

G I T C | REVIEW

VOLUME XVI NUMBER 2
JANUARY 2020

Editor: Milton Grundy

LONDON

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IN THE FOOTSTEPS OF LORD MACNAUGHTON

By Milton Grundy

“Income tax, if I may be pardoned for saying so,” Lord Macnaughton famously observed¹, “is a tax on income. It is not a tax on anything else.” We might go on to say that inheritance tax is a tax only on transfers of assets. And neither of them are taxes on possibilities, hopes or expectations. From which it follows, as is well-known, that UK beneficiaries of a discretionary trust pay no tax on undistributed income and their estates no inheritance tax on their death. In the era of very high taxes after the Second World War, what had been an amenity for the rich and titled in England became the huge industry of the offshore discretionary trust. If we look at the offshore discretionary trust through the eyes of the tax collector, we see that it does three really distasteful things. If the trust fund is £10m and it is invested at 4%, it will produce a yield of £400,000, some of which may be income and some of which may be capital gains, but if the fund had stayed in the hands of the settlor, the tax collector might be looking at collecting half of it – £200,000 – in tax. But if the trustees decide to accumulate the income, he will see no tax at all, and what is more, the £200,000 may be invested next year and produce another untaxed £8,000 and so on and so on – a process of accumulation which, over time, produces such astonishing results that we used to have in England a rule limiting accumulation to lifetime or 21 years – a rule never, for some reason, extended to Ireland, and never, happily for the growth of the offshore industry, extended to the Overseas Territories. And when – to add, our tax collector may think,

insult to injury, the accumulated income comes to be paid to a beneficiary, it may come in the form of capital which is not, in principle, subject to taxes on income or capital gains. As if that were not bad enough, the effect of the discretionary trust is to make assets “disappear” – disappear in the sense that the trust fund is not part of the estate of anyone – not of the settlor and not of the discretionary beneficiaries. It is impossible to guess how much wealth tax, exit tax and – especially – tax on death has been avoided by the use of the discretionary trust by taxpayers in many countries.

The very success of the discretionary trust in escaping tax charges has led many jurisdictions to surround it with a thicket of anti-avoidance provisions. In the United Kingdom, for example, we have provisions for taxing trust income at a specially high rate, for attributing income and capital gains to the settlor and for charging inheritance tax when the trust is made, and again on every tenth anniversary and on distributions. None of this is very new. But there has been in the last few years what I can describe as a change of perception. The change of perception has not just affected discretionary trusts. It has affected trusts of all kinds. You could say the word “Trust” has become a dirty word. There have been HSBC Geneva accounts, Panama papers, Paradise papers – “leaks” of one kind or another, and somehow the public perception now is that anyone connected to a trust is up to no good. It is amusing – but also indicative, that the Society of Trust and Estate Practitioners became so embarrassed by the word “trust” that it resolved to omit it from its name! So what I want to explore here is whether we can have the benefits of the discretionary trust, by using some other kind of vehicle in place of the trust.

Let me begin with a story of long ago. A production company was putting on a musical at a London theatre. Both the composer and the leading lady were famous, and it was

agreed that they should get 15% of the box office receipts in excess of half a million pounds, the 15% to be divided between them in whatever proportion they should decide. By the time the company came to do its accounts, the musician and the star had not come to an agreement. Could the company nevertheless deduct the 15% in computing its profits for tax purposes? And was any part of the 15% taxable as income, either in the hands of the composer or in the hands of the leading lady? It seemed at first anomalous that there could be a trading expense without a receipt, but in fact a receipt is not a requirement for a deduction. What you need is a liability. The company was going to have to pay the 15%. It was only a question of how the payment would be divided between the two of them. In those circumstances, I was happy to advise that the 15% was undoubtedly deductible for the company and not taxable for the individuals. I should like to say that after a long fight with Her Majesty's Revenue, it was eventually held by the House of Lords that my view was correct, their Lordships observing, to my embarrassment, that the Revenue would have been well advised to have listened to Mr Milton Grundy's views in the first place and not waste public money pursuing the appeal. But that did not happen. The show closed after a fortnight and there were no box office takings to distribute. But the story provides an interesting example of the difference between a possibility of income and taxable income – even though, in this case, the person providing the funds for the possibilities gets a deduction for the provision.

This is a story without a happy ending, but I think it is worth the telling, because it illustrates the basic truth, as I said earlier, that income tax is a tax on the taxpayer's income and not on his hopes or expectations. I have found support for this proposition in a UK tax case from 1930, called *Franklin v Commissioners of Inland Revenue*². The case is not very well known and is little noticed in the textbooks. It is about

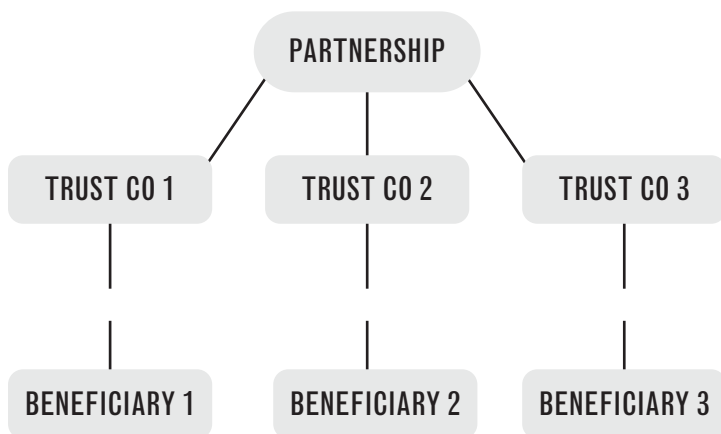
partnership income, but it is of much wider interest. The partnership concerned was the banking firm of Samuel Montagu & Co. One of the partners had died, exercising by his will a right under the partnership deed to appoint his son to be a partner. The other partners did not regard the son as a suitable new partner, and there was disagreement – stretching over many years, and including two sets of proceedings in the High Court – between the son and the remaining partners. While all that was going on, what would have been the son's share of the profit, if he had succeeded in becoming a partner, was accumulated in a reserve. It was eventually decided that the partners were entitled to refuse the son admittance to the partnership, and the accumulated reserve was distributed to the partners, so that each of them got the amount he would have received if the income put to reserve had been distributed year by year. The Court held that amounts put to reserve were not income of the partners. What the case tells us is that where a taxpayer's entitlement to income is, as the judge put it, *contingent upon a fact which is going to happen in a future year*, "it is," he said, "impossible to say that he is entitled to it in the years which passed before that event happens." He is not talking about amounts which are uncertain, but can nevertheless be estimated. An estimate can be brought into an account. This was a case where no estimate could possibly be made: nobody knew at the time whether the partners would succeed in keeping the son of the deceased partner out of the partnership, or whether the son or they would ultimately become entitled to the money placed to reserve. There was therefore nothing which could be brought into account in computing the partners' liability to tax in that year, and – logically – nothing the son could be taxed on in that year, either. This is a statement of the income tax law of the United Kingdom, but I think it reflects a general principle – the principle that sums which cannot be ascertained cannot be

taxed, and one which ought to apply to tax systems everywhere in the world. What I want to do in a moment is to see whether this principle can still be applied to partnerships.

But before I do that, I want to go forward from the year in which the amount is uncertain, and ask what happens when, in some later year, the uncertainty comes to an end and the amount is ascertained. Is the amount then taxable? And if so, is it taxable in the year in which it is ascertained, or is it related back to the earlier year when it would have been taxable if the amount had been known? The UK cases are not very easy to reconcile, but the tendency is to relate the amount back to the earlier year and re-open an earlier assessment, if it is still possible to do so. Other tax systems may well do things differently. But I think one always has to keep at the back of one's mind the possibility that, though it might be all very well to avoid a charge to tax while the discretion remains unexercised, a tax charge may crystallise once it is exercised – bearing in mind that the ability to invest money which would otherwise have gone in tax – even for a limited period – is itself an advantage (provided, of course, that the investment is a success).

Let me stay with the United Kingdom a little longer, and envisage a UK partnership with three partners, carrying on a business in the United Kingdom. 80% of the partnership profits is to be distributed among the partners in shares fixed by the partnership agreement, but 20% of the trading profit is not to be distributed, but will be re-invested in the business and distributed at some future date in such shares as shall then be decided. In the meanwhile, it will be shown in the accounts as a reserve. Is the 20% subject to tax? Well, not in the United Kingdom, because the United Kingdom does not levy tax on partnership income as such. It taxes each partner on his share of partnership income, and so long as I am not entitled to any part of the 20%, it is not my income. One practical disadvantage

of a partnership is that it comes to an end if a partner dies. A structure I have used to overcome this replaces each partner with a trust for his benefit, like this—



I envisage that each trust company holds its interest in the partnership on trust to pay the trust income to the beneficiary for X years and subject thereto as the beneficiary may by deed or will appoint – a “thin” trust. The Beneficiary in each case is beneficially entitled to the income of the trust – that is, the distributions of partnership profits, but let us suppose that distributions are postponed until such time as the beneficiaries are not liable to tax on them – either because they have gone non-resident, or because the time limit for charging tax has expired or for whatever other reason. The really nice thing about this structure is that clients like it: it is not complicated and not difficult to understand. It is, as said, particularly suited to clients who are resident in a jurisdiction which taxes partners rather than partnerships, but it does in any case have the advantage, whatever the tax regime of the beneficiaries, that the partnership is unaffected

by the death of a beneficiary, and – incidentally – the beneficiaries get the benefit of limited liability.

I will leave partnerships now and turn to companies. Is there some corporate vehicle which has the same sort of effect as the discretionary trust? The obvious candidate, of course, is the foundation. The Liechtenstein Foundation has been popular for many years. It is a creature of statute, and owes nothing to those concepts of fairness and justice – the rules of equity – which are the basis of the anglo-saxon trust. It came into existence in 1926 – a year not without other claims to fame. The Liechtenstein Foundation is not something on which I can speak with any authority or any real insight. In fact, the more I know about it, the less I understand it. I was shocked a little while ago to learn that the founder can lawfully provide that if any beneficiary has any complaint against the governing body of the foundation and goes to law to find a remedy, he will be automatically excluded from all future benefit! But whatever the merits and shortcomings of the foundation, I do not think it really has any place in a survey of alternatives to the trust. The imaginary client wants to avoid the trust, because he thinks the word carries the message of avoidance, and he does not want to be stigmatised as an “avoider”. Is he going to be any happier being connected with a “foundation”? I, for my part, do not think he is. But I can see there is an opposite view: “foundation” is the label attached to many charitable bodies – the Ford Foundation, for instance. In the early years of this century, it became fashionable for jurisdictions with English-style trusts to provide a corporate alternative. It is in the form of a statutory foundation. There is a list of these jurisdictions in the Appendix below, and I have included Cyprus, which enacted such a provision many years earlier. But to carry this train of thought to what I suppose is its ultimate destination, are we just talking costumes here? Could we not give our discretionary trust a name excluding the word

“trust” and using instead the word *foundation*? “I am a beneficiary under the Soloman Grundy Foundation.” How does it sound?

But I digress. Let us leave aside the corporate foundation, and look at the common corporate vehicle – the company limited by shares. Can a regular limited company function like a discretionary trust? Well, I think the first thing to be said is such a thing is possible – very unusual, perhaps, but possible. I looked back in my archive and found a constitution I had drafted for a discretionary company dated 1980! I do not now recall what impelled the client to ask for a discretionary company in 1980, but nowadays I can quite see that to be associated with a company is somehow more respectable than to be associated with a trust, at any rate in a domestic context, even though – ironically – trust income and gains may be taxed more heavily than income and gains of a company. In an offshore context, I think we need to consider the image of the jurisdiction as well as the image of the vehicle. If what we want to achieve is to circumvent the popular prejudice against offshore trusts, we need to move away from the well-known zero tax centres as well as move away from trusts. If I say, ‘I am a beneficiary of a discretionary trust in the Cayman Islands’, I am obviously a wicked tax avoider. But if I say I have some shares in a company in Uruguay, people will take me for a shrewd investor.

A positive advantage of the company to practitioners with a civil law background is that they know what kind of entity they are dealing with. The trust, on the other hand, comes with all the baggage of a couple of centuries of the Court of Equity, with its perpetuity period, and *cy-près* doctrine and rule in *Andrews v Partington*. But the trust was invented for the purposes of conferring bounty on others, whereas the company’s purpose was to confer limited liability on investors, and it is only natural that we find problems when we apply one for the purposes of the other. The first that springs to

mind is lack of mobility. By replacing the trustee in one jurisdiction by a trustee in another, the trust can migrate in a moment, without any permission from anybody. Some countries allow companies to redomicile themselves elsewhere, but the process is more cumbersome, and of course if my reason for leaving the jurisdiction is because a revolution has installed a dictator, I may find that redomiciliation has already been forbidden. A serious disadvantage of the corporate form comes in the matter of succession. There is no way for the constitution of a company to confer rights on an unborn person. The constitution can provide for parents to be entitled to new shares for a new child, but that would be a right vested in the parents, and if they forget or die or for some other reason do not do it, the child has no remedy. But shares may be gifted or settled, and the UK taxpayer may find that a combination of gifts to living descendants and settlements for unborn ones offers the ideal structure.

It is worth pausing for a moment, to reflect what a revolutionary departure this is: companies, as we know them, are – yes – there for their shareholders, but for their shareholders only in an abstract sense. They do not have to know whether a shareholder has needs, or is married or infirm or insolvent. The company does not need to know whether a shareholder has any beneficial ownership in the shares at all. Discretionary trustees, on the other hand, need to know about all of these things, and if we are going to construct a kind of discretionary company embodying all these features, we are going to have to do some hard thinking. What happens if one of the shareholders is unhappy with the treatment he is getting from the directors? Will the Companies Court take on the obligation to guide the directors in the way a Court of Equity would feel obliged to guide trustees? One point where the difference emerges – between trustees who are focussed on the needs and aspirations of beneficiaries and directors assuming similar

obligations, is when the point arrives that the directors want to distribute a sum which would reduce share value below par. In principle, dividends are declared out of profits. What happens if there are no profits? I think some offshore funds in corporate form have issued participating preference shares at a premium, and I believe that some jurisdictions – and Jersey is one of them – will let you redeem preference shares otherwise than out of profits. Otherwise, I suppose the company will have to go to the court for permission to reduce its capital, and how is the court going to react to a proposal to reduce the capital of the company – giving £X pounds to one, half £X to another, a token amount to a third? One escape from this problem is to use – not a company limited by shares, but a company limited by guarantee. These are commonly used in England as a corporate form of charity. There are, typically, just a few guarantors, each guaranteeing only a nominal sum, the substantial assets being given to the company by one or more founders and these assets can be distributed down to the last penny if that is when the guarantors want. The model is quite easily adapted by substituting individuals for charitable purposes, and – behold! – the draftsman's problems are solved.

But not quite. An intending benefactor may see it as a disadvantage of the corporate form that it does not enable him to rule from the grave in the same way he can with the trust. If the beneficiaries are shareholders, they can always get together and pass a resolution to make whatever changes in the constitution of the company they choose. And even if you use some corporate body which does not have shareholders, like a company limited by guarantee, there are always going to be some people – directors, committee members, guardians, whoever – who are going to have the power to make changes. You may know the story of Sergeant's Inn. The Inns are rather like university colleges for students of the law. This particular

Inn was founded in the 15th century and took the form of an unincorporated association. By the 1870s its members had dwindled to a very few, and it no longer had any students. But what it did have was a substantial property in Chancery Lane, and a property in Chancery Lane was, even in those days, an asset of considerable value. So the members called a meeting, to decide what to do next. They could start a new legal education programme and recruit some new students. But then it occurred to them that nothing in their charter forced them to do that. And moreover, there was nothing in their charter to prevent them forgetting about education altogether, selling the building and dividing the proceeds amongst themselves. Which they did, and lived happily ever after.

This story should discourage any intending donor from entrusting any significant sum to a discretionary company. Is there anything we can do to solve the problem? Well, I think we might take a tip from the Charity Commissioners in the United Kingdom. There used to be nothing in the Charities Act to prevent trustees from altering the memorandum of association of a charitable company, to take out charitable objects and insert “for the benefit of Milton Grundy absolutely.” It was just that the Charity Commissioners would not recognise the company as a charity unless its memorandum included language providing that the objects could only be changed with the prior consent of the Commissioners, which of course in such a case they would not give. If the company was not recognised as a charity by the Commissioners, one consequence was that it would not be recognised as a charity by HMRC. And so, of course, in practice, UK charitable companies had such a proviso. For charitable companies, this manoeuvre is now forbidden by statute, but can we adapt this mechanism for a discretionary company? I have never seen it done in practice, but I have toyed with the idea of vesting the right to give or withhold consent to any change in the memorandum

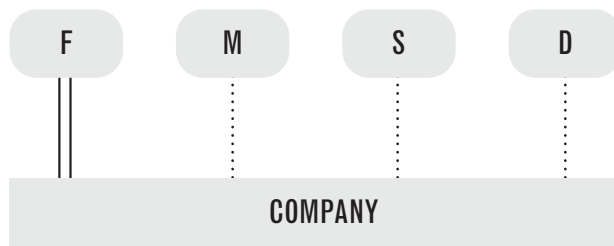
of the company in a trustee for the benefit of the same beneficiaries.

On the other hand, there is the kind of client who does not want the future of the family fortune to be determined by a trust, but prefers a structure where the power is shared out among family members. For such a client a corporate vehicle could be an option. I see no reason why shareholders, or guarantors for that matter, should have to share dividends equally, if the constitution of the company provides otherwise. It is only a matter of drafting. Distribution may not be all that tax efficient, but for UK taxpayers, at least, accumulation in a company – with no tax on UK dividends, and 18% on everything else, is a great improvement on accumulation in a trust, with a 40% income tax rate and an inheritance tax charge every ten years and on distributions. I think the establishment of the discretionary company will carry the same 20% inheritance tax entrance charge as the trust, but no ten year charge and no exit charge. Of course, the zero-tax offshore company can in some circumstances be more tax efficient, but then we come back to the problem I discussed earlier – that some clients are going to think that they do not want to be associated with a vehicle established in a jurisdiction associated in the public mind with tax avoidance.

Is there a half-way house – the jurisdiction which behaves like an offshore jurisdiction, but does it not look like one? I mentioned Uruguay. It has a territorial system, not essentially different from that of Gibraltar or Panama, but without the suggestion of avoidance. I once used a company incorporated in Botswana. It was managed and controlled in Gibraltar and therefore non-resident for tax purposes, but nobody outside the government office in Gaborne knew this, and the company attracted no attention from any journalist. Botswana is perhaps a little exotic for most clients, but is worth mentioning, if only to make the two vehicles I am now going to talk about seem

more run-of-the-mill. One is the English company resident in Barbados and effectively free of tax on income not arising in Barbados. The other is the Limited Liability Company incorporated in one of the states in the United States which imposes no state tax, all of whose members are non-resident aliens. It is effectively free of tax on non-US income. These are big topics, on which I can touch only fleetingly here. I have not actually tried the UK/Barbados route, but I have tried a discretionary LLC in Texas, which worked for many years without problems.

Let me come back onshore again, and consider whether there is a way of combining the security of the trust with the tax advantage of a company? Well, consider this –



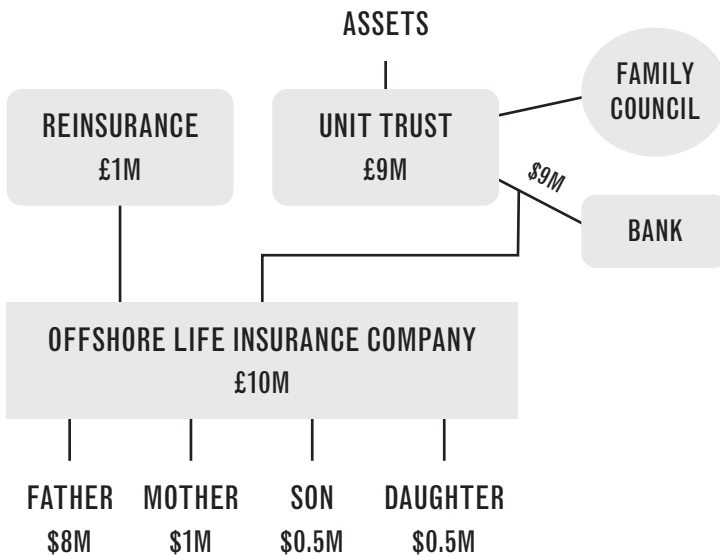
Father – “F” in the left-hand circle – forms an investment company whose constitution reserves to the directors a discretion to determine which, if any, of the ordinary shareholders is to receive a dividend and how much is to be paid to each of them. He subscribes for all the ordinary shares, which he gives away to members of his family – mother, son and daughter, shown here as “M”, “S” and “D”, their ordinary shares shown as dotted lines. Father himself takes a single share, which I show as a double line. This is a “golden” share: it has little value in itself, but carries 51% of the votes and can thereby determine the identity of the board members, who in turn have power to determine the distributions, if any, to be

made to the family members – a role similar to that of the Protector in the usual kind of discretionary trust. Father could even settle the golden share, on trusts bequeathing its very extensive powers to future holders of that office.

I have mentioned ways of having an offshore company without appearing to do so. But if we move from *offshore company* to *offshore unit trust* we enter a completely different world. Lots of people have offshore unit trust units. It is true there was a bit of a flutter when the Panama leaks revealed that our then Prime Minister's father had them. And when the Queen of England was discovered to own some. But I think it is fair to say that offshore investment funds are respectable. An offshore unit trust with a corporate trustee will do everything an offshore company can do – accumulate tax-free income and capital gains and distribute as little or as much of them as it cares. I think I am the only person who has drafted a discretionary unit trust, but I am here to say that there is no mystery to it: the trustees of a unit trust can be given a discretion, just like the trustees of any other trust, and just like the directors of the discretionary company. And the unit trust has the advantage over most companies – that you do not have to worry about distributions reducing share capital, and an advantage over all companies – that, like any other trust, it can be redomiciled in another jurisdiction at the stroke of a pen.

Is there a way to apply the discretionary principle to life insurance policies? I do not think anybody ever has done so in the past, but that is no reason to refrain from doing so in the future. I am conscious that we are in uncharted territory here, and one of the first questions we are going to have to ask is, who is going to be our insurance company? I doubt very much whether any of the major insurance companies would want to do this kind of business. In many countries, they have managed to get a quite favourable tax treatment for insurance policies, and they may well see the instant tax freedom offered by the

discretionary policy as endangering their good relations with government. A smaller company, on the other hand, may see here a promising new line of business, which it cannot afford to refuse. I will assume, for present purposes, that we have found a company in an offshore jurisdiction, willing to do the business. The problem from the policyholder's point of view, is risk – the risk that some act by the company (and it may be an act wholly unconnected with the policy) will make the company insolvent, with the policyholder sharing the loss with other creditors. Is there a way to ring-fence the assets allocated to the policy so as to avoid the risk? Well, let us try this.



Here is an imaginary offshore life insurance company. It has issued four life policies – one to Father, who has paid a premium of \$8m, one to Mother for \$1m and one to Son and to Daughter who have paid half a million each. Suppose the insurance company spends one out of the \$10m to re-insure

the life risks and has \$9m to invest. The bank creates a unit trust and subscribes for 9m units of \$1 each. It then sells the units to the insurance company which allocates 80% to Father's policy 10% to Mother's and 5% each to Son and Daughter. The unit trust invests the \$9m in the assets the family wants to hold – shares in quoted or unquoted companies, properties, yachts, art, holiday homes and so on, and (if any of the policyholders' is UK resident) makes its investments through a subtrust. The policies provide for a sum to be payable on death, 10% of which is a fixed sum payable in cash and 90% depends on the value of the units allocated to the policy.

So far so good, you may say, but where is the discretion? The discretion is in the constitution of the unit trust. I envisage that the unit trust will be in the form of what I have elsewhere³ called the *Fortress Trust*, that is to say, a unit trust where the unit holders cannot be sure what distribution of income or capital they will get from the trustee, because that is left to the discretion of the trustee and requires the unanimous consent (in this case) of the Family Council. The assets allocated to the policy are not, of course, the shares, properties, boats and so on. These are owned by the trustee of the unit trust, and it is the units which belong to the insurance company. Let us suppose that the worst happens and the 9m units are now in the hands of a liquidator of the insurance company. Are the units worth anything? In the absence of agreement with the Family Council, the unitholders have the right to sit out the rest of the Perpetuity Period, and then to enjoy whatever distributions are determined by the trustee – the trustee being a person owing his office to the Family Council. In these circumstances the liquidator is going to be open to an offer by the family to purchase the units for a nominal amount.

I said that the bank creates the unit trust, subscribes for the units and sells them to the insurance company. 'Why', you may ask, 'do we need the bank? Why cannot the company just

subscribe for units?’ Well, it could. And I expect the tax effect would be much the same, with income and gains accumulated within the unit trust, and the units allocated to each policy having a nil value, even though all the units taken together have a value equal to the value of the trust fund. There is however an advantage to a UK taxpayer who is a policy holder, and that is that – in my view at least – the income of the unit trust does not arise to the trustee by reason of any transfer of assets made by him and therefore cannot be attributed to him under our “transfer of assets” provisions. But my more general reason for preferring purchase to issue is the obstacle it places in the way of the creditor who would like to have access to the trust fund. Insolvency is not my area of the law, but my understanding is that if the insurance company subscribes for units at a total premium of 9m, the creditor may try to set aside that transaction and claim the \$9m from the trustee. But if the insurance company has bought the units from the bank, the creditors can only go against the bank and have no way of laying their hands on the assets in the trust fund. The use of the discretionary units will also protect the family fortune in the event of the insolvency of one of the family members. If, in my example, Father were to become insolvent, the creditors would get the benefit of the life cover, but have no access to the assets which I show at the top of the diagram, which would continue to be held by the trustee of the unit trust for the benefit of the family. Part of the charm of the insurance policy as an asset-holding vehicle is that nowhere is there – for the time being any at rate – a register of beneficial owners of policies. And the insurance industry is such a powerful lobby everywhere that one might expect them to put up a successful resistance to any change in the *status quo*. Moreover, taking out a foreign life policy does not automatically brand you as a tax avoider.

I shall say no more on the possible income and capital gains tax savings to me made by a discretionary policy. These are of

course going to depend on the tax regime applicable to the policy-holders, but I venture to say that the benefits of a policy are unlikely to be less than the benefits of a trust. Where the discretionary vehicle comes into its own is in the field of exit tax, estate tax and inheritance tax. On the death of a policy holder, the life company will place only a nominal value on the units, and it is hard to see what arguments could be raised by any taxing authority to attribute to the policy any value significantly higher than the death benefit. And it is also very possible that the taxing authorities would not see any reason to challenge the valuation, if there had been no occasion for the payment of the premium or the issue of the policy, let alone the constitution of the unit trust, to come to their attention.

I am rather drawn to the discretionary policy. Of course, it has novelty value, which makes it a great topic for a GITC Review article. And it is a Milton Grundy original, so I can glow with inventor's pride. But it does not *look* like a novelty. Offshore policies linked to unit trusts are quite common: in the United Kingdom they are widely marketed under the name "offshore bonds" and have a well-established tax regime, with income tax postponed until disposal, and allowing an annual 5% tax-free drawdown of the premium. Lots of people have them. And in tax matters, it is never a good idea to stand out from the crowd. A little while ago one of my colleagues in these chambers was involved in a case⁴ where the client had decided he would like to be non-resident. So he berthed his yacht in Monte-Carlo and spent in England only the days indicated as permissible in HMRC's then guidance notes – IR20. Then a Daily Mail journalist spotted his private plane landing in Blackpool airport on a regular basis, found he spent three days a week in his office and spent the intervening night in his old home in Skelmersdale. Then came the denunciations in the newspaper indicating that Her Majesty's Revenue and Customs had been hoodwinked by a taxpayer

smarter than they, and so on and so on. Naturally, staff at HMRC were stung, and there followed years and years of litigation. The charm of the discretionary policy is that there is no yacht, no Monte-Carlo, no private plane. It is well-nigh impossible for journalists to make out of an insurance policy a story to captivate his readers. Indeed, it is quite hard to say what tax is avoided. And from popular disapproval, it is saved by its sheer dullness. As you may gather, my top choice of discretionary non-trust is the discretionary offshore policy.

Appendix

Anguilla (2006)
Antigua (2006)
Bahamas (2004)
Cyprus (1972)
Jersey (2009)
Gibraltar (2017)
Guernsey (2012)
Isle of Man (2011)
Malta (2006)
Nevis (2004)
St Kitts (2003)

Endnotes

1. In *London County Council v A-G* [1901] AC 26
2. 15 TC 464
3. GITC Review Vol XV No 1
4. *Hargreaves v Commissioners* [2019] UK FTT 0244 (TC)

Adapted from a talk given to Itpa last year in Estepona.

IR35 + BEPS + DAC6 = ?

By David Goldberg QC

A little while ago, I had to argue a case about whether certain repayments of petroleum revenue tax should carry interest. Unusually in a tax matter there is no statutorily prescribed method for contesting HMRC's refusal to pay interest, so the challenge we made was by way of ordinary civil litigation. There were a number of interesting features about the case, but one of them was the relief I was seeking: I was not asking the Court to order HMRC to pay interest to my clients: I was just asking the Court to declare that the repayments in question carried interest, and, assuming that I got that declaration, I would then just sit back, as it were, and wait for HMRC to do what they ought to do. And, no matter what we might think about the Revenue, we all expected that they would do just that – and pay the interest. There are all sorts of situations in which declaratory relief is sought nowadays: the declaration is quite often aimed at some part of government, but all conditions of person can be affected by a declaration; the common feature of this kind of litigation is that, in the end, someone is told, "You ought to do that", and then they do it.

Legal philosophers spend quite a bit of time asking themselves why people do what they ought to do when they are not compelled to do it. The answer quite often given is that, long ago, people were compelled by the use of brute force to do things that a powerful sovereign or neighbour thought they ought to do, and, then – over time – societies became more consensual, and they managed to agree on a common way of doing things. And that brought the added advantage that, on the whole, violence could be done away with. The philosophers tell us that this degree of consensus can only be

achieved when a society has respect for its laws and its institutions. Doing what you ought to do, just because you ought to do it, is a sign of a civilised, mutually respectful society: my hope that if, in that litigation, I secured the declaration that I wanted, HMRC would do what they ought to do – shows that I had at least some belief that I lived in a civilised society; I did not expect to have to use force to make HMRC do what they ought to do. Civilisation cannot, of course, be unilateral: a society, in which one group did things without compulsion just because they ought to do them and another group only did things when compelled by force, could hardly be happy; and I do not think unhappiness is caused only by the actual use of force. A happy, civilised state, is one in which all groups have roughly equivalent expectations of each other: we all behave in a particular way because we are expected to do that and not because we are made to do it.

But, sometimes, when I think about the state of our tax system, I do wonder if we live in a society which can truly call itself civilised: does the group we call the Revenue and the group we call the taxpayers have similar expectations of each other, or has one been given excessive power over the other? In a phrase of which I am rather fond, the economist Joseph Schumpeter said that “You can hear the thunder of a nation’s history in its fiscal policy”. He meant, of course, that you could tell when a country was planning to go to war by how much money it was raising and what it was spending it on. But I am sure that we can tell more than that from a nation’s fiscal policy. And, here, I do not refer to the economics of that policy but to the machinery. There is, I think, a widespread belief that, nowadays, we should treat a claimant for social security benefits who lies on his claim form and a taxpayer who makes a mistake in his tax return (especially if the mistake relates to an overseas matter) in the same way, even though the former has been active in promoting error while the latter is, at worst, passive.

I understand why the belief exists, but I am not sure that I fully accept it: it does seem to me that we should have different expectations of those who contribute and those who take; and I have some concern that we are both asking too much, in terms of compliance, of those who contribute, and, are seeking to enforce that excessive demand by something akin to force. If I am right, the question arises whether the law deserves respect. And it can only do so if it passes a fourfold test.

First, it must be at least relatively intelligible and fair.

Secondly, it should respect legal choices and structures, recognising that people can choose to do things in different ways.

Thirdly, it must hold a proper balance between the ability of the State to demand money and the right of the citizen to challenge that demand.

Fourthly, it should show a proper respect to those who are subject to it.

I doubt if our tax system presently meets that test. Indeed, from my standpoint, the philosophy underlying our tax code is that it should set traps for people and then gleefully punish those who fall into them. I shall seek to illustrate my thesis by reference to three specific topics – IR35, BEPS, DAC 6, and, more generally, by considering the way the tax world is going.

Let me start with IR35. In some ways, being an employee is a bore particularly because, instead of getting what you are supposed to be paid, you get your money after stoppages for PAYE income tax and national insurance. Of course, in other ways, being an employee is quite liberating: it frees you to a large extent from the obligation to complete a tax return, which

means that you can go about your life without worrying too much about tax or the compliance burden. But, after all, a bird in the hand is worth two in the bush. So it is very good if you can get out of those stoppages. Of course, if you are going to work for – say – X, for a full working week, it seems fairly obvious that you will be employed by X and he will make those stoppages.

But is that what the analysis would be, if you formed a company which agreed to hire your services to X in return for a fee, and your company then paid you dividends instead of wages? Going back about 20 years, that would have been a wizard wheeze: there is clearly no employment relationship between your company and X, so X could pay the company gross (though, depending on the turnover, the company might have to charge VAT); and the company could pay you dividends which, when corporation tax and the tax credit were taken into account, carried what was in comparison to an employment a very attractive rate of tax. What you would have done, by entering into that arrangement, was to turn what would have been employment income carrying PAYE and NICs into dividend income – paid after corporation tax and then bearing the appropriate rate of income tax: you would have saved some tax, but I rather doubt if you would have thought of yourself as avoiding tax. I am quite sure that no one doing that would have thought themselves wicked, particularly because the arrangement had real consequences as against the State and third parties: one of those real consequences was that your protections against X taking a decision not to use your services, and the possible claims you might be able to make against the State, were significantly reduced. And it worked. It never seemed to me that an arrangement of that kind was objectionable: no doubt, it saved a bit of tax but, case by case, it does not appear to be large scale tax avoidance.

But it turns out that tens and tens of thousands of people were doing that sort of thing – people like nurses working for the NHS – and the government got a bit fed up with it, and they

enacted what is generally known as IR35, the main provision of which is found in ITEPA 2003 s.49. IR 35 applies where –

1. an individual, called the worker, personally performs or is under an obligation to perform services for another person, called the client;
2. the services are provided through an intermediary – what I referred to earlier as your company – rather than under a contract between the worker and the client; and
3. the circumstances are such that, if the services were provided under a contract directly between the client and the worker, the worker would be regarded for *income tax purposes* as an employee of the client. (And here the concept of *employee* is a strict one: a taxpayer does not escape the IR35 by saying not be in a true employment).

Where those three conditions are satisfied, as things stand, the intermediary – what I have been calling *your company* – has to pay the income tax and NICs that would have been due if there had been a direct employment relationship between the worker and the client.

These rules did not – for reasons I shall explain in a moment – work terribly well: they have caused a great many disputes. So, in an endeavour to reduce the disputes – and, I suppose, to make these provisions seem fairer than they presently do – the burden of applying the rules is, from next year, being moved from the intermediary to the client; and I sense that there are many clients here who want to know when they should be applying IR35 and when not. I say that the changes to IR35 are designed to make the rules seem fairer, because, as the IR35 cases now being heard show, very often the client has imposed the requirement for there to be an intermediary, and it does seem quite fair that the person who insisted on the arrangement in issue should bear the risks attaching to it.

In general terms, there is no difficulty in deciding whether the first two conditions for the application of IR35 – personal

performance and no direct contract – are fulfilled: the problems arise with the third condition, which is the employment condition. How do you tell whether a person with whom you do not have a direct contractual relationship would be an employee if you did have that relationship? The first thing you have to do is to invent the contract that would have existed if there had been one, and, in doing that, you have to do a bit of guessing. What terms would you have put in it? There will, of course, be an agreement between the intermediary and the client and that agreement may tell you a lot about what would go in the direct contract between the client and the worker if one existed. That is because, if the intermediary did not exist, the intermediary/client contract would, almost certainly, have been made between the client and the worker, and the importance of the worker in the relationship will often be emphasised by the terms of the intermediary/client relationship. For example, the intermediary/client agreement may require the intermediary to perform its services to the client by using Y and only Y to do the work; and it might also say that the work will be done for fixed periods of so many hours per week: provisions like this (not necessarily in this form, but like this) relating to the time to be spent working and where the work is to be done, tend to be an essential feature of any working relationship, and, since that is so, it is inevitable that they will be part of the hypothetical contract treated for the purposes of IR35 as existing between the client and the worker.

But there might be all sorts of other features which are present in the intermediary/client relationship which might or might not feature in a direct worker/client relationship; and that means that there will be some element of choice as to whether they are included in the hypothetical contract. The theory of course, is that once you have constructed the hypothetical contract, it will be possible to determine from the contractual terms what the relationship between the parties

would be. But there is an element of circularity here: sometimes you cannot construct the hypothetical contract without knowing the true character of the worker. Most people would, I think, say that, in considering whether IR35 applies or not, constructing the hypothetical contract must precede any determination of the worker's status as an employee or not. And that is certainly logical. But it may be more honest to recognise that, sometimes, you cannot determine what terms will be in the hypothetical contract, until you know something about the worker and his or her character absent the contract. I rather think that the process might be iterative, so that the terms which you decide would be in the direct relationship hypothetical contract can only be determined once you have decided whether the worker is going to be self-employed or employed. In any event, and no matter what the order in which you do things or think you should do things, it is going to be necessary at some point to confront the question of whether the worker is an employee or not: you can do that after you have decided what the terms of the direct contract would be, or you can do it before then and allow it to inform your view of what will be in the hypothetical contract, but, either way, you cannot avoid answering the question. How do you go about doing that?

As with most areas of the law, the way in which we determine whether a person is an employee or not is developing: before the Second World War, the test was whether the person in question took orders, but that has rather gone out of fashion today; in the 1950s a distinction was made between a contract of service (which was an employment) and a contract for services (which was not an employment). The modern starting point for the enquiry is nowadays said to be found in the 1968 decision in the case of *Ready Mixed Concrete* in which McKenna J said this:

“A contract of service exists if these three conditions are fulfilled. (i) The servant agrees that, in consideration of a wage or other remuneration, he will provide his own

work and skill in the performance of some service for his master. (ii) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's control in a sufficient degree to make that other master. (iii) The other provisions of the contract are consistent with its being a contract of service”.

This passage is often trotted out like some charming mantra which will provide the answer to the question, but – actually – on analysis, it says nothing. It is to be noted that it uses the terms servant and master, which are not common currency of the day and are not defined by the test – which is supposed to tell us whether there is a servant and master. In other words, the test is circular: if there is a servant and master, there is a servant and master. If we think in terms of a person other than a servant or master, the so-called test still tells us nothing.

The first limb of the test requires a person to agree that, in consideration of a wage or other remuneration, he will provide his own work and skill in performing a service. This is known as the mutuality obligation or, sometimes, as the wage/work bargain: one person provides work, the other pay. The existence of mutuality is essential to the contract of employment. If there is no mutuality, there is no employment. It sounds as if we are really beginning to get somewhere. But are we? Surely this mutuality obligation is only a requirement that there be a contract and contracts can exist between all sorts of different types of people: the existence of a contract cannot, on its own, be the test of whether there is an employment because there are many contracts which are not contracts of employment. Since the existence of a contract cannot, of itself, mean that there is an employment contract, the first limb is more or less a given in any relationship and not truly an indication of employment.

The second limb of the test is that the putative employee agrees that, in the performance of the agreed service, he will

be subject to the putative employer's control in a sufficient degree to make the putative employer the master. But nearly every contract provides for elements of control: for example, when I call the plumber, he has to do the job I have asked him to do, in the place and at the time I ask him to do it. There are certainly elements of control here. But are they sufficient to create an employment? The test does not answer that question. Almost every contract for work is, on the face of it, going to satisfy the first two limbs of the test: when I appear in Court. I am – nowadays - allowed to do that under a contract which will satisfy those two tests. I am fairly certain that I am not an employee, but why do I think that?

Perhaps the answer lies in the third limb of the test, which is that the other provisions of the contract (those which do not relate to the wage/work bargain or to control) are consistent with it being a contract of service. But what does that mean? What guidelines does it give us? And in determining whether the contracts are consistent with employment or not, what do I look at? Is it only the terms of the contract? If it is, the terms of the hypothetical worker/client direct contract are going to be very important indeed. Indeed, in my view, this third limb of the test is the one which carries all the weight. The way the test works is that, if the first two limbs are satisfied, there is an employment unless the existence of an employment, is negated by other factors. So this third limb has a lot of work to do. Just pausing here, I am not so far, at least, giving much hope for anyone who does not want to operate IR35. Given that the first two limbs of this test more or less deem there to be an employment, the safe course might seem to be to assume that there is an employment whenever there is a worker provided by an intermediary.

But that does not seem to be very exciting advice. How can you tell when it is safe to think that IR35 does not apply? The best answer I can give you is, I think, that if the putative

employee is in business on his or her own account, then he or she will not be an employee. So what are the indications of being in business on your own account? The chief indication is that you have a number of clients, who change reasonably frequently and do not give any guarantee of repeat business. The second indication is that you are not guaranteed work, so you do not know whether you will actually earn anything. Many of the recent cases about IR35 concern TV presenters whose intermediary companies were given a guarantee that there would be a minimum amount of work over a fairly long period. In return the company promised that the presenter would turn up at certain specified times in the period. Both of these features are generally hallmarks of an employment. The third indication is the incurring of expenses by the worker which are borne in carrying out work for the client or in trying to find other clients: incurring expenses is generally the hall mark of an independent business. The fourth indication is that the worker is not integrated into the client's business organisation: if the worker does not have a regular place of work at the client's premises and provides his or her own tools for the job, he or she stands rather outside the business organisation and seems to be running his own business.

Where some or all of these features suggest that the worker has his or her own business, that should be enough to prevent the worker being treated as an employee. But, conversely, if the worker has only one client and, in particular, if the client has guaranteed to the worker or to the intermediary that there will be a minimum amount of work for him or her with a fixed payment, these are pretty clear hallmarks of an employment. Of course, there are going to be all sorts of cases which fall somewhere in the middle of the examples I have given, and the question then is, how does the law help you to resolve that type of case? The law used to be a system of apparently black-letter rules, but, in the last few decades, we have seen a blurring

of the hard lines creating something much softer: it has happened in all areas of the law, even tax; we tend nowadays to search for the fair answer. Is it fair to treat the worker as an employee? Is it fair to say that the worker is in business on his own account? If the answer is that he has his own business, there is no need to apply IR35. But err on the side of caution!

Under the new rules coming in this year, there are some quite burdensome information requirements, just as there are if the worker is an employee. There are inconveniences for the user of a worker's services, no matter whether the true relationship is treated as one of employment, as one to which IR35 applies or as one to which IR35 does not apply. Where IR35 applies, it treats as employment something which is not in law an employment. The question which arises is whether it is fair and right for the law to treat something which is not an employment as an employment, especially in circumstances where, apart from tax, the law says there is no employment. As I have mentioned, there can be penalties for being wrong about whether IR35 applies. It seems to me that the burden placed on the taxpayer is higher than is properly justified by the risks to the State: taxpayers, like revenue officials, tend to do what they are expected to do, so penalties do not seem to me to be justifiable.

Let me now turn to BEPS and DAC6 – other matters where the balance between taxpayers and revenue authorities is not quite right. The thinking behind BEPS is that the growth in the digital economy, which allows the value attributable to intangibles to be located outside what might be called the main population centres, has shown that there is something wrong with out national tax systems if they are not working in harmony with each other. According to the OECD's action plan, fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable

income from the activities which generate it: what is needed is a “realignment of taxation and relevant substances to restore the intended effects and benefit of international standards.”

In my (perhaps rather old fashioned) view, this is all nonsense. It might have some coherence, if the view was that every state should tax everybody in the same way so that, whether you conducted your business in China, Peru or Timbuctoo, you ended up paying tax on the same amount of profit. But nobody really thinks that should happen: there are always going to be differences between countries in the way they tax business. Since that is so, it really does not make sense to choose a limited number of transactions and try to align their tax treatment. I also doubt if anybody is, as the OECD say they are, artificially segregating taxable income from the activities which produce it: there is usually a close alignment between profits and the activities which really produce them; it is just that the OECD chooses to characterise as the profit-making operation something which does not truly produce profits. Nonetheless, the OECD wants a realignment to take place, and it is to be achieved by the 15 actions which I have mentioned. On the whole, we can be relatively relaxed about all of them, unless there is a cross-border element, though that is not an absolute rule.

The actions have been grouped under three headings, the first of which is establishing international coherence of corporate taxation which covers Actions 1 to 5. The first action is to think about the digital economy and see how to tackle the opportunities which it provides to taxpayers to make sure (in our context) that profits arise outside the UK rather than in the UK. We here in this country have done some thinking about that, and we have come up with the diverted profits tax, which is capable of increasing the taxable profit of a non-resident doing business here or of a UK resident which has sought to mitigate its tax bill by seeking to exploit tax mismatch

arrangements. The second action is to neutralise the effects of hybrid mismatch arrangements which occur when, for one reason or another, a country allows a deduction for a payment which is then not taxed or not fully taxed in the country where the recipient is resident; and we have done our bit about that with Part 6A of the Taxation (in International and Other Provisions) Act 2016 dealing with hybrid and other mismatches. Actions 3 and 4 relate to limitations on the deduction of interest and other financial payments both for domestic companies and for CFCs, and, here again, we have been active in introducing provisions which are capable of limiting the deductions available for interest. Action 5 is to counter harmful tax practices more effectively, taking into account transparency and substance, which seems to be an action intended to encourage, in particular, non-OECD members not to provide preferential tax regimes. I rather doubt if it will be particularly successful in abolishing preferential tax regimes: whether the OECD likes them or not, they are popular with people who feel that they are being overtaxed, and there are a lot of people like that.

The second heading under which the Actions are grouped is “restoring the full effects and benefits of international standards” and this is dealt with by Actions 6,7,8,9 and 10, which are to prevent treaty abuse, largely by updating the concept of a permanent establishment, and by making transfer pricing rules more sophisticated (by which I mean more effective at locating profits in jurisdictions in which the OECD thinks they should be located) with particular reference to intangibles, risks and capital and other supposedly high-risk transaction. I do not think these actions restore international standards at all: they allow Country A to impose tax on the activities of a resident of Country B who could, up until now, arrange his affairs so as not to pay tax in Country A. That is

not a restoration but a change, allowing the imposition of tax, when it was once accepted that tax should not be charged.

The next four actions – 11 to 14 are under the heading “ensuring transparency while promoting increased certainty and predictability”, and that is to be done by efficient data collection, by requiring taxpayers to disclose their aggressive tax planning arrangements, by thinking even more about transfer pricing, and by making dispute resolution mechanisms more effective. Quite how all this transparency will promote increased certainty and predictability is beyond me. Cutting through the verbiage, Actions 11 to 14 are designed to increase the information-gathering powers of revenue authorities, and experience suggests that doing that will be productive of increased uncertainty and unpredictability. The last action is to develop a multilateral instrument designed to make sure that all the countries are using the same principles in taxing their taxpayers, so that, to adopt the OECD’s language, opportunities for double non taxation do not exist.

Let me put that piece of pie in the sky to one side for the moment and revert to Actions 11 to 14 relating to transparency, because those actions and DAC 6 quite obviously have something to do with each other. DAC 6 requires notification to domestic tax authorities of reportable cross border transactions. Although DAC6 does not require notifications to be made until August 2020, the notifications which have to be made then include notifications of reportable transactions undertaken before August 2020, but only when the first step in the transaction is taken on or after 25th June 2018. So, by the time reporting has to occur, we shall have just over two years of transactions to report. DAC6 raises two initial questions: the first is, what is a reportable cross-border arrangement, and the second, who has to do the reporting. A reportable cross-border arrangement must, of course be

cross-border, though that on its own does not make it reportable. But let us start with the concept of cross-border.

In UK terms, an arrangement is cross-border where it concerns more than one country, and

- a) not all the participants are resident for tax purposes in the same jurisdiction; or
- b) one or more of the participants is simultaneously resident in more than one jurisdiction; or
- c) one or more of the participants carries on business outside the UK through a permanent establishment, and the arrangement forms at least part of the business of the permanent establishment; or
- d) one or more of the participants carries on an activity in another jurisdiction, without being resident there for tax purpose or creating a permanent establishment there; or
- e) the arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

So the type of arrangements which may be cross-border include, for example, reinsurance transactions where the reinsurer is in a different, perhaps low-tax, jurisdiction; cross-border leasing transactions; cross-border financing; the payment of property rentals from one country to another; and securities lending (because that can create issues with the identification of beneficial ownership). Purely domestic transactions are not cross-border.

Even if there is a cross-border transaction, it is not reportable, unless it bears a hallmark: the hallmarks are set out in Annex 4 of Council Directive 2011/16 EU which I found, but only with great difficulty. The hallmarks bear some similarity to those which have to be satisfied before we need to report a transaction under our DOTAS rules but, of course, they are not exactly the same. Some of the hallmarks only exist where the cross-border transaction fulfils the main benefit

test, which is that one of the main benefits of the arrangement is the obtaining of a tax advantage. This is to be defined, - by domestic legislation and here by Article 12 of the proposed statutory instrument – generally in fairly familiar terms, but, in a way which is quite novel, only catches a tax advantage where the obtaining of it cannot reasonably be regarded as consistent with the principles and policy objectives on which the provisions giving rise to the tax advantage are based.

Other hallmarks exist regardless of whether they give rise to a tax advantage or not. Each hallmark is identified by a letter. The hallmarks which have to satisfy the main benefit test are (using the lettering adopted in Annex 4) –

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| Hallmark A | which essentially relates to marketed tax avoidance arrangements, that is, arrangements where a participant has to enter into a confidentiality undertaking, or which have standardised documentation or where there is an intermediary who gets a fee fixed by reference to whether the arrangement achieves a tax saving or by reference to how much it saves; |
| Hallmark B | arrangements involving the use of loss-making companies and their losses, the conversion of income into capital or into non-taxable income or the use of circular transactions; and |
| Hallmark c(b)(1), (c) and (d) of Category C1 | arrangements involving cross-border deductible payments, where the recipient does not bear tax on what he gets or gets preferential tax treatment on what he gets. |

The hallmarks which do not have to satisfy the main benefit test are those falling in the rest of Hallmarks C, D and E. The

residue of Hallmark C relates to deductible cross-border payments paid to a person not resident for tax purposes in any tax jurisdiction or to a person who is resident in a proscribed non co-operative tax jurisdiction; it also relates to payments where deductions for depreciation are claimed in more than one jurisdiction, or where double tax relief is claimed in more than one jurisdiction, or where a transfer of assets is treated as occurring at different prices in different jurisdictions. One of the things which DAC6 does is to require the automatic exchange of information between Member States to enable the tax authorities of Country B to know that it is taxing its taxpayers on the full amount of income they are getting from Country A and Country B. Any arrangement which has the effect of undermining these reporting requirements, whether by trying to change the nature of a payment or by hiding the beneficial ownership of an asset, bears Hallmark D. The last hallmark, Hallmark E, is concerned with transfer pricing and exists where a taxpayer is seeking to make use of unilateral safe harbour rules, where there is a transfer of hard-to-value intangibles or where there is a transfer which more than halves the expected EBIT of the transferor.

Where you have a cross-border arrangement which bears a Hallmark, there is a reporting obligation, and the question then is, who has to do the reporting? Reporting obligations fall first on an intermediary, who is defined in Article 3.2.1 Council Directive 2011/16/EU as “any person that designs, markets, organises or makes available for implementation of a reportable cross border arrangement” – though only if he has some sort of presence in a Member State. So anybody who advises on an arrangement is likely to be an intermediary, and any bank providing finance for a cross border arrangement is also likely to be an intermediary – and will have a reporting obligation requiring them to make a return of the reportable information (as defined in DAC6 Article 6) in its knowledge

possession or control. Where there is an intermediary with a reporting obligation, there is no need for the relevant taxpayer (a person who is party to the relevant cross border arrangement) to make a return, but, if there is no intermediary, then the relevant taxpayer must make a return. The returns will have to be made electronically: no employee of an intermediary or of a relevant taxpayer is required to make a return (Article 13 of the draft regulations); there are, of course, penalties for non-compliance with the reporting requirements.

Now, why do we have all of this? What is the justification for requiring all this information, especially when there are domestic requirements for returns to be made of very similar but not identical information? According to Recitals (1) and (2) of Council Directive 2011/16/EU, “the tremendous development of the mobility of taxpayers, of the number of cross-border transactions and of the internationalisation of financial instruments...affects the functioning of taxation systems and entails double taxation which incites tax fraud and tax evasion...Therefore, a single member state cannot manage its internal tax system”. What is the evidence for the proposition that increasing internationalisation means that a Member State cannot manage its own tax system? I do not believe there is any evidence for that at all. When Country A allows a deduction in accordance with its own rules, how can it matter to it how Country B taxes the receipt in its jurisdiction? It is of no moment at all to Country A, whether Country B fails to tax the payment, taxes it favourably or taxes it unfavourably; in any of those cases, Country A's tax system is working exactly as it should and, indeed, in most cases, so is Country B's system.

So why the fuss? Why do we have BEPS and DAC6? According to the OECD, globalisation has opened up opportunities for multi-national enterprises “to greatly minimise their tax burden”. This, they say, “has led to a tense situation in which

citizens have become more sensitive to tax fairness issues” which has become a critical issue for all parties because

Governments are harmed;
Individual taxpayers are harmed;
Businesses are harmed.

Well, I shall agree with all of that, but I think that what is causing the harm is the exploitative reaction of revenue authorities around the world, which, in an endeavour to cash in on the supposed tax fairness issues, have overloaded their systems with rules which are too complicated to be applied with the necessary degree of clarity and certainty, while, at the same time, becoming increasingly aggressive in the way they seek to enforce their tax systems. Every rational person knows that a tax system does not operate on the basis of fairness: it operates through rules, which, increasingly, have departed from the essential basis of income taxation (which leads to taxation of one measure of a commercial profit) by the introduction of arbitrary rules that sometimes tax unexpected amounts. Fairness has got nothing to do with it; and the idea that it does represents a political and administrative failure on a huge scale.: it is used as an excuse for BEPS which encourages the introduction of more and more artificial rules that bear no resemblance to tried ways of measuring commercial profit and impose increasing burdens on individual taxpayers. Of course governments are harmed, but they are harmed not by the absence of BEPS but by its introduction, which interferes with the core of their sovereignty and, by overloading their citizens with rules, harms the relationship between wealth creators and the state.

Of course taxpayers and businesses are harmed, but not by allowing the commercial practices which BEPS seeks to prohibit, but by prohibiting them. Quite often these days when I am

researching a case I will pick up my Yellow Book and look at a particular provision, and, when I have done that, I put it to one side. As I do that, my Yellow Book sometimes opens at a random page, and I see that there is a penalty for doing this or that – there is a penalty for error, there is a penalty for not rectifying error within a reasonable time after it is discovered, and HMRC have incredible powers to obtain information. There are provisions which limit or are intended to limit the ability to get advice and provisions that limit the ability to appeal decisions of HMRC. It seems to me that the message which the tax system sends to those subject to it is that the revenue authorities do not trust them – do not expect them – to comply with their obligations voluntarily, and want to have powers to coerce them into paying tax whether it is due on a fair reading of the legislation or not. That situation does not match the criteria for a civilised society. Taking each of the topics which I have examined briefly – IR35, BEPS and DAC6, I doubt if any of them is sufficiently certain to be called intelligible or fair. IR35 certainly does not respect legal choices and structures and large parts of BEPS suffer from a similar defect. And each of the topics I have considered weights the system in favour of the taxing authority and so shows a lack of respect for those subject to the tax system. The vast body of taxpayers is highly responsible: taxpayers do not deserve to be weighed down by burdens such as these. I have recently learnt that there are some highly irresponsible marketers of tax fraud, who make a living by selling arrangements which are never going to work. I am shocked to discover how large that problem is, but, no matter how large, it does not need and should not be covered by changes to our tax laws which increase the burden on the law abiding. It is time to restore better balance to our tax system, but I cannot promise that it will be restored soon.

GETTING LOST IN THE WORLD OF DEEMED REALITY

By Laurent Sykes QC

The effect of s28 TCGA 1992

Every now and again a bit of common sense needs to be injected into the tax system by higher courts. s28 TCGA seems to have generated more need for this than many other provisions.

On its face, the effect of s28 TCGA is simple: it provides that the time of a disposal and related acquisition will be the time of entering into an unconditional contract, rather than completion of that contract (if different). The House of Lords explained the limited effect of s28 in *Jerome v Kelly* [2004] STC 887 per Lord Hoffmann at [11]:

“It is hard to see why the abolition of Case VII (which needed a provision to fix the time of the acquisition and disposal) should have made it necessary to introduce one for the capital gains tax, which did not depend on the time of disposal. The rules for the two taxes are quite distinct. Whatever may be the explanation, it seems to me clear that the paragraph was intended to deal only with the question of fixing the time of disposal and not with the substantive liability to tax. It does not deem the contract to have been the disposal as the 1962 Act had done...” [underlining added]

Lord Hoffmann is clear in his approach; the effect of s28 is no broader than dictating the timing of a disposal. In particular, it should not affect the substantive calculation of the gain. The narrow point was that, where there was no ultimate disposal in the ordinary sense, s28 could not apply to deem one into existence.

The Upper Tribunal's decision in *The Commissioners for Her Majesty's Revenue and Customs v Desmond Higgins* [2018] UKUT 280 was therefore surprising. The Upper Tribunal explained at [27] that the effect of *Jerome v Kelly* did not preclude the deeming effect of s28 from treating the taxpayer as owning the off-plan property he had contracted to purchase at a time when it had not yet been built (with a consequent reduction in principal private residence relief). This would have tax consequences beyond the mere timing of the disposal, and affect the computation of the gain:

“In our judgment, the FTT was wrong to say at [6(5)] that “a deeming provision must give way where it is dealing with an ancillary issue and not the substantive liability to tax”. It is not a question of whether a deeming provision “gives way” as such. It is necessary to identify what is deemed to be the case and in what circumstances. *Jerome v Kelly* is authority for the proposition that section 28 is concerned solely with fixing the time of disposal by a person whose identity is to be ascertained by other means. It is the ultimate disposal of an asset which engages capital gains tax and that is why Lord Hoffmann stated that section 28 did not deal with the substantive liability to tax. We do not read that statement as meaning that section 28 can never have any substantive effect on the incidence or computation of the tax so that it cannot apply to determine the period of ownership for the purposes of section 222.”
[underlining added]

The Upper Tribunal decision was reversed by the Court of Appeal in *Higgins v RCC* [2019] EWCA Civ 1860 which held that ownership meant what it said and the period of ownership did not start until completion. But there are still other ways in which the scope of s28 causes confusion.

Value

The Upper Tribunal assumed in *Higgins* (and neither party argued the point) that market value for the purposes of s17 TCGA would be the market value of the asset at the time of contracting, rather than completion (see [16]). This seems like more of the same confusion.

The emphasis is on what is received (or deemed to be received) in return for the asset and therefore value and market value should be ascertained at completion. The point is more stark when what is received does not exist at the time of the contract but only exists at completion, for instance on the transfer of an asset in return for newly issued shares. *Stanton v Drayton* [1983] 1 AC 501 illustrates this point. The shares did not exist at the time of the contract. Lord Fraser said: “In my opinion, the consideration was the Drayton shares. That is, I think, how any businessman would have seen the transaction, and it is the commercial reality. Counsel for Drayton argued that the correct legal analysis was not for businessmen, but for lawyers, and I agree, subject to this, that the lawyer must have regard to the businessman’s view. From the lawyer’s point of view, it seems plain beyond argument that what Eagle Star received as consideration for its portfolio was the Drayton shares.” It is impossible to see one how can value something which does not exist – at best one is speculating. In *Stanton v Drayton* it was never suggested by HMRC that the value should be the market value of the to-be-issued shares at the time of the contract as that would have been impossible to determine. Their argument was that it should be the market value of some sort of credit under the agreement relating to the future issue which was the consideration and which therefore fell to be valued. That was rejected by the House of Lords.

This illustrates the wider point that the value at completion is likely to be what is relevant, regardless of whether the asset

exists at the time of the contracting. Any other view would result in tax on “arithmetical differences”, rather than on what business people would consider to be gains, which is not in accordance with the purpose of the legislation.

The effect on the availability of PPR

The Court of Appeal decision in the *Higgins case* mentioned above concerns an off-plan purchase of a dwelling where there is a contract for its acquisition. Suppose the dwelling is being built by the taxpayer? There is no contract in such a case and one would not expect to have to treat the period of ownership of the dwelling as beginning in a period where the dwelling did not exist. But that is not what HMRC appear to think.

Extra-statutory concession D49 is explained in the Manuals at CG65003:

“ESC D49 sets out three circumstances in which you should allow relief for a period between the acquisition of land, including land on which a dwelling house stands, and the beginning of residence in a dwelling house on that site. Those circumstances are:

- where the delay in taking up residence is because a dwelling house is being built on that land,
- where the delay in taking up residence is because of the continuing occupation of the previous residence while arrangements are made to sell it,
- where the delay in taking up residence is because alterations or redecorations are being carried out.

The concession allows relief for a period up to 12 months, although where there are good reasons for the period exceeding 12 months which were outside the individual’s control the period may be extended up to 2 years. The extended period which can qualify for relief in these circumstances is explained at CG65009. The effect of these provisions is explained at CG65013.”

ESC D49 suggests that where no dwelling has yet been constructed, the taxpayer only has 12 (or 24) months from the acquisition of the land to inhabit a dwelling on the land before the right to full PPR relief will begin to dissipate. This assumes that the period of ownership begins with the time the land was acquired, not when the dwelling came into existence.

The FTT make the same error in *Andrew White and Melanie White v The Commissioners for Her Majesty's Revenue and Customs* [2019] UKFTT 659 in which no attention is given to when the dwelling first existed; the operative point in time was considered to be the acquisition of the land.

This is all quite odd. s222(1)(a) applies to “a dwelling-house or part of a dwelling-house which is, or has at any time in [the taxpayer’s] period of ownership been, his only or main residence”. This naturally refers to the period of ownership of the dwelling-house – which, surely, requires that it exists.

s222(7) provides a definition of the “period of ownership” but this applies only where different interests in the dwelling-house are acquired at different times and therefore does not provide a general definition of the concept of “period of ownership” (so the natural meaning should prevail, as above). s222(7) states:

“In this section and sections 223 to 226, “the period of ownership” where the individual has had different interests at different times shall be taken to begin from the first acquisition taken into account in arriving at the expenditure which under Chapter III of Part II is allowable as a deduction in the computation of the gain to which this section applies”.

The “different interests” are clearly different interests “in” the dwelling-house (where the relief is sought under s222(1)(a)), which presupposes there is a dwelling-house and not simply land. So the prior ownership of land is not relevant since the acquisition of land on which the dwelling-house is

to be built is not the acquisition of an interest in the dwelling-house. In *Higgins* Newey LJ said at [26] in relation to s222(7):

“The subsection is directed at a situation in which a person acquires successive interests: first, say, a lease and later the freehold. If the acquisition of an earlier interest is to be taken into account when calculating deductible expenditure, the “period of ownership” must likewise encompass that in which the earlier interest was held: a taxpayer cannot have it both ways. Section 222(7) does not purport to deal with whether someone who has done no more than contract to purchase a property has relevant “ownership” or stipulate that section 28 (which is to be found in chapter II of part II, not chapter III) applies when determining “period of ownership”.”

HMRC’s approach to own-built properties, like their approach in *Higgins*, seems ripe for a reality check.

JUDICIAL UNALLOWABLE PURPOSES

By Nikhil V Mehta

The Past

In the early 1990s, in the heady days of tax-based structured finance, a number of us were involved in the design and implementation of interesting (excuse the pun) debt instruments for companies. The tax ingredient in the recipes for these instruments was simple: to use the arbitrage which then existed between capital and income for corporate investors or between revenue and capital expenditure for corporate debtors.

One of my favourite instruments was the DIMBO. Any resemblance to a flying Disney pachyderm is entirely coincidental, except that the terms of some DIMBOs were so ambitious that the financial magicians who concocted them may well have believed elephants could fly.

A DIMBO stands for a “Deep-in-the-Money Bond Option”. In its purest form, it is an option granted by a company over its own bonds to a corporate investor. The investor pays a hefty premium on the grant of the DIMBO in the knowledge that, at maturity of the underlying bond, there will almost certainly be a profit. So, an investor pays 70 for a DIMBO and a further 10 on exercise for a bond which will yield 100 at maturity (which may be soon after exercise of the DIMBO). The net profit (ignoring discounted cashflows) is $100-80=20$. If that 20 is tax-free, that is a great result all-round since the investor gets that benefit and the borrower gets a pricing advantage.

Now, you may say that this looks awfully like a discount which should be taxable as income. But the trick was in arriving at terms which respected the integrity of the instrument as an option, not debt, including being careful that there was some element of optionality about exercise. Where things

started getting out of hand was when both those ingredients became flaky and exercise was deemed to occur at the exercise date without the option holder having to do anything.

But assuming “good” ingredients, how was the tax-free objective achieved? This was done simply by ensuring that the underlying bond was a sterling-denominated bond which, for the purposes of corporation tax on chargeable gains (“CGT”), was a qualifying corporate bond, or “QCB”. Alternatively, the underlying debt instrument could have been a gilt, although the challenge with that is that the pricing of the debt instrument was outside the parties’ control. Gains on QCBs and gilts are exempt, and were in those days for companies.

The interplay between the tax treatment of exercised options and QCBs meant that the whole of the gain of 20 was made at maturity of the bond, and that was a disposal of a QCB for CGT purposes.

One could even turbo-charge the tax benefit for the investor if it borrowed the option premium and exercise price amounts to invest in the DIMBO. Interest on the borrowing would be tax deductible, while the profit on the DIMBO would be tax-free.

Along came 1996 and the introduction of the “loan relationships” legislation. The eradication of the capital/income divide for corporate debt made the DIMBO as extinct as the mammoth (this really is my last elephantine allusion!) at least as far as tax-based motivations were concerned.

Buried in the loan relationships package was a quite sinister provision which attacked the borrowing side of the DIMBO investment on anti-avoidance grounds and, had the tax-free nature of the DIMBO remained, would, in all likelihood, have killed off the deduction for interest.

I. The Introduction of Para. 13

That provision was contained in Schedule 9, paragraph 13, Finance Act 1996. It is commonly known just as “para. 13”. If

you are in the know, you know what it means – say no more. Just as people talk about the “Furniss” issue, they talked about the para. 13 issue. In fact, I still do even though para. 13 was done away with in the tax rewrite of the Corporation Tax Acts. I will continue to call it that in this article, even though the current measure is in Sections 441 and 442 of the Corporation Tax Act 2009. Somehow, the “Sections 441 and 442 issue” does not quite have the same ring about it.

So, what do these sections say?

They are worth setting out in full:

“441 Loan relationships for unallowable purposes

(1) This section applies if in any accounting period a loan relationship of a company has an unallowable purpose.

(2) The company may not bring into account for that period for the purposes of this Part so much of any credit in respect of exchange gains from that relationship as on a just and reasonable apportionment is attributable to the unallowable purpose.

(3) The company may not bring into account for that period for the purposes of this Part so much of any debit in respect of that relationship as on a just and reasonable apportionment is attributable to the unallowable purpose.

(3A) If—

(a) a credit brought into account for that period for the purposes of this Part by the company would (in the absence of this section) be reduced, and

(b) the reduction represents an amount which, if it did not reduce a credit, would be brought into account as a debit in respect of that relationship,

subsection (3) applies to the amount of the reduction as if it were an amount that would (in the absence of this section) be brought into account as a debit.

(4) An amount which would be brought into account for the purposes of this Part as respects any matter apart from this section is treated for the purposes of section 464(1) (amounts brought into account under this Part excluded from being otherwise brought into account) as if it were so brought into account.

(5) Accordingly, that amount is not to be brought into account for corporation tax purposes as respects that matter either under this Part or otherwise.

(6) For the meaning of “has an unallowable purpose” and “the unallowable purpose” in this section, see section 442.

442 Meaning of “unallowable purpose”

(1) For the purposes of section 441 a loan relationship of a company has an unallowable purpose in an accounting period if, at times during that period, the purposes for which the company

(a) is a party to the relationship, or

(b) enters into transactions which are related transactions by reference to it;

include a purpose (“the unallowable purpose”) which is not amongst the business or other commercial purposes of the company.

(1A) In subsection (1)(b) “related transaction”, in relation to a loan relationship, includes anything which equates in substance to a disposal or acquisition of the kind mentioned in section 304(1) (as read with section 304(2)).

(2) If a company is not within the charge to corporation tax in respect of a part of its activities, for the purposes of this section the business and other commercial purposes of the company do not include the purposes of that part.

(3) Subsection (4) applies if a tax avoidance purpose is one of the purposes for which a company—

- (a) is a party to a loan relationship at any time, or
- (b) enters into a transaction which is a related transaction by reference to a loan relationship of the company.
- (4) For the purposes of subsection (1) the tax avoidance purpose is only regarded as a business or other commercial purpose of the company if it is not-
 - (a) the main purpose for which the company is a party to the loan relationship or, as the case may be, enters into the related transaction, or
 - (b) one of the main purposes for which it is or does so.
- (5) The references in subsections (3) and (4) to a tax avoidance purpose are references to any purpose which consists of securing a tax advantage for the company or any other person.”

“Tax advantage” incorporates the general definition in Section 1139 of the Corporation Tax Act 2010. It includes:

- “(a) relief from tax or increased relief from tax,
- (b) a repayment of tax or increased repayment of tax,
- (c) the avoidance or reduction of a charge to tax or an assessment to tax,
- (d) the avoidance of a possible assessment to tax.”

Para 13 (which has not changed much since its original enactment) caused a lot of consternation when it was first unveiled. Today, it is described as a targeted anti-avoidance provision or “TAAR”, but I am pretty certain it was not called that in 1996-in fact, I think the acronym TAAR came in a little later to distinguish a TAAR from the general anti-avoidance rule, which then of course became the GAAR we have today in the shape of a general anti-abuse rule.

Like a number of other TAARs, there was nothing particularly “targeted” about the language of para. 13, and this is what created great uncertainty. Of course, it was clear that it applied to tax relief for corporate funding costs, but

its parameters were ill-defined. The biggest concern was that seemingly innocent commercial borrowings might be caught. It did not help that it was part of the extensive new code for loan relationships introduced in 1996, which permitted tax relief for items which were recognised as debits for accounting purposes i.e. the relief was not just restricted to interest costs, and neither was the restriction in para. 13.

The uncertainty was exacerbated by the fact that twenty years before para. 13, what was Section 787 of the Income and Corporation Taxes Act 1988 had been enacted to deal with interest deductions and tax avoidance. That section said:

“Restriction of relief for payments of interest

- (1) Relief shall not be given to any person under any provision of the Tax Acts in respect of any payment of interest if a scheme has been effected or arrangements have been made (whether before or after the time when the payment is made) such that the sole or main benefit that might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief.
- (2) In this section “relief” means relief by way of deduction in computing profits or gains or deduction or set off against income or total profits.
- (3) Where the relief is claimed by virtue of section 403(7) any question under this section as to what benefit might be expected to accrue from the transaction in question shall be determined by reference to the claimant company and the surrendering company taken together”.

The simple question was what was the interaction between Section 787, which had been introduced to attack highly aggressive tax avoidance schemes and the new para.13. Section

787 applied to all taxpayers, but that meant that companies were now exposed to both Section 787 and para.13.

Para 13 was intended to be broader than Section 787, and most importantly, was based on the subjective motivation of the taxpayer. Section 787, in using the words “sole or main benefit that might be expected to accrue” followed an objective approach. Incidentally, any overlap no longer exists because the latest version of Section 787, which was Section 443 of the CTA 2009, has been repealed.

The unclear matters in para. 13 related to the definition of “unallowable purposes”, what amounted to a “main” purpose, and how one operated the “just and reasonable” basis. Further, it was a new notion that a tax avoidance purpose could be a business or other commercial purpose and therefore an allowable purpose, if it was not a main purpose. And, in determining whether there was a business or other commercial purpose, what exactly did not being within the charge to corporation tax in respect of activities actually mean?

The breadth and uncertainty of the “unallowable purposes” language, caused the then Economic Secretary to the Treasury to make the following statement to Parliament:

‘The Government are aware of concerns that have been raised by my hon. Friends and by others regarding the particular anti-avoidance provisions in paragraph 13. This paragraph was amended significantly in Standing Committee but, because of the concerns that my hon. Friends and others have raised, I take the opportunity to allay some of the fears that have been expressed about the anti-avoidance rules.

Paragraph 13 of the schedule disallows tax deductions to the extent that tax avoidance is the main motive behind a loan relationship. We have been told of concerns that this could be interpreted as preventing companies from getting tax relief for legitimate financing arrangements. I am happy to offer a reassurance that this is not the intention of the legislation. The paragraph

denies tax deductions on loans that are for the purpose of activities outside the charge to corporation tax. Among other things, this will ensure that United Kingdom branches of overseas companies do not get tax relief for borrowings that are for overseas activities outside the United Kingdom tax net.

We have been asked whether financing - which, for example, is to acquire shares in companies, whether in the United Kingdom or overseas, or is to pay dividends - would be affected by the paragraph. In general terms, the answer is no, but the paragraph might bite if the financing were structured in an artificial way.

It has been suggested that structuring a company's legitimate activities to attract a tax relief could bring financing within this paragraph - some have gone so far as to suggest that the paragraph might deny any tax deduction for borrowing costs. These suggestions are clearly a nonsense. A large part of what the new rules are about is ensuring that companies get tax relief for the cost of their borrowing.

One specific point has been put to me by my hon. Friend the Member for Gloucester - that is, borrowing by a finance leasing company to acquire assets where this is more tax efficient than the lessee investing in the asset direct. Again, I am happy to offer a reassurance. Where a company is choosing between different ways of arranging its commercial affairs, it is acceptable for it to choose the course that gives a favourable tax outcome. Where paragraph 13 will come into play is where tax avoidance is the object, or one of the main objects, of the exercise.

Companies that enter into schemes with the primary aim of avoiding tax will inevitably be aware of that. The transactions we are aiming at are not ones which companies stumble into inadvertently. As one top tax adviser said recently, companies will know when they are into serious tax avoidance; apart from anything else, they are likely to be paying fat fees for clever tax advice and there will commonly be wads of documentation.

The last thing I want to do, however, is set out a list of so-

called acceptable or unacceptable activities. Borrowing for commercial purposes can be structured in a highly artificial way in order to avoid tax. If we said that borrowing for certain types of activity would always be okay, tax advisers would quickly take advantage and devise artificial financial arrangements simply to avoid tax. Provided that companies are funding commercial activities or investments in a commercial way, they should have nothing to fear. If they opt for artificial, tax-driven arrangements, they may find themselves caught.

It is clear that a balance must be struck between meeting the concerns that have been raised and weakening the provision in those instances where it needs to apply, but I can assure my hon. Friends that we shall keep the matter under review.’ (Hansard 28 March 1996 Finance Bill Report Stage, Columns 1192-1193).

This extract still appears in the HMRC Manuals, so it is clear HMRC continue to consider it of relevance today: see the Corporate Finance Manual at 38170. The simple transaction which the Economic Secretary specifically mentioned was borrowing to acquire equity, the concern being that to earn tax-free dividends would not be within the business or other commercial purposes of the company as an activity not within the corporation tax charge. Did that automatically show an unallowable purpose? This concern was assuaged in part by the Economic Secretary saying that in general terms para. 13 would not apply to such a transaction. But then she qualified this by excluding financings structured in an artificial way and then later on also giving a warning about “artificial, tax-driven arrangements”.

II. Para. 13 Goes to the Courts

It was clear that there would be areas in different shades of grey, particularly in complicated financings, where the application of para. 13 could not be ruled out. It would only be a matter of time before para. 13 came before the courts.

In fact, it took well over a decade for the first decision to be published. There have also been a handful of further cases since. What I propose to do is to look at some of these and see how the courts have applied unallowable purposes and to see what lessons there are to be learnt for future financings.

There are four outcomes possible in relation to para. 13:

- (i) The tax avoidance purpose is either the only purpose of the company in doing the financing, or that purpose so dominates other purposes that it is an unallowable purpose and para 13 should result in a 100% prohibition of tax relief;
- (ii) The tax avoidance purpose, not being a main purpose, is one of the business or commercial purposes of the company. In this case, even though there is a tax avoidance purpose, it is not an unallowable purpose so there should be no restriction on the tax relief;
- (iii) The tax avoidance purpose is an unallowable purpose because it is a main purpose. But there are other main purposes too to which the deduction is attributable. In this situation, a just and reasonable apportionment would be appropriate so that only part of the funding costs should be denied;
- (iv) There is no tax avoidance purpose at all, and all the purposes are business or commercial purposes. There is, however, a beneficial tax effect or consequence of doing the borrowing. Here, there is no unallowable purpose at all, so the tax relief should not be in doubt.

All of these different outcomes have been recognised by the courts. But only the first outcome i.e. denial of relief in full, has so far been upheld.

The first Para. 13 case was *A.H. Field Holdings Limited v HMRC* [2012] UK FTT 104. This got as far as the First Tier Tribunal (“FTT”) and no further. One rather got the impression that HMRC had decided to fight one of their strongest cases

on para. 13 as the first case. The facts involved a property rich/cash poor property investment company entering into a financing to pay dividends to its shareholder. But the financing involved the company raising bank funds for a matter of days, paying the dividends, getting the dividend proceeds back from the shareholder in exchange for a short-term zero coupon note, repaying the bank from the subscription proceeds and, in the following year, raising bank funds again to repay the zero coupon note and repeating the circular transactions. This happened for a number of years. The tax purpose in the transactions was to get a tax deduction for the discount on the zero-coupon notes. It was clear from the evidence that the structure of the financing was heavily tax-driven.

HMRC did not have too much difficulty in attacking the transactions under para. 13 and denying the deductions. The FTT found that the tax deduction was a main purpose based on the evidence including the documentation. The flow of funds was circular, but nevertheless purportedly attracted tax relief.

In coming to their decision, the FTT stated that the onus was on the taxpayer to show that there was no unallowable purpose. This had clearly not been discharged. In considering what the purpose was, the FTT thought it was legitimate to look at the intentions not just of the taxpayer, but also that of its shareholders and other stakeholders like tax advisers. This was a surprisingly wide net for catching an unallowable purpose, and has since been narrowed to the purpose only of the taxpayer-see below.

The FTT clearly did not think much of the facts before them. They said that a tax benefit was not a main purpose if it was merely icing on the cake. What they were confronted with “produced a preponderance of icing and very little cake.”

The weakness of the facts in *Field Holdings* provided a strong forensic start for HMRC in para. 13 challenges.

Three other cases were *Versteegh Limited* [2013] UKFTT 642,

Fidex Holdings Limited [2014] UKUT 0454 and *Travel Document Service* [2018] EWCA Civ 549. The first case went as far as the Upper Tribunal. The other two went to the Court of Appeal. The facts in all three were rather different from those in *Field Holdings*, inasmuch as they all involved large financing transactions with a rather clearer business rationale. In *Field Holdings*, the deduction claimed was some £150,000 whereas the amounts in these cases ran into many millions. But the common theme in all three was the existence of a tax avoidance scheme in the structuring, as the courts found. *Versteegh* was a fairly straightforward tax arbitrage in a group whereby the borrower company sought a deduction for financing costs whereas the lender got no corresponding taxable income. *Fidex Holdings* was an old-fashioned tax-based structured finance transaction involving one financial institution proposing a scheme to another – in this case to generate tax losses available for surrender within the borrower’s group. *Travel Document Service* (“TDS”) involved a scheme devised by tax advisers. This was probably the most complicated of the three and the key to some intricate transactions within a large group involved devaluing shares which were treated as debt so as to be able to claim relief for a debit under the loan relationship rules generated by the diminution in value.

The taxpayer lost in *Fidex Holdings* and in *TDS* on the para. 13 point. *Versteegh* was a little more curious in terms of outcome. Although the final appeal went to the Upper Tribunal, the para. 13 point was one of a number of points of issue and was only taken at FTT level. It was argued in a strange way. There was no evidence adduced as to what the purpose of the financing was, but HMRC invited the FTT to come to the inevitable conclusion that para. 13 should apply where:

- The only reasons for the borrowing were to enable other group members to get a tax-free benefit in their hands whereas the borrower would get a tax deduction;
- All the participating group companies were aware of

the tax benefits at the time of entering into the borrowing;

- The borrower had a commercial need for the borrowing.

The FTT refused to follow this approach and said that the issue had to be decided on all the evidence. There was no shortcut of inevitability. So, HMRC lost on this approach.

In *Fidex Holdings*, the scheme turned on obtaining derecognition of existing bonds so that a debit could be claimed for the effect of derecognition. The holding of the bonds went from an unobjectionable purpose pre-scheme to an unallowable purpose (and other commercial purposes) once the scheme was implemented. So, the case is a good example of how the purpose of having a loan relationship can change. Further, the “all or nothing” approach to attribution meant there was no scope for a just and reasonable apportionment providing some relief as a result of mixed purposes.

The *TDS* case is notable for the fact that the loan relationships in question were in fact deemed loan relationships: the actual instruments were shares which, because of linked hedging arrangements including a total return swap, were deemed to be loan relationships. The judges had no difficulty in applying para. 13 to deemed loan relationships; one simply looked at the purposes attributable to the actual instruments even though they were not actual loan relationships. There was some discussion of apportionment on a just and reasonable basis, but the court found that there had been insufficient evidence available to determine whether any apportionment should be made.

It would be easy to conclude that any set of facts incorporating a “tax avoidance scheme” is, even after full production of evidence, bound to fail. But I do not think that is correct. What is still important is whether the scheme constituted a main purpose or not. What is clear is that HMRC were quite strategic in permitting cases to go to court where either there was

extremely aggressive avoidance as in *Field Holdings*, or at least the existence of “schemy” characteristics in situations where the amounts at stake were huge. So, the fact that the three cases I have mentioned above involved tax avoidance schemes shows the attitude of HMRC in case selection rather than inevitable judicial conclusions against the taxpayer.

III. Oxford Instruments

The most recent case on para. 13 is *Oxford Instruments UK 2013 Limited v HMRC* [2019] UK FTT 0254. The transaction involved a complex refinancing within a UK multinational group which had a US subgroup. The structure put in place for the refinancing was a “tower” structure, consisting of a number of companies held vertically including the taxpayer (“UK Newco”), which was a new hybrid entity treated as transparent in the US and opaque in the UK. The new structure involved eight steps. UK Newco only participated in the last step, which consisted of it subscribing for 1.4m preference shares issued by a US affiliate in exchange for a US\$140m promissory note. None of the steps in the refinancing involved any movement of cash, and the previous seven steps did not have any UK tax-motivated features. The tax benefit to UK Newco lay in the fact that dividends on the preference shares were tax-free, but interest on the promissory note would be tax deductible. Taken in isolation, this was precisely the benefit on which the Economic Secretary gave comfort back in 1996.

However, HMRC challenged UK Newco on the basis that para. 13 applied to the promissory note. Interestingly, the top UK company had applied for a clearance in relation to the proposed structure under the arbitrage tax provisions. The facts disclosed in the clearance application included an increased UK benefit overall by comparison to the existing group financing arrangements. To nullify this, the applicant offered that UK Newco should forgo a specified percentage

of its tax deductions on accrued interest on the promissory note so that the overall position would be flat when compared to the previous financing structure. HMRC granted clearance on that basis, but made it clear that it related to the arbitrage legislation, and not to any other anti-avoidance provisions.

In the clearance application, the purpose of the refinancing was described as follows:

- To refinance existing loans which were due to mature in the near future;
- To introduce additional intra-group debt to achieve a suitable debt:equity ratio for the US sub-group, which had grown considerably;
- To simplify and consolidate existing intra-group debt; and
- To allow a flexible structure for funding future acquisitions in the US.

In a very careful and meticulous decision, the FTT held, with some reservation, that UK Newco was caught by para. 13, and further, that it should be denied relief for interest on the promissory note in full. A number of important general points come out of the decision, which I understand has become final:

- (1) In looking at purpose, it was important to determine whose purpose. The purpose is only that of the taxpayer company claiming the tax relief and no-one else-in this case, it was only UK Newco or, more accurately, its directors;
- (2) The intentions of other stakeholders such as tax advisers was irrelevant unless such parties had effectively exercised *de facto* control of the taxpayer company (there was no evidence of that before the FTT). What the FTT said in *Field Holdings* was rejected on this point;
- (3) The initial burden of proof is on the taxpayer to show there is no unallowable purpose;
- (4) The interest deductions generated the tax advantage in the form of relief capable of surrender by the taxpayer within

the UK group. The tax advantage has to be measured by reference to the taxpayer only and HMRC. Is the HMRC losing out as a result of the relief generated by the taxpayer? The net overall position of the group is irrelevant to this question, although it may be relevant to the question of identifying the taxpayer's main purpose;

- (5) So far as UK Newco's main purpose was concerned, the FTT found that its sole purpose was to get the tax deductions for interest accruing on the promissory note so that it could surrender the relief. None of the broader purposes listed in the tax arbitrage clearance application could be attributed to it. Indeed, it did not even exist when those purposes were formed. The fact that it made a commercial spread between dividends earned and interest accrued was not a self-standing separate business or other commercial purpose. The evidence showed that the directors of UK Newco would not have carried out Step 8 if the tax advantage had been unavailable. The spread was simply a consequence of that step, not a self-standing purpose. Unlike earlier authorities where the tax avoidance purpose was held to be *a* main purpose, in this case the FTT found that the tax avoidance purpose was *the* main purpose. In the absence of any apportionment, nothing turns on this although I find it somewhat strange that UK Newco had a sole purpose of tax avoidance whereas in *Field Holdings*, which seemed to me to be a much more aggressive exercise, the tax avoidance purpose was only one main purpose.
- (6) In a postscript to the judgment, the FTT expressed sympathy for the taxpayer because of the existence of the arbitrage clearance. The judge commented that had HMRC given the clearance with the intention of making a para. 13 challenge, that would have been misleading even with the express qualification in the clearance that it did not extend to other anti-avoidance provisions. There was no evidence to suggest

that, so UK Newco was just unfortunate to be attacked in this way by a subsequent decision by HMRC to raise para. 13.

IV. What About Just and Reasonable Apportionment?

No court to date has permitted just and reasonable apportionment so as to allow the deduction in part. To repeat the statutory wording, “The company may not bring into account ...so much of any debit in respect of that [loan] relationship as on a just and reasonable basis is attributable to the unallowable purpose.” This presupposes that there are other purposes to which at least part of the deduction is attributable.

But what does this mean? If a company has one (non-commercial) tax avoidance purpose and two commercial purposes, should that not automatically mean some apportionment merely by the existence of three purposes? Simplistically, if all the purposes carry equal weight, then the deduction should only be disallowed as to one-third. But it would be unusual to find such a scenario, and the question of weighting is extremely difficult.

In the early case of *Iliffe News and Media Limited v HMRC* [2012] UKFTT 696, the para. 13 issue was one of eight disputed issues. The taxpayer argued that it had both tax avoidance and commercial purposes in entering into the financing. It contended that the legislative purpose of para. 13 was to strike down a debit only to the extent that it is greater than it would be but for the tax avoidance purpose. If the debit would have remained the same based just on the commercial purpose, the fact that the tax avoidance purpose was a main purpose should not affect the deduction. On the evidence before it, the FTT accepted this argument and found in favour of the taxpayer. So, the existence of a tax avoidance main purpose did not affect the relief.

Not surprisingly, HMRC are not happy with this approach and challenged it in the *Oxford Instruments* case. They said that the correct approach is simply whether the statutory

language, read plainly, requires an apportionment to be made between the tax avoidance purpose and the other self-standing purposes. Since the FTT found the taxpayer to have only one purpose i.e. of tax avoidance, the point became irrelevant, but the judge made some observations on the question of apportionment on the hypothesis that the taxpayer had both tax avoidance and self-standing commercial purposes, being the achievement of the US objectives for the group and getting a spread on the financing.

He looked at the authorities and, in particular, the Court of Appeal authorities in *Fidex Holdings* and *TDS*. He derived no help from the former case since it again required attribution of the whole deduction to the tax avoidance purpose. In the latter, he found support in the judgment of Newey LJ for the *Iliffe* approach in relation to one of the participants to the scheme in question. He noted that relief was denied because there was insufficient evidence to support the application of the *Iliffe* approach, not because that approach was incorrect. He concluded that, if there had been mixed main purposes for the taxpayer in *Oxford Instruments*, the taxpayer would not have suffered any denial of tax relief as the relief would not have been increased by the tax avoidance purpose.

So, we still do not have any real guidance on the circumstances in which a debit will be allowed in part on the basis of just and reasonable apportionment. The *Iliffe* approach involves high stakes since it produces an “all or nothing” result. Realistically, if a company is considering entering into a new financing transaction or a refinancing, its purposes will all arise concurrently at that time. In a new transaction, the debit will be whatever it is, and if it is attributable to the commercial purposes, relief cannot be denied. In a refinancing, it may be that the debit is increased, but even that increase would be attributable to the concurrent purposes and not any historical reason for the original financing. The mere fact that the

deduction is greater than what it was earlier is not fatal if there are new commercial purposes to which the debit can be attributed.

The “all or nothing” approach means that apportionment could never result in a deduction being allowed in part. This is a startling result. It is perhaps worth noting, although it has no binding effect, the cautionary words of the FTT in *Versteegh* on the *Iliffe* approach. At para. 166 of the Decision, they thought that this approach involved putting a gloss on the para.13 language. The approach may be appropriate in some cases, but should not be regarded as a substitute for the statutory test itself.

HMRC clearly endorse this view, as they made clear in argument in *Oxford Instruments*. One cannot, therefore, assume that the *Iliffe* approach is the last word on just and reasonable apportionment. It does not in any event carry the force of precedent.

V. Some Concluding Remarks

I draw together the following strands on para. 13, based on the case-law:

- (1) The existence of a “tax avoidance scheme”, while optically unhelpful, is not fatal to the availability of tax relief. It is all a question of marshalling the different purposes for the transaction of which the scheme forms part;
- (2) The purpose is that of the taxpayer company and no-one else. It is, therefore, extremely important to ensure that it, through its directors, exercises its decision-making functions and records all the proper purposes for implementing the relevant financing. The cases on corporate residence, particularly those involving special purpose companies, are helpful in showing what proper corporate governance should be;
- (3) Benefiting other members of a group is a legitimate purpose. In the case of a new company, it obviously cannot backdate the purposes to those of other members of the group which

- were formulated prior to its incorporation. But, with appropriate care, it can adopt those purposes for itself later;
- (4) The need for purposes to be found in individual companies can be particularly challenging in practice where groups tend to make many common decisions at a higher level. So, there may be an education process for some multinationals in adhering to this;
 - (5) The burden of proof to show no unallowable purpose is on the taxpayer, which is why it is even more important than otherwise to have strong evidence, both documentary and oral, of the lack of an unallowable purpose. I distinguish this from “paying fat fees for clever tax advice” and “wads of documentation” linked to that, as per the Economic Secretary’s Statement;
 - (6) There is a difference between purpose and effect/consequence. If a financing produces a beneficial tax effect, that is not the same as a tax avoidance purpose. The Economic Secretary’s Statement in this area remain valid today;
 - (7) Other tax avoidance clearances on the structure are irrelevant and cannot be relied upon unless there is some suggestion of misleading conduct by HMRC;
 - (8) Just and reasonable apportionment remains an unknown quantity.

There is a tendency to assume that, given the pattern of HMRC victories before the courts on para. 13, any para. 13 challenge is bound to succeed. But that is not what the cases say. A well-structured financing with robust evidence of purpose (including a tax avoidance purpose), implemented with care and monitored for its duration (particularly to ensure that “good” purposes do not become “bad” purposes or new bad purposes do not arise), should still withstand a para. 13 challenge. Indeed, in all likelihood, such a transaction would go nowhere near the courts on the basis that HMRC would have granted the taxpayer relief in full.

THE TURBULENT STATE OF THE DISGUISED EMPLOYMENT REGIME

By Laura K Inglis

The disguised employment regime (colloquially known as IR35) was introduced in 2000 to counter a perceived form of tax avoidance, where, instead of supplying services directly, individuals contract through an intermediary (usually a personal services company or “PSC”) and then pay themselves in dividends, thereby avoiding employment income tax and national insurance contributions. Of course, contracting through a PSC can be perfectly innocent and indeed a very sensible way of limiting personal liability, but there were reports of such structures being abused. The stated goal of the legislation was to create a level playing field between employees and contractors, or, as one consultation expressed it, “to ensure that individuals who work like employees pay broadly the same employment taxes as employees, regardless of the structures they work through”.¹ Broadly, where it applies, IR35 treats the fees paid to the personal services company as deemed employment income of the worker in question, with the result that such fees become subject to income tax and NICs.

Although these rules have appeared in the statute books for a long time, they have been raising headlines over the last two to three years like never before. There are two main reasons for this:

- Firstly, HMRC appear to be enforcing these rules much more aggressively than they did in the past. This has resulting in large numbers of contractors who previously thought themselves to be plainly self-employed being subjected to IR35 challenges. Many

well-known journalists have recently found themselves in this uncomfortable position, and this has drawn public attention to the issue.

- The second reason why IR35 has been much in the news of late is the large-scale expansion of the regime – to public authorities in 2017, and from April 2020, to large and medium private enterprises – dramatically increasing the number of taxpayers affected.

This article summarizes the current regime, the forthcoming changes, and the relevant judicial principles, before surveying the most recent IR35 case law and highlighting the apparent confusion within the First Tier Tribunal as to how these rules should be applied. In light of the forthcoming extension of the regime to the private sector, intervention by the higher courts seems to be urgently required.

The Legislation

The income tax provisions of IR35 appear in Chapter 8 of Part 2 of ITEPA 2003. The applicability conditions for the regime are set out in s.49, as follows:

- (1) *An individual (“the worker”) personally performs, or is under an obligation personally to perform, services for another person (“the client”);*
- (2) *The client is not a public authority;*
- (3) *The services are provided not under a contract directly between the client and the worker, but under arrangements involving a third party (“the intermediary”);*
- (4) *The circumstances are such that –*
 - if the services were provided under a contract directly between the client and the worker, the worker would be regarded for income tax purposes as an employee of the client or the holder of an office under the client; or*
 - the worker is an office-holder who holds that office under the client and the services relate to the office.*

It should be noted that the first three of these conditions focus on the actual facts and circumstances of the particular case. The fourth condition, on the other hand, asks whether a *hypothetical* direct contract between the worker and the end client would be an employment contract or not.

The National Insurance provisions of IR35 appear in the Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727) (“the Intermediaries Regs”). The Intermediaries Regs are usually treated as applying in the same circumstances as the income tax provisions. However, although the first three applicability conditions are effectively the same, the fourth condition is slightly more widely drafted than its income tax counterpart. The fourth applicability condition for NICs purposes is set out in Regulation 6(1)(c) of the Intermediaries Regs as follows: “the circumstances are such that, had the arrangements taken the form of a contract between the worker and the client, the worker would be regarded for purposes of Parts I to V of the Contributions and Benefits Act as employed in employed earner’s employment by the client.”

The Social Security (Categorisation of Earners) Regulations 1978 (SI 1978/1689) (“the Categorisation Regs”) deem certain types of non-employed workers to be treated as in employed earner’s employment for NICs purposes, in order to preserve their entitlement to social security benefits. This means that the Categorisation Regs can cause a worker to be caught by the Intermediaries Regs, even if their self-employed status is undisputed. This happened in the case of *Big Bad Wolff Ltd v HMRC* [2019] UKUT 121 (TCC), where an actor, who was acknowledged to be self-employed for tax purposes, was deemed under the Categorisation Regs to be in employed earner’s employment. The Upper Tribunal held that the word “regarded” in Regulation 6(1)(c) was broad enough to catch the deemed treatment mandated by the Categorisation Regs.

Thus, it is possible for a person to fall outside the tax provisions of IR35, but still to be caught by the NICs provisions.²

Expansion of the Regime

With effect from April 2017, IR35 has been expanded, shifting the responsibility for compliance from intermediaries themselves to public authorities that engage them. The new rules are set out in Chapter 10 of Part 2 ITEPA 2003. Save for the public authority condition, which is reversed, the applicability conditions for Chapter 10 are the same as those for Chapter 8 (see s.61M ITEPA 2003). Where these conditions are met, Chapter 10 requires a public authority end client to determine whether the worker would have been employed if the public authority had engaged them directly (see s.61T ITEPA 2003). Chapter 10 also makes the party that pays the intermediary (the “fee payer”) responsible for accounting for and paying income tax on the worker’s behalf via PAYE (see ss.61N and 61R ITEPA 2003).³ These changes were intended to enable HMRC to recover the tax from a single entity (likely one with deeper pockets), whilst minimising its recovery costs (particularly in cases where a public authority has engaged multiple PSCs).

As highlighted in a 2019 parliamentary debate on IR35, however, this extension of the rules has not been smooth.⁴ Some public authorities have been overly cautious in interpreting the rules (as they are incentivized to do to protect their own position) with the result that many self-employed contractors are being inappropriately taxed as employees, without receiving any of the associated employment rights. Additionally, a public authority’s determination as to whether IR35 applies might be wrong. After all, many public authorities may not have the requisite legal expertise to make such determinations correctly. But the statute currently provides no avenue for appeal. This effectively gives public authorities the power to make tax

judgments that significantly affect someone else's welfare, whilst denying the affected person access to the courts. There is also evidence that the uncertainty and complexity generated by the new rules has been causing some contractors and freelancers to leave the public sector all together.⁵

It was announced in the Autumn Budget 2018 that, from April 2020, responsibility for IR35 compliance will shift to large and medium private enterprises that contract with PSCs. Thus, in the future, such enterprises will not only have to decide whether the rules apply in relation to their contractors, but also (potentially) to account for income tax and NICs on those contractors' behalf. Draft legislation was published in July 2019, with a stated goal of bringing the private sector into line with what has already occurred in the public sector.

The rule extension will apply to all private-sector organisations that do not qualify as "small", where "small" is defined in accordance with the Companies Act 2006. Broadly, a company (or relevant undertaking) is considered small if at least two of the following three conditions are met: its annual turnover is not more than £10.2 million; its balance sheet total is not more than £5.1 million; and it has no more than 50 employees (see s.382(3) Companies Act 2006). There are special rules for joint ventures and subsidiaries (see draft ss.60B and 60C ITEPA 2003 as set out in paragraph 5 of the IR35 Schedule to the Finance Bill 2019-20). For non-incorporated bodies such as partnerships, only the turnover test will apply (see draft ss.60E and 60F ITEPA 2003). It should be noted that a company's smallness is assessed by reference to the last financial year, the accounts and reports filing date for which ended before the start of the tax year in question (see draft s.60A(3)-(4)), and also that it takes two consecutive financial years to lose or re-gain "small" status (see s.382(2) Companies Act 2006). The existing IR35 rules under Chapter 8 of Part 2 of ITEPA 2003 will continue to apply to small

enterprises, with the result that, where the engaging enterprise qualifies as small, the PSC, rather than the engaging enterprise, will remain responsible for determining if IR35 applies and accounting for any appropriate tax.

The draft Finance Bill makes three primary changes to the new IR35 rules (which, accordingly, will apply to public sector end clients also). First, the Bill contains a requirement for the client to give the worker a “status determination statement” setting out the client’s conclusion as to whether the final IR35 applicability condition is met, with reasons for the decision. The client is under a duty to take reasonable care in reaching this conclusion (see draft s.61NA ITEPA 2003, as set out in paragraph 12 of the IR35 Schedule to the Finance Bill 2019-20). Unless and until the client gives the worker a status determination statement that complies with the statutory requirements, the client (rather than the fee payer) must ordinarily account for the appropriate tax (see paragraph 12(3) of the IR35 Schedule to the Finance Bill 2019-20).⁶ This process seems likely substantially to increase the cost and compliance burden for businesses. Second, the draft Finance Bill introduces a process whereby the worker (or the fee-payer) can disagree with the client’s determination as to whether the final applicability condition is met (see draft s.61T ITEPA 2003, as set out in paragraph 13 of the IR35 Schedule to the Finance Bill 2019-20). The process is triggered by the worker (or the fee payer) making representations to the client. Then, within 45 days, the client must either inform the party making the representations that it has considered the representations and is standing by its original decision (with reasons), or else issue a new status determination statement both to the worker and to the person who would be treated as making the deemed payment of employment income under s.61N(3) ITEPA 2003. If the client fails to comply with these duties, then from the end of the 45 days, it becomes the obligation of the client (rather than the

fee-payer) to account for any appropriate tax. However, the draft provisions still provide no access to the courts or any other official channel for dispute resolution. Finally, the draft Finance Bill allows HMRC to recover unpaid tax from any “relevant person”, meaning anyone in the payment chain above the fee-payer (see draft s.688AA ITEPA 2003, as set out in paragraph 15 to the IR35 Schedule to the Finance Bill 2019-20).

The Autumn Budget 2018 listed the private sector expansion of IR35 as the single greatest source of increased public revenue for tax years 2020-2023⁷, with the result that aggressive enforcement action from HMRC should be expected.

The Judicial Approach to IR35

It is almost always the final applicability condition that is disputed in IR35 cases. In evaluating whether or not a hypothetical direct contract between the client and the worker would be an employment contract, the judicial methodology may be summarized in two steps.

- The first step is to construct the hypothetical contract. This should ordinarily be done by identifying the terms of the actual agreement between the client and the PSC (bearing in mind that the terms of the actual agreement may differ from any written agreement between the parties). The terms of that actual agreement then form the basis of the hypothetical contract (see *Usetech v Young* [2004] STC 1671 at [36]).
- Having identified its terms, the next step is to evaluate the nature of the hypothetical contract to determine whether or not it is an employment contract. This involves applying the criteria from *Ready Mixed Concrete v Minister of Pensions* [1967] 2 Q.B. 497 and other case law, bearing in mind that it is important to look at the whole picture, rather than mechanically apply a checklist.

With regard to the first of these steps, in a two-contract case, where there is a contract between the worker and the intermediary on the one hand, and a contract between the intermediary and the client on the other, the contents of the hypothetical contract will be based (as near as may be) on the terms of the actual agreement between the intermediary and the client (see *Usetech v Young* at [36]). Where there is a chain of contracts involving one or more agencies between the intermediary and the end client, the agency contracts should also be taken into account in constructing the hypothetical contract, even if the worker was unaware of the contents of those contracts (see *Usetech v Young* at [47]). In IR35 cases, the parties often disagree over the terms of the actual agreement (and particularly over the extent to which any written agreement(s) reflect reality).

In *Autoclenz v Belcher* [2011] ICR 1157, the Supreme Court gave some helpful guidance on how to identify the terms of a contract involving work and service. The Supreme Court acknowledged previous authorities affirming that the written agreement may not reflect the reality of the relationship (see [22]). This is especially true for contracts relating to work and service, because unlike commercial contracts, the bargaining power between the parties is often unequal (see [34]). The question that a court or tribunal must ask is “what was the true agreement between the parties?” (see [21], [29]). In order to answer that question, the court or tribunal must consider all the relevant evidence – including the written terms, but also evidence as to the parties’ conduct and expectations (see [31]-[32]). The fact that rights conferred by a written agreement may not have been exercised does not prevent them from being genuine contractual rights (see [19]). The important question when evaluating the genuineness of such an unused term is whether it reflects what the parties might realistically have expected to occur (see [25], [29]).

The House of Lords also affirmed in *Carmichael v National Power plc* [1999] 1 WLR 2042 that where the parties do not intend the written record to constitute “an exclusive memorial of their relationship”, it is permissible to take into account the surrounding circumstances and conduct of the parties, as revealed in oral evidence (see 2047). Thus, in IR35 cases, a lot of time is often spent hearing evidence as to how the contractual arrangements actually worked out in practice. This is to enable the judge to identify the terms of the actual agreement, which then form the basis for the hypothetical contract.

Having identified the terms of the hypothetical contract, the next step is to evaluate the nature of that contract: in particular, to determine whether it is a contract of service (indicating employment) or a contract for services (indicating self-employment). The starting point here is the *Ready Mixed Concrete* decision, where McKenna J held at 515 that an employment contract exists if three conditions are met: (i) the servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master (this has become known as “mutuality of obligation”); (ii) the servant agrees that the performance of the service will be subject to the other’s control to a sufficient degree to make that other master; and (iii) the other conditions of the contract are consistent with it being an employment contract. In *Montgomery v Johnson Underwood* [2001] I.C.R. 819, the Court of Appeal affirmed that the first two of these conditions (mutuality of obligation and a sufficient degree of control) form an “irreducible minimum” for the existence of an employment contract, and should always be considered first (see [46], [23]). Similarly, in *Weightwatchers (UK) Ltd v HMRC* [2011] UKUT 433 (TCC), the Upper Tribunal held that where mutuality of obligation and the requisite degree of control exist, the contract is *prima facie* an employment contract, “unless, viewed as a whole, there is

something about its terms that places it in a different category” (see [42]).

Mutuality of obligation can be confusing, because the phrase is used in the case law in two very different ways. On the one hand, mutuality of obligation can mean simply an obligation to pay for work actually performed. However, this type of mutuality exists in every contract involving services, whether the relationship is one of employment or self-employment. Importantly, this is not the type of mutuality that distinguishes employment contracts. As Park J stated in *Usetech v Young* at [60]: “Mutuality of some kind exists in every situation where someone provides a personal service for payment, but that cannot by itself automatically mean that the relationship is a contract of employment; it could perfectly well be a contract for free lance services.” On the other hand, mutuality of obligation can also extend through time – in this sense, the phrase usually involves an obligation on the worker to work (at least if work is available) and an obligation on the employer to pay (regardless of whether work is offered). It is the second type of mutuality, typically involving some continuing obligation between the parties, that distinguishes employment contracts⁸. Moreover, mutuality of obligation encompasses a requirement on the worker to perform the work personally. Accordingly, an unrestricted substitution clause has been held to be fatal to the existence of the requisite mutuality (see *Weightwatchers (UK) Ltd v HMRC* at [32]-[37]).

The second criterion, a sufficient degree of control, was described in *Ready Mixed Concrete* at 515 as follows: “Control includes the power of deciding the thing to be done, the way in which it shall be done, the means to be employed in doing it, the time when, and the place where it shall be done. All these aspects of control must be considered in deciding whether the right exists in a sufficient degree to make one party master and the other his servant...” However, as Lord Parker CJ

affirmed in *Morren v Swinton and Pendlebury Borough Council* [1965] 1 W.L.R. 576 at 582, control cannot be the decisive test when one is dealing with a professional or expert. This is because many experts (e.g. surgeons, pilots, and research scientists) are commonly employed, but are not really susceptible to direction as to how they do their work. The Supreme Court affirmed in *Various Claimants v Catholic Child Welfare Society* [2013] 2 A.C. 1 at [36] that: “the significance of control today is that the employer can direct what the employee does, not how he does it”. Similarly, in *Montgomery v Johnson Underwood* at [19], the Court of Appeal held that for an employment relationship to exist, there must be a sufficient “framework of control”. In *White v Troutbeck* [2013] IRLR 949, the Court of Appeal explained that the key question is not whether the putative employer actually exercises day-to-day control over the worker, but whether he has a contractual right of control over the worker (see [16]-[19] and [38]-[39]).

The final element of the *Ready Mixed Concrete* test considers whether the other conditions of the contract are consistent with it being an employment contract. Thus, even where mutuality of obligation and the requisite degree of control are established, there may be other features of the relationship which will entitle a tribunal to conclude that there is no contract of employment in place, even during an individual engagement (see *Quashie v Stringfellow Restaurants Ltd* [2013] IRLR 99 (CA) at [14]). It is always important to stand back and consider the whole picture.

There is also a wealth of other case law on how to distinguish employment from self-employment. Another authority often cited in IR35 cases is *Market Investigations v Minister for Social Security* [1969] 2 QB 173 where Cooke J stated at 184-185 that the fundamental test to be applied is this: is the person who has engaged himself to perform the services performing them as a person in business on his own account? Whilst there is

not and can never be an exhaustive list of relevant considerations for answering this question, Cook J identified the following factors as potentially significant: whether the worker provides his own equipment; whether he hires his own helpers; the degree of financial risk he takes and the degree of responsibility he has for investment and management; whether he can profit from sound management in the performance of the services; and whether he engages himself in the course of an already-established business. Whilst it might be tempting to treat these factors as a checklist, numerous decisions have confirmed that that is not the correct approach. Rather, it is necessary to stand back and consider the whole picture.⁹ In *Hall v Lorimer* [1994] 1 W.L.R. 209 at 218, the Court of Appeal acknowledged that the factors identified in *Market Investigations* may be of little assistance in determining the status of someone carrying on a profession or vocation, but added that the extent to which the individual is dependent on a particular paymaster may be significant. Yet another way of formulating the employment test is to ask whether the worker is integrated into the client's business or only an accessory to it (see *Beloff v Pressdram Ltd* [1973] F.S.R. 33 (Ch) at 42).

Where a person's work involves a series of engagements, as is often the case in IR35 disputes, the starting point is that a series of engagements in the course of carrying on a profession is indicative of self-employment (see *Davies v Braithwaite* [1931] 2 K.B. 628 at 635-636, quoted in *Hall v Lorimer* (CA) at 219). However, the Court of Appeal recognized in *McMeechan v Secretary of State for Employment* [1997] ICR 549 at 555-557 that an employment can arise either from a specific engagement or from an "umbrella" arrangement covering multiple engagements. For example, in *O'Kelly v Trusthouse Forte* [1984] 1 Q.B. 90, which involved wine waiters who were on a list to be called when a London hotel was short-staffed, neither the umbrella arrangement of being on the list nor the specific

engagements of being called upon to serve constituted employments. Conversely, in *Cornwall County Council v Prater* [2006] ICR 731, which involved a teacher who taught pupils on behalf of a local authority when they were unable to attend school, each engagement to teach a particular pupil (but not the umbrella arrangement with the local authority) was held to constitute an employment. As the Court of Appeal affirmed in *Quashie* at [12], it all depends on the facts and circumstances of the particular case.

Chaos in the First Tier Tribunal (2018-2019)

This section surveys the IR35 decisions of 2018 and 2019, in order to highlight the lack of a consistent approach on the part of the First Tier Tribunal as to how these rules should be applied. It should be noted that all of the decisions considered here were decided under the old IR35 rules in Chapter 8 of Part 2 ITEPA 2003. In so far as the author is aware, no decision involving the 2017 rule expansion has yet been published.

Christa Ackroyd Media Ltd v HMRC [2018] UKFTT 69 (TC) was the first of several recent IR35 cases involving well-known television presenters to come before the Tribunal. From the taxpayer's standpoint, the factual situation was quite damaging: There was a written contract giving the BBC "first call" over Ms Ackroyd's services for up to 225 days per year, although in practice the days worked were mutually agreed (see [40]). Whilst the BBC was not obliged under the contract to call on Ms Ackroyd's services, if they did not, they were still obliged to pay (see [51], [56]). The contract also prohibited Ms Ackroyd from providing her services for other broadcasts or publications without first obtaining the BBC's consent (see [30], [47]). Moreover, Ms Ackroyd could be told whom she was interviewing (see [35]) and it was for the BBC's editor to decide what stories were covered and in what order (see [38]). Also, the vast majority of Ms Ackroyd's income (more than 95% during the years in

question) came from the BBC (see [81]). On the other hand, though, there were various other factors pointing towards self-employment: Ms Ackroyd did not have a desk at the BBC and used her own computer and mobile phone to perform the services; she also kept her own diaries and the BBC did not log the days she worked (see [42]). Unlike regular BBC employees, Ms Ackroyd did not have a line manager and was not subject to appraisals; she had no set hours and no entitlement to sick pay, holiday pay, maternity leave, or pension benefits (see [53]). She also received a “success fee” for every 6-month period in which her ratings exceeded those of a rival programme (see [57]). Whilst her scripts were “greened” by a producer, Ms Ackroyd could and did modify them right up to final delivery on air (see [66]-[68]). Moreover, she did in fact undertake some additional work without seeking the BBC’s permission, and, prior to 2013, was never prevented from doing so (see [76]-[80], [86]). The Tribunal accepted that Ms Ackroyd had a high degree of autonomy in carrying out her work, as well as in identifying the stories she wished to follow (see [88]). The Tribunal then applied the *Ready Mixed Concrete* criteria:

- Mutuality of obligation was not disputed here, as both sides agreed that Ms Ackroyd was required to work at least 225 days per year and the BBC was obliged to pay her annual fee in monthly installments (see [157]).
- As regards control, the Tribunal found that the BBC could direct which services it required Ms Ackroyd to perform (see [160]) and, although she had no line manager, the BBC could direct both what she did and how she did it (see [165]). This was held to be necessary for “business efficacy” to ensure compliance with the BBC’s editorial guideline (see [167]).
- As regards the other conditions of the contract, the Tribunal noted that this was “a highly stable, regular, and continuous arrangement” (see [170]). The lack

of provision for holiday, sick pay and pension benefits was held not to be significant, since the actual contract between the BBC and Ms Ackroyd's PSC was plainly not an employment contract and so would not be expected to include such benefits (see [171]).

The Tribunal concluded that Ms Ackroyd was not in business on her own account – she was economically dependent on the BBC and devoted most, if not all, of her working time to them (see [176]). An appeal against this decision was heard by the Upper Tribunal in July 2019 and dismissed in late October.¹⁰ However, this appeal is unlikely to carry significant precedent value, as it was limited to the narrow issue of whether the FTT had erred in law in concluding that, under the hypothetical contract, the BBC would have had sufficient control over Ms Ackroyd to establish an employment relationship. Apart from some minor differences as to reasoning, the UT accepted the FTT's conclusions on that point.

The next IR35 decision published was *MDCM Ltd v HMRC* [2018] UKFTT 147 (TC), which involved a contractor who was engaged by a construction company as a night shift manager. The main point of interest in this case is the sheer number of factors that pointed towards employment, but the Tribunal nevertheless found for the taxpayer. HMRC argued that control was the most important factor here, since the contractor was required to work specific shift patterns, to report to the client's project manager to receive instructions for in each shift, to ensure the safe operation of the site, and to serve as point of contact for the workers (see [44]-[47]). The Tribunal also identified various other factors pointing towards employment: the client directed what the contractor had to do during each shift (see [49]); the contractor did not take any financial risks (see [53]-[57]); the client provided all the equipment (see [58]); and the contract was open-ended as to duration (see [62]). However, evaluating the overall effect, Tribunal found for

taxpayer. In particular, there was no evidence that the contractor was controlled any more than any other contractor would be, and he could refuse to work on another site (see [74]). Further, the contractor received a flat daily rate, with no notice period and no benefits, and was not integrated into the client's business (see [74]-[75]). As regards the lack of employee benefits (dismissed as insignificant in *Christa Ackroyd*), this differently-constituted Tribunal said that what mattered was what would have been in the hypothetical contract between the client and the contractor. The fact that the contractor was in fact employed by the PSC (and not by the end client) was therefore irrelevant. The availability of statutory rights was also considered to be irrelevant because the hypothetical contract is only concerned with contractual rights (see [65]).

Jensal Software v HMRC [2018] UKFTT 271 (TC) involved an IT consultant, Ian Wells, who provided his services through a PSC, via an agency, to the Department of Work and Pensions. He was engaged to provide expert advice in relation to the operational readiness of certain parts of the Universal Credit Programme. As regards mutuality of obligation, the Tribunal found that, outside of each short-term contract, there was no continuing obligation on the DWP to provide work or on Mr Wells to work. Additionally, a genuine right of substitution (albeit never exercised) was found to exist. Thus, whilst there was mutuality of obligation, it was no more than the irreducible minimum for any engagement (see [132]). As regards control, the Tribunal found that Mr Wells was subject to minimal oversight or supervision; he was brought in for his specific expertise to complete a task, but it was for him to assess what needed to be done, how it could be done, and the timescale in which it could be done (see [127]). Moreover, the level of oversight Mr Wells received was much lower than that of DWP employees, and did not go beyond what might be expected for any independent contractor (see [131]), with the result

that the requisite degree of control was not present (see [132]). As regards other factors, the Tribunal found that the absence of holiday pay, sick pay, and pension benefits pointed away from a contract of employment (see [133]). Also, whilst Mr Wells had no opportunity for additional profit from the arrangement, he was exposed to more financial risk than an employee would have been, in that he had to remedy any defects in the work at his own expense (see [136]). He was also required to take out his own public liability and professional indemnity insurance (see [138]). Looking at everything in the round, the Tribunal found that the hypothetical contract was a contract for services (see [139]).

In March 2019, the FTT decided another television presenter case, *Albatel Ltd v HMRC* [2019] UKFTT 195 (TC), this time involving Lorraine Kelly, host of the eponymous *Lorraine* programme for ITV and a former presenter on *Daybreak*. The Tribunal held that mutuality of obligation did exist, but that it only amounted to the irreducible minimum and therefore was not determinative (see [164]). As regards control, the Tribunal found that control of Ms Kelly's work pursuant to the hypothetical contract lay with Ms Kelly, and was far below the sufficient degree required to evidence a contract of service (see [175]). In particular: Ms Kelly received minimal or no supervision (see [168]); she determined the running order of her programme, the items to feature, and the angle to take in interviews (see [169]-[170]); she was hired not to be part of a team but to lead a team (see [171]), and was free to carry out other work without any real restriction (see [173]). The fact that Ms Kelly was bound by the OFCOM rules was held not to assist HMRC, since those rules apply across the industry, whether an individual is employed or self-employed (see [175]). As regards other factors, the Tribunal found that ITV was not employing a servant, but purchasing a product, namely the brand and individual personality of Lorraine Kelly, and this

was found to support the conclusion that Ms Kelly was in business on her own account (see [180]). Additionally, a host of other factors pointed towards self-employment, including: the lack of employment benefits; the lack of training and appraisals; the intentions of the parties; and Ms Kelly bearing the risk of having her programme dropped if ratings fell or if she suffered a long-term illness (see [176]-[178]).

Atholl House Productions Ltd v HMRC [2019] UKFTT 0242 (TC) (published in April 2019) involved television presenter Kaye Adams, in her work for the BBC. The Tribunal found that mutuality of obligation and some degree of control were present (see [117] and [123]), and noted that these two conditions are necessary but not always sufficient to establish an employment relationship. However, the FTT also found a number of other factors to be inconsistent with employment: Ms Adams used her own equipment (laptop, iPad, and mobile phone) in providing the services and had no access to the BBC's system outside the studio (see [125(a)]). The lack of holiday or sick pay, maternity leave or pension entitlement also pointed away from the relationship being one of employment (this is in contrast to *Christa Ackroyd* where the lack of such benefits was dismissed as insignificant) (see [125(b)]).¹¹ Additionally, Ms Adams was treated differently from the BBC's employees in a number of respects – she received no performance reviews, was not subject to the same formal processes in relation to changes in the nature of her work, and did not have the right to apply for BBC vacancies in the way that employees did (see [125(c)]). The intentions of the parties (see [128]) and the fact that the BBC did not regard Ms Adams as “part of the organisation” (see [126]) were also found to point away from the relationship being one of employment. Standing back from the detail and considering the whole picture, the Tribunal concluded that the hypothetical

contract between the BBC and Ms Adams was a contract for services and not an employment contract (see [129]).

The next case, *George Mantides Ltd v HMRC* [2019] UKFTT 0387 (TC), involved a urologist who provided services via a PSC to two NHS hospitals. The Tribunal found that IR35 applied in relation to the arrangements with one hospital but not in relation to the other. In the case where IR35 did *not* apply, the following factors were found to be decisive (see [121]): Mr Mantides had a right (albeit never exercised) to send a suitably qualified substitute; the contract could be terminated with one day's notice by either party (in the other case, a week's notice was required); and finally, the hospital had no obligation to provide Mr Mantides with a minimum number of hours of work (in the other case, the Tribunal inferred that the hospital would "endeavour" to provide 30-40 hours of work per week). These were the only material differences that the Tribunal identified between the arrangements with the two hospitals (see [122]), illustrating the fine distinctions on which IR35 outcomes can turn.

Kickabout Productions Ltd v HMRC [2019] UKFTT 0415 (TC) involved a radio presenter, Paul Hawksbee, in his work for Talksport. Although this was a taxpayer victory, there were a number of factors that seemed to point towards employment: The Tribunal found that Mr Hawksbee was obliged to provide his services for a minimum of 222 days per year (although Talksport was not obliged to provide him with work, and was only obliged to pay for services actually performed) (see [180]-[183]). Mr Hawksbee was also required to perform the services personally, and there was no provision for substitution (see [206]). Moreover, Mr Hawksbee had presented the show for 18 years under successive two-year contracts (although the IR35 challenge related to only three of those years, and there was no guarantee of renewal when each short-term contract expired) (see [228]-[229]). Mr Hawksbee was also restricted

from providing similar services to other broadcasters without prior consent from Talksport (see [198]-[199]). Additionally, Talksport had ultimate editorial control over the broadcasts (see [191]). Finally, more than 90% of Mr Hawksbee's income for the years in question came from Talksport (see [227]). The Tribunal gave limited attention to mutuality of obligation and control, finding them not decisive in this case (see [234]). Of much greater significance were the following factors, pointing towards self-employment: Talksport was not obliged to provide work for Mr Hawksbee (see [236]). There was no provision for holiday, sick pay, pension benefits, or paternity leave (the Tribunal expressly rejected the conclusions of the *Christa Ackroyd* Tribunal on this point) (see [209]-[210]). Mr Hawksbee had no rights relating to medicals, training, appraisals, or grievance or disciplinary procedures (see [212], [230]). He was also exposed to financial risk in the form of opportunity cost (he had turned down an opportunity to work as a writer on another show as it would have clashed with his presenting responsibilities) (see [216]). Finally, Mr Hawksbee was not "part and parcel" of the Talksport organisation (see [225]). The Tribunal itself was divided in this case, with the outcome being determined by the casting vote of Judge Thomas Scott (see [93]).

Paya Limited, Tim Willcox Limited, and Allday Media Limited v HMRC [2019] UKFTT 0583 (TC), which involved BBC presenters Joanna Gosling, Tim Willcox and David Eades ("the Presenters"), was another victory for HMRC. The Presenters had all worked for the BBC for many years. They gave evidence that, around 2004, the BBC had required them to set up and begin working through personal services companies as a condition of continuing to work for the organisation. The Tribunal acknowledged that there was a "substantial disparity of bargaining power" between the BBC and those it engaged as presenters (see [435]). However, in relation to the *Ready Mixed*

Concrete criteria, the Tribunal concluded that “in each of these cases, in each relevant tax year, there was sufficient mutuality and at least a sufficient framework of control to place the assumed relationships between the BBC and the Presenters in the employment field” (see [557]). As regards mutuality of obligation: the Presenters (via their PSCs) worked under a series of short-term contracts, which incorporated certain standard terms, and gave the BBC “first call” on each Presenter’s services for a minimum number of days per year in exchange for an annual fee. The parties disputed what these provisions meant. HMRC argued that the BBC was obliged provide work for the Presenter for the minimum number of days or (assuming the Presenter made him/herself available) to pay the specified fee, regardless of whether the Presenter was actually called upon to work (see [439]). The taxpayers argued that there was no obligation on the BBC to offer the Presenters any work at all; the PSCs merely agreed to give the BBC “first call” over a minimum days which the BBC could take up or not at its discretion; there was no obligation on the Presenter to accept an individual assignment when offered (there was evidence of specific assignments being refused); and the BBC was only obliged to pay for the programmes which the Presenters actually presented on (see [439]). The Tribunal sided with HMRC on mutuality, holding that the BBC was obliged to provide work or to pay if it did not, and the PSCs were required to make the Producers available for at least the minimum number of days (see [445], [451]). The Tribunal also held that, since the Presenters continued to work and be paid during the “gaps” between contracts, the terms of the previous contracts should be taken still to apply until new terms were put in place, creating continuous mutual obligations throughout the relevant period (see [463]). As regards control, the Tribunal concluded that the BBC had the contractual right to decide when and where the work was to be done, and via its editorial controls, how it

was to be done (see [583]-[598]). The BBC also had a contractual right to prevent the Presenters from working for others without its consent (see [599]). As regards other provisions, the Tribunal held that the presenters were economically dependent on the BBC (see [623]-[624]), and faced limited opportunities for either profit or loss under the contracts (see [627]-[631]). Moreover, the Presenters did not have sufficient outside activities to qualify as providing the services as part of broader self-employment businesses (see [632]). The Tribunal also had regard to the overall duration of arrangements (see [615]) and did not consider the lack of employment benefits to be a material indicator against employment (see [640]). It should be noted that, as in *Kickabout Productions*, the Tribunal was divided in this case, with the outcome being decided by the casting vote of Judge Harriet Morgan. The dissenting member, Mr Andrew Perrin, would have held the Presenters to be self-employed for the following reasons (see [647]):

- They had no guarantee of renewal when each short-term contract expired.
- They had flexibility in their patterns of work and could refuse particular slots or swap with other presenters.
- They had considerable autonomy in conducting their work, and the BBC's editorial guidelines applied equally to employed or self-employed presenters.
- The Presenters had only limited insurance cover, and received no holiday pay, sick pay, maternity/paternity benefits, pensions, premium rates for overtime, or mobile phones or company cars (which staff had). Further, their passes to access the BBC building were only valid during each short-term contract.
- The Presenters could seek to use their journalistic talents elsewhere and in practice the BBC's consent for outside work was usually forthcoming.

- Finally, the imbalance of bargaining power should be taken into account, as the BBC effectively used their position to force the Presenters to contract via PSCs.

Canal Street Productions Ltd v HMRC [2019] UKFTT 647 (TC), another taxpayer victory, involved Helen Fospero, a television presenter who worked for ITV as an occasional substitute on the *Daybreak* and *Lorraine* programmes. There were three successive contracts governing the relationship between ITV and Ms Fospero's PSC. One of these contracts anticipated that Ms Fospero's services would be required for 20 days per year (although in fact Ms Fospero worked more days than that), and she was paid a fixed fee for each engagement actually performed. The contracts required Ms Fospero to disclose all her commercial activities to ITV, and imposed some ongoing restrictions on her personal conduct and on her ability to work for other broadcasters (see [91]). During the two tax years in question, Ms Fospero worked for between 10 and 20 other clients, but ITV accounted for approximately 61% and 72% of her income, respectively (see [107]). As regards mutuality of obligation, the Tribunal found that there was no contractual obligation on ITV to offer Ms Fospero any work or on Ms Fospero to accept any work that was offered. However, once a particular engagement was offered by ITV and accepted by Ms Fospero, there was sufficient mutuality of obligation to place the arrangements "in the employment field" (see [169]-[170]). As regards control, the Tribunal found that, despite Ms Fospero's considerable autonomy during live broadcasts, ITV could determine the nature of the services they required her to perform and also retained ultimate editorial control over the programmes. This was held to constitute a sufficient degree of control to evidence employment (see [176]-[181]). However, as in many other IR35 taxpayer victories, it was the third of the *Ready Mixed Concrete* criteria that proved decisive in this case. The Tribunal identified a number of factors that

it considered to be inconsistent with employment and which instead pointed towards Ms Fospero being in business on her own account. First, although there were some contractual obligations that continued between engagements (such as obligations on Ms Fospero to maintain her health and not to engage in dangerous activities without ITV's consent), there were no continuing *work-related* obligations; when Ms Fospero finished a particular engagement, there was no obligation on ITV to offer her work again, and she was under no obligation to accept work that was offered (see [187]-[189]). Additionally, although there was a sufficient right of control to establish an employment relationship, the control that ITV actually exercised over the production and content of Ms Fospero's programmes was the same as would have been exercised over any presenter, whether employed or self-employed (see [190]). Further, although Ms Fospero in fact only did broadcasting work for ITV during the years in question, she tried to find such work for other clients during those years, and actually worked as a broadcaster for others both before and after the period in question (see [193(1)]. Ms Fospero also incurred costs in relation to her business (such as employing an agent) that an employee would not have needed to incur (see [193(2)]. Further, the parties did not intend that Ms Fospero would be an employee (see [193(3)]). Finally, Ms Fospero was treated very differently from ITV staff: she had no laptop, no ITV email address, no workstation, and did not receive an expense allowance comparable to that of employees (see [193(3)]). For all of these reasons, the judge concluded that if Ms Fospero had contracted directly with ITV, the relationship would have been one of self-employment (see [194]).

The final IR35 decision of 2019, *RALC Consulting Ltd v HMRC* [2019] UKFTT 0702 (TC), involved an IT consultant, Richard Alcock, who provided services through a PSC via an agency to Accenture and to the Department of Work and

Pensions under a series of short-term contracts. As regards mutuality of obligation, the Tribunal found that there was no obligation on either end client to provide Mr Alcock with work or to renew the contracts. Further, Mr Alcock was only paid for work actually offered and accepted; the work itself was project-based rather than role-based, and the contracts could be cancelled at any time. Thus, there was insufficient mutuality of obligation to establish an employment relationship (see [342]-[345]). Mr Alcock also had a contractual right (albeit never exercised) to send a substitute, but because this right was fettered by a requirement for the end client's approval, the Tribunal found that it was insufficient to negate a requirement for personal service (see [362]-[370]). As regards control, the Tribunal held that, whilst the end clients did have some control over *what* Mr Alcock did, the degree of control, by right or in practice, was not such as to indicate an employment relationship (see [390]). The Tribunal also found that the end clients had some control over *how* Mr Alcock did his work, but this was only such as was necessary to secure a good outcome his clients and so did not indicate an employment relationship (see [402]). The end clients had full control over *when* and *where* Mr Alcock worked (see [417]), but this was outweighed by Mr Alcock's substantial control over what he did and how he worked (see [419]). As regards other factors, the Tribunal found that Mr Alcock's contractual right to work for others (which he exercised to a limited extent, and which pointed towards self-employment) was offset by his significant degree of economic dependency on Accenture and the DWP (see [429]). However, there were numerous other indicators of self-employment, including the fact that neither Mr Alcock nor the end clients considered him to be "part and parcel" of those organisations (see [437]); the fact that the PSC leased and paid for the premises from which Mr Alcock worked (see [438]); the fact that Mr Alcock was required to bear the cost

of his own professional indemnity insurance (see [439]); and the fact that the contracts could be terminated at any time (see [443]-[450]). The Tribunal considered the lack of sick pay, holiday pay, and pension benefits to be a neutral factor (see [442]).

These recent cases illustrate the ongoing lack of consistency within the First Tier Tribunal as to how the IR35 rules should be applied in practice. This appears to be an area ripe for intervention by the higher courts. In *Kickabout Productions* at [20], the FTT itself highlighted the forthcoming extension of IR35 to the private sector, as well as the anachronistic nature of the existing case law on employment status, stating “In our view, increased clarity is badly needed.”

Endnotes

1. See “Off Payroll Working Rules from April 2020”, HMRC policy paper and consultation document (published 5 March 2019) at page 4: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/822388/Consultation_document_off-payroll_working_rules_from_April_2020.pdf
2. In *Big Bad Wolff* at [40]-[46], the Upper Tribunal specifically rejected the argument that IR35 was intended to function as a “unitary code” where the tax and NICs parts would always apply in the same way. The tribunal pointed out that, before IR35 was brought in, income tax and NICs treatment did not always align (by virtue of the Categorisation Regs), with the result that there was “no compelling reason” to assume that the IR35 provisions should operate identically.
3. Where the fee-payer is not the client and not a qualifying person (broadly, a person resident or having a place of business in the UK and which the worker does not control and in which he does not have a material interest), then the next lowest link in the chain that is a qualifying person is treated as making this payment.
4. See *Ged Killian MP (Lab, Rutherglen and Hamilton West)* and others,

House of Commons debate on IR35, 4th April 2019: <https://hansard.parliament.uk/Commons/2019-04-04/debates/2B3F5406-7F82-447C-99D6-382F41E57E2B/IR35TaxReforms>

5. See Ged Killian MP (Lab, Rutherglen and Hamilton West), House of Commons debate on IR35, 4th April 2019, Column 477WH: <https://hansard.parliament.uk/Commons/2019-04-04/debates/2B3F5406-7F82-447C-99D6-382F41E57E2B/IR35TaxReforms>
6. A private-sector client must withdraw the status determination statement before the beginning of a tax year if it ceases to be medium or large for that tax year (see draft s.61TA ITEPA 2003, as set out in paragraph 13 of the IR35 Schedule to the Finance Bill 2019-20).
7. See Table 2.1: Budget 2018 policy decisions, available here: <https://www.gov.uk/government/publications/budget-2018-documents>
8. See *Dragonfly Consulting Ltd v HMRC* [2008] EWHC 2113 (Ch) at [59] where Henderson J affirmed that an obligation on the employer to provide work or in the absence of work to pay is a “touchstone” of an employment contract, the absence of which would call into question the existence of an employment relationship.
9. See, for example, *Hall v Lorimer* [1992] STC 599 (Ch) at 612 per Mummery J: “In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person’s work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail.”
10. [2019] UKUT 0326 (TCC).
11. In *Atholl House* at [125], Judge Beare disagreed with the FTT’s reasoning in *Ackroyd* on this issue, pointing out that it would have been perfectly possible to achieve the substance of these benefits through the actual contract between the BBC and the intermediary – e.g. by providing that if Ms Adams was unable to present due to illness, the BBC would pay the intermediary anyway.

CHANGING PERSPECTIVES: THE PUBLIC RELATIONS BATTLE FOR TAX ADVISERS

By Samuel Brodsky

Public opinion affects the direction of travel of our system of taxation: the tax policy of our current and future governments, the attitude of HMRC to individual taxpayers in correspondence and negotiation, and (whisper it quietly) even how judges view tax cases. It is troubling therefore that, in the current climate, “tax” is a dirty word and “tax adviser” suggests to many someone who aids and abets those who cheat the system. HMRC has had considerable success in the public relations battle in recent years, but a new government is an opportunity for the profession to fight back. How might they do this? One of the first steps must be to talk about those cases where victory for the taxpayer really is the right result, and I start with some cases in which I have been involved.

Principal private residence relief:

HMRC v Higgins [2019] EWCA Civ 1860

This case was about principal private residence relief, and whether a taxpayer needed to live in a property from the date of exchange of contracts in order to qualify for full relief, or whether it was sufficient to occupy from the date of completion. Mr Higgins exchanged contracts on an off-plan flat in 2006, agreeing to purchase from a developer at a time when the flat was still to be constructed. The flat was physically completed in December 2009, and the purchase was legally completed in January 2010. He lived in the flat for two years, as his principal residence, and then sold it at a gain. Mr Higgins claimed full relief on the sale, on the basis the flat had been

his main residence for his entire “*period of ownership*”, as required by s.223 of the Taxation of Chargeable Gains Act 1992. HMRC however took the view that Mr Higgins’ “*period of ownership*” commenced on the date of exchange (rather than completion). It was common ground that Mr Higgins did not live in the property from the date of exchange: it is rare for a purchaser to be entitled to move in before completion, and in this case the flat had not even been constructed at that point in time.

As a matter of law, HMRC’s position was weak and unanimously rejected by the Court of Appeal. A purchaser obtains only limited land rights on exchange of contracts, and is not properly described as the “*owner*”. And, in the case of an off-plan purchase, it is hard to see how someone can “*own*” a property before it has even been built. HMRC’s approach was also bizarre as a matter of policy. It would have led to most ordinary members of the public having a CGT liability on the sale of their homes as it is rare for a purchaser to be entitled to occupy before completion. As the Court recognised, that would have meant that the legislature had failed to grant the relief in the paradigm case. This approach also risked significantly undermining the property market. The delay between exchange and completion is inevitably larger on an off-plan purchase, and so a decision in HMRC’s favour would have been a significant disincentive to those considering an off-plan purchase. That may have put at risk the ambitious housing plans of the government and developers. It could also have trapped current home-owners in their properties, unwilling or unable to pay the high CGT bill that even a lateral move would trigger. That would cause further stagnation in the market.

Higgins was a case where a taxpayer victory was important not only for the individual concerned, but also for the government and the wider body of taxpayers.

Claim for NICs without limitation of time

In general, the Limitation Act 1980 (LA 1980) does not apply to claims by HMRC for the recovery of any tax or duty, as such claims are expressly excluded by s.37(2)(a). However NICs are not a tax but a “contribution”. Accordingly LA 1980 does apply, and any claim must (subject to some exceptions) be brought within the six year time limit in s.9. If a company has failed to pay their NICs, HMRC can in some circumstances issue a personal liability notice (PLN), which imposes personal liability on company directors. This power is contained in the Social Security Administration Act 1992, s.121C, but it is not subject to any express time limits. There is however an inherent time limit: a PLN can only be issued if there is an existing “*liability*” on the company, and the best view is that a time-barred liability is not a “*liability*” for the purposes of s.121C. Accordingly the six-year limit also applies to a PLN.

HMRC however have taken the point that – if the company entered liquidation during the six-year window – this “stops the clock” for the purposes of issuing a PLN against a director. That interpretation is not supported by the statute. It is also worrying as a matter of policy. Section 121C already represents a significant erosion into the principle of separate corporate personality, and inevitably will most often be utilised where the relevant company is insolvent (as otherwise it would be able to pay the NICs itself). There is thus a real risk of injustice if directors are held personally liable more than six years after the tax debt fell due on the company. Where there is no allegation of fraud or deliberate conduct, certainty for the taxpayer is an important principle. Certainty is especially important in the context of PLNs, because the amount of liability is based on the company’s unpaid debts, and accordingly might be far in excess of any remuneration or other income which the director actually received.

Conclusion

Communicating cases of injustice to the wider public is a difficult task, but one which has the potential to dramatically shift public perception of the tax code and, by extension, the direction of legislative reform in the new decade.

CRYPTO-ASSETS: THE TAXATION OF SECURITY TOKENS

By Harry Winter

The taxation of crypto-assets has been something of a hot topic of late, and one made all the more interesting by the lack of comprehensive guidance provided by HMRC.

Crypto-assets are conventionally (insofar as there are yet conventions) split into three – exchange tokens, utility tokens, and security tokens.

1. Exchange tokens are intended to be used as a method of payment and include cryptocurrencies such as bitcoin.
2. Utility tokens provide the holder with access to particular goods or services on a platform. A business or group of businesses might issue utility tokens and commit to accepting the tokens as payment.
3. Security tokens provide the holder with particular interests in a business, typically akin to loans or shares.

HMRC guidance currently covers only exchange tokens in the hands of individuals and companies. This note addresses security tokens in the hands of UK investors. I should in passing observe that utility tokens are likely to be regarded as prepayment for goods or services and taxed on that basis (including VAT), although one could potentially be regarded as trading in such tokens.

Traders

One point seems tolerably clear: if one is trading in security tokens, then one's profits will be taxed as trading profits. The test for this is likely to be similar to those applicable in deciding whether one is trading in other financial assets, for which a certain level of expertise tends to be required (typically because

of HMRC's reluctance to grant tax relief for the inevitable losses suffered by the unwary). As the charge to trading income takes priority over savings and investment income, tax would be chargeable at normal rates rather than dividend rates for sums arising from the tokens that would otherwise appear to fall within the definition of distributions. For companies which are trading, matters may be more complicated than for individuals. Credits and debits may well be calculated under the loan relationships and/or derivatives codes, depending on the exact nature of the security token, before being fed into the charge to trading income. Since the charge to trading income takes priority over the distribution exemption, there will be tax chargeable on sums arising from the tokens that would otherwise appear to fall within the definition of distributions.

Non-traders

Individuals holding security tokens but not trading are not out of the income tax woods. The deeply discounted securities rules may apply if (as I have seen), security tokens can be redeemed after a period for a substantial premium. Further, income from the tokens that constitutes distributions will be charged to income tax at dividend rates, and there may be interest or disguised interest to account for.

If an individual can successfully navigate through to capital gains tax and its lower rates, pooling and negligible value claims are likely to be in point. For companies, the loan relationships and derivatives codes have priority over capital gains rules: if they apply, credits and debits calculated under those codes would then be charged to tax under the loan relationships code. If they do not, then capital gains rules would be used.

Stamp taxes

Stamp Duty Reserve Tax will in theory be chargeable on some security tokens. However, between the exemption for securities

issued or raised by a company incorporated outside the UK with no UK register, the exemption for vanilla non-convertible loan capital, and the exemption for the issuance of new securities, SDRT will often not be in point. Stamp Duty is in principle payable on any instrument of transfer of security tokens (including an instrument constituting an agreement to transfer) which is executed in the UK or which relates to any matter or thing done or to be done in the UK. Again, the exemptions for the issuance of new securities and for vanilla non-convertible loan capital are likely frequently to apply. Further, given Stamp Duty is not a legal obligation, where the security token is issued by a foreign company and any instrument of transfer is executed and retained outside the UK, Stamp Duty will often not in practice need to be paid.

Inheritance tax

Crypto-assets are, as the name suggests, assets. Accordingly, if UK-situs, they will be chargeable to inheritance tax wherever the holder is domiciled, and, if foreign-situs, chargeable to inheritance tax if the holder is UK-domiciled or deemed domiciled. The situs of security tokens is likely to be the place where the obligations of the issuer fall to be enforced, being typically debts or choses in action. (This stands in contrast to the HMRC guidance on the situs of exchange tokens, which are said to be located where the beneficial owner is resident – likely to be a problem for non-doms.)

Conclusion

In the end, security tokens are unlikely to cause real problems for the tax system, at least in principle. Often, they amount to little more than a fancy way of dressing up a loan or share in the issuer and they will be taxed accordingly.