectives of the Treaty, the Council notes that the Commission undertakes to publish guidelines on the application of the State aid rules to measures relating to direct business taxation by mid- 1998, after submitting the draft guidelines to experts from the Member States at a multilateral meeting, and commits itself to the Strict application of the aid rules concerned, taking into account, inter alia, the negative effects of aid that are brought to light in the application of this code. The Council also notes that the Commission intends to examine or re-examine existing tax arrangements and proposed new legislation by Member States case by case, thus ensuring that the rules and objectives of the Treaty are applied consistently and equally to all.

### Action to combat tax avoidance and evasion

K. The Council calls on the Member States to cooperate fully in the fight against tax avoidance and evasion, notably in the exchange of information between Member States, in accordance with their respective national laws.

L. The Council notes that anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion.

### Geographical extension

M. The Council considers it advisable that principles aimed at abolishing harmful tax measures should be adopted on as broad a geographical basis as possible. To this end. Member States commit themselves to promoting their adoption in third countries; they also commit themselves to promoting their adoption in territories to which the Treaty does not apply.

In particular, Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories commit themselves, within the framework of their constitutional arrangements, to ensuring that these principles are applied in those territories. In this connection, those Member States will take stock of the situation in the form of reports to the group referred to in paragraph H, which will assess them under the review procedure described above.

Monitoring and revision

N. In order to ensure the even and effective implementation of the code, the Council invites the Commission to report to it annually on the implementation thereof and on the application of fiscal State aid. The Council and the Member States will review the provisions of the code two years after its adoption.

## APPENDIX II

## PRIMAROLO COMMITTEE LIST OF MEASURES WITH HARMFUL FEATURES (66)

(i) Member States (40)

Austria AAM002b: Holdings (Schachtelbegünstingung-Intra Group Relief)
Austria EAM009: Tax Exemptions
Belgium A001: Co-ordination Centres
Belgium A002: Distribution Centres
Belgium A003: Service Centres
Belgium E001: US Foreign Sales Companies Ruling
Belgium E002: Informal Capital Ruling
Denmark AAM021: Holding Companies
Finland B008: Åland Islands Captive Insurance
France A006: Headquarters and Logistic Centres

France A012: Royalty Income - Patents
France CAM058 Provisions for Renewal of Mineral Reserves
France CAM059: Provision for Renewal of Oil and Gas Reserves
Germany AAM019: Control and Coordination Centres of Foreign Companies in Germany
Greece B011: Offices of Foreign Companies under the Law 89/67
Ireland * B001: The International Financial Services Centre (Dublin)
Ireland * C024: 10% Manufacturing Rate
Ireland **** C025: Petroleum Taxation
Ireland * D017 Shannon Airport Zone (SAZ)
Ireland E007: Foreign Income
Italy *** B002: Trieste Financial Services and Insurance Centre
Luxembourg ** A007: Co-ordination Centres
Luxembourg A0013: 1929 Holding Companies
Luxembourg ** B003: Luxembourg Finance Companies
Luxembourg B007: Provisions for fluctuations in reinsurance
Luxembourg Z002: Finance Branches
Netherlands A008: Cost Plus Ruling
Netherlands A009: Resale Minus Ruling
Netherlands A010: Intra Group Finance Activities
Netherlands A014: Holding Companies
Netherlands A015: Royalties
Netherlands B004: International Financing Activities
Netherlands B005: Finance Branch

Netherlands E003: US Foreign Sales Companies Ruling
Netherlands E004: Informal Capital Ruling
Netherlands Z003: Non Standard Rulings (including Greenfield-rulings)
Portugal * B006: Madeira and Sta Maria (Azores) Free Zones
Spain A004: Basque Country Co-ordination Centres
Spain A005: Navarra Co-ordination Centres
Spain CAM025: Investigation and Exploitation of Hydrocarbons

* Measures time limited or being phased out …
** Measures abolished, benefits being phased out ….
*** Not operational ….
**** Measure will, from January 2000, no longer apply a lower rate than the generally applicable rate

(ii) European territories for whose external relations a Member State is responsible under Article 299.4 of the EC Treaty. (3)

UK: Gibraltar A017: Gibraltar 1992 Companies
UK: Gibraltar B012: Exempt (offshore) Companies and Captive Insurance
UK: Gibraltar B013: Qualifying (offshore) Companies and Captive Insurance

(iii) Dependent or associated territories (23)

Aruba F027: Offshore Companies
Aruba F028: Exempt Companies (AVVs)
Aruba F030: Free Zones
Aruba F032: Captive Insurance

British Virgin Islands F056: International Business Companies
Guernsey (incl Alderney) F037: Exempt Companies
Guernsey (incl Alderney) F038: International Loan Business
Guernsey (incl Alderney) F040: International Bodies
Guernsey (incl Alderney) F042: Offshore Insurance Companies
Guernsey (incl Alderney) F043: Insurance Companies
Isle of Man F061: International Business Companies
Isle of Man F062: Exemption for Non Resident Companies
Isle of Man F063: Exempt Insurance Companies
Isle of Man F065: International Loan Business
Isle of Man F066: Offshore Banking Business
Isle of Man F067: Fund Management
Jersey F045: Tax Exempt Companies
Jersey F046: International Treasury Operations
Jersey F047: International Business Companies
Jersey F048: Captive Insurance Companies
Netherlands Antilles F020: Offshore Companies
Netherlands Antilles F023: Captive Insurance
Netherlands Antilles F024: Free Zones

# APPENDIX 3

## OECD 2004 Progress Report

## Table of Conclusions Reached on Potentially Harmful Regimes Identified In 2000

| **Country** | **Regimes** | **Abolished** | **Continuing Regimes** | | |
|---|---|---|---|---|---|
| | | | **Amended to remove potentially harmful features** | **Not Harmful** | **Harmful** |

## Insurance

| | | | | | |
|---|---|---|---|---|---|
| Australia | Offshore Banking Units | | | √ | |
| Belgium | Co-ordination Centres | √ | | | |
| Finland | Aland Captive Insurance Regime | √ | | | |
| Italy | Trieste Financial Services and Insurance Centre | √ | | | |
| Ireland | International Financial Services Centre | √ | | | |
| Portugal | Madeira | √ | | | |

| | | | | | |
|---|---|---|---|---|---|
| | International Business Centre | | | | |
| Luxembourg | Provisions for Fluctuations in Reinsurance Companies | | √ | | |
| Sweden | Foreign Non-Life Insurance Companies | √ | | | |

## Financing and Leasing

| | | | | | |
|---|---|---|---|---|---|
| Belgium | Co-ordination Centres | √ | | | |
| Hungary | Venture Capital Companies | | | √ | |
| Hungary | Preferential Regime for Companies Operating Abroad | √ | | | |
| Iceland | International Trading Companies | √ | | | |
| Ireland | International Financial Services Centre | √ | | | |
| Ireland | Shannon Airport Zone | √ | | | |
| Italy | Trieste Financial Services and Insurance | √ | | | |

| | | | | | |
|---|---|---|---|---|---|
| | Centre | | | | |
| Luxembourg | Finance Branch | | √ | | |
| Netherlands | Risk Reserves for International Group Financing | √ | | | |
| Netherlands[6] | Intra-Group Finance Activities | | √ | | |
| Netherlands | Finance Branch | | √ | | |
| Spain | Basque Country and Navarra Coordination Centres | √ | | | |
| Switzerland | 50/50 Practice[7] | | | | |

## Fund Managers

| | | | | | |
|---|---|---|---|---|---|
| Greece | Mutual Funds/Portfolio Investment Companies [Taxation of Fund Managers] | | | √ | |
| Ireland | International Financial Services Centre [Taxation of Fund Managers] | √ | | | |
| Luxembourg | Management companies | | | | |

| | | | | | |
|---|---|---|---|---|---|
| | [Taxation of management companies that manage only one mutual fund (1929 holdings)] | | | | |
| Portugal | Madeira International Business Centre [Taxation of Fund Managers] | √ | | | |

**Banking**

| | | | | | |
|---|---|---|---|---|---|
| Australia | Offshore Banking Units | | | √ | |
| Canada | International Banking Centres | | | √ | |
| Ireland | International Financial Services Centre | √ | | | |
| Italy | Trieste Financial Services and Insurance Centre | √ | | | |
| Korea | Offshore Activities of Foreign Exchange Banks | √ | | | |
| Portugal | External | √ | | | |

| | | | | | |
|---|---|---|---|---|---|
| | Branches in the Madeira International Business Centre | | | | |
| Turkey | Istanbul Offshore Banking Regime | √ | | | |

## Headquarters regimes

| | | | | | |
|---|---|---|---|---|---|
| Belgium | Co-ordination Centres | √ | | | |
| France | Headquarters Centres | | √ | | |
| Germany | Monitoring and Co-ordinating Offices | | √ | | |
| Greece | Offices of Foreign Companies | √ | | | |
| Netherlands | Cost-plus Ruling | | √ | | |
| Portugal | Madeira International Business Centre | √ | | | |
| Spain | Basque Country and Navarra Coordination Centres | √ | | | |
| Switzerland | 50/50 practice | | | | |
| Switzerland | Service Companies | | √ | | |

## Distribution Centre Regimes

| | | | | | |
|---|---|---|---|---|---|
| Belgium | Distribution Centres | | √ | | |
| France | Logistics Centres | | √ | | |
| Netherlands | Cost-plus/Resale Minus Ruling | | √ | | |
| Turkey | Turkish Free Zones | | | √ | |

## Service Centre Regimes

| | | | | | |
|---|---|---|---|---|---|
| Belgium | Service Centres | | √ | | |
| Netherlands | Cost-Plus Ruling | | √ | | |

## Shipping

| | | | | | |
|---|---|---|---|---|---|
| Canada | International Shipping | | | √ | |
| Germany | International Shipping | | | √ | |
| Greece | Shipping Offices | | | √ | |
| Greece | Shipping Regime (Law 27/75) | | | √ | |
| Italy | International Shipping | | | √ | |
| Netherlands | International Shipping | | | √ | |
| Norway | International | | | √ | |

| | | | | | |
|---|---|---|---|---|---|
| | Shipping | | | | |
| Portugal | International Shipping Register of Madeira | | | √ | |

## *Miscellaneous Activities*

| | | | | | |
|---|---|---|---|---|---|
| Belgium | Ruling on Informal Capital | | √ | | |
| Belgium | Ruling on Foreign Sales Corporation Activities | √ | | | |
| Canada | Non-resident Owned Investment Corporations | √ | | | |
| Netherlands | Ruling on Informal Capital | | √ | | |
| Netherlands | Ruling on Foreign Sales Corporation Activities | √ | | | |
| United States | Foreign Sales Corporations | √ | | | |

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[1] This is the text of a talk originally delivered to the International Tax Planning Association in June 2003 in Hamburg. It has been updated and revised to include material available as at April 2004,

particularly the 2004 Progress Report of The OECD's Project on Harmful Tax Practices (OECD, Paris, March 2004).

[2] Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco.

[3] Directive 2003/48/EC.

[4] The OECD 2004 Report notes that the Icelandic International Trading Company regime, the Netherlands Risk Reserve regime and the Madeira International Business Centre regime are to be ended in 2008, 2010 and 2011 respectively, but no new entrants are to be admitted to these regimes.

[5] See the draft EU Council Decision on the Conclusion of an Agreement between the European Community and the Swiss Confederation, COM (2004) 75 final of 10th February 2004.

[6] The Netherlands has replaced this regime with an Advance Pricing Agreement/Advance Tax Ruling practice.

[7] In the 2000 Report these were referred to as administrative companies. The 50/50 practice will be subject to
further analysis.

# NO LOSS ALL GAIN FOR NON-RESIDENT COMPANIES

**Felicity Cullen**

Sections 148-155 FA 2003 have changed the basis of the charge to corporation tax for non-resident companies.

Until the introduction of FA 2003, non-resident companies were charged to corporation tax if they carried on a trade in the UK through a branch or agency. For accounting periods beginning on or after 1 January 2003, non-resident companies are charged to corporation tax if they carry on a trade in the UK through a "permanent establishment" (as defined in s.148 FA 2003) and on the profits attributable to that permanent establishment.

This Note considers the position of capital gains and capital losses accruing to non-resident companies and does not consider the broader position.

Section 11(2A) ICTA 1988 (introduced by s.149 FA 2003) provides that the profits attributable to a permanent establishment for the purposes of corporation tax are (so far as relevant to this note):

> "(2A) …
>
> (c) chargeable gains falling within s.10B of the 1992 Act –

(i) by virtue of assets being used in or for the purposes of the trade carried on by the company though the establishment, or

(ii) by virtue of assets being used or held for the purposes of the establishment or being acquired for use by or for to purposes of the establishment."

Section 10B(1) TCGA 1992 (introduced by s.149 FA 2003) provides as follows:

"**10B Non resident company with United Kingdom permanent establishment**

(1) Subject to any exceptions provided by this Act, the chargeable profits for the purposes of corporation tax of a company not resident in the United Kingdom but carrying on a trade in the United Kingdom through a permanent establishment there include chargeable gains accruing to the company on the disposal of –

(a) assets situated in the United Kingdom and used in or for the purposes of the trade at or before the time the gain accrued, or

(b) assets situated in the United Kingdom and used or held for the purposes of the permanent establishment at or before the time the gain accrued or acquired for use by or for the purposes of the permanent establishment."

So the basis of charge to corporation tax on chargeable gains is acceptably clear.

As regards capital losses the general position is that, in reading the provisions of TCGA 1992, reference to gains can be read as references to losses and reference to chargeable gains can be read as references to allowable losses: see s.16(2) TCGA 1992.

Section 16(3) TCGA 1992 deals specifically with losses accruing to non-residents as follows:

> "(3) A loss accruing to a person in a year of assessment during no part of which he is resident or ordinarily resident in the United Kingdom shall not be an allowable loss for the purposes of this Act unless, under section 10, he would be chargeable to tax in respect of a chargeable gain if there had been a gain instead of a loss on that occasion."

No mention is made in the "unless" to section 10B – the new provision bringing into charge gains accruing to non-resident companies carrying on a trade in the United Kingdom through permanent establishments; and so losses accruing to non-resident companies cannot be allowable losses as a result of the opening words of s.16(3) TCGA 1992.

Section 153 FA 2003 contains provisions replacing references in the Taxes Act to branches or agencies of companies with references to permanent establishments of companies but does not remedy the position.

Neither is the solution in Schedule 27 FA 2003 which contains amendments consequential on the provisions of sections 148 to 153 FA 2003: paragraph

2(2) of Schedule 27 amends s.10 TCGA 1992 to take out the parts (including s.10(3) TCGA 1992) relevant to corporation tax which are now in s.10B TCGA 1992. Paragraph 2(3) Schedule 27 substitutes “10B” for “10(3)” in many sections of TCGA 1992 in order to deal with the introduction of section 10B, but does not include any amendments to s.16(3) TCGA 1992.

No doubt the absence of any amendment to s.16(3) TCGA 1992 is an unintended error but, unless and until the position is rectified, the strict position for non-resident companies which are chargeable to tax in the United Kingdom under s.11 ICTA 1988 and s.10B TCGA 1992 is that chargeable gains are comprised within profits attributable to permanent establishments but there can be no allowable losses to reduce these chargeable gains.

# PROPERTY DEALERS: WHY NOT SET UP YOUR OWN FURBS?

Patrick C Soares

A FURBS is a Funded Unapproved Retirement Benefit Scheme and it offers a number of attractive tax advantages especially to land dealers who may want to put some money aside for their pensions paying modest tax rates and having an inheritance tax free fund.

A FURBS is usually set up by a company for the benefit of one or two directors who normally have shares in the particular company.

The contributions to the FURBS are normally exclusively made by the company and are modest because they will result in income tax liabilities on the members of the FURBS when they are made (the contributions are treated as salaries) (ITEPA 2003 s.386(1)). NIC would also be in point.

The real attraction in the FURBS is if it uses the settled monies plus borrowings to buy property which comprises part of the trust capital under trust law but is nevertheless traded in for income tax purposes only the basic rate of tax (22%) is payable on the trading profit even though the trust can accumulate income and even though the shareholders in the company which created the FURBS can benefit under the FURBS (see *Carver v Duncan* 59 TC 125).

The FURBS would be similar to an approved scheme (minus many of its restrictions) and will seek to provide a retirement lump sum (this lump sum would be tax free (ITEPA s.395(1)(a), (2) and (4) and s.396(a)) to a member. If the member dies before taking the funds out of the FURBS there is no charge to inheritance tax and the same can be appointed out to his spouse or children without a charge to inheritance tax. It could even be appointed out to a discretionary trust for the benefit of the surviving spouse and children.

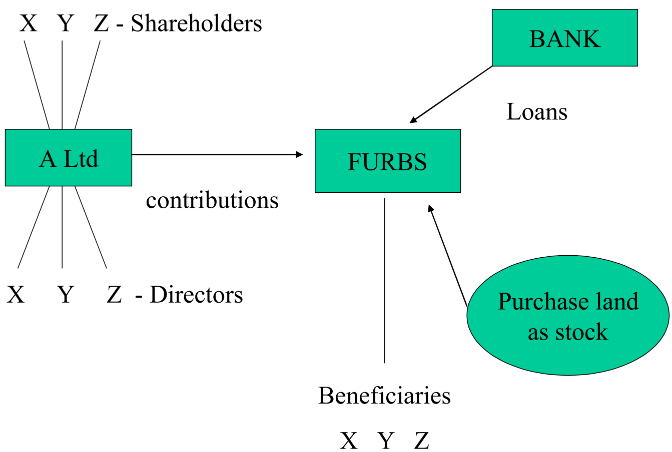
Investment income arising in the FURBS, say, bank interest or rents, only bears tax at the basic rate (TA 1988 s.612 and s.686(2)(c)) even though the trust is a discretionary one.

Individuals therefore looking at possible property deals which they may take in their own names (bearing tax at 40% on any profit) or through their company (bearing tax at 30% in the company and further tax when the monies are taken out), should see whether a FURBS will prove more attractive to them.

There are a great number of points to take into account and a number of anti-avoidance provisions lurking in the background but FURBS are attractive propositions. Some FURBS even trade in the land via an LLP, i.e., in partnership under the Limited Liability Partnerships Act 2000 with the FURBS having the benefit of limited liability under the Limited Liability Partnerships Act 2000.

The only fly in the ointment is the Government review of the pensions legislation: see Rev BN 39 17th March 2004. It is difficult to know how the changes will affect FURBS but in para 10 of the above Rev BN it is stated:-

> "Non-registered pension schemes may continue in the new regime, but without any tax advantages. They will be treated like any other arrangement to provide benefits for employees…Transitional protection will be available for pension rights accrued at 6 April 2006 within non-registered schemes."



# VAT AND ALTERATIONS TO LISTED BUILDINGS – THE *ZIELINSKI BAKER* APPEAL

**John Walters Q.C.**[1]

Zero-rating for VAT is available under Group 6 of Schedule 8 to the VAT Act 1994 for the first grant of a major interest in a substantially reconstructed "protected building" by the person carrying out the substantial reconstruction (item 1). It is also available for the supply of construction services and building materials made in the course of an approved alteration of a "protected building" (items 2 and 3).

The *Zielinsky Baker*[2] appeal, in which the House of Lords gave judgment on 26th February, was about whether an approved alteration of an outbuilding within the curtilage of a dwelling house, which was a listed building, was eligible to be zero-rated. The alteration in question was the conversion of the outbuilding to provide games and changing facilities and the construction of an adjoining indoor swimming pool. This conversion required listed buildings consent (which was duly obtained) because it was an "approved alteration" to the listed building.

The VAT Tribunal's decision[3] was to allow zero-rating of the construction services. This was reversed in the High Court by Etherton J[4]. His decision was, in turn, reversed by the Court of Appeal[5] in a 2:1 majority decision. The House of Lords by four to one have reversed the Court of Appeal's decision and refused zero-rating.

In the course of the appeal process a number of problems with the drafting of Group 6 have been encountered. It has been difficult to ascertain what precisely was (or is) the legislative purpose behind Group 6, in particular, whether Parliament's purpose in providing for the zero-rating is to assist housing or to assist the nation's heritage. And at least one problem area remains, which has not been dealt with by the House of Lords' decision. Practitioners will need further guidance from Customs and Excise on what their policy will be as a result of the decision.

To begin with a bit of history that will be familiar to many readers: from the introduction of VAT in 1973, repairs and maintenance of all buildings have been taxable at the standard rate. The position was different for construction and alterations. These were all zero-rated from 1973 to 1984. This lead to a lot of litigation on the question of whether particular works were repairs or alterations, culminating in the *Viva Gas*[6] case in 1983 which left the category of (zero-rated) alterations so wide that in the next year's Budget the Government announced that it would put an end to the importance of the distinction by standard-rating all alterations. It was as a result of a political concession during the course of the 1984 Finance Bill that zero-rating was in the end retained for substantial reconstructions and "approved alterations" of "protected buildings". This was achieved by the insertion into the zero-rating schedule of the VAT Act 1983 of a new Group 8A entitled "Protected Buildings".

There was, of course, a definition of "protected building", which was simply a building which was a listed building within the meaning of the relevant planning Act dealing with listed buildings or a building which was a scheduled monument within the meaning of the relevant Act dealing with ancient monuments. "Approved alteration" was defined (by Note (3) of Group 8A) as meaning, chiefly, an alteration requiring authorisation under the relevant planning or ancient monuments Act.

From 1984 to 1989 all "approved alterations" of "protected buildings" were zero-rated, but by the Finance Act 1989 a residential condition was imposed in line with the general recasting of the VAT law on supplies of property following the ECJ's decision in *EC v UK*[7]. This was done, not by completely recasting Group 8A (as was done in the case of Group 8, renamed "Construction of Dwellings, etc."), but by inserting a residential requirement into the definition of "protected building". On consolidation in 1994, Group 8A so amended was re-enacted as Group 6 of Schedule 8 to the VAT Act 1994. Thus the current (post-1989) definition of "protected building" is as follows:

> '"Protected building" means a building which is designed to remain as or become a dwelling or number of dwellings (as defined …) or is intended for use solely for a relevant residential purpose or a relevant charitable purpose after the

> reconstruction or alteration and which, in either case is–
>
> (a) a listed building, within the meaning of– [the relevant planning legislation] or
>
> (b) a scheduled monument, within the meaning of– [the relevant ancient monuments legislation]'

*Zielinsky Baker* was, of course, a case about a listed building, not a scheduled monument, and so the meaning of "listed building" in the Planning (Listed Buildings and Conservation Areas) Act 1990 was directly in point.

That meaning is found in section 1(5) of the 1990 Act and is as follows:

> 'In this Act "listed building" means a building which is for the time being included in a list compiled or approved by the Secretary of State under this section; and for the purposes of this Act–
>
> (a) any object or structure fixed to the building;
>
> (b) any object or structure within the curtilage of the building which, although not fixed to the building,

forms part of the land and has done so since before 1st July 1948,

shall be treated as part of the building.'

The taxpayer's argument in the Tribunal and the High Court focussed on the illogicality (as a matter of policy, and, therefore, of construction) of confining zero-rating to a single structure, the main dwelling house, when the approved alteration is made to another structure within the curtilage of the main dwelling house, which is used (together with the main dwelling house) as a single dwelling. This argument encountered difficulties in the Tribunal (which found for the taxpayer on the different, technical, ground, which was pursued in the Court of Appeal and the House of Lords), and was dealt a fatal blow by Etherton J., who held that "building" in the definition of "protected building" could not be read as including two or more buildings. Ironically, Lord Nicholls, who dissented in the House of Lords, was attracted by this argument, which in his view dealt with the absurd consequences of Customs' position in accepting that zero-rating applied to an alteration to the physical structure of the main dwelling house, but not to an alteration of a similar residential nature to an outbuilding within the curtilage.

As a result of the House of Lords' decision, zero-rating will continue to be available for all approved alterations to the fabric of the listed building itself – *i.e.* the building on the list maintained by the Secretary of State – provided that the listed building fulfils the residential conditions laid down in Group 6. Approved alterations to certain (but not all) garages will also qualify. Thus, alterations consisting purely of architectural ornamentation will be zero-rated (as well as alterations to the accommodation), provided that the building being altered is the listed building itself, which is also a dwelling or used for a relevant residential or charitable purpose. But alterations, however domestic or residential in nature, will not qualify for zero-rating if what is being done is to convert an outbuilding into an adjunct of the listed building itself.

The technical ground, which appealed to the Tribunal and was pursued successfully in the Court of Appeal, but rejected by the House of Lords, relied on the definition of “listed building” in the 1990 planning Act. By that definition the outbuilding was treated as part of the main dwelling house, which was the listed building in question, and, indeed, as Rix L.J. pointed out in the Court of Appeal, the “approved alteration”, which was in fact carried out to the outbuilding, was technically (as a matter of planning and even VAT law) an alteration to the main dwelling house which required, and received, approval or authorisation under the 1990 planning Act. The approach of treating the outbuilding as part of the main dwelling house – which, of course, itself satisfied the residential condition imposed by Group 6 – was carried through, on the taxpayer’s argument, to illuminate the definition of “protected building” itself. Thus the “building” in that definition, which is required to be both a dwelling and a listed building or an ancient monument, was to be taken to be the artificial construct indicated by the definition of “listed building” in section

1(5) of the 1990 Act, and on that basis, of course, an approved alteration which was physically carried out to the outbuilding was to be taken to be an alteration of a the "listed building", which was a dwelling.

There were a number of indications that this was the right approach, in particular Note (10) to Group 6, which was introduced in 1989 at the same time as the residential condition which caused all the trouble, and which specifically provided that the construction of a building within the curtilage of a protected building does not constitute an alteration of the protected building. The taxpayer argued that this was a clear indication that the draftsman of the 1989 Act thought that the alteration of a building within the curtilage of a protected building *would* constitute an alteration of the protected building. This argument was dismissed by Lord Walker, giving the leading speech in the House of Lords, as an "uncertain straw in the wind" and Note (10) itself was disregarded, as being "unfathomable".

In the result, the House of Lords accepted Customs' case that it was wrong to use the definition of listed building in the 1990 planning Act to determined which building was to be taken to be the "protected building". This involved reading the definition of "protected building" as requiring that a "protected building" should be a residential building and *also* a listed building, though of course the word "also" is not found in the legislation. A more fundamental objection to the taxpayer's case was that it worked where the protected building was a listed building, but not – or not in the same way – where the protected building was an ancient monument. This is the gist of the reasoning of Lord Hope of Craighead.

And what of the problem area not dealt with by the House of Lords? The main difficulty is the mismatch between the definition of "listed building" and the definition of "protected building" which results from the decision. In particular, "parts" of a listed building within the definition, sit in a kind of VAT limbo. A building within the curtilage of a listed building, which has been there since 1948, is not itself a listed building, although the listed building controls apply to it. It is "part" of a listed building and therefore *cannot*, strictly speaking, be a "protected building" for zero-rating purposes. This means that alterations (or sales after "substantial reconstruction") of a barn or other outhouse within the curtilage of a listed building, *even though* the barn or outhouse is a self-contained dwelling, do *not* qualify for zero-rating – unless Customs decide to allow zero-rating by concession. This is the position whether the main "listed" building is itself residential or not. Lord Walker, by words in parenthesis, indicated that an alteration to a detached potting shed would obtain zero-rating if it qualified as a separate dwelling with self-contained living accommodation. Unfortunately, the precise terms of the legislation do not give this result and Customs should be invited to give an assurance that this will be the position in practice.

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[1] Counsel for the taxpayers, Zielinski Baker & Partners, in the Court of Appeal and the House of Lords.

[2] *Commissioners of Customs and Excise v Zielinski Baker & Partners Limited* [2004] UKHL 7, on appeal from [2002] EWCA Civ 692.
[3] (2000) VAT Decision 16722
[4] [2001] STC 585
[5] [2002] STC 829
[6] [1983] STC 819
[7] [1988] ECR 3127

# THE *RAMSAY* PRINCIPLE – WHERE ARE WE NOW?

**Patrick Way**

## Introduction

The Independent recently published a compendium of classic literary works whose plots were summarised in 25 words or fewer and challenged its readers to do better. The readers' attempts at improvement were printed on 14 April 2004 and I will show you some of these efforts in a minute or two. This method of approaching literature is one which I first came across thirty years ago when I bought a pocked-sized book, the title of which I forget, which reduced about 180 great works to a few well chosen paragraphs. But the most attractive feature of that book – now sadly lost – was that it did not stop at telling you what happened in each "oeuvre"; no, it told you what you thought of it. You know the sort of thing: the angst you had gone through when first reading Zola; the fatalistic experience of reading Hardy; the awe-inspiring sadness you felt when you first watched Romeo and Juliet: come on, we've all been there. And this was all particularly useful because you could pop these words of wisdom into conversations at cocktail parties with erudite friends at the moment critique, and hope to impress them.

To give you a flavour of this I have taken three of the readers' summaries from the Independent but I have included the sort of thing which I imagine that that very helpful book from thirty years ago would have added.

*Moby Dick – Herman Melville*

"Man goes fishing and eventually has a whale of a time. White is definitely not his colour."

"You enjoyed this novel recognising it as firmly at the foundation of American literature. You were swept away by its all subsuming symbolism, the pursuit of the whale being a marvellously evocative representation, of course, of man's tortured ambitions and single-minded aspirations (but you would probably not bother to read it again)."

*Macbeth – William Shakespeare*

"Scottish megalomaniac urged on by wife, eventually meets his doom because he can't see the trees for the wood."

"You enjoyed the delicious caricature of feminism in the persona of Lady Macbeth alongside the time-honoured image of lily-livered male. You thought Lady Macbeth had her roots in those great English heroines, Boadicea and Elizabeth I and possibly represented a premature brush with Lady Thatcher. You saw the play as yet more evidence of Shakespeare's timeless genius in his observation of the human experience (but you thought all that business of moving forests a little unconvincing)."

*Ulysses – James Joyce*

> "Man ambles round Dublin for hundreds upon hundreds upon hundreds of pages. Nothing happens."
>
> "You found Joyce's stream of consciousness a radical and exhilarating approach to story-telling and although of course you enjoyed every long minute involved in the journey which the narration of necessity entailed you felt, quite frankly, like saying to the author "Less is more, JJ, less is more."

Now I wondered whether it might be possible to apply this sort of summarising approach to some of the tax avoidance cases which you and I have to read from time to time partly because some of the judgments are very long and could benefit from truncating (the *Ensign Tankers* case[1] runs to 134 pages, after all) and partly because I thought (between you and me, dear Reader) that some of those dry old cases could do with livening up.

Before doing so I need to remind you, if you who have been out of the country for a year or so (or ploughing your way through full-length novels) that our understanding of how tax avoidance is viewed by the Courts has enjoyed significant analysis (some might say, "re-analysis") in the recent cases of *MacNiven*[2], *Arrowtown*[3] and *Carreras*[4] and in some talks given by Lord Hoffmann to the International Fiscal Association in the summer of 2003, by Lord Millett on 1 March 2004 to an invited audience at Mishcon de Reya and by Lord Walker on 23 March 2004 to the Chancery Bar Association. In addition we have the *Barclays*[5] and *Scottish Provident*[6] cases to look forward to which are scheduled to be heard by the House of Lords in the autumn of this year.

## Where Were We Before *MacNiven*?

Now, I don't know about you, but I think that before *MacNiven* we pretty much knew where we were and there is as good a summary of the *Ramsay*[7] doctrine in *Craven v. White*[8] as anywhere else. Thus Lord Oliver of Aylmerton said at page 203G:-

> "As the law currently stands, the essentials emerging appear to me to be four in number:
>
> (1) that the series of transactions, was at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result;
>
> (2) that the transaction had no other purpose than tax mitigation;
>
> (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and
>
> (4) that the pre-ordained events did in fact take place."

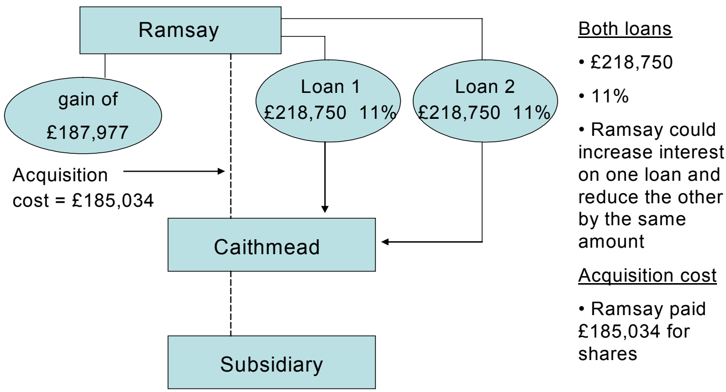
The *Ramsay* scheme, as Lord Wilberforce said, was intricate in detail but simple in its essentials. Ramsay had made a gain of £187,977 and sought to obtain a loss to offset against that gain. It could not afford, of course, to make a "real" (or "commercial") loss and therefore, it had to contrive to make a (tax free) gain of a similar amount as well so that Ramsay was not out of pocket. As an aside, the scheme would probably have failed anyway because the gain which was produced was taxable after all – but that is another story.

Accordingly, Ramsay entered into two loans: one was to produce an indirect loss, and one a gain. Both Loan 1 and Loan 2 were for £218,750 at a rate of 11% interest. It was a term that Loan 1 had to be repaid at par after thirty years and Loan 2 at par after thirty-one years. The loans were made to a company called Caithmead, as part of the overall scheme, and it was provided that the borrower in respect of the loans could repay earlier and would have to repay in any event on its liquidation. On a repayment the sum to be repaid was the higher of the market value or par.

Critically, Ramsay could increase the rate of interest on one loan provided that it decreased the rate of interest on the other loan by the same amount.

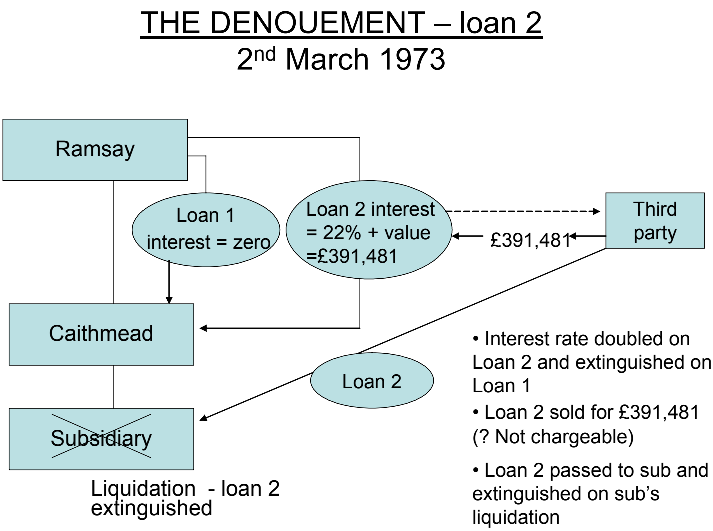
The following is a diagrammatic representation:-

## HOW DID WE GET HERE?
## 23RD February 1973




and that on Loan 1 was cancelled out to zero. This made Loan 2 very valuable, of course, and it was sold to a third party for £391,481 in circumstances where it was contended (unsuccessfully as it turned out) that no gain arose because this was an exempt transaction in respect of a "simple" debt.

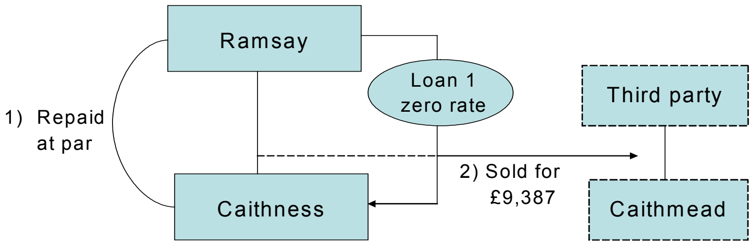
The obligation as debtor in relation to the very valuable Loan 2 was then transferred from Caithmead to a subsidiary which was then liquidated resulting in Loan 2 being repaid.




Finally, on the 9th March 1973 Caithmead itself went into liquidation on which event Loan 1 was repayable and was repaid to the appellant.

The shares in Caithmead, however, for which the appellant had paid £185,034 became of little value and the appellant sold them to a third party for £9,287 resulting, so the appellant contended, in a loss of £175,647. That, after all, had been the intention all along.

<u>THE DENOUEMENT – loan 1</u>
9th March 1973




1) Loan 1 repaid at par
2) Caithness sold for £9,387
3) "Loss" of £175,647

So, in a nutshell, the question was (leaving aside the fact that the disposal of Loan 2 was an unintended chargeable event) whether Ramsay could offset its contrived loss of £175,647 against its gain of £187,977.

As Lord Wilberforce said at p.189C/D:

> "On these facts it would be quite wrong, and a faulty analysis, to pick out, and stop at, the one step in the combination which produced the loss, that being entirely dependent upon, and merely a reflection of the gain. The true view, regarding the scheme as a whole, is to find that there was neither gain nor loss, and I so conclude."

He had previously said, at p.187E as follows:

> "To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, there **is not such a loss (or gain) as the legislation is dealing with** (my emphasis), is in my opinion well and indeed essentially within the judicial function."

So even at its inception, the *Ramsay* principle involved considering what the legislation meant, and whether the particular event in question should properly fall within the statute. This is most important.

## What *MacNiven* Said

I will set out the facts in *MacNiven* a little later (I am sure you know them anyway). Suffice it to say, at this stage, that a circular routing of money allowed a payment of interest to be made. Did that payment produce a charge on income, under s.338 Taxes Act 1988, as the taxpayer intended; or, did the circularity involved "nullify" matters pursuant to *Ramsay* as the Revenue contended?

Lord Hoffmann confirmed in *MacNiven* that everyone agreed that *Ramsay* was a principle of construction (paragraph [28]) but, at paragraph [56], he referred to Lord Cooke's judgment in *IRC v. McGuckian*[9] where he had said

> "Always one must go back to the discernible intent of the Taxing Act"

So, he picks up what had already been said in *Ramsay*: what does the statute mean? As will be seen later in this article it is this approach, of course, which has allowed the courts to give a purposive analysis of legislation but, it seems to me, that this current imperative based on *Ramsay* itself and owing its origins to the American case of *Helvering v. Gregory*[10] (of which more later) is to see, in deciding what the statute means, whether the transaction in question <u>is the sort of transaction which the statute "has in mind"</u>. This is particularly relevant when the legislation affords a relief or states that a loss arises in other words, where a tax advantage arises. I use the expression "tax advantage" widely not adopting, for example, the definition of that expression found in s.709 Taxes Act 1988. This approach means, in essence, and most importantly, that the courts can determine what they consider to be the facts, or to identify, if you like, what really happened. This, after all, truncates Lord Oliver's four semi-paragraphs above succinctly. More colloquially, one might say:- "Hand on heart, bearing in mind that you are hoping to obtain a tax advantage, does the statute intend you to get away with it and did you really do what you say you did?"

Needless to say, this is put much more eloquently elsewhere. For example, Carnwath LJ said in the *Barclays* case that:

> "… It is difficult to see [*Ramsay*] as a principle of statutory interpretation, in the normal sense. The way in which the House of Lords got over the obvious conceptual hurdles in *Furniss*[11] was, not by reinterpreting the statutory words, but by

> "reconstituting" the facts (to use Lord Oliver's term) … The purposive approach is applied not just to construction of the statute, **but also to the recharacterisation of the facts** (my emphasis)".

If I had to truncate this article then I would do so by reference to these words of Carnwath LJ. This approach seems to me to foreshadow the way in which the *Arrowtown* and *Carreras* decisions, mentioned later, were formulated and also to have its roots firmly in *Ramsay* itself.

In many ways, therefore, the Courts most recently are steering us back to what one might call the original *Ramsay* doctrine and are reducing the relevance of pre-ordination as a test in its own right, are removing the difference between avoidance and mitigation and are putting the dichotomy between juristic and commercial concepts firmly in the background. Let me explain.

## Commercial or Legal Concepts

In the immediate aftermath of *MacNiven* most commentators seemed (not unreasonably) to focus on the distinction between commercial concepts and juristic (or legal) concepts which seemed to be the principal feature of that case. Thus if a situation were susceptible to a commercial analysis then, so it seemed, "old style" (or pure) *Ramsay* principles could apply to it (see Lord Oliver above for an indication of pure *Ramsay*): whereas if the concept were purely legal then it was not susceptible to *Ramsay* recharacterisation (you could read the legislation literally). Inevitably this *MacNiven* distinction between commercial and juristic concepts led the Courts to consider, in the immediate aftermath of that case as the principal question in each avoidance case, which concept they were being asked to consider and, not surprisingly, the Courts found this very difficult.

Elsewhere, Lord Templeman[12] dismissed the distinction as “reflecting ingenuity but not principle”, Lord Millett described the distinction as “something of a red herring”[13] and Lord Hoffmann said that his judgment in *MacNiven* had been misinterpreted[14].

For what it is worth, I think the distinction still has its uses as I think it assists in certain areas of construction, particularly if one is asked whether a particular act is the sort of transaction that the statute has in mind because it helps the Courts to identify the particular act or transaction and whether that extends to a whole series of steps or something less. In *Ramsay*, as has been seen, there were two equal and opposite transactions, one seeking to produce a tax-free gain and the other a chargeable loss. This strikes me as the paradigm situation where a commercial analysis should be applied: commercially speaking there was neither a gain nor a loss, there was a nullity because you looked at the intertwined features of that scheme as one commercial whole.

Where the distinction is unhelpful, in my view, is because it has been interpreted by others as if certain <u>words</u> are <u>always</u> juristic or commercial, whatever their context. This is patent nonsense. After all, “payment” was juristic in *MacNiven* but commercial in *DTE*[15]. If the concept of juristic:commercial analysis is to have application it must, in my view, be the transaction under review, in its entirety, which is relevant, not a single word.

In *MacNiven* all that was needed to produce the tax advantage sought was for the pension scheme involved to carry out a discrete act of lending and being repaid. Could that circular (but single) transaction still give rise to a tax loss applying the *Ramsay* principle? In *DTE*, however, the whole paraphernalia of what happened was to give employees cash remuneration which was dressed up in the form of trust interests in circumstances where commercially speaking, the reality was that the employers were only ever going to get cash.

However, there is no doubt that the juristic:commercial distinction has been overdone and for the time being, at least, has limited application. Indeed, Lord Hoffmann described *MacNiven* as a "very exceptional" case[15].

Lord Hoffmann did seek, however, in *MacNiven* to put an end to the distinction between acceptable tax mitigation and unacceptable tax avoidance saying that since the statutory provisions did not contain words like "avoidance" or "mitigation" it was unhelpful to introduce them into *Ramsay* arguments ([para.62]). He went on to say:-

> "The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory

> language to the facts of the case. It is not a test for deciding whether it applies or not".

This approach was supported by Lord Hope at paragraph [77] where he said that the issue is one of statutory interpretation which should be approached:

> "without any preconceived notions as to whether this is a case of tax mitigation or tax avoidance"

He also said, I think very importantly, as follows:-

> "The relevant questions are:
>
> (1) the question of law: what is the meaning of the words used by the statute? and
>
> (2) the question of fact: does the transaction, stripped of any steps that are artificial and should be ignored, fall within the meaning of those words?"

So, again, we can see some real threads which remain present three years after *MacNiven* namely:-

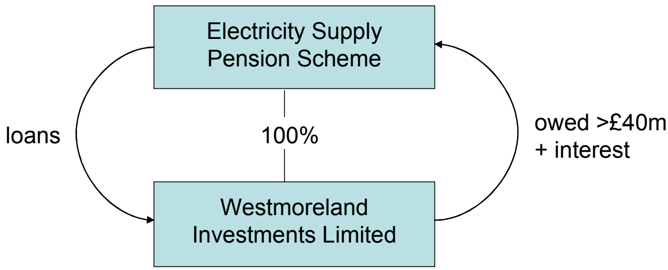
(1) what does the statute mean, and

(2) is this the sort of transaction that the legislation has in mind, and,

(3) what (really) was the transaction to which the statute should be applied?

## The facts of *MacNiven*

MACNIVEN v. WESTMORELAND
– starting point



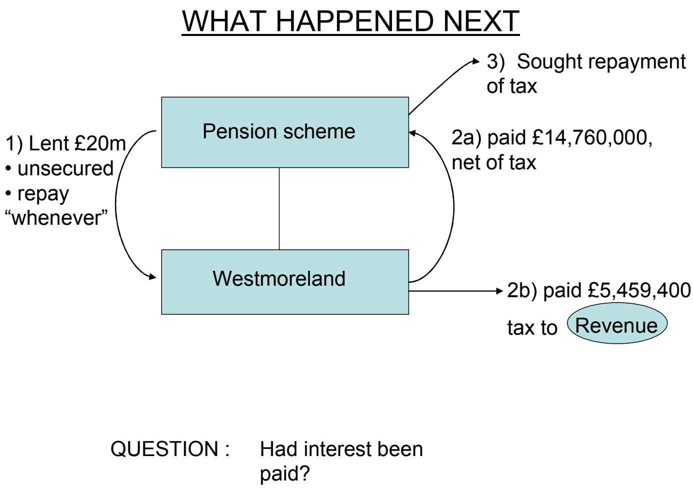

- interest had to be paid to be deductible (s. 338)
- Westmoreland could be sold for £2m as "loss company"

A little late in the day, perhaps, I now look at the facts of *MacNiven*, but I wanted to set out the ground rules involved in the analysis of *MacNiven* before looking at the facts which are quite brief.

In essence, Westmoreland was a property-holding company which had suffered financial difficulties and was loaned substantial amounts of money by its major shareholder which was a pension scheme. The pension scheme wanted to obtain some benefit from the fact that Westmoreland was a loss-making company which could be sold on the market, but in order to crystallise those losses it had to be the case that Westmoreland had actually paid the interest which had accrued on the loans made to it by the pension scheme for the purposes of s.338 Taxes Act 1988.

Accordingly, as the diagram below shows, the pension scheme lent significant amounts of money to Westmoreland which were immediately utilised to pay outstanding interest back to the pension scheme itself and to pay monies on account to the Revenue in relation to which the pension scheme sought repayment.

The Inland Revenue contended that, having regard to the *Ramsay* principle, the interest had not been paid and therefore no charges on income had arisen. The case reached the House of Lords where, as everyone knows, a decision considered at the time to be ground-breaking was given in favour of the taxpayer.




Although Lord Hoffmann is most closely associated with *MacNiven*, it is worth remembering that it was a unanimous decision of all five Law Lords and to my mind, at least, the most helpful learning comes from Lord Nicholls' judgment at paragraphs [15] and [17] where he said:

> "[15] Does it make a difference when the payment [of interest] is made with money borrowed for the purpose from the very person to whom the arrears of interest are owed? In principle, I think not. Leaving aside sham transactions, a debt may be discharged and replaced with another even when the only persons involved are the debtor and the creditor. Once that is accepted, as I think it must be, I do not see it can matter that there was no business purpose other than gaining a tax advantage. A genuine discharge of a genuine debt cannot cease to qualify as a payment for the purpose of s.338 by reason only that it was made solely to secure a tax advantage. There is nothing in the language or context of s.338 to suggest that the purpose for which a payment of interest is made is material.
>
> [17] The feature which makes the … transactions unattractive to the Revenue … is the ability of the pension scheme trustees to reclaim the tax deducted by [Westmoreland] from the payments. But that is the consequence of the tax exempt status of a pension scheme. The concept of payment … cannot vary according to the tax status of the person to whom the interest is owed."

Speaking with the benefit of hindsight, I think that the Revenue were forgetting (when they raised the *Ramsay* doctrine), therefore, that:

(a) the whole structure in question had been in place long before it was sought to take the final step which actually crystallised the loss; and

(b) the only question was: has interest been paid? This question was exclusively juristic in the circumstances and took no account of the fact that no-one became out of pocket when the circular payment had occurred – they were already out of pocket.

Thus, the fact that the "tax" loss was crystallised by steps which <u>at that time</u> produced no commercial loss was not relevant. It would have been different if the scheme had started much earlier but it did not.

**Lord Hoffmann's talk**

I now consider what Lord Hoffmann said to the International Fiscal Association last year relying as I do on the notes of a member of the audience (for which I am grateful) as I was not there myself.

First, Lord Hoffmann said that there is no question of considering whether there is tax avoidance at the outset when analysing matters and then proceeding on that basis. Tax either attaches to a transaction or it does not. If it does then tax is payable; if it does not then no tax is payable and nothing has been avoided. Those who object to this approach, says Lord Hoffmann, seem to think that there are transactions which "ought" to be subject to tax and that as a result a sort of "judicial bandaid" should be applied to the statute. This according to Lord Hoffmann is an entirely fallacious argument since one cannot know that a transaction ought to be subject to tax. All that one can do is to read the statute.

Secondly, Lord Hoffmann said that his judgment in *MacNiven* had been much misinterpreted, to his dismay, as substituting one solve all magic formula (the "pure" *Ramsay* doctrine) for another (the juristic:commercial concept). Lord Hoffmann had intended this to be a helpful description of situations where a statute taxes an economic event as a whole rather than taking what he described as an atomistic approach and looking at each step separately. (This is why, I have said in this article, that I think it is wrong to attach the juristic: commercial concepts to specific words such as "payment". The approach, if it has any long-term application – which is doubtful – must be in relation to situations as a whole rather than words.)

Then Lord Hoffman went on to say what I think is very interesting. He said that the process of statutory construction is always to some extent a *creative* judicial act. It is not unique to taxing statutes. It involves weighing up the consequences of adopting competing constructions, and deciding which construction best fits:-

(a) the system enacted by the statute;

(b) other statues; and

(c) the common law.

So you cannot look at the statute in blinkers but must look at the overall position.

He took exception to Lord Templeman's attack on his *MacNiven* judgment in the Law Quarterly Review. Lord Templeman had said, apparently, that it could be assumed "with certainty" that Parliament intended that steps with no business purpose except the avoidance of tax should be ignored in ascertaining the tax treatment of a transaction. Lord Hoffmann countered that whilst it might be a good provisional assumption that Parliament intended to tax a transaction, raising that assumption to the status of certainty would wrongly relieve judges of their duty to read the statute itself.

When looking at *MacNiven* itself he said that the clear application of "the pure" *Ramsay* doctrine would have resulted in the entirely circular payments being ignored and the interest not being a "charge on income". However the Lords had decided to take a "harder" look at the statute and had concluded that interest due to a non-bank was only deductible when paid because the interest was only taxable in the hands of the creditor when received i.e. Parliament had provided for symmetry in the system.

Mirroring what Lord Nicholls had said, Lord Hoffmann said that it was a fact that the interest had been paid, the tax had been withheld and was actually paid over to the Revenue. The fact that it could then be recovered because the creditor was a superannuation fund was immaterial. Adopting any other construction of the statute would have distorted the system that Parliament enacted.

Finally, Lord Hoffmann said, without casting doubt on the correctness of the decision in *Pepper v. Hart*[16], that it was not helpful to look at ministerial statements when considering a statute. This is because Parliamentary "intention" is a metaphor that is resorted to when considering a statute and it should be treated as such. To talk of actual Parliamentary intention would imbue Parliament with all sorts of wisdom, knowledge and foresight that it did not possess. Accordingly, he said that *Pepper v. Hart* had fallen out of favour with the judiciary.

**Lord Millett's talk**

Lord Millett's talk on 1 March 2004 was illuminating and repeated important points from past cases as well as showing how tax avoidance cases may well be viewed by the Courts in the future. Lord Millett first of all took the audience back to the American case of *Helvering v. Gregory* which is a case from 1934 and it is this case which has had a most significant effect on the way in which the *Ramsay* principle has evolved because it plays such an important part in determining how to construe legislation, especially tax legislation.

In *Helvering v. Gregory* a taxpayer had an indirect holding in a target company and sought to avoid tax on a pending sale of the shares in that target company by steps which involved a reorganisation and a liquidation. As a result, the taxpayer claimed to have avoided the gain that would otherwise have arisen on the basis that there had been a previous tax-free reorganisation resulting in an uplifted base cost in the hands of the taxpayer.

The now legendary judge in that case, Judge Learned Hand, considered whether the statutory definition of reorganisation was satisfied in the circumstances to give the relief sought. It was true, he said, that the word "reorganisation" was defined in the statute and that the transaction fell fairly and squarely within that definition but he held that this was not decisive:-

> "It does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition."

He went on to say:-

> "We cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by a winding up of the company. The Averill Corporation had a juristic personality, whatever the reorganisation; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that **they were not what the statute means by a "reorganization"** (my emphasis) because the transactions were no part of the conduct of the business of either or both companies."

As an aside, in the *Arrowtown* case (dealt with later) Lord Millett said that the transactions in *Helvering v. Gregory* fell outside the statutory definition of reorganisation:

> "…not because they were undertaken in order to avoid tax, but because they had no other purpose. This was a manifestation of a purposive approach to the statutory construction of a tax exemption."

He also referred both in *Arrowtown*, and in his talk, to the Hong Kong case of *Shiu Wing Limited*[17] at which Sir Anthony Mason MPJ had said, at p.240:

> "The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction but does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the Act to provide an escape from the liabilities that it sought to impose."

In his talk, Lord Millett also said that the particular facts of *Arrowtown* were most unhelpful to the taxpayer because the relative interests of the parties were so extravagant. For example, in that case certain non-voting shares were said to carry 90% of the value of a company called Prepared, whereas the reality was that the shares were virtually valueless. The extravagance which he had in mind was that those shares had a right to a dividend only for a year in which the net profits exceeded HK$1 million billion (said to be a sum larger than the gross national product of the USA) and a right to distribution on a winding up only after the holders of all other shares had received what in the *Arrowtown* case Lord Millett described as the "somewhat more modest distribution" of HK$100,000 billion per share.

Indeed this moved Lord Millett to say, in his talk, that the moral of all this was that if something looked too good to be true then it was or, as he succinctly put it, "Don't be silly". If you take the *NMB*[18] case, said Lord Millett, involving platinum sponges which were to be given to employees as a means of avoiding NICs, you could see that the overall arrangement was simply a cash arrangement because it was pre-arranged that there would be a sale back to the brokers by the employees who received the platinum sponges in circumstances where the reality was that they just received cash. More simply, all that one had to do was to apply the "don't be silly" argument: had the employees received platinum sponges or had they received cash? "Don't be silly – it's clearly cash that is received."

Lord Millett added that it was unfortunate, from his point of view, that Lord Diplock had used the expression "pre-ordained" rather than "pre-conceived" in *Burmah Oil*[19] and it is my observation that it certainly is the case that the pre-ordained test is more onerous than a pre-conceived test would be. After all, in *Pigott v. Staines*[20] Knox J said as follows, at p.372:

> "The fact that there is, at the time of the first transaction, active contemplation or even a better than evens chance of the second transaction taking place is not sufficient if there is a real possibility of a different event taking place.
>
> The fact that the second transaction exactly matches the transaction that was planned at the time of the first transaction cannot be sufficient to bring the totality of the transactions within the Ramsay/Furniss principles if there is, at the time of the first transaction, a real possibility that a different second transaction might be effected. Contemplation of correspondence with an anticipated outcome and probability of occurrence of the second transaction are all insufficient unless it can also be said that the double negative test is satisfied, viz., that there is no real possibility of the particular second transaction not being effective."

It can be seen, therefore, that the approach of pre-ordainment is much narrower than the test of pre-conception would have been, but I consider that the relevance of pre-ordainment has possibly been overdone by the architects of tax schemes. It is not the case that, just because pre-ordainment is avoided, perhaps by long-time gaps, or the use of extraneous and superfluous conditions that a scheme – by that fact alone – "sneaks through".

The principal point which arose from Lord Millett's erudite and cogent talk was, to repeat his "snappy" phrase, that when construing artificial tax avoidance schemes one should at all times adhere to the direction, "Don't be silly".

## Lord Walker's talk

Lord Walker's talk on the 23rd March 2004 was an overview of the way in which the *Ramsay* principle has evolved over the last quarter of a century. Much of my record of what he said turns out to be a repetition of many of the points which have already been mentioned in this article (which is not altogether surprising), but by repeating some of these points I am seeking to show again the threads that I think keep appearing in relation to an analysis of *Ramsay*. These seem to me to show that in the recent past the *Ramsay* principle has been pulled back from the place where *MacNiven* took it, and, *MacNiven* can be seen to have been given too much weight in relation to the notion of juristic and commercial concepts.

Thus Lord Walker referred again to the comments which have been expressed by Sir Anthony Mason in *Shiu Wing* that the *Ramsay* principle is concerned both with statutory construction and with the right approach to the analysis of the facts.

Lord Walker then proposed three particular points.

(a) The *Ramsay* principle really is no more and no less than a new <u>and more realistic</u> approach to the construction of taxing statutes (<u>and, as an associated issue, the analysis of the facts to which the statutory provisions have to be applied</u>);

(b) The distinction between tax avoidance and tax mitigation is overdone;

(c) Lord Hoffmann's distinction in *MacNiven* between commercial and legal concepts, although rough and ready and obviously throwing up borderline cases, "is a valuable insight reflecting the varying structure and terminology of taxes, and the variety of avoidance strategies or tactics which may be available".

Interestingly he did refer to the fact that Lord Hoffmann had chosen to illustrate the notion of an entirely legal concept – a conveyance on sale – by referring to the law of stamp duty which Lord Hoffmann seemed to imply was exclusively a juristic matter.

However, Lord Walker cast doubt upon even this canard when he referred to what Vinelott J had said in *Ingram v. IRC*[21] in a judgment which repays careful study.

> "Stamp duty is a tax on instruments. But, in the language of the older cases, to determine whether an instrument falls within a chargeable category and the duty payable, the Court must ascertain the substance of the transaction effected by it. The *Ramsay* principle requires that, in a case where the conditions described by Lord Brightman are satisfied, a composite transaction or series of transactions be treated as a single transaction achieving the pre-ordained end."

In other words, one cannot assume that stamp duty is a purely juristic tax given that it required an analysis of what actually happened: the labels attaching to documents are not conclusive as to their intent.

He also referred to *Helvering v. Gregory* although this was largely to point out that at the time of that decision the United States' Supreme Court was a million miles away from what was said in *Westminster*[22] the American case having been heard only a few months before. He said, as many others have said, that he thought *Westminster* had been wrongly decided and that it was his view that the dissenting judgment of Lord Atkin was on all fours with current thinking.

Indeed, Lord Walker said:

> "The calm and compelling irony of Lord Atkin's dissenting speech (one passage begins, "The embarrassments, however, are not all on the Duke's side" P.514) has to my mind stood the test of time far better than Lord Tomlin's grandiloquent invocation of the "golden and streight mete wand of the law" (p.520).

<u>Pausing there,</u>

So it can be seen, it seems to me, lapsing back into more "laddish prose" as follows.

> "What we're really looking at is a process of construction of the statute and of the facts. Should the Courts look at the facts as they are presented or should they take a "more grown up" view of things in determining what actually happened.

> Having done that the Courts are then entitled to say, "Well, this is not really the sort of transaction which should carry the relief".

## The *Arrowtown* Case

The facts in *Arrowtown* were relatively complicated but the issues can be briefly stated. Very valuable land in Hong Kong was to be transferred by an intra-group transaction from Shiu Wing (the eponymous subject of a case already mentioned) to Arrowtown which was an indirect wholly-owned subsidiary of Shiu Wing. Shiu Wing's economic ownership in the relevant sub-structure was then to be sold off to a third party but to avoid Hong Kong stamp duty on the initial intra-group transfer of the land it was intended that effectively valueless shares retained by Shiu Wing in that sub-structure should carry sufficient rights (as to 90% thereof, in effect) such that on any literal reading of the relevant Hong Kong stamp duty legislation that sub-structure remained within Shiu Wing's stamp duty group, thus avoiding the exit charge.

The question arose as to whether the virtually valueless holding of these shares could be said to attract a relief afforded in circumstances where the shares actually carried a 90% interest in the sub-structure.

Ribeiro PJ said the following at paragraph 39:

> "The "valuable insights" that Lord Hoffmann was acknowledging were all centred on the proposition that the *Ramsay* doctrine has at its core the purposive interpretation of statutes

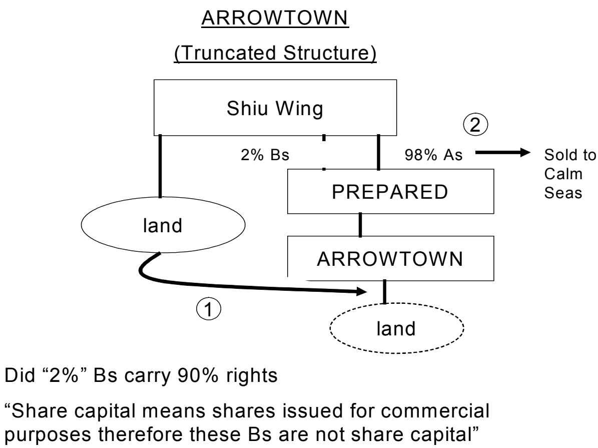
> applied to facts viewed realistically and untrammelled by "limitations" which might be thought to arise out of Lord Brightman's formulation. Such an approach strikes me as the antithesis of a mechanistic use of the "commercial"/"legal" dichotomy as a straightjacket limiting construction of the relevant statute."

The taxpayer lost and the two penultimate paragraphs of Lord Millett's judgment are particularly important:-

> "[156]. The legislature could have confined relief to the case where the transferor was the beneficial owner of 100% of the issued share capital of the transferee. Had it done so, the present scheme would not have been possible. But the legislature was content with 90%. It must have recognised the commercial need for flexibility in order to permit the holding of small minority stakes without jeopardising the relief. But the legislature cannot have intended the 10% allowance to outsiders to be exploited so as to permit relief to be available in a case where the property was, to all intents and purposes, transferred to a 98% owner with the transferor retaining only 2% even if the literal requirements for exemption were complied with.
>
> [157] Section 45 is not an end in itself. The words "issued share capital" in the section, properly construed, mean share capital issued for a commercial purpose and not merely to enable the taxpayer to claim that the requirements of the section had been complied with. It follows that the "B" non-voting shares issued to Shiu Wing are not "share capital" within the meaning of the

section, and it should be disregarded when calculating the proportions of the nominal share capital owed by Shiu Wing and Calm Seas respectively."

The following is a diagrammatic representation:-

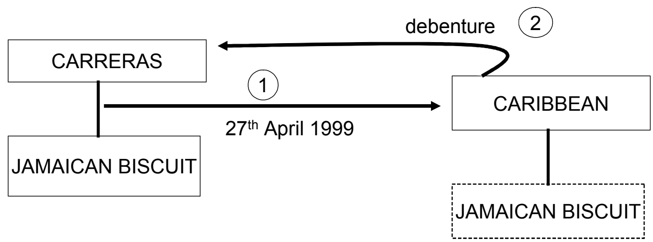


## The *Carreras* case

The facts in *Carreras* can be represented by the following diagram.

CARRERAS

(Transfer tax copied 1965 capital gains tax legislation)




Sale for debenture = exempt

Sale for cash = chargeable

The case was heard by the Privy Council earlier this year and such is the clarity of Lord Hoffmann's wording that I can set out the facts from the first three paragraphs of his judgment in that case.

> "1. On 27 April 1999 Carreras Group Ltd ("Carreras") entered into a written agreement to transfer all the issued ordinary share capital and most of the preference shares in Jamaica Biscuit Company Ltd ("Jamaica Biscuit") to Caribbean Brands Ltd ("Caribbean"). The consideration was expressed to be a debenture to be issued by Caribbean in the sum of US$37.7 million and in terms annexed to the agreement. The terms were that the debenture would not be either secured or transferable. The principal debt would carry no

> interest and be repayable by banker's cheque on 7 May 1999.
>
> 2. In the event, the debenture was not redeemed until 11 May 1999, when Caribbean paid US$19.9 million and J$700,344.814 and Carreras accepted these payments in full settlement.
>
> 3. The question in this appeal is whether the transfer of shares is chargeable to transfer tax."

The point was that the Jamaican transfer tax legislation had copied the 1965 Capital Gains Tax legislation so that there was the equivalent of what is now s.135 TCGA 1992 (share for debenture exchange – exempt) and s.251 (disposal of a debt – exempt). Putting these two sections together it could be argued that there had been a tax-free reorganisation producing a debt followed by a tax-free disposal of that debt when the debenture was redeemed.

The obvious problem with the Jamaican legislation was that it did not keep track of the UK legislation and did not have the equivalent of s.137 TCGA 1992 which, of course, denies reorganisation relief where it is tax-driven. So, was the transaction tax-free?

Paragraphs 6, 7 and 8 of the judgment repay close reading and are set out below with my added emphasis:

> "6. Carreras says that if one reads the agreement of 27 April 1999, it falls squarely within these exempting provisions. The issue of the debenture by Caribbean in exchange for the

original shares held by Carreras in Jamaica Biscuit was required to be treated as if Caribbean and Jamaica Biscuit were the same company and the exchange was a reorganisation of its share capital. By virtue of paragraph 4(2), it was therefore not to be treated as involving any disposal of the Jamaica Biscuit shares.

7. Their Lordships agree that the question is whether the relevant transaction can be characterised as a reorganisation of share capital as defined in the Act. That is to say, as a debenture in exchange for shares. They also accept that if the relevant transaction is confined to what happened on 27 April by virtue of the agreement executed on that date, there can be no doubt that it fell within that description. **On the other hand, if one is allowed to take a wider view and to treat the terms of the debenture and its redemption two weeks later as part of the relevant transaction, it looks very different**. (my emphasis) From this perspective, the debenture is only a formal step, having no apparent commercial purpose or significance, in a transaction by which the shares in Jamaica Biscuit were exchanged for money.

8. **Whether the statute is concerned with a single step or a broader view of the acts of the parties depends upon the construction of the language in its context**. (my emphasis) Sometimes the conclusion that the statute is concerned with the character of a particular act is inescapable: see *MacNiven (HM Inspector of Taxes) v Westmoreland Investments Ltd* [2003] 1 AC 311. But ever since *Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300 the courts have tended to assume that revenue statutes in particular are concerned with the

> characterisation of the entirety of transactions which have a commercial unity rather than the individual steps into which such transactions may be divided. This approach does not deny the existence or legality of the individual steps but may deprive them of significance for the purposes of the characterisation required by the statute. This has been said so often that citation of authority since *Ramsay's* case is unnecessary."

So, it can be seen that *Carreras* is telling us to look and see what act or transaction is relevant and so encapsulates all that has been said about the *Ramsay* principle (see especially Lord Oliver's analysis earlier) but truncates the thinking most succinctly and with great clarity. *Carreras* is a very important decision.

Now, dear Reader, you know the outcome of *Carreras* of course, but put yourself in the position of the taxpayer. If one looks at *MacNiven*, things happened very quickly there and the money went round in a circle but one applied a juristic approach and said (albeit for the reasons that are mentioned in this article) that in reality there had been the appropriate payment. Now, if one is going to apply a juristic formulation, is it not possible that you simply say, well, there was a debenture and it does not matter whether the debenture lasted for a year, half a year, one month or one minute; there either was or was not a debenture. This, after all, is a juristic concept, so you argue, at least. If, then, as a further juristic matter, the debenture is redeemed does not that just simply mean that you follow the paper trail which takes you through the two exemptions in the legislation and you say "No tax". This, after all, seemed a wholly justifiable and worthwhile argument at the time the Privy Council heard the *Carreras* case.

Answer, I am afraid: "Don't be silly" or, a little more fully, "You are missing the point" because the real point is that *Ramsay* allows the Courts not just to construe the legislation but also to construe the facts and the Courts say that there was one single transaction and that transaction taking account of all that they heard and saw (and, frankly, did not hear and see) was that it was always intended that the vendors would receive cash. Of, if you like, *MacNiven* could focus just on the act of loan and repayment because that was the relevant matter for analysis; whereas in *Carreras* the whole process of payment, including the issue of the debenture, was susceptible to *Ramsay*. Put it another way, identify the first step in the avoidance and apply *Ramsay* from that event onwards.

It is worth setting out paragraphs 15 and 16 of the judgment.

> "15. [The taxpayer] submitted that a factual inquiry into what constituted the relevant transaction … would give rise to uncertainty. He was disposed to accept that if the representative of Carreras had handed the share certificates over the desk in exchange for the debenture and the representative of Caribbean had then handed it back in exchange for a cheque, it would be hard to say that the relevant transaction should not be characterised as an exchange of shares for money. But what if the debenture had been redeemed a year later? Why should a fortnight be insufficient to separate the exchange from the redemption?

> 16. One answer is that it is plain from the terms of the debenture and the timetable that the redemption was not merely contemplated (the redemption of any debenture may be said to be contemplated) but intended by the parties as an integral part of the transaction separated from the exchange by a shorter time as was thought to be decent in the circumstances. The absence of security and interest reinforces this inference. No other explanation has been offered. <u>In any case, Their Lordships think that it is inherent in the process of construction that one will have to decide as a question of fact whether a given act was or was not a part of the transaction contemplated by the statute.</u> In practice, any uncertainty is likely to be confined to transactions into which steps have been inserted without any commercial purpose. <u>Such uncertainty is something which the architects of such schemes have to accept.</u>"

So one can see in *Carreras* what has been evident throughout this article. *Ramsay*:-

(a) is a question of construction of the legislation,

(b) is a question of construction of the facts,

(c) is an identification of which act or transaction (if any) must be submitted to *Ramsay* analysis, and

(d) means that the Courts have to do their best and if there is some element of uncertainty which might produce a "tough" decision

> then that is the risk which the tax avoiders have to take.

Thus it can be seen that Lord Hoffmann's judgment in *Carreras* gives a mature and intelligent analysis of *Ramsay* shorn of all the imperfections of earlier court judgments which have been taken us on wild goose chases and up blind alleys. It is the *Ramsay* principle distilled to its unblemished essence.

## ***Barclays* and *Scottish Provident***

There are two big cases coming up in the House of Lords which are the *Barclays* case and *Scottish Provident*. All that one can say is that these cases, it is to be hoped, will throw yet more light on to the way in which the *Ramsay* principle is developing post-*MacNiven*. I think it is difficult to pre-judge the outcome but I hope the judgments will be as elegant and comprehensible as in *Carreras*.

## **The Student's Guide**

Now, dear Reader, if you have a long memory you will recall that at the beginning of this article I copied out the Independent's summary of three literary works and then added my, very flippant, comments as to what you thought of them so that you could drop this into the conversation when appropriate. Heaven help you!

So let's finish off by looking at some of the tax cases that have been mentioned in this article, in the style of the Independent's summary.

*The Duke of Westminster Case*

“The Duke got away with an early form of remuneration planning.”

You say “Antediluvian tax case, especially that bit about the “golden and streight mete wand”. You had thought Lord Atkin’s dissenting judgment to be correct for a long time and are glad to see the rest of the world catching up.”

*Pepper v. Hart*

“Some schoolteachers at a fee-paying school got pretty much tax-free education for their kids because of a ministerial statement in Parliament to that effect.”

“You say that you think the case was a one-off. Very much out of favour now and quite frankly you’re surprised it’s still mentioned outside academic circles.”

*MacNiven v. Westmoreland*

“Circular payments were OK because the juristic concept prevailed and did not allow *Ramsay* recharacterisation.”

“You have had to change tack on this. Three years ago you would have said that *MacNiven* represented a dramatic new analysis of *Ramsay*, and cases from then on would turn on the critical juristic: commercial dichotomy; six months ago you denied ever having said that bit about juristic:commercial dichotomy and would have said that the case was highly exceptional and unlikely to be repeated; now you think the case may possibly have some relevance but you're not really sure."

*Helvering v. Gregory*

"An attempt at a tax-free reorganisation failed because it was not what the statute had in mind."

"You think this is <u>the</u> seminal case on tax avoidance and you keep a copy of it with you at all times, even by your bedside. As for that Judge Learned Hand, in your opinion he was the brightest man of his generation and your American cousins almost certainly knew him."

*Carreras*

"In a judgment which crystallised and clarified *Ramsay* thinking, the relevant act was held to be nothing more or less than a cash transaction."

"You, dear Reader, when *Carreras* is mentioned, appreciate that this case is the contemporary distillation of *Ramsay* but you say nothing and just smile knowingly (until the next case comes along, that is!)."

[1] *Ensign Tankers (Leasing) v. Stokes* HL 1992, 64 TC 617.
[2] *MacNiven v. Westmoreland Investments Ltd* HC 2001, 73 TC 1.
[3] *Collector of Stamp Revenue v. Arrowtown Assets Limited* FACV No.4 of 2003.
[4] *Carreras Group v. SC* PC No.24 of 2003.
[5] *Barclays Mercantile Business Finance Ltd v. Mawson* (2003) CA, [2003] STC 66.
[6] *IRC v. Scottish Provident Institution* (2003) CA, [2003] STC 1035.
[7] *Ramsay v. IRC* ]1981] STC 174.
[8] *Craven v. White* HL 1988, 62 TC 1.
[9] *IRC v. McGuckian* HL 1997, 69 TC 1.
[10] *Helvering v. Gregory* (1934) 69 F. 2d 809, (1935) 293 VS 460.
[11] *Furniss v. Dawson* [1984] STC 153.
[12] *Law Quarterly Review* (117 LQR at 582).
[13] Mishcon de Reya talk, 1st February 2004.
[14] The International Fiscal Association in June 2003.
[15] *DTE Financial Services Ltd v. Wilson* CA 2001 (74 TC 14)
[16] *Pepper v. Hart & Others* HL 1992, 54 TC 421.
[17] *Shiu Wing Ltd v. Commissioner of Estate Duty* (2000) 3 HKCFAR 215.
[18] *NMB Holdings Limited v. Sec. of State for Social Security* QB 2000, 73 TC 81.
[19] *CIR v. Burmah Oil Co Ltd* HL 1987, 54 TC 200.
[20] *Pigott v. Staines Investments Ltd* Ch.D 1998, 68 TC 342.
[21] *Ingram v. IRC* 1985 Ch.D, [1985] STC 835.
[22] *Duke of Westminster v. IRC* HL 1935, 19 TC 490.

# Members of Chambers

Milton Grundy (Head of Chambers)
Michael Flesch QC
David Goldberg QC
David Goy QC
John Walters QC
Philip Baker QC
Patrick Soares
Felicity Cullen
Barrie Akin
Patrick Way
Hugh McKay
Aparna Nathan
Conrad McDonnell
Nicola Shaw
Claire Simpson
Michael Thomas

*Senior Clerk: Chris Broom*
**GRAY'S INN TAX CHAMBERS**
*Gray's Inn Chambers, 3rd Floor, Gray's Inn,*
*London WC1R 5JA*
*Tel: 020 7242 2642 Fax: 020 7831 9017*
*e-mail: clerks@taxbar.com*