THE LEGAL ADVISER'S RESPONSIBILITY

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I once met a man on a boat in Amsterdam - though where I met him is really irrelevant to the story - who told me that he was an American lawyer who advised on SEC law. He said that was a good area to advise on because there were only two types of advice you ever had to give. If the client came through the door and said "I've done so and so" you said "Uh huh, you've just committed a felony" and if the client came through the door and said "We want to do so and so" you said "Well, this is a grey area but, basically, there are four things you can do, A, B, C - and D, which is none of the above".

Tax law is not like that: clients tend to think that it is a science and not an art and they want answers; sometimes they want to be told what to do, and sometimes they want reassurance. I suppose any lawyer's work will fall into a tremendously broad category which it will be difficult to characterise too precisely, but tax lawyers generally deal with three types of situation. First, they will be asked to advise on transactions carried out wholly in a commercial context. For example, the client may wish to sell a business or make a takeover bid or just rationalise his group. Secondly, the client may have been presented with a proposal to mitigate his tax and this type of situation can arise in the context of companies and in the context of individuals. Here the client will want to be told what to do. He wants to know the answer to the question: "should I do this scheme?" Thirdly the client may have

carried out a commercial transaction or a tax mitigation scheme and is now in dispute with the revenue about the consequences. Here the client wants reassurance. He wants to hear the lawyer say "Maybe I can get you out of this". I concentrate here on the second and third situations. I should, however, mention a few points about the first situation. Quite often, when a transaction is carried out in a commercial context, clearances will be sought and obtained for the transaction and the legal adviser will be asked to draft or to settle the applications for the clearances. Here, the legal adviser's responsibility will consist principally of ensuring that the clearance applications are drafted in a clear and full fashion. Clarity is essential because confusion may lead to difficulty for the Revenue official considering the application and so to an unnecessary refusal. One particular point here is to get the names of the parties right. Sometimes, applications are drafted using code names. The code names are, in a later draft, imperfectly changed to the real names and the final version of the application is sent to the Revenue with an incoherent mix of names that makes it impossible to tell who is who. A lawyer should see that this type of confusion – which happens surprisingly often in the real world – is avoided.

Next, the clearance application must give all material information, so that a clearance given in response to the application cannot be withdrawn, and in this connection the disclosure needs to be extremely full so as to satisfy the requirements of the Matrix case: it may, indeed, even be necessary to mention arguments that the Revenue might want to raise, even though the

adviser himself believes them to be wrong. Of course, in the first situation, the legal adviser may very well have some input as to how the transaction will be structured, the aim of the tax lawyer being to mitigate tax. But in this type of situation there will always be a real transaction carried out for commercial purposes, and cases of that sort tend not to raise the sorts of issue which arise where transactions are carried out solely for the purposes of tax mitigation. This is not, however, a hard and fast rule. As has been shown by the *Barclays Bank v. Mawson* case – a case I refer to in more detail below – a commercial transaction can have aspects that raise the sort of issue that arises with the second type of case, but I can comment on this adequately in dealing with the second situation.

The second situation – the case where a client comes through the door and says that he has been presented with a proposal to mitigate his tax – can arise both for individuals (particularly in the field of inheritance tax planning) and companies. I concentrate here on the situation with a company. Once upon a time, when I started advising on tax, there were basically only two "outfits" which sold tax avoidance schemes. But, nowadays, every corner merchant bank – and even firms of accountants – spend a great deal of time thinking up tax avoidance or tax mitigation schemes which they try to sell to clients. And the clients, having been presented with the scheme, will quite often seek advice on these schemes from their lawyers. Counsel is often consulted by the promoters of a scheme at the time it is being put together *and* by the potential user of the scheme after he

has been presented with it. In some quarters it is believed that the recent Westmoreland case has so liberalised the environment that tax avoidance has again become acceptable. In my view, for reasons which I shall explain in a moment, this is a dangerous conceit.

When I am presented with a tax mitigation scheme, I adopt a three stage approach to the analysis. First, I read the papers to find out what the scheme is about and to get an initial and very general impression of whether the scheme is good or bad. To me, a scheme is good if it is elegant, by which I mean it is simple and easy to understand. In my experience, clients usually prefer schemes that are more complicated to schemes which are simple, but that is an error: complications require intense analysis and the more analysis that has to be done on a scheme, the more likely it is to go wrong. The simpler a scheme is, the better it is. Having got my initial impression I then try to put that to the back of my mind and analyse the proposals step by step to discover whether there is a weakness on the detailed wording of the applicable legislation. In some cases, Counsel will be presented with proposals and no analysis. In other cases, he will be presented with a detailed analysis prepared by somebody else. Where that happens he needs not only to consider the analysis given to him to see whether he agrees with it, but also to make sure that no relevant provisions of the legislation have been omitted from the analysis. Where he is not given an analysis he needs to ascertain for himself what the relevant provisions are and consider their meaning afresh for himself.

At this stage of the analysis one quite often finds a relevant provision which will apply adversely if the main purpose or one of the main purposes of the transaction is tax avoidance. ICTA 1988 s.703 is one of those provisions, as is FA 1996 Schedule 9, paragraph 13, which relates to debits arising from loan relationships, is another. Paragraph 13 is of considerable current interest, partly because many of the tax mitigation schemes presently around raise the issue as to whether it applies adversely and partly because the Revenue seem surprisingly keen to litigate the meaning of this provision.

A number of points are relevant here. First a provision which refers to the main object or main purposes of a transaction usually imposes a subjective test. The provision asks, "What was the taxpayer's purpose? What was the taxpayer trying to achieve?" And to answer this sort of question it is necessary to discover what was in the taxpayer's mind. A provision of this sort does not require an objective determination of what a hypothetical observer might expect the position to be, but an enquiry into the taxpayer's state of mind. This does not, however, mean that a taxpayer can simply say, "Well I did not intend to get the tax relief and therefore that was not my purpose". What the taxpayer says must be credible in the context of what he did; and if there is no explanation for what he did other than that he wanted tax relief, then he cannot talk himself out of the provision. In such a case it may be found that the taxpayer has a subconscious purpose of which he was unaware. In a dispute as to what the taxpayer's purpose

was, the matter is determined by the Commissioners as a matter of fact, so that the evidence given before the Commissioners will be of critical importance to the outcome of the case. I return below to this aspect of the lawyer's job.

Secondly, a purpose needs to be distinguished from a consequence or incident. Just because a transaction has a certain consequence, it does not automatically follow that it had that purpose. For example, if a company borrows money and pays interest, the paying of that interest will, subject to paragraph 13, attract interest relief. But this does not mean that the *purpose* of the borrowing is to obtain interest relief: the purpose of the borrowing can only be discovered by hearing the taxpayer's explanation for it and evaluating that explanation against what has been done with the borrowed money. If something highly artificial has been done with the borrowed money, then it may appear, despite any explanation to the contrary from the taxpayer, that the purpose of the borrowing was to obtain relief for the interest. But if something commercial has been done with the borrowed money, then relief for the interest is plainly an incident of the transaction and not its purpose or one of its purposes.

Thirdly, a transaction may have a tax avoidance purpose which is, nonetheless, not a main purpose. For example, if a person needs money of a certain amount to carry out a commercial transaction, such as a purchase of an income-yielding asset or a business, and he can only get the money by carrying out some form of arrangement

which produces non-taxable receipts, his main purpose may be to get the money, and the tax avoidance may only be something that happens in the course of getting the money rather than the purpose of the transaction. This was the position in the highly helpful case of *Brebner* and in *Clarke v. IRC*. In *Brebner*, Lord Upjohn says this at 43 TC 718H to 719A:

> "My Lords, I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong as a *necessary* consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant facts before them and the proper inferences to be drawn from that evidence."

Lastly, a particular issue of law arises in relation to paragraph 13 which is this: "Suppose that a borrowing does have an unallowable purpose, how much of the interest payable by the taxpayer is disallowed under paragraph 13?" Paragraph 13 itself stipulates that the amount not allowable is so much of the debit as, on a just and reasonable apportionment, is attributable to the unallowable purpose. In our context the question posed is "How much of the interest payable by the company is

attributable to a tax avoidance purpose?" There are two schools of thought here: one is that if a borrowing is made for a tax avoidance purpose *all* of the interest is unallowable; and the other is that only that part of the interest payable in order to secure the tax avoidance is unallowable. I favour the second view, but litigation as to which view is right seems imminent.

I might add that a different kind of anti-avoidance provision is to be found in the intellectual property provisions of FA 2002 Schedule 29. Paragraph 111 directs that "tax avoidance arrangements" are to be disregarded and tax avoidance arrangements are defined in terms of arrangements which enable certain types of debit to be obtained. This is different from other UK anti-avoidance provisions because it directs that the arrangements are to be disregarded and other provisions do not do that. It is also different because the provision does not apply only where the relevant arrangement produces a tax benefit but also where it enables the tax benefit to be obtained, so this provision is quite a lot wider than our existing provisions and may be a precursor of a new form of anti-avoidance clause.

If the detailed analysis of a proposal reveals weaknesses there is, of course, no need to go any further: the client should not implement the proposal. But if the proposal is sound in its details there is a need to embark on a third stage of analysis. It is necessary to stand back from the detail of the proposal and look at the matter as a whole, and to ask whether, if challenged in court, it will succeed in its object. The terminology at this stage of the

process has been changing lately. Originally – in early *Ramsay* and *Furniss* days – the question considered was whether the transaction in issue was "real", as distinct from, I suppose, unreal. This was the sort of terminology favoured by Lord Wilberforce in *Ramsay*. At a slightly later stage, a distinction was made between unacceptable tax avoidance and acceptable tax mitigation. This was the terminology favoured by Lord Templeman. Another way of approaching the matter – the way currently favoured by the Courts – is to focus on the purpose of the provisions which are in issue and to construe them in the light of that purpose. As demonstrated by *Westmoreland* and perhaps highlighted even more starkly by the *Barclays Bank v. Mawson* case, in analysing any transaction for tax purposes it is first necessary to identify the statutory provisions which are relevant and then to determine precisely what question those provisions are raising. In the determination of the statutory question, the purpose of the legislation has now been given a paramount role and this will have a huge impact on the approach of the Courts to a transaction. In the *Westmoreland* case the statutory question was "had the interest there in issue been paid as a matter of law?" But the key point to note about *Westmoreland* is *not* the question in that case itself, but the point the case makes that each statutory provision raises its own particular question, which will not necessarily respond to the same sort of analysis as has been adopted in previous cases. Each issue may – indeed, will – require separate analysis. And this is why I think it is a dangerous conceit to believe that *Westmoreland* has liberalised the attitude of the Courts to tax planning. In fact it has created a very

flexible analytical tool which enables the Court to give a profound role to the underlying purpose of the legislation. The points I am making are neatly summarised by what Lords Hope and Nicholls say in *Westmoreland*, and I think if I run what they say together the point becomes very clear. Lord Hope says

> "The only relevant questions here 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?"

And Lord Nicholls says

> "When searching for the meaning with which Parliament has used the statutory language in question, Courts have regard to the underlying purpose that the statutory language is seeking to achieve."

A striking application of these principles is found in the *Barclays Bank v. Mawson* case. In that case a finance leasing transaction was carried out which, it might be thought fell within the wording of the statute but did not attract allowances because it did not fulfil the purpose of the Capital Allowances legislation – see, in particular, paragraph 51h to j of Mr Justice Park's judgement at [2002] STC 1100.

> "In my opinion it is legitimate to have in mind the points which I have made in the last few paragraphs in considering whether the requirements of s.24 have been met by BZW's scheme. In *Westmoreland*

> [2001] STC 23 at [6], [2001] WLR 377 Lord Nicholls said:
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> 'When searching for the meaning with which Parliament has used the statutory language in question, courts have regard to the underlying purpose that the statutory language is seeking to achieve … weight is given to the purpose and spirit of the legislation'
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> As regards finance leasing the underlying purpose of Parliament, in my view, is to enable capital allowances to be used so as to provide to lessees at attractive rates finance for them to use and to develop their real business activities. The underlying purpose of Parliament is not to enable cash payments to be made annually to third parties who are able to provide a major item of machinery or plant which satisfies one of the conditions for a finance lessor to claim the allowances. Nor is that in accordance with 'the purpose and spirit of the legislation'."

I note, in passing, that how the purpose of the legislation is found is not explained in the cases. Some statutes do clearly have a particular purpose. The purpose of other statutes is less clear; and some statutes have a penumbral spirit, the result of which is that the limits of the apparent purpose are not rigidly defined. In the case of finance leasing, for example, the underlying purpose of Parliament might extend to enabling capital allowances to be used to provide finance *or* (this was not mentioned by the judge) *other business benefits* to lessees; and, if the purpose went that far, the transaction in *Barclays Bank* might properly have attracted allowances. Indeed, there is an issue as to why the purpose of the capital allowances legislation does not go that far. What

difference is there between finance and other business benefits? The question of purpose can be very hard to determine.

Nonetheless, no matter how hard it is to determine, there is now a need to ascertain the underlying purpose of any relevant legislation. So I think one of the functions of the legal adviser, when advising on a tax mitigation proposal, is to consider the purpose of the legislation in an endeavour to see whether the proposal fulfils that purpose. I try to ask myself "Does this proposal use the legislation as it was intended to be used, or does it abuse the legislation?" And I think that there may be a third category, distinct from use and abuse, which is skilful navigation – not definitely fulfilling the purpose of the legislation but not abusing it either. I do not pretend that this task of deciding whether a proposal uses, abuses or skilfully navigates the legislation is an easy one. In some cases views as to what the purpose of legislation is can differ. As I have indicated, we might not all agree with Park J's statement as to the purpose of the capital allowances legislation. But on other occasions, the point can be clear and, where it is clear, I think it is the legal adviser's responsibility to say so and to discourage his clients from implementing proposals which are an abuse of the legislation.

There is a great deal of pressure put on people to do tax schemes and put on advisers to say that they work; and it takes some courage to say that they don't. But it is a job that should not be shirked, especially given the approach of the Courts demonstrated by

Westmoreland and, as I say, highlighted by the *Barclays Bank* case. However, where a proposal uses the legislation properly, or skilfully navigates around its pitfalls then I think the legal adviser can approve of the proposal, and it is in this sort of area that the future of tax mitigation lies.

Before leaving this second situation – the tax mitigation proposal – there is one other point I should make. Many of the currently available tax mitigation proposals seek to rely on Revenue practice statements, such as SPD 12 in the context of partnerships. The view often put to Counsel is that these statements are binding on the Revenue and so can be relied upon by the taxpayer. For my own part, I think this is very doubtful: there is no reported case in which the revenue have been held bound by a substantive statement of the law which the Court considers to be wrong. There are, of course, statements in the cases by eminent judges that the Revenue may be bound by such statements – but, in the end, the Revenue have not been held bound on any substantive (as distinct from procedural matter) even where they have entered into a specific agreement. So I think the view that the Revenue are bound by practice statements is highly optimistic, and I try to discourage clients from relying on them where it seems to me that they do not accord with the law.

If a client, who has been told not to by his legal adviser, implements a proposal, it is almost inevitable that the third situation I envisaged at the beginning of this talk will arise: the client will come back to say that

he is involved in a dispute with the Revenue. I should, of course, add that this is possible even where the adviser has said that it is sensible to implement the scheme: any tax mitigation transaction carries with it the risk of dispute which cannot be ignored. At the dispute stage the legal adviser has two functions. First, he must guide the correspondence with the Revenue and second, he must advise on the preparations for a contested hearing. During the dispute stage the Revenue will very often ask for information, particularly in relation to the purposes with which a transaction was carried out, and the Revenue will seek documents. One question which a legal adviser is frequently asked is what documents should be provided to the Revenue. My own answer is always that every document should be provided to the Revenue.

In this connection, however, it must be remembered that the s.20 powers of the Revenue are subject to three limitations in relation to documents which attract legal professional privilege or some other similar form of protection. First the Revenue cannot obtain documents which are the subject of legal professional privilege. They cannot obtain these documents either from the taxpayer himself or from his adviser, unless the taxpayer is willing to provide them. This has been made clear by the *Morgan Grenfell* case in the House of Lords. It should be noted, however, that legal professional privilege is not as wide as is sometimes thought. In general terms it extends to all communications between the client and his legal adviser (or vice versa) for the purpose of obtaining or giving

advice, and it certainly extends to the advice itself. It does not cover original documents implementing a proposal nor, unless they can be characterised as advice, drafts of those documents or copies of them. Secondly s.20B(2) creates a limited form of litigation privilege so that a party to an appeal does not have to produce documents relating to the conduct of the appeal. It should be noted that this protection only applies where a s.20 notice is given by an Inspector and not where it is given by the Board. Thirdly, under s.20B(9) a tax adviser does not have to deliver or make available documents which are his property and which contain advice about tax. This protection is subject to the limitations in s.20B(11) and (12) so that advice explaining a tax return can be obtained from a tax adviser, but the Revenue have given certain assurances as to the way in which they will use these powers in paragraphs 10 and 11 of SP5/90, which read as follows:

> "10 Accountants' working papers will not be called for on a routine basis. The Revenue will normally do so in connection with enquiries into a client's tax affairs only where they have been unable to satisfy themselves otherwise that the client's accounts or returns are complete and correct. Although the new provisions give the Revenue formal powers to require access to accountants' working papers, this has been given in the past on a voluntary basis where appropriate. The Revenue will continue their general policy of seeking access on a voluntary basis and will use their formal powers only where they consider it absolutely necessary.
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> 11 Requests will be limited as far as possible to information explaining specific entries. But there

> may be occasions when the Revenue will wish to examine the whole or a particular part of the working papers. The Revenue will usually be willing to visit the accountant's office or the client's premises to examine the papers and to take copies or extracts."

It must, however, be noted that advice given by a tax advisor who is not a lawyer is not protected from disclosure by the rules relating to legal professional privilege. Thus, if a taxpayer has in his possession advice given to him by a tax adviser who is not a lawyer, the Revenue can obtain those documents by serving a s.20(1) notice on the taxpayer and this is so notwithstanding the *Morgan Grenfell* decision itself. However it does seem possible that the Courts would strike down an attempt to obtain documents of this sort under Article 8 of the Human Rights Convention. Once the process of Revenue investigation is complete, it may be, and very often is, possible to do a deal with the Revenue without going to Court, but if this is not possible, then the matter will have to go to a hearing and the case will have to be prepared. In my view, the preparation of the case should begin at the same time as the dispute process or, if not then, at least as soon as it seems likely that a settlement will not be reached. Of course, most clients do not want to begin preparing for litigation. There are cost and resource implications, and there is always the hope of settlement, which many fear will somehow recede into a remote galaxy if preparations are begun. But I have a number of reasons for believing that it is best to begin preparing for litigation early. First, litigation is an incremental process. A case looks a bit different each time it is considered.

The sooner one starts thinking about arguing a case, the better the argument presented at trial is likely to be. Secondly, litigation takes time to prepare. There are documents to gather up, and there may be witnesses to interview, and these processes can be lengthy: you do not want to be doing this preparation against the deadline of an incipient hearing date. Thirdly, there is a need to determine what evidence will be needed to prove the case. At the beginning of a tax case, one tends to assume that a lot will be agreed and that the issues on which evidence will be needed will be narrow. But, as the case develops, it may become apparent that there is less common ground than was imagined, and the correct witnesses need to be identified to prove what one might originally have taken for granted. Sometimes it may be necessary to have expert witnesses – and all witnesses should these days provide witness statements which will need to be carefully considered, and all this takes time. But lastly, and most important, the best reason for starting preparation early is this. If you have a good case, or even just a reasonable case in which you believe, an appeal is your right. It is how the taxpayer defends himself against an unjust claim of the Revenue. And by beginning to prepare for litigation – by letting the Revenue know that you have begun – you send the important message that you believe in your case and are willing to fight. And, conversely, if you do not send the message that you are willing to litigate, then, in my view, you send the message that you do not believe in the case. The message that you do believe in your case helps to promote a settlement: the message that you don't has the opposite effect. So the best and strongest reason for

beginning preparation early is that it produces the best prospect of not having to litigate.

A lawyer should never too easily encourage litigation. The Courts are not always easy places; the outcome of litigation, however certain it may appear, is always doubtful, and a settlement is usually better than a fight. But it does not pay to be too frightened of litigation either. And in the dispute phase, the lawyer's role can be to stiffen the sinews and not allow clients too meekly to surrender. If a case does have to be prepared for trial, the lawyer will have valuable input both in the mechanical form of saying what needs to be before the Court and in the more imaginative role of determining just how the case should be put and with what witnesses. And generally it cannot be overstressed that the help of a lawyer – especially counsel – in tax disputes is always beneficial.