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PRIVATE FOUNDATIONS - AN ASPECT OF THE REMITTANCE BASIS

by Felicity Cullen

A foreign private foundation ("Foundation") might be described as a corporate vehicle which exhibits many of the characteristics of, and in some ways resembles a settlement or trust.[1] It has no exact equivalent in the law of England.

The UK tax treatment of a Foundation, its Founder and its beneficiaries is (because of its uncertain status for UK tax purposes) to a considerable extent a matter of speculation and, as Robert Venables QC has said[2], "anyone who prefers to become a Founder of a Foundation ... must appreciate that he is entering upon unchartered waters." There are many tax issues to be considered when establishing a Foundation and during the life of that Foundation. In this note I propose to consider only one of those many issues. This issue has evolved as a result of the amendments to the remittance basis of taxation in FA 2008. It concerns the capital gains tax ("CGT") treatment of gains accruing to the Foundation (as distinct from gains which may accrue to the Founder on creation of the Foundation).

For the purposes of considering this point, a number of assumptions are made as follows:-

- it is assumed that one of the fundamental tax issues concerning a Foundation, namely whether it should be treated as a company or a trust for

tax purposes, can be neither conclusively nor exclusively resolved one way or another

- it is assumed that the trustees of the trust (if the Foundation is that) are resident, for tax purposes, outside the United Kingdom

- it is assumed the company (if the Foundation is that) is resident, for tax purposes, outside the United Kingdom

- it is assumed that the Founder of the Foundation will be an individual who is resident and ordinarily resident in but domiciled outside the United Kingdom for tax purposes

- it is assumed that the Founder will effectively control the Foundation for the benefit of himself and his family. As many Foundations will be created for asset protection purposes, this is indeed likely to be the case

- it is assumed that the Founder will be able to direct that all of the assets in the Foundation can be transferred to him or applied for his benefit.

Analysis

Though it will depend upon the type and terms of the particular Foundation created, as well as the law of the jurisdiction under which it is formed and by which it is regulated, the property in (to use a neutral term) the Foundation will probably not be "held in trust" so that

the Foundation should not be treated as a settlement[3] for general CGT purposes. For the purposes of ss.86A – 96 TCGA 1992, however, the definition of “settlement” is the wide income tax definition, which is now found in s.620 IT(TOI)A 2005. Under this definition, “Settlement” includes any disposition, trust, covenant, agreement, arrangement or transfer of assets ...”. It is considered that a Foundation will fall within this definition of settlement (in s.620 IT(TOI)A 2005) so that gains accruing to those persons who are regarded as the trustees of the Foundation[4] will be attributable to and chargeable on persons (beneficiaries) who receive capital payments (as widely defined) from the Private Foundation which (if those persons are taxable on the remittance basis in its new form) they remit (as defined by FA 2008) to the United Kingdom.

On the basis that the Foundation may also be a company for UK tax purposes, the provisions of s.13 TCGA 1992 will also apply to attribute capital gains accruing to the Foundation to the participators in it according to their respective interests. On the assumption that the Founder is able to direct that the whole of the assets “in” the Foundation are transferred to him (or otherwise provided for his benefit), all of the gains accruing to the Foundation will be attributable to the Founder in accordance with s.13 TCGA 1992 and the new remittance rules which are (effectively) made applicable to s.13 TCGA 1992 by s.14A TCGA 1992. Before the introduction of the new rules in FA 2008, non-domiciled individuals were wholly excluded from liability under ss.13 and 87 TCGA 1992 even if they

were resident in the UK for tax purposes. So the potential for liability to CGT to arise under these rules is a recent development.

Significantly, it will be apparent that there are two possible charges on the same gain. In practice, one would expect there to be a charge to CGT on the single gain accruing to the Foundation under one provision only. The question of priority of charge is, however, quite a difficult one. Under the new remittance basis, s.13 TCGA 1992 will apply to charge gains accruing on the disposal of assets situated in the United Kingdom on an arising (rather than a remittance) basis. In these circumstances (i.e. where gains accrue on the disposal of assets situated in the United Kingdom), it seems likely that HMRC will seek to apply s.13 TCGA 1992 in priority to s.87 TCGA 1992. Where, however, assets situated outside the United Kingdom are disposed of by the Foundation, it seems more logical for the charge under s.87 TCGA 1992 to apply so as to cause tax to be suffered by the (more direct) beneficiary of the gain.

It may be that there is some experience of the potential conflict between these two potential heads of charge in matters involving UK domiciled founders of Foundations. Historically, however, it seems likely that there will have been relatively few such founders. The lack of a decisive conclusion on this point is typical of many tax points concerning Foundations so it is not wholly surprising; it is, nevertheless, not satisfactory. What might be more surprising – indeed alarming - is the potential extent and impact of the new unchartered

waters of the remittance basis. Mapping has only just begun.

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[1] For a general summary of jurisdictions in which Foundations may be established, reference should be made to the Private Foundations Handbook 2007, published by the ITPA in March 2007, editor Milton Grundy.

[2] The Liechtenstein Foundation and UK Tax Avoidance – Robert Venables QC, The Offshore Tax Planning Review, Volume 4, 1993/94 Issue 3.

[3] As defined in s.68 TCGA 1992. Strictly, s.68 TCGA 1992 defines settled property as "any property held in trust other than property to which section 60 applies (and reference, however expressed, to property comprised in a settlement are references to settled property". It is considered that the property in a Foundation is not held "in trust" and so is not settled property. Accordingly, the property in the Foundation is not comprised in a settlement for the purposes of s.68 TCGA 1992.

[4] Determining the identity of the trustees of the Foundation can, itself, be a difficult exercise.

TAX AVOIDANCE IN PRACTICE[1]

by David Goldberg

What reasons did you have for becoming a lawyer? Perhaps you had dreams of inheriting the gown of Erskine. Perhaps you hoped, one day, to heal, through the balm of compensation, the economic or physical harm caused by a tortfeasor or to do battle for an oppressed minority shareholder. Some of you may have become lawyers to have, one day, the privilege of doing just this: to plead before a jury for the life of an innocent man. It is, I suppose, just possible that you might now hope to spend your life dealing with the drama of ships that go bump in the night in the Arabian Gulf or, as that is sometimes called, commercial law. I doubt if any of you became a lawyer because you had dreams of going to the Tax Bar.

For myself, I became a lawyer partly out of family tradition and partly because I admired the bravery and apparent integrity of men like Chief Justice Coke and like Sir Thomas More, whose Inn I chose to join and for whom I had the deepest admiration, though later reading suggests that he may have been a bit of a hypocrite. Nonetheless, I admired – and still admire - the guts of these men, and I looked, I suppose, for the opportunity to ply my craft despite the antipathy of an overwhelming executive power, and looked to have the opportunity to remain true to myself, when every instinct of self-preservation said, “Bend to the wind!” And yet, for all these high-sounding dreams, I ended up practising at the Tax Bar, knowing by heart large chunks of the five

volumes which now make up the Yellow and Orange Books, knowing them even better than the perhaps more memorable and certainly more beautiful prose and poetry of Shakespeare or Virgil, which I learnt long before there even was a Yellow Book. But, believe it or not, life at the Tax Bar has measured up to the hopes which I had; and what I shall do this evening is to explain why and to link that to a discussion of the attitude of the Courts to tax avoidance, which may yet prove to be a field of dreams for the aspirational lawyer.

In his book *The Worker and the Law,* Lord Wedderburn made the remark that "most people want nothing more from the law than that it should leave them alone". The phrase is striking; and I believe it to be true. We live in a country sewn thick with laws, and – for the most part – we are at once glad that they are there and completely unaffected by them. There is, however, one area of the law which affects virtually every adult person in this country and probably almost anyone in any modern economy in the world. It is the law of tax: if you work, it is inevitable that you will have something to do with the law of tax and something to do with the people who administer it. If you do not work, the probability is that you will be entitled to benefits, and – again – you will have something to do with the persons who administer tax. So here's the thing: you can go through life without having anything to do with the criminal law, without having anything to do with the law of tort and without having anything to do with commercial or company law or the law of trusts; you can even go through life without being aware that you have had

anything to do with the law of contract. But you cannot go through life having nothing to do with the law of tax, unless you completely divorce yourself from the society in which you live.

Having something to do with the law of tax does not just impact on the relationships which one individual has with other individuals; it inevitably brings every taxpayer or benefit-seeker into contact with the State. When you deal with tax, the administrator can (and very often will) assert an unlimited power – the unlimited power of the State or, as we used to say before we became quite so European, of the Crown – to get involved with the detail of your life. It is improbable – not wholly impossible, but improbable – that you will regard the tax administrator as your friend; but many people will and do regard the taxman as an enemy, and, while that is undoubtedly unfortunate and regrettable, it is also – given the nature of the tax collector's job – almost inevitable that that will be how he or she is often regarded. This may make a life dealing with tax sound a little bit gritty, a bit like a Cold War stand-off or a black and white movie scripted by John le Carré – say *The Spy who came in from the Cold.* So let me see if I can add a little bit of colour.

Life at the Tax Bar has not been entirely without glamour. At the moment, the remittance basis is very much in the news. In my early days at the Bar, anybody who was employed by a non-resident and worked, under that employment, wholly abroad was on the remittance basis in respect of his or her salary. Moreover, once the

employment had ceased, the foreign emoluments could be brought here entirely free of tax, a significant benefit when the marginal rate of tax for even relatively modest earners was 83%. The arrangement, by which what might have been regarded as one job was divided between two employments – one wholly onshore and one wholly offshore, was known as a Split Schedule E, (this schedule being the one under which employment income was taxed). Many of the people who used this Split Schedule E arrangement were film stars and pop stars; and an advantage of the arrangement was that some of them remained resident and spending money here, when – without it – they would (as they very easily could) have become resident in a lower-rate jurisdiction such as the USA. The knowledge needed to put this arrangement into effect was not very great and the technology needed to implement it was not very difficult, so it was the sort of thing about which a relatively young barrister could advise. So I got to meet many well-known faces, who came as clients for advice as to just how to enter into and to operate their Split Schedule E arrangements.

The magic of Split Schedule E was available not only to actors, actresses and pop stars: it was available to anybody who worked outside the United Kingdom; and one of the people who availed himself of the benefits of the arrangement was a well-known politician called Mr Duncan Sandys. Mr Sandys was employed by what was then a high-profile company called Lonrho, which was managed by the buccaneering figure of Tiny Rowland – who was called "Tiny" for the same reason as Little John

was called “Little”, though I’m not entirely sure that they were taking and giving to the same groups of people. The arrangements involving Mr Sandys became public, and the Prime Minister of the day, Mr Edward Heath, who was not particularly noted as a phrase-maker, said that they represented the “unacceptable and unpleasant face of capitalism”. The only other remark of Mr Heath’s which I can remember was about Saddam Hussein, of whom he said that “he was not the sort of man you would want to have to dinner; not even to lunch actually”. That remark, of course, had nothing at all to do with tax, but the remark about capitalism did; and Split Schedule E was restricted, so that it was only available for non-domiciled taxpayers although, for some time, other reliefs remained available for domiciled employees working abroad. This trip down memory lane began with a grim tale of confrontation between the individual and the State and seems now to have strayed into the hedonistic and perhaps even selfish world of film stars, and – as we would now regard them – sleazy politicians on the take. The one seems rather far from the other, but is that really so?

Before I answer that question, let me ask another: what does it mean to be free? Do you consider yourselves free men and women? You do not have the freedom to stand up in a theatre and shout “fire” when there is no fire: you do not have the freedom to commit murder or theft. You do not have the freedom to open a bank account without going through the most ludicrous amount of regulation required by the money laundering legislation; and you do not have the freedom to travel

through this land without being photographed over and over. And yet I suspect that each of you considers yourself free. Why? What do you mean by "being free"? Let me suggest that the essence of freedom lies in knowing what it is you are allowed to do and what it is that you are not allowed to do. When we say that we are free, we mean that we can do any of the things that are permitted; and we might add that there is here – it may be different in Continental jurisdictions – a presumption that everything is permitted unless it is prohibited. The essence of the British concept of freedom, then, lies both in the assumption that you may do whatever is not prohibited and in the knowledge of what is prohibited.

In 1981 the House of Lords decided *Ramsay*[2] and they followed that up in 1984 with *Furniss v. Dawson*[3]. It was originally not entirely clear whether these were decisions based upon an analysis of the facts or upon a method of statutory construction; but in *Craven* v *White*[4] the Court strongly declared that it was just construing the statute and not doing anything special in relation to the facts. Over time, this encouraged the Revenue to think that there was a special rule of construction that tax avoidance does not work; and that was the argument they put to the Court in *MacNiven*[5]. The Court rejected the proposition that there was a special rule about tax avoidance; it said that it was conducting an ordinary exercise in statutory construction and attempted to set out an approach to statutory construction which, among other things, made a distinction between legal and commercial terms – a distinction which then got overblown by commentators.

What was going on here was something that is, in some respects, quite conventional; and it happens in all areas of the law. Judges perceive a problem and then set about trying to solve it: they attempt a solution, and if it works – that is, if it seems satisfactory as a solution in other cases, it becomes more or less fixed, and is used over and over again. However, if, in a later case, it seems that the solution is not satisfactory, then it is adjusted.

Up until *MacNiven,* I rather suspect that the House of Lords was indeed trying, as the Revenue thought they were, to create a general rule against the perceived problem of tax avoidance. However, when that proposition was put boldly to the judicial committee in *MacNiven*, the judges felt that it was too broad to be workable. Not everyone was happy with the process of reasoning by which the result in *MacNiven* was achieved, and the whole area was reviewed later, first in the *Arrowtown*[6] case in Hong Kong. According to the judgments in that case, the Courts in tax cases were doing no more than applying orthodox cannons of statutory construction to a realistic view of the facts of each case. In the jargon of the day, we call this purposive construction.

The science – or is it really an art? – of modern construction was pithily summed up by Mr Justice Ribeiro in the Hong Kong Court of Final Appeal in the case of *Arrowtown*. He said that "the ultimate question is whether the relevant statutory provision, construed purposively, was intended to apply to the transaction, viewed realistically". That was the first clear statement

in any of the tax cases that the approach of the Courts to tax avoidance involved a large factual element; and it is to be welcomed for that degree of honesty.

But let us examine that sentence, which may – perhaps – properly be designated as an aphorism and which has been approved by the House of Lords in *Barclays Mercantile*[7] and in *Scottish Provident*[8], so that it now represents the law here as well as in Hong Kong. What Mr Justice Ribeiro does not say is that you apply the statute to the facts. He says that you apply the statute, construed purposively, to the facts which are viewed realistically. What the Court is doing has been adjectivally expanded. It is not just applying the statute to the facts: it is construing the statute purposively, viewing the facts realistically, and then applying the purposively construed statute to the realistically viewed facts. That is, presumably, to do more than just to apply the statute to the facts because, if it is simply applying the statute to the facts, the adjectival phrases add nothing – indeed, mean nothing. Since, in our legal tradition, we attribute weight to everything that a Judge says, we must assume that these adjectival phrases do not mean nothing. Construing purposively is not the same thing as applying the statute. Indeed, when a Judge says that he is construing something purposively, it is inevitable that he is going to construe it to mean something that it does not say: if he is not going to construe something to mean what it does not say, he does not have to construe purposively.

The approach summed up by Mr Justice Ribeiro has its roots, as far as the English legal tradition is concerned, in *Ramsay*, but the decision in *Ramsay* is the inheritor of a tradition begun in the 1930s in America by the charismatically named Mr Justice Learned Hand, who wrote the most beautiful English. The beauty of his prose perhaps hides a lack of rigour in his analysis. I have not looked up the precise quote, but somewhere he makes a remark along the lines that the meaning of a statutory provision differs from the meaning of the words in it in the same way as a melody is different from the single notes which go to make it up. Lord Hoffmann has, of course, rejected the idea that a statute carries with it some kind of penumbral spirit, and, although he is now one of the arch proponents of purposive construction, I doubt if he would altogether accept the idea inherent in Learned Hand's notion of melody. I protest at the suggestion that words and music can be analogised in the way that Learned Hand did: words convey meaning and the statutory draughtsman is careful in the way in which he or she puts words together. Music, on the other hand, sets free the mind, so that emotions can take over: the combination of words does not achieve the same sort of thing as the combination of notes; and I do not find it any easier to swallow what Mr Justice Learned Hand says, given my knowledge that he was thrown out of his glee club at college because he could not sing.

By 1984 or, perhaps a bit later, and no matter what or where its origins were, the House of Lords seemed to have crafted a rule – or, at least, sent a message – that, if a statute had to be applied to something that was tax

avoidance, it would be construed so that it did not permit the tax avoidance to happen. Now, of course, the House of Lords has, apparently, been running away from that proposition in the recent cases or, at any rate, has been running away from that way of putting the matter. But you will, I am sure, have noted the extraordinary contradiction between the remark made by the House of Lords in *Barclays* that there was no special rule applicable to tax cases and the remark made by the very same judicial committee on the same day in *Scottish Provident*, that the rule in *Ramsay* had a beneficial effect in tax cases. Wherever we are now in our thinking about our approach to tax avoidance, we are a very long way from the sort of thinking which prevailed in the *Duke of Westminster's* case[9], with its insistence that form and substance were the same thing and that the question of whether what was done was acceptable or not was irrelevant. It seems to me that a very flexible rule of statutory construction has been crafted, a rule which allows the Court to arrive at the result which it thinks sensible, even if the wording of the statute does not actually easily lend itself to the interpretation adopted.

Some of you might respond to me that that is not what a rule of purposive construction does: you might say that that rule does not allow a sensible result, but only a result mandated by a meticulous analysis of the underlying purpose of the legislation. I wish I could agree with such a halcyon view. Unfortunately, however, I cannot find any meticulous examination of purpose in any of the authorities, but only assertion.

I know, for certain sure, that the purpose of the stamp duty group relief legislation in its original form here, and in the form it was in, in Hong Kong, when it was considered in *Arrowtown*, was to impose a formalistic test for the existence of a group, even though the CFA in Hong Kong purported to find some more substance related purpose in the legislation. What is actually happening in all these cases about purposive construction is that where a tax planner has discovered something which has not been dealt with by the legislature, the highest level of the Courts is filling the gap with the solution which they believe would have been adopted by the legislature if it had thought about the matter. That is not really construing purposively but legislative guessing: it has not generally been done in the past at the High Court or Court of Appeal level, as the recent *Bank of Ireland*[10] case shows; but it is done at the House of Lords level and, now increasingly, in the High Court and the Court of Appeal, as the recent *Harding*[11] and *Prizedome*[12] cases demonstrate. What is perhaps most (or at least, very) concerning is that the approach adopted in a case is very dependent on the particular judge or judges hearing it. Some judges will look to the words of the statute; others will fill a gap in what the words provide for by guessing at the purpose. In tax cases, when a judge of a particular sort is presented with a legislative gap as a result of which no tax appears to be payable, he or she will fill the gap with tax even in a situation where it is plain that Parliament just did not think about the matter at all. That is not finding the intention of the legislature but, rather, stipulating what

the intention would have been if Parliament had thought about the situation, which it didn't.

I have no doubt whatever that all of us can find cases – they may not be the same cases for each of us, but all of us will be able to find cases – where we applaud the result reached, even if we have doubts about whether the law, as we understood it before the case, really supports the decision. Let us, however, bear in mind that if we have a rule which allows us to reach a sensible result in spite of the language of the statute, the same rule can be adapted, so that it allows us to reach a politically convenient result: it might even be that "sensible" and "politically convenient" are synonyms. At any rate, once a Court has decided that it can interpret a statute to mean what it does not say, a little of our democracy has been lost: a little of our knowledge as to where the boundary, between the permitted and the prohibited, lies, has been eroded.

Our response to a Court's decision is, of course, not wholly influenced by reason: to some extent it is influenced by whether we approve of the result. I work, more or less every day, with the authorities about tax avoidance constantly in mind. I have become used to them: they are familiar friends, part of an everyday patchwork. But, as I have been preparing this talk, trying to look at these cases with a fresh eye so as not to say something too dull to you, one point has struck me: and it has, as it struck me, shocked me. In some, at least, of the familiar list of tax avoidance authorities, the legislation was absolutely clear, without any trace of

ambiguity and mandated a result in favour of the taxpayer. Yet the taxpayer lost, because clear legislation had a different meaning from that appearing from its words when it was construed purposively. If that does not shock, surely it at least surprises; and I suggest that it should shock. There is a difference here between cases where it is possible to regard the facts in different ways and those where the facts are absolutely clear and the only issue is whether the statute applies to them. The shocking cases are those of the latter kind and examples of them are on the increase, as lower Courts get used to the idea that they may construe purposively. What the House of Lords has been doing is to look for a satisfactory response to what I shall, for the moment, call "the problem of tax avoidance".

There are, however, logically prior issues here. First, is tax avoidance a problem? If so, what is the problem? Does it stop the government from achieving the revenues to match its budget? The answer is, by the way, No. If it does not have that adverse result, what other problem is it causing? Is it all types of tax avoidance or only some that are a problem? I shall need to come back to these issues in a moment. For the time being, I shall note that the present response of the Courts to the problem of tax avoidance is extremely flexible. As an aside, I might note that the most ancient sorts of law – those that have been tested by experience for much longer than ours - do not permit this sort of latitude: they are extremely formalistic so, for example, many ancient systems (including Sharia law, which has shaped the form of some financial instruments and so is something

one might have to deal with while practising UK tax law) prohibit lending at interest, but do not prohibit the economically equivalent discount. That does not, of course, mean that ancient systems have never flirted with rules that put substance above form, but it does mean that, having tried them, they rejected them. I venture to suggest that that is because experience has demonstrated that a degree of certainty is needed in a legal system and that the necessary degree of certainty can only be achieved when regard is paid to form.

In theory, of course, Parliament can remedy any wrong decision by a Court, but the prospect is that it will not: while it may remedy a decision that says black is white, it will not remedy a decision that, although the words seem to say "A" they actually mean "B", especially if nobody actually gave a lot of thought to whether they meant "A" or "B" when they wrote down "A". So Courts have taken for themselves a very flexible power and, to my mind, flexibility lies at the heart of what our present generation of judges is seeking to achieve. At any rate, whenever I have, as an advocate, advanced a bright line rule as a solution to a case, the Court has rejected it; and my feeling is that it has been rejected because it fetters the ability of the Court to reach its own conclusion as to the right result. An element of flexibility has been inserted into the rather rigid statutory structure of our tax code.

We may see that development as a bit akin to the amelioration of rigid common law rules by equity; and we all regard equity as a good thing. There is, however, a

difference between equity and a rule of purposive construction. Equity is, itself, a form of customary law, changing another form of customary law. A rule of purposive construction is a rule of customary law which affects a statute; and it may at least be asked whether it is appropriate to have a customary law, even if it is comfortingly called a rule of construction, which permits the meaning of a statute to be changed. The question of whether that sort of rule is appropriate becomes even more acute if one considers that the operation of the rule is not going to be well policed or controlled by the institutions of democracy other than the Courts.

Now let me turn to consider how all this theory interacts with the everyday practice of tax law. I cannot now remember exactly when, but, at some time during the late 1970s or the early 1980s, the Revenue set up a series of what they called "Special Offices", which were supposed to deal with complex cases of avoidance. Since these offices were first set up, the name has been changed on a number of occasions: I think the current title is Special Compliance Office, though, no matter what version there has been, the word "special" – am I alone in thinking it has slightly sinister connotations? – has been retained. What the Special Offices used to do – I am sure things are a good deal better now – but what they used to do was to take a taxpayer who had done any form of planning and say "that planning does not work: you owe us some more tax. If you are willing to pay something – not necessarily the full amount we say is due – we shall go away; but if you say you are not willing to pay anything, we shall use our wide range of

investigatory powers and continue investigating you until we have worn you down and you pay us the lot". The lawyer's response to this was to say, "You cannot behave like that: it is not law; in particular, the tax planning works". The official response was along the lines of "that's what the taxpayer said in *Furniss v. Dawson"*. So you can see that a rule which appears to be about statutory construction of detailed technical provisions actually transfers power to the administrator: he has been given the power – or, at least, more power – to harass, by the enhanced flexibility created by this sort of rule of statutory construction.

In the early 1980s one of the Revenue's supposedly star investigators was a man called Mr Michael Allcock, and he used to style himself as the Revenue's specialist on Schedule E and Iraq: what the Inland Revenue had to do with Iraq I am not entirely sure, but I think that, among those whom the Revenue regard as their customers, there were a number of Iraqi individuals with oil wealth; and I think Mr Allcock may have been their chief customer liaison officer. Because Mr Allcock was the Revenue's specialist on Schedule E, I had a number of meetings with him about non-domiciled salaried individuals who were still using Split Schedule E arrangements. It was Mr Allcock's tactic to say that these arrangements did not work: the basis for the assertion was not terribly well made out, but it seemed to have something to do with *Ramsay* and *Furniss v. Dawson*. At any rate the message came over loud and clear that, if money was paid, Mr Allcock would go away, and if it wasn't paid, well, the Revenue would go

on making a nuisance of themselves, requiring more and more information and using their powers under the Taxes Management Act 1970, including – especially – section 20, to get it. Many taxpayers could not bear the burden of the investigation: the psychology of most taxpayers is such that being investigated by the Revenue causes astonishing trauma, and many of them paid money just to get rid of the inquiry, and not because they believed it to be due. That way of running a tax system was not very likeable: it smacked of extortion, and, although there is some element of extortion inherent in every tax system, the extent of the extortion element seemed to cross the line. It was not only Mr Allcock who, in those days behaved in this way: there were others. To my way of thinking, a tax system should be run in an entirely rational way and should not have any elements of emotional bullying such as was often then found in the conduct of the Special Offices.

Happily, we seem to have made some progress towards a more rational way of administering the tax system; and three developments may have assisted to that end. First, some taxpayers proved themselves willing to stand up to Revenue bullying: the taxpayers who were willing to do this were relatively few, but there were enough to make a difference. The initial stand was over the Revenue's power to obtain information under section 20; and there were a number of administrative law grounds on which the use of the power could be and was challenged. So, here, the tax lawyer had also to be an administrative lawyer, demonstrating the width of tax practice.

The next thing that happened was that it turned out that some of the money which Mr Allcock had been collecting from taxpayers had been kept by him for himself. Everybody was astonished at this, and, I suppose, given that we have a Civil Service that we regard as sea green incorruptible, it was a very shocking thing to happen. However, when you stand back and think about it, if your business plan is to collect money even in cases where it is doubtful whether the law properly empowers you to collect it, this sort of thing is all too likely to happen. Mr Allcock was tried and convicted: the evidence established that very many taxpayers were only too willing to pay him and that made what he was doing a bit too easy for him. There were, however, some of us whose clients did not pay up like lambs to the slaughter: there were a few of us who, as it was put to him at his trial, used "to put him through the wringer". The way we were behaving was regarded by the majority of tax practitioners as vaguely shocking. You were, apparently, not supposed to answer back to the Revenue. But there is not much doubt that the only thing which curbed Mr Allcock's ability to help himself in the way that he did was the stand that a few taxpayers and the lawyers or accountants acting on their behalf took against him.

The last thing that happened – and the thing which really improved things – was that the Revenue raided a firm of accountants called Kingston Smith: the raid was not because of any suspicion that Kingston Smith had done anything wrong, but was part of an investigation into one client of the firm. Nonetheless, the Revenue, in

exercise of their powers under section 20C wanted to take away the hard disk from the firm's computer. An injunction was obtained stopping the raid. Quite astonishingly, the Revenue breached the injunction, and, eventually, that led to a wide-ranging internal review of their procedures, which has had the most beneficial effects. So now we have a tax system which, no doubt, is not being run perfectly, but is, I think, being administered much more carefully than it was 20 or so years ago; and the efforts of the Tax Bar have certainly done something to help bring that about.

Nonetheless, we still have a culture in which Revenue officials can, and sometimes do, seek to challenge an arrangement made by a taxpayer on the grounds that it constitutes tax avoidance. Although the Courts now deny that there is any special rule about tax avoidance, there is, nonetheless, a general trend in every type of case – not just tax cases, but in all areas of the law in which a question of construction arises – to interpret the instrument before the Court in a way which leads to a sensible result. But this does rather beg a question. What is a sensible result? It seems that, in tax cases at any rate, the sensible result is assumed to be the one which prevents tax avoidance, and examples of that sort of approach are to be found in both *Arrowtown* and *Carreras*[13], which are both cases where the statutory language was, if not ignored, at least added to by implications not drawn from the legislation itself. So, in advising a client about what transactions he can safely do or not do, in advising a client whether to appeal an assessment, and in deciding how to present a case, the

question of whether what was done or is to be done is tax avoidance now looms quite large. And that is not, here, because of any specific statutory language (or not usually because of any specific statutory language) but because of a concern that a Court will be willing to apply purposive construction to strike down tax avoidance even more widely than it would be willing to in other cases, and that the Revenue, being aware of that possibility, will assert claims to tax which are not supported by the express wording of the statute.

A tax practice involves almost every aspect of human and, so far as it is a different thing, commercial life. You might find yourself advising a farmer or an entrepreneur whether to put assets into a trust or to make an outright gift of his assets to a member of the family. You will need to consider not only the effect that transaction will have for tax, but also what impact the gift will have on the donor's ability to live; and potentially the impact which it will have on family life. Or you might have to advise a person who is about to take up employment on his remuneration package, or whether – as for example in the case of private equity partnerships – it might be fiscally more advantageous for him to become a partner: in that context, you will need to know something of the liability risks to which you are exposing him by the suggestion. It was, indeed, tax and liability considerations which led to the development – originally in the USA – of Limited Liability Partnerships, in the form of a body corporate which is treated as fiscally transparent.

Matters which are less involved with the human side of things but which are, nonetheless, intellectually most challenging relate to what is, in the jargon of the City, called structured financing. In the end, all structured financing is a form of straightforward lending dressed up with a whole load of different financial instruments such as swaps or options and other complex derivatives. A cynic would say that many of these different structures have a tax purpose: they seek to generate reliefs greater than those which would be available if interest were simply paid on a straightforward loan. A greater cynic might take the view that the whole purpose of derivatives is to persuade fools to part with their money; and they certainly seem to have been very successful in achieving that result recently, with the consequence that we are now having to unwind many of these structures because of the credit crunch. Sometimes you get involved with ships and oil rigs and things like that; and that is especially so when capital allowances are involved.

Then there are takeovers and mergers and corporate reconstructions: and many of these will have an international cross-border element, so that questions of how EU law, other tax systems and double tax relief impact on them will need to be considered. In all of these cases the desire is to keep tax to a minimum and in all of them you will need to consider how the Court will react to what has been done in the light of its approach to tax avoidance.

One issue which arises here is whether the Court

has adopted a different approach to the imposing of charges to tax on the one hand and the granting of reliefs from tax on the other. Many of the cases in which the Courts have talked about tax avoidance have involved cases where a taxpayer is seeking to bring himself within the scope of a relief. There is a difference between that sort of case and the sort of case where the taxpayer seeks to keep himself outside the scope of the charge to tax. The difference is that, where the taxpayer is seeking a relief, he is attempting to say "this specific relieving provision applies to me" but, where he is saying that he is not within the charge, the matter is the other way round: he is there saying "this provision does not apply to me". In litigation generally, the presumption is that he who asserts must prove so that, in a way, the burden is different in the two cases.

In actual practice – I think it is not so when you are learning law or thinking about it in theory – the question of burden becomes very important. "What do I have to prove?" and "What do I have to do to prove it?" are questions which loom very large when you are preparing a case for trial, and here tax litigation is no different from any other sort of litigation. When a taxpayer is seeking a relief, he carries the burden of establishing that it applies to him: if he says, "I am not within the charge", he does – of course – carry a burden, but there is also a burden on the Revenue to establish that the charge does apply. There ought, accordingly, to be a difference of approach in the one case and in the other. It does, however, have to be said that the cases in this area do not actually establish that the Courts will adopt wholly

different approaches in the two different types of case.

A synthesis or attempted synthesis of the case law so far means that foremost in the mind of the adviser is the question: "Will the Court consider this to be tax avoidance?" The reason why the adviser has to consider this question is that, as I have said, the Courts have devised a very flexible rule of purposive statutory construction which they appear to use, most particularly to strike down tax avoidance by finding a legislative purpose which fills any gap which has been left in the tax net. So it becomes very important to know whether something is tax avoidance or not.

Many jurisdictions – though, dare I say it, on the whole not those with the largest economies – have attempted to deal with questions of tax avoidance by enacting a general anti-avoidance rule or, as it is known in the jargon of the trade, a GAAR, and these rules – with some exceptions – bear a strong family resemblance to each other. The provisions attempt to define, in one form or another, what tax avoidance is. In Australia, the definition goes on and on, and it contains, in some instances, the need to make a comparison between what actually happened and some other reasonable hypothesis. In Hong Kong, the GAAR operates by reference to the concept of "tax benefit" and the definition of "tax benefit" is very much shorter than in the Australian code: it is defined as "the avoidance or postponement of the liability to tax or a reduction in the amount thereof". In a recent Hong Kong case, Lord Hoffmann has said that this definition, too, requires a comparison (not

specifically required by the wording of the legislation – Lord Hoffmann has divined the need to make this precise sort of comparison) between what actually happened and some other appropriate alternative hypothesis: he was not, however, very clear as to what would constitute an appropriate alternative hypothesis.

For example, a moment ago, I gave you a list of the sort of things a tax adviser might have to advise on and, at the head of that list, I put advising on gifts to a member of the family. A gift like that, if made seven years before a death, means that the donor's estate will be less than it would have been and, on his death, his estate will bear less inheritance tax then would have been the case if the gift had not been made. It may also be that the gift will shift the burden of income tax. If we seek to apply Lord Hoffmann's definition here, there is, undoubtedly, tax avoidance; but I am not sure that everybody would call that tax avoidance or, if they would, that they would call it objectionable tax avoidance. In the late 1980s and the early 1990s, Lord Templeman, in the middle of speeches which quite often seemed like a rant, drew a distinction between what he called tax avoidance and acceptable tax mitigation. The difference between them was, he said, that one had real economic consequences and the other did not. That does rather beg the question as to what is a real economic consequence but it does seem to me that it provides at least some indication of the way in which the Court will approach an arrangement which it perceives to be fiscally driven. I rather think that, if a Court believes that a fiscally driven arrangement has a real economic effect,

then it will not regard the matter as tax avoidance, but that if it regards what has happened as wholly artificial, then it will identify tax avoidance and seek to stop it. I cannot say that that is a precise guide: Lord Hoffmann has been at particular pains to say that circularity is not, in itself, a vice. But real things can be achieved by circular transactions in the sense that even something circular can effect permanent changes in, for example, group indebtedness; and other apparently permanent things may not have any real effect.

I was recently asked to advise on a structure which was intended to result in a profit being realised in a way which was outside the charge to tax. It seemed to me that the charging provisions, read literally, clearly did not attach to the profit, but in my heart, I knew that the Court would feel that the charge ought to attach; and that it would feel that way, even though the way the profit was realised involved a transaction between genuine third parties acting at arm's length which, undoubtedly, had real economic consequences. I wanted to advise that the Court would strike this arrangement down: after all, in the context of the relief being sought in *Arrowtown*, the Court did strike down an arrangement which obviously fell precisely within the wording of the statute. My heart said "tell them not to do it", but my head could not find any rational basis for imposing the charge other than that the legislature had not thought at all about the situation being created. One should, in that situation, be able to advise with clarity and vigour, but experience, bought with grief, teaches. In the end, I advised that the charge should not attach but, I was nearly reduced to the

drivelling three handed lawyer by the concern that the Court, faced with a legislative gap, would fill it with a tax charge, relying on some supposed purpose to impose a charge in this unthought about transaction.

One of the difficulties here is that nobody actually knows what they mean by tax avoidance: I shall be interested to hear how you define it, but I doubt if we shall all agree on what it is, and I also expect that, however you define it, you will be unable to do it by reference to factors which, if we examine them with sufficient rigour, will prove to be wholly objective, so that somewhere or another in your definitions there will be a subjective element. My study of GAARs suggests that, in the end, the subjective element is always present, so that a decision that the GAAR applies is essentially an expression of a view that the Court does not like what was done in the case. The same is, of course, true when the Court says that tax is payable on a purposive (but not a literal construction) of the legislation.

And if we do not agree on what tax avoidance is, we may also not agree on whether tax avoidance is a good thing or a bad thing. The mantra of the day is that tax avoidance is a problem. However, a thing about mantras is that they are meaningless phrases designed to provide comfort; and that is just as true of this mantra as any other. I raised earlier a number of issues related to the question of whether tax avoidance is a problem. Essentially I asked what, exactly, the problem is. If you have spent any time thinking about that question I expect you will have some sort of answer to it. Before we

consider what that answer might be, let me put another proposition to you. Let me suggest to you that tax avoidance might be a good thing.

Suppose you were asked to sit down with a blank sheet of paper and devise a tax system for the 21st century, ignoring all the political complications that would be involved in moving from our current system to another. How would you go about structuring that system? I venture to suggest that, given the first place accorded in our everyday life to the market economy, the first thing you would do is to try to devise a tax system which least distorted economic decision making. You might, for example, not have an income tax because, at least at certain rates, that discourages people from working and so on: one of the reasons doctors don't work at night now is that the inconvenience of it is not compensated for by keeping 60% only of your gross pay. Most tax avoidance of the kind which is perceived by taxing authorities as really objectionable is done by companies and by large companies at that: I do not say that all tax avoidance is done by that sort of person, but most of it, the sort that gets taxing authorities really worked up, is done by large companies. And the reason why they do it is not necessarily selfish: it may be and usually is done by companies to make themselves more competitive; they do it so that they can do the things they want to do without worrying about tax. And if this is not a good thing it may, at least, not be a bad thing: the almost automatic reaction that it must be stopped does not seem to me to have any logical foundation other than the notion that it is somehow unfair for tax to be

avoided, and I rather suspect that, if I asked for your answer to the question: "what problem is tax avoidance?", it would have something to do with fairness.

Indeed, I believe that what our current generation of judges is seeking to do by the use of purposive construction is to introduce some aspect of what they regard as fairness to our tax system in the belief that they are thereby curing something wholly unfair. Notions of fairness are, however, essentially emotional and not rational and one person's view of fairness is not another person's view. Suppose, for example, that we live in a community where there is a rule that every family must contribute to the well which provides water for the community. There is one family of five people earning £10,000 a year and the rule is that it must contribute 10% of its income (that is £1,000) to the upkeep of the well. There is a widow, a single person with an income of £100,000 a year and the rule is that she must pay 10% of her income (that is £10,000) towards the upkeep of the well, so that she pays 10 times what the family of five pays while using only one-fifth of the water. Is that fair? Would it be more fair or less fair if the widow had to pay £20,000 towards the well which is what happens with a progressive tax system? How do I measure a company's ability to employ more people because it has saved tax against the benefits that its tax payment would have purchased? I am not going to provide a definitive answer to these questions, but I think I have demonstrated that a conclusion about whether something is fair or not does not have any logical basis: pure logic would indicate that

what is happening in relation to the well is unfair, but that may not be a good guide to how the cost should be shared. Once you permit an emotional conclusion about fairness to influence the result on a question, you have moved very far from the strict lines apparently drawn by a statutory code; and have introduced an element of discretion.

I suspect that I may be alone here in thinking that tax avoidance is not necessarily a bad thing, but I may not be alone in finding a rule which allows a Court an ability to dispense with the black letter of the law objectionable. It seems to me that a rule of purposive construction, which is essentially a rule that says we will interpret the statute to catch you if we do not like what you have done, is not very far from the sort of discretionary rule that we should all find objectionable. Some time ago, when the financial arrangements on divorce were much in the news and a professional tax adviser, Mr McFarlane, was ordered to pay his ex-wife half his income for the rest of his life, a colleague of mine said to me "we should never have allowed the law to get in this mess". It was a criticism of the divorce practitioners, who have allowed the law to reach a state in which what, to some, seems to be state-sponsored theft is permitted. And all of this has come about from a genuine desire to do good, based on a statute which contains a mandatory rule about reasonableness. The majority view seems to be that the Courts' no doubt genuine desire to do good in this area has actually created wholly unreasonable results. So my colleague imposed on me, by his casual remark, the feeling that I

needed to do whatever I can to stop the law of tax becoming a mess.

There are, no doubt, lots of ways in which the law of tax may become a mess, and, indeed, the current state of our statutory code may already be described as a ghastly mess. However, putting that right falls mainly in the political field. What the tax lawyer needs to be doing is to stop the Courts from creating a mess or adding to an existing mess, and that means, in particular, confining the rule about purposive construction so that a degree of certainty is restored to our tax system. We may not think that a discretionary element in the law of tax is a bad thing. Very few people will stand up and say tax avoidance is a good thing or that the opportunity to do it should be permitted. That makes the law of tax an easy area in which to introduce rules which gather a wide measure of public acceptance.

But consider where a rule introduced acceptably and easily in an unpopular area like tax may go. Both tax law and crime are considered by international convention to be penal. If a discretion gets built into the tax system might the discretionary rule be spread to the criminal area? If so, how comfortable do we feel about that, at a time when the tone of government is more authoritarian and more Tudor-like than I can ever recall? How comfortable would we feel if there were a rule that an action would be criminal if the Court thought it ought to be criminal? And if we feel uncomfortable with that, why would we allow that sort of rule as a rule of tax law, and how different is it, really, from a rule of purposive

construction?

Here is an extract from Robert Bolt's play "A Man for all Seasons" which profoundly influenced my thinking. Richard Rich is being courted by Thomas Cromwell, who wants him to betray Sir Thomas More. Rich goes to More and asks for a job.

> "RICH (*desperately*): Employ me!
>
> MORE: No!
>
> RICH (*moves swiftly to exist: turns there*): I would be steadfast!
>
> MORE: Richard, you couldn't answer for yourself even so far as tonight.
>
> Exit RICH. All watch him; the others turn to MORE, their faces alert.
>
> ROPER: Arrest him.
>
> MORE: For what?
>
> MARGARET: Father, that man's bad.
>
> MORE: There is no law against that.
>
> ROPER: There is! God's law!
>
> MORE: Then God can arrest him.
>
> ROPER: Sophistication upon sophistication!

MORE: No, sheer simplicity. The law, Roper, the law. I know what's legal not what's right. And I'll stick to what 's legal.

ROPER: Then you set Man's law above God's!

MORE: No far below; but let me draw your attention to a fact – I'm *not* God. The currents and eddies of right and wrong, which you find such plain-sailing, I can't navigate, I'm no voyager. But in the thickets of the law, oh there I'm a forester. I doubt if there's a man alive who could follow me there, thank God ... (*He says this to himself*.)

ALICE (*exasperated, pointing after* RICH*):* While you talk, he's gone!

MORE: And go he should if he was the devil himself until he broke the law!

ROPER: So now you'd give the Devil benefit of the law!

MORE: Yes. What would you do? Cut a great road through the law to get after the Devil?

ROPER: I'd cut down every law in England to do that!

MORE (*roused and excited*): Oh? (*Advances on* ROPER). And when the last law was down, and the Devil turned round on you – where would

> you hide, Roper, the laws all being flat? (*Leaves him*). This country's planted thick with laws from coast to coast – Man's laws, not God's – and if you cut them down – and you're just the man to do it – d'you really think you could stand upright in the winds that would blow then? (*Quietly*). Yes, I'd give the Devil benefit of law, for my own safety's sake."

We need to be able to stand up when the winds blow. It is never too early to make sure that the forest is in good order; and even the least part of the forest needs tending to keep the trees healthy. There is a job for tax lawyers to do: it is the job of keeping their part of the thicket of the law in sound order, safe from a too pervasive role for purposive construction. It's an important job and it begins with supposed doctrines about tax avoidance, which is why I said at the beginning of this talk that that may yet be a field of dreams for the aspirational lawyer. "The worst possible disorder that can fall upon a country is when subjects are deprived of the sanction of clear and positive laws", said Erskine; and perhaps I might adapt the Psalmist and say, "Unless the tax lawyer watches over the house, they labour in vain who build it".

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[1] From a lecture given in Oxford on 5 March 2008 and subtitled "An uninspiring title for a talk intended to be inspiring".
[2] [1982] AC 300.
[3] [1984] AC 474.
[4] [1989] AC 398.
[5] [2003] 1 AC 311.
[6] [2003] HKRCA 46
[7] [2004] UKHL 51

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[8] [2004] UKHL 52
[9] [1936] AC 1
[10] [2008] STC 2008
[11] [2008] STC 1965
[12] [2008] EWHC 19 (Ch)
[13] [2004] UKPC 16

MISCELLANEOUS POINTS ON VAT AND PROPERTY

by David Goy

1. The rewritten Schedule 10 VATA 1994 – the option to tax rules

The option to tax rules used to be found in 3 densely-packed paragraphs. They are now to be found in 34 paragraphs! The new Schedule 10 is not merely a rewrite of the old but contains a series of amendments. The main ones are as follows:-

(i) New certification procedures disapply the option where buildings are to be converted into dwellings and where land is supplied to housing associations;

(ii) a revised definition of "occupation";

(iii) a new way of opting to tax ("a Real Estate Election");

(iv) changes to the "cooling off period";

(v) new rules governing revocation after 20 years;

(vi) automatic revocation if no interest has been held in a property for 6 years;

(vii) an option to tax now applies to both the land and buildings on the same site;

(viii) an ability to exclude a new building from an option to tax;

(ix) new appeal rights where Customs refuse to grant a permission under Schedule 10 (only if Customs act unreasonably).

Notable exception

It is worth noting that no change is made to the "beneficiary" rule, now in paragraph 40, to the effect that if the benefit of the consideration for the grant of an interest accrues to a person that person is treated as the person making the grant not the actual grantor. To change this rule appears to have come within the "too difficult" category. In their new notice 742A Customs say that this rule applies in a simple nominee situation but not where the beneficiaries are numerous e.g. where there is a unit trust. To say this avoids numerous complications (e.g. if the paragraph applied to a unit trust would all unit holders have to opt for tax before a valid option would bind the trustees) but it lacks any logical justification.

Statute not the end of the story

One feature of the new Schedule 10 is that despite its length it does not contain all the relevant statutory rules. In a number of cases various conditions must be met before something can or cannot be done (e.g. revocation of an option) but these are as set out in a notice published by Customs. Thus, it is not possible to merely look at the new Schedule 10, despite its length,

and be aware of all the relevant rules. Schedule 10 and the new notice 742A must be looked at together.

2. The real estate election ("REE")

a) The new Schedule 10 in para.21 contains a new way to opt to tax, a REE.

Where a REE is made it has effect only with respect to interests in land acquired after the election is made by the person opting or, where that person is a member of a VAT group, by any other member of that group at that time. What it does is to obviate the need to exercise individual options as regards property acquired after the making of the REE. When made it does not amount to the exercise of the option at the time it is made but rather when and if an interest in land is acquired the option is treated as exercised on the day on which the acquisition is made.

b) A number of points are to be noted:

i) While notification of the REE is required (within 30 days – para.21(7)) there is no requirement to notify when and if new interests in land are acquired. If there were there would be no merit in making such an election. Customs have power, however, to obtain such information from a person 'making' a REE.

ii) Because when a REE is made an option is only treated as exercised on the day of acquisition the ability to revoke immediately

after exercise, which has now been extended from 3 to 6 months, applies from the day each new interest is acquired. A REE may not be revoked, save by Customs in limited circumstances, but once an acquisition has been made the normal power to revoke, subject to the satisfaction of certain conditions, will apply.

iii) It should be noted that a REE has no effect where a person has made a previous specific election in respect of the land acquired having effect from a time prior to the time of acquisition of the land (see para.21(3)). Where a REE is made the option is treated as exercised on acquisition of an interest in land. There may be circumstances e.g. on a TOGC, where a person wishes to ensure that an election has effect at a certain time – in that case the earliest time at which a grant is made which can include the payment of a deposit. In such a case the REE may not be effective. To ensure that the TOGC rules apply a specific option should be exercised in respect of the property to have effect from a date earlier than acquisition (i.e. prior to contracts being exchanged).

iv) A REE has no effect where a person owns an existing interest in land and then acquires a further interest in the same land after the REE is made. In such a case a specific option will have to be exercised in respect of the land (see para.21(4)).

v) Hitherto a few large taxpayers have made what has become known as a global option to tax – typically an option over the whole of the UK. The ability to make such an option has not been removed by the new rules but it is likely to disappear. This is because:-

1. Para.24 provides that an option exercised by any person is treated as revoked if a person does not have an interest in the property for any period of 6 years beginning after the option has effect. There are no transitional rules so that it may be that many global options will immediately (on 1st June 2008) have ceased to have effect in respect of unacquired land if the election was made more than 6 years ago.

2. Hitherto where a global option has been exercised Customs have by concession allowed the right to revoke to apply to each property when acquired rather than within 3 months (now 6 months) of the time the option had effect. This concession has now been withdrawn so that the 6-month period will apply to the time the global option has effect. It follows from this that the ability to change one's mind is more limited with a global option than where there is a REE.

3. An existing global option and a REE cannot co-exist.

   Para.22(2) provides that once a REE is exercised any option to tax exercised before such time in respect of land and buildings that neither the person exercising the REE nor a member of its VAT group has an interest in is automatically revoked. This does not prevent *future* specific exercises of the option which are wanted to have effect prior to the date of acquisition.

3. Revocation

Rules regarding revocation are now contained in detail in the new Schedule. To an extent these rules represent an enactment of prior Customs' practice.

a) Cooling off period – para.23

The old rule permitted revocation within 3 months in certain cases, this has now been extended to 6 months. It also required consent to be obtained from Customs in all cases as well as certain conditions being satisfied namely

- no tax being chargeable or credit for input tax being claimed as a result of the exercise
- no TOGC

The new rules are slightly different.

i) It is a condition that the taxpayer has not used the land since the option had effect;

ii) again no tax must have become chargeable nor a TOGC made;

iii) as regards input tax, the condition that no credit for input tax must have been obtained as a result of the exercise is now contained in Notice 742A but in respect of this requirement if it is not satisfied revocation is still possible if Customs give their consent.

The ability and need for Customs to give consent in all cases has therefore gone. The ability of Customs to give consent only overrides one requirement.

b) Revocation after 20 years

Revocation after 20 years permitted by changes in 1995 required the consent of Customs in all cases. The position is now that revocation is possible if either the taxpayer obtains prior permission or if certain conditions specified in notice 742A are met. These conditions are either that:

1. The taxpayer or associate has no interest in the property when the options is revoked or;

2. if 4 conditions are satisfied

- ownership for 20 years and since option had effect

- capital goods adjustments cannot be made

- no grants of interest in preceding 10 years at less than open market value or which will give rise to a supply after revocation for a consideration significantly greater than consideration for a supply before revocation (except normal rent review)

- no goods supplied to taxpayer prior to revocation are attributable to supply of property by taxpayer more than 12 months after the options is revoked

4. The disapplication provisions

The new Schedule 10 in paragraphs 12 to 17 contains the redrafted anti-avoidance rule that disapplies the option in specified circumstances. The rule applies when broadly two conditions are satisfied at the time of the grant of an interest -

i) that the property is a capital item of the grantor concerned for the purposes of the capital goods scheme; and

ii) the property will be occupied for exempt purposes by the grantor or certain associates.

The redrafted rules are essentially the same albeit with certain redefinitions.

a) One of the requirements of the disapplication provisions is that occupation of the property by a relevant person must not be "wholly or substantially wholly for eligible purposes (i.e. taxable purposes)". The previous rule was "wholly or mainly" for eligible purposes. In its notice 742A Customs say "substantially wholly" means land occupied at least as to 80% for eligible purposes. This has force of law, and while it accords with prior Customs' practice, such practice did not previously have force of law (and probably was incorrect). Now it does.

b) The question of when a person is in occupation of land has been the subject of recent litigation in the case of *Newnham College* [2008] STC 1225. This case involved a leaseback scheme involving the college library and the specific question that arose was whether the college remained in occupation of the library.

There are two points worth commenting on.

i) One question that arose was as to the meaning of occupation for these purposes. The taxpayer contended, and the House of Lords held, that the term "occupy" had the meaning that the term had been given by the European Court for the purposes of the 6th Directive. In other words, referring to *Sinclair Collis* [2003] STC 898 – it was the right to occupy as if that person were the owner and to exclude any other person

from enjoyment of such a right. On the facts the House of Lords held by a majority that there was not such occupation. Customs had argued that a different and broader approach should be adopted so that occupation meant any physical presence on the land for the purpose of making use of it. This was not accepted. While *Newnham College* represents a tax avoidance case that succeeded, it is a doubtful precedent. This is because Customs deliberately did not argue that the "abuse of rights" doctrine rendered the arrangements ineffective. Customs said that they wanted a decision on the UK legislation alone.

ii) A very live question in the circumstances is whether the abuse of rights doctrine has any application to the option to tax rules, bearing in mind that these rules do not represent community legislation by reference to which the doctrine has been expressed by the European Court to apply. The option to tax rules are rather rules contemplated and permitted by community legislation. In the *WHA* case [2007] STC 1707 it was argued that as reliance was being placed on national legislation, transposing provisions of the 6th Directive, the abuse principle was not applicable. Lord Neuberger said that the principle extended to domestic legislation and rules intended to implement or reflect the terms of the Directive. This hardly covers the option to tax which is something permitted by the Directive but does not implement or reflect its terms. Nevertheless, if the doctrine does not apply to matters permitted but not provided for in the Directive, a rather odd situation arises of certain provisions in the VAT Act being subject to the

abuse of rights doctrine and some not. Perhaps this is why Lord Neuberger went on to express the view in *WHA*:-

> "I do not see any reason in principle or logic why the applicability of the abuse principle should be limited to schemes which depend on their efficacy solely on community law, whether transposed into domestic legislation or of direct effect."

The *Newnham College* case was, as I have said, not concerned with the abuse doctrine. Nevertheless, Lord Neuberger said that:

> "... on the face of it the Commissioners would have a strong case for applying that principle in the present case."

At present there is no authority determining that the abuse of rights doctrine applies to the option to tax. As a matter of principle, it appears strongly arguable that it does not. It is not a doctrine applicable to UK law generally and therefore there is no basis for saying that it is applicable to a set of rules created under UK law, merely because such rules are contemplated by and permitted by EC Directive. Having said this, and in particular bearing in mind the approach of Lord Neuberger, it is difficult to be optimistic that this is what the UK courts will ultimately hold.

An indication of a possible approach of the Courts is shown by the Tribunal decision of *Redcats*. In that case an attempt was made to artificially treat a supply of

taxable goods as involving a zero-rated supply. Zero rating, somewhat like the option to tax, while permitted by Community Law (i.e. it is a permitted derogation from it) is not a provision of such law or a provision which implements it. When faced with the argument that the *Halifax* doctrine could not apply to zero rating, the Tribunal managed to conclude that the abuse of law argument founded on provisions other than zero rating.

So in the context of the option to tax, it may be possible in many cases for a court to say that the abuse is not based on the option to tax rules themselves. Thus if the option to tax rules are manipulated to give an input tax benefit, the argument may be that input tax rules are being abused and hence that the arrangements should be struck down.

5. The Capital Goods Scheme and the Disapplication Provisions

A requirement of the anti-avoidance provisions, in Schedule 10 paragraphs 12 to 17, is that for them to apply the grant giving rise to the supply must be made by someone described as a "developer". The use of this term is entirely confusing because there is no requirement that a person must develop before he is a "developer" for this purpose. For this purpose a person is a developer if he holds the property as a capital item or if the property is expected to become a capital item either for the grantor of the interest or for a transferee. A "capital item" is an item falling within the capital goods scheme and the grant must be made before the end of the

period during which adjustments may be made relating to the deduction of input tax as respects that capital item.

In applying the anti-avoidance rules what is relevant to know is whether the property in question is subject to the capital goods scheme and, if so, the period during which it is so subject. The capital goods scheme rules are set out in Regs.113-117 of the General Regulations. In broad terms, property will be a capital item if taxable supplies (either on an acquisition or a building) have been made in respect of it in excess of £250,000 (excluding rent).

Note:-

i) An item is not a taxable item if a person uses it solely for the purposes of selling it. Thus a developer who develops property solely in order to sell, will not hold the property he develops as a capital item. Nevertheless, the anti-avoidance provisions apply on the grant of an interest in land, if the grantor **expected** that the building would become a capital item in respect of a transferee.

ii) The TOGC rules do not apply if on a transfer

- the item would become a capital item for the purchaser; and

- that person's supplies would involve exempt use (i.e. use not mainly for taxable purposes) by the purchaser, a

connected person or a person providing finance.

Thus, if a developer builds and lets property to a bank, and the bank then lends money to a purchaser to buy the property, the TOGC rules will not apply on the sale. There will, in such circumstances, not only be a VAT charge on the sale but the anti-avoidance provisions will subsequently apply so as to prevent an exercise of the option to tax permitting recovery. Particular difficulty arises if the bank in the above example occupies merely a small part of the building. A person is said to occupy land if he occupies only part of it (para.17(10)). Does this mean that a lease to the bank in the above example of, say, 5% of the total lettable area of the building, precludes the TOGC rules applying at all?

iii) Schemes have been implemented to manipulate the rules applicable where a capital item is sold. These rules apply where the "whole interest" is sold. The rule in Reg.115(3) is that the taxable/exempt nature of that supply determines the calculation of the adjustment in all remaining intervals. This was sought to be exploited in the case of *Centralen Property* [2006] STC 1542 where

an exempt lease at a premium was granted followed by a taxable sale of a freehold at a small charge. The taxpayer argued that only on the freehold sale was the whole interest of the taxpayer sold and therefore that such taxable sale governed the mechanics for making adjustments in the subsequent intervals. The European Court held, however, that as the two disposals were closely and inextricably linked both were to be taken account of in making adjustments in proportion to their respective values. The arrangement failed because most of the value arose on the exempt grant of the lease rather than the taxable sale of the freehold.

To counter schemes of this sort more generally, Customs introduced new paras.115(3A) and (3B) in 1997, so that if as a result of a sale, the input tax relieved exceeds the tax charged on the ultimate sale, Customs are given power to secure that the input tax relief is limited to the output tax charged.

6. TOGCs

Morton Hotels v. Customs (20039) is a case which concerned the sale of three hotels which were immediately subject to a sale and leaseback of the properties by the initial purchaser. Customs argued that the TOGC rules did not apply because the assets transferred (i.e. the land) were not used after the sale in

the same business. Rather different assets (the leases) were used. The Tribunal rejected Customs' argument. It held that the requirement was that the **assets** had to be used in the same way as before but that there was no requirement that the specific proprietorial interest acquired had to be retained.

This is a welcome decision and removes a possible pitfall existing in a not uncommon situation where a refinancing occurs on a business being acquired. It should be noted in any event that there is real doubt whether the requirement in our domestic legislation that assets must be used in the ".... same kind of business ...." does not go beyond what the European Directive envisages (see *Zita Modes Sarl* [2005] STC 1059).

CFC CODE REMOVED FROM STATUTE BOOK BY JUDGE[1]

by Laurent Sykes

It is by now uncontroversial that domestic law which enters into conflict with directly enforceable Community law rights must be disapplied so as to give effect to those rights. This flows from s2 European Communities Act 1972 and the principle of direct effect.[2] What happens, however, where a provision is capable of entering into conflict with directly enforceable Community law rights on *some* occasions but *also* applies in situations which have nothing to do with the exercise of directly enforceable Community law rights? There is, in the writer's view, no basis for a disapplication of UK domestic law where there are no directly effective Community law rights to protect. So in the latter case the provision of domestic law stands. As a result a statutory provision may, so to speak, be "switched" on and off according to whether it enters into conflict with Community law. The uncertainty which results for users of the legislation is for the Member State to sort out. This point (although, in part at least, a question of UK domestic law) has been addressed by the ECJ in *ICI v Colmer*[3]:

> "Accordingly, when deciding an issue concerning a situation which lies outside the scope of Community law, the national court is not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation. Where a particular provision must be disapplied

> in a situation covered by Community law, but that same provision could remain applicable to a situation not so covered, it is for the competent body of the State concerned to remove that legal uncertainty in so far as it might affect rights deriving from Community rules.
>
> Consequently, in circumstances such as those in point in the main proceedings, Article 5 of the Treaty does not require the national court to interpret its legislation in conformity with Community law or to disapply the legislation in a situation falling outside the scope of Community law."

This very issue fell for consideration in *Vodafone 2*.[4]

Vodafone 2 concerns the controlled foreign companies ("CFC") regime[5], the corporate tax cousin of s720 ITA 2007 (transfer of assets) and s13 TCGA 1992 (attribution of gains to members of non-resident companies). The CFC regime imposes a charge on UK resident companies with interests in UK controlled subsidiaries which are resident in low tax jurisdictions (subject to a limited number of exemptions).

An example of the CFC code entering into conflict with directly effective Community law rights (in that case rights under Article 43 of the EC Treaty (freedom of establishment)) is a CFC charge imposed on a UK company carrying on genuine economic activities in the EU through its local subsidiary (even if the activities are being carried on outside the UK purely to save tax). The ECJ said so in *Cadbury Schweppes*[6]. An example of the CFC code *not* entering into conflict with directly

effective Community law rights is the imposition of a CFC charge on a UK company carrying on genuine economic activities in a country which is not in the EU through its local subsidiary[7]. Yet another case of the CFC code *not* entering into conflict with directly effective Community law rights is the imposition of a CFC charge on a UK parent company in respect of an EU subsidiary in circumstances where there is no genuine establishment through the subsidiary, e.g. where it is merely a "brass plate operation". That is because (as the ECJ put it in *Cadbury Schweppes*):

> ''the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. Consequently it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there.''[8]

The requirement for an ''actual establishment'' before the freedom of establishment in Article 43 can be engaged was expanded upon by Advocate General Léger in his Opinion in *Cadbury Schweppes*. He referred to the need to examine ''whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company which have resulted in the reduction of the tax due in the State of origin''. This approach was followed by the ECJ, which referred to ''the extent to which the CFC physically exists in terms of premises, staff and equipment''.

The judge's decision

The *Vodafone 2* case concerned the legitimacy of HMRC's enquiry into the accounting period of Vodafone 2 for the year ended 31 March 2001. The enquiry was stated to be for the purposes of establishing whether Vodafone 2 was liable to a charge under the UK's CFC legislation in respect of the profits of its wholly owned Luxembourg subsidiary. HMRC argued that, even if the CFC regime was incompatible with Article 43 of the EC Treaty, Vodafone 2 should still be required to demonstrate that it was genuinely established in Luxembourg through its subsidiary before the CFC regime could be disapplied in relation to it. As a result the enquiry should continue. The judge rejected this submission. He decided that the CFC code was to be disapplied, irrespective of whether Vodafone 2 was genuinely established in Luxembourg (an issue which could have been determined by being remitted back to the Special Commissioners, as well as, possibly, a continuation of the enquiry process). In effect, the CFC code was, on the judge's analysis, removed from the statute book irrespective of whether Community law-protected rights were being exercised. He said:

> "The CFC legislation and the motive test are of potentially wide application throughout the UK business world. To adapt the speech of Lord Hope in [the *Fleming*[9]] case, the nature of the defect [in the UK CFC legislation] is such that a single solution is required that can reasonably be applied to all taxpayers. That can only be done by Parliament, or possibly by appropriate

> executive steps as was suggested by the House of Lords in the *Fleming* case….
>
> In my judgment the CFC legislation, which depends on Section 747 and Section 748 for its effectiveness, must be disapplied so that, pending such amending legislation or executive action, no charge can be imposed on a company such as Vodafone under the CFC legislation. It follows that HMRC's enquiry into Vodafone's tax return for the Accounting Period has no legitimate purpose and should be closed."

It is not clear whether the disapplication of the CFC code was considered by the judge to extend to companies in respect all overseas subsidiaries (that would be a "single solution") or in respect of EU subsidiaries only (that would apply to companies "such as" Vodafone 2, but would not, in all senses at least, be a "single solution"). That is of course a point of fundamental importance in practice. In the former case this would allow companies with CFCs in non-EU jurisdictions to "piggy back" from the disapplication of the CFC code to give effect to directly enforceable Community law rights even in cases when no such rights were being exercised. In the writer's view however, the judge's decision is flawed on either basis. The proper relationship between Community law and domestic law requires directly effective Community law rights to be exercised before a provision of domestic law which conflicts with those rights can be disapplied.

The relationship between Community law and national law

The *ICI* case dealt with the point at issue. The ECJ judgment in that case (see above) makes it clear that the disapplication of a provision of national law is required only to the extent necessary to permit directly enforceable Community law rights to be exercised unhindered. Moreover, domestic case law suggests that, in giving effect to Community law rights, the relevant provisions of national law take effect "as if enacted as being without prejudice to" the directly enforceable Community rights in question.[10] A process of "moulding" or "adapting" consequential provisions may be appropriate[11] as a result. That was not the rather more heavy-handed approach adopted by the judge in *Vodafone 2*. He considered the CFC code to be disapplied in a manner which made the question of enforceable Community rights irrelevant. The basis for the disapplication of the CFC regime given by the judge was the uncertainty for taxpayers which would result were the CFC regime to be effective on some occasions and on others not. Confusion would result. In the writer's view however the "switching" on and off a provision according to whether it is conflict with Community law is of course unwelcome, but it is an issue for Parliament, not the judiciary.

The case of *Fleming*, cited by the judge in *Vodafone 2*, does not provide support for the judge's reasoning on this point. The case concerned the absence of transitional provisions in changes to the VAT time

limit rules which, as Lord Walker put it, resulted in an "infringement of directly enforceable Community rights"[12]. Transitional provisions which were Community law compliant could not be read into the domestic legislation, since that would have amounted to the invention of transitional rules by the courts. This would have resulted in uncertainty for taxpayers, who would never have been in a position to know from the face of the legislation what those Community law compliant transitional measures might have been. The avoidance of uncertainty therefore required the offending measures to be disapplied completely, until Community law-compliant transitional rules were introduced by the legislature.

The *Fleming* case involved directly enforceable Community rights only, however, since it concerned claims for repayment of VAT under the VAT Directive. *Fleming* was therefore, it is submitted, an imperfect analogy for the judge to draw on in *Vodafone 2* since the case did not address the disapplication of domestic law in cases where it did not enter into conflict with directly effective Community law rights.[13] At some point Vodafone 2 should therefore, in the writer's view, have been required to demonstrate that it was exercising a right of establishment protected by the EC Treaty before the CFC legislation was disapplied in relation to it, whether this was through an enquiry on the basis of "remoulded" CFC legislation which exempts cases where a genuine right of establishment in the EU is being exercised[14] or, more probably, a further Special Commissioners' hearing.

The other point

Little has been said above in relation to the point which occupied most of the judgment, namely the question of whether a specific exemption in the CFC code (the motive test, contained in s748(3) ICTA 1988) could be construed so as to allow the CFC code to be compatible with Article 43. The judge found, reversing the Special Commissioners, that it could not be. In the writer's view the impact of this issue on the facts of the *Vodafone 2* case should have been procedural only. On any analysis Vodafone 2 should have been required to demonstrate that it was actually established in Luxembourg.

Had the judge found that the motive test *could* be read as compatible with Article 43, then this would have resulted in the disapplication of the CFC regime in relation to Vodafone 2 only if it could show that it was indeed exercising its right of establishment in the EU through the Luxembourg subsidiary: i.e. if, through the subsidiary, Vodafone 2 was actually established in Luxembourg and carrying on genuine economic activities there. However, if the motive test could *not* be construed as compatible with Article 43, the CFC regime should also have been disapplied in relation to Vodafone 2, this time as a consequence, not of the motive test, but of the direct effect and supremacy of Community law, as a result of which measures of domestic law which offend directly effective provisions of Community law are disapplied to give effect to Community law. However, this would have required Vodafone 2 to qualify for the

protection of Article 43 in the first place. This too would, once again, have required it to be shown that, through the subsidiary, Vodafone 2 was actually established in Luxembourg and carrying on genuine economic activities there.

In both cases therefore one would have expected that the company would have been required to demonstrate that it was actually established in Luxembourg and carrying on genuine economic activities there.[15] The judge's conclusion, however, was that finding the CFC code to be incapable of being read as compatible with directly effective Community law rights was the end of the matter. Whether that is indeed the position was, in the writer's view, a more fundamental issue on the facts than the construction of the motive test and should have been addressed at the outset, rather in the last few paragraphs of the judgment.

Where does this leave us?

The discussion above should not be taken to suggest that a taxpayer who does not exercise directly enforceable Community law rights, as a result of provisions of domestic law which are in breach of the EC Treaty, has no Community law rights – e.g. an action for damages. However that issue is distinct from the disapplication of the offending measure of domestic law.

The *Vodafone 2* decision is, it is understood, being appealed. The writer's expectation is that the relationship between Community law and domestic law set out in *ICI* will be re-established and that it will therefore at some

point be necessary to determine whether Vodafone 2 was, in 2001, exercising its freedom of establishment in the EU through its Luxembourg subsidiary, in order for the CFC regime to be disapplied in relation to it.

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[1] The subject of this article is also addressed in an article by the writer for the British Tax Review to be published later this year ([2008] 5 BTR).

[2] *R v Secretary of State for Transport, ex p Factortame Ltd (No 2)* [1991] 1 AC 603 and Case 106/77, *Amministrazione delle Finanze dello Stato v Simmenthal SpA*.[1978] ECR 629, [1978] 3 CMLR 263, ECJ: "Any national court must, in a case within its jurisdiction, apply Community law in its entirety and protect rights which the latter confers on individuals and must accordingly set aside any provision of national law which may conflict with it, whether prior to or subsequent to the Community rule."

[3] Case C-264/96 *Imperial Chemicals Industries plc (ICI) v Colmer (Inspector of Taxes)* [1998] STC 874 at [34] and [35].

[4] *Vodafone 2 v HMRC* [2008] EWHC 1569 (Ch), [2008] STC 2391

[5] Contained in Chapter IV Part XVII ICTA 1988

[6] Case C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 190.

[7] And also outside the non-EU EEA, since similar considerations apply to the EEA as apply to the non-EU EEA. As to the possible application of Article 56, case C-201/05 *The Test Claimants in the CFC and Dividend Group Litigation v HMRC* [2008] STC 1513 suggests that this would not be of assistance to the UK parent of a non-EU subsidiary. However the ECJ did not deal fully with the possibility that a CFC charge can be imposed even where the UK company on which the charge is imposed is not the UK resident controlling the CFC.

[8] Case C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 190 at [54].

[9] *Fleming (trading as Bodycraft) v HMRC; Condé Nast Publications Ltd v* HMRC [2008] UKHL 2, [2008] STC 324.

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[10] Per Lord Nolan in *ICI v Colmer (Inspector of Taxes)* [1998] STC 874 at [23] and Lord Bridge in *R v Secretary of State for Transport, ex p Factortame Ltd* [1990] 2 AC 85 at 140.

[11] Per Lord Nicholls in *Re Claimants under Loss Relief Group Litigation Order (*sub nom *Autologic Holdings plc v IRC)* [2005] UKHL 54 [2005] STC 1357 at [17].

[12] At [26].

[13] The point is well made by P. Davison, Freshfields Bruckhaus Deringer, in a *Letter to the Editor*, Tax Journal, Issue 946, 3.

[14] It is not clear whether that was how HMRC were genuinely proposing to approach things, although it might have been, given that HMRC considered the motive test to be *Cadbury Schweppes*-compliant. Account must however be taken of HMRC's controversial views as to what establishment protected by Article 43 requires in practice, as one can glean from new ICTA 1988 section 751A, intended to make the CFC regime *Cadbury Schweppes*-compliant, and HMRC statements in relation to that provision. This would not have made the CFC legislation compliant with the EC Treaty (see Case C-33/03 *EC Commission v United Kingdom* [2005] STC 582 at [25]), but one would have nevertheless expected it to make the procedural imposition on Vodafone more likely to have been palatable to the court.

[15] The difference may though have been relevant in determining the procedure for demonstrating this i.e. whether through a continuation of the enquiry process or a Special Commissioners' hearing to have the enquiry closed.

EBTS AND FBTS AFTER *SEMPRA*

by Patrick Way

Background

Sempra Metals Ltd v. The Commissioners of Her Majesty's Revenue & Customs[1] is the latest case to consider the tax treatment of payments into an employee benefit trust – but with an added twist, since it also considers the deductibility of payments into a "family benefit trust" by reference to the provisions of FA 2003 Schedule 24, which took effect from 27th November 2002. The *Sempra* case is a natural progression from the *Dextra* case (*Dextra Accessories Ltd & Others v. MacDonald*[2]) which has been considered previously in the *Review*[3]. At first blush, it raises a deceptively straightforward question: if payments to an EBT are not deductible, what is the position concerning payments to a family benefit trust?

The question is deceptively easy (that is to say it is difficult), because the facts of *Sempra*, as it turned out, very much played into the hands of the Revenue. Prior to the use of the family benefit trust by Sempra Metals Ltd, there had already been an employee benefit trust in "traditional" form. The decision was made to use a *single* family benefit trust rather than separate trusts for separate employees. The family benefit trust had much the same features of the old EBT, and a similar pattern was adopted in the hands of the relevant parties

(employer, employee and trustees) as to how amounts to be paid into the trust should be quantified and then paid over. Whilst there were differences in relation to the drafting of the trust document (employees were excluded), nevertheless the overall effect was as if very little had changed. It would have been interesting to see what the outcome would have been had there been a series of separate family benefit trusts for each of a number of individual employees (rather than one single family benefit trust). I return to this point subsequently.

New readers join here

There now follows a brief resumé of how EBTs have evolved and how they have been viewed from time to time by the revenue authorities.

In the beginning

Given the difficulties, as a matter of company law, of effecting buybacks of shares, EBTs became in the 1980s a useful vehicle to achieve a similar result. Companies could make payments from time to time to the trustees of EBTs and the trustees could hold the cash received as a sort of treasure chest, ready as and when the need arose to acquire the shares of a retiring shareholder. In due course, such a shareholder could offer to sell his shares to the trustees of the EBT, who could then use the capital in the trust fund to pay him out. The case of *Mawsley Machinery Ltd v. Robinson*[4] shows that even this had its hazards, but on the face of it, in the writer's view, the original rationale of EBTs was to provide a

means of buybacks or their equivalent. One of the attractions, as it turned out, was that the sponsoring company would obtain a deduction when it made the payments into the EBT, even though there was no tax to pay in the hands of any beneficiary of the EBT, for until such time as a payment was made out no receipt had occurred. So, as is mentioned in the *Dextra* case itself, a form of tax "asymmetry" appeared: *early deduction; late taxable receipt*.

Time moves on

This asymmetry made EBTs very popular in their own right, and, in addition, the workforce of the sponsoring company could see that they would benefit from working hard, because the EBT trustees would, in due course, pay out sums effectively by way of bonus remuneration. The company would have received a deduction long beforehand, and although there was tax to pay in the hands of the recipient upon receipt, that seemed entirely fair.

The usual tax opinion that was given at this time by advisers would describe how it was felt that deductions would be available pursuant to Taxes Act 1988 s.74, but only if the payments were wholly and exclusively for the benefit of the paying company's trade; there would be warning about how the capital element of any payment into the trust (see *Atherton v. British Insulated & Helsby Cables Ltd*[5] would not be deductible; there might be a warning that care should be taken to make sure that there were regular payments into the EBT to emphasise the income

nature of the payments. And typically a reference was made to the wording of Finance Act 1989 s.43, together with a caveat drawing the reader's attention to the fact that if the payments received by the EBT trustees amounted to "potential emoluments held by an intermediary" within s.43, then no deduction would be available until emoluments had been paid out. However, almost invariably this caveat included a "placebo" to the effect that so far as the adviser was concerned the Revenue as a matter of practice never invoked s.43, and – in any event – it seemed hard to see how trustees could be *intermediaries* on behalf of the employer (as s.43 would require) when the reality was they were independent trustees dealing with money comprised in the trust fund, not by reference to any direction from the employer, but by reference to the independent powers founded in them by virtue of the trust document itself.

The going gets tough

Since it proved relatively easy to obtain a deduction for payments into EBTs, advisers began to see them as a first step in a number of planning techniques: at least a deduction could be "guaranteed". Indeed, their popularity grew to such an extent that at the time the disclosure rules were introduced there were approximately 1300 EBTs under review by the Revenue. They were becoming a "nuisance", and the Revenue's obvious attack was to challenge the deductibility of the employer's contributions. The principal objections which the Revenue raised at this

time were by reference to UITF 13 and 32, on the basis – in a nutshell – that the employing company did not relinquish control over the assets because of the apparent relationship which the employer had with the trustees, and therefore the contributions, in effect, had never been paid away but remained under the control of the company. So no deduction was available.

To this writer, at least, these arguments always seemed unmeritorious. But they became time-consuming to shift. They are now long since forgotten anyway, for the reasons which follow.

Dextra

Finally, we come to the *Dextra* case (see the previous article in *GITC Review*), where – broadly speaking – the Revenue ran for the first time an argument that FA 1989 s.43 had application after all. More particularly, so the argument went, the trustees *were* intermediaries, and the payments into the trust were potential emoluments held by those intermediaries with a view to their becoming relevant emoluments. On this basis no deduction was available until such time as these payments were paid out (FA 1989 s.43(11)).

The Revenue were unsuccessful with this argument both before the Special Commissioners and in the High Court, but won their appeal to the Court of Appeal and were upheld in the House of Lords. The decision of the Special Commissioners was given on

the 3rd September 2002, and – presumably – as a precaution – the law was changed on 27th November 2002, by changing the wording of Finance Act 1989 s.43 itself and by introducing Finance Act 2003 Schedule 24 with effect from 27th November 2002. This date is relevant in the *Sempra* case, as will be seen, since after that time it was decided to adopt a family benefit trust, rather than an EBT in the hope to circumvent the new law.

So what were they trying to achieve in the *Sempra* case?

After this reminder of the background, it is appropriate to look at the facts of the *Sempra* case. The company had made payments into an EBT and had done so up to the end of 2000. Following the change in the law described above, a new strategy was adopted. Instead of payments being made into an EBT, the company as settlor executed a deed of trust establishing a "family trust" called the Guardian Trust. An Isle of Man trustee was appointed. There was an initial fund of £1000, the trust period was eighty years or less, and the beneficiaries were members of the family of the present or former directors, officers or employees of the settlor and any charitable body, but neither the settlor nor any present or future employee of the settlor could be a beneficiary. The intention was that the trust would not fall within the definition of an *employee* benefit trust, since it would be a *family* benefit trust thus, so it was hoped, circumventing the provisions of Schedule 24 and the revised FA 1989 s.43.

However, as is described in the decision at paragraph 51, the family benefit trust was operated in a way very similar to the way in which the employee benefit trust had been operated. Each year a decision was made about the total amount of the bonus pool, which was usually the same percentage of the amount of the pre-tax profits for that year. Each employee would be asked if he would like his bonus pool paid into the family trust, or whether he would prefer to take it in cash through the payroll, or whether he would prefer a mixture of the two. Once the bonus pool had been approved, the directors of the appellant company decided how it was to be allocated amongst the employees depending upon performance. Each year, the appellants sent to the trust an amount equal to the amount of the bonuses awarded to the employees. Beneficiaries were nominated and they could choose to receive either a loan from the trust or to have allocated funds invested by the trustees. Out of the 32 beneficiaries, 31 opted for loans. So the question arose as to whether the use of a family benefit trust meant that the contributions fell outside the provisions of FA 2003 Schedule 24; and as an aside questions arose in relation to the previous treatment of the contributions which had been made to the EBT prior to the change in law which occurred with effect from 27th November 2002.

What the *Sempra* case tells us

The Special Commissioners considered firstly the position concerning the earlier payments that had been made into the EBT, prior to the introduction of Schedule

24. In other words, they considered precisely the same statutory wording which had been considered by the House of Lords and below in the *Dextra* case – the old form of FA 1989 s.43. Perhaps not unsurprisingly, they came to the same conclusion as the Court of Appeal and the House of Lords, which was that the contributions were properly to be treated as potential emoluments, because they were held by intermediaries "with a view to" becoming emoluments. So no deduction could occur until an outgoing payment had been made.

It had been hoped that the Special Commissioners would consider more carefully whether trustees could properly be described as "intermediaries". Whilst it had been *conceded* in *Dextra* that trustees were intermediaries, this concession was effectively withdrawn in the *Sempra* case, and it was agreed by the parties that where a Court assumes a proposition of law to be correct without addressing its mind to it, the decision of that Court is not binding authority for that particular proposition. (*Baker v. The Queen*[6] and *Barrs v. Bethell*[7]. What was difficult for the appellant, however, was that in the High Court the view had been expressed that it had *rightly* been conceded the trustee was an intermediary, and the Court of Appeal reached the same view. Not surprisingly, therefore, the Special Commissioners held that the trustees were intermediaries for the purposes of s.43, and said they could see nothing to distinguish the facts in *Sempra* from those in *Dextra*. Whilst the writer of this article has not *quite* given up on this point (mainly because he thinks that – as a matter of common sense – trustees are *not* intermediaries), it

would seem a very difficult argument to win. Nevertheless it would be one which could be raised as part of a general appeal if relevant, because as an intellectual matter it has merit.

The Special Commissioners also considered whether the payments were held with a view to becoming relevant emoluments under the old form FA 1989 s.43. The appellant argued that, because loans had been made to beneficiaries on what was intended to be an indefinite basis and would not be repayable if an employee left the company, and because on death the loans were renewed to members of the employee's family, there could never be any possibility of there being an emolument: there would be *benefits* but not *emoluments* – so s.43 did not apply. However, the Special Commissioners held that the trustees did have power to pay emoluments and had done so in favour of one individual. So it was reasonable to assume they would do this again. Consequently, in effect the *Dextra* decision was repeated. The payments were held with a view to becoming emoluments.

Transfers into the family benefit trust

The Special Commissioners then considered how FA 2003 Schedule 24 operated in the particular circumstances – where the sponsored trust in question was described as a *family* benefit trust, rather than what might be called a traditional *employee* benefit trust. The starting point is that Schedule 24 has application to restrict deductions for *employee benefit contributions*. Such a contribution is made if as a result of any act or

omission property is held under an employee benefit scheme. The definition of an employee benefit scheme is "a trust, scheme or other arrangement for the *benefit* of persons who are or include present or former employees of the employer". The appellant argued that the so-called family benefit trust was not an employee benefit scheme, as employees were excluded under the terms of the trust. Whilst the appellant accepted that the payments to the trust were beneficial to the employees (and so were deductible under general principles), this was only because it was in the interest of the employees that members of their families should benefit. However, in the context of Schedule 24, the word "benefit" – so it was argued – meant a settlement or some other enforceable arrangement which had as its beneficiary the employee. It was not enough that it was just beneficial to the employee for a payment to go into the trust. So it followed, in the appellant's submission, that the provision of benefits to a named member of an employee's family was not for the benefit of that employee.

The Revenue argued a number of points, including the point that, on a wider view, the family benefit trust was an arrangement for the benefit of employees. It could be demonstrated, so they said, that there was an established practice of the payment of bonuses. Each employee was given the choice of taking his bonus in cash or by way of payment into the trust. Each employee could nominate a beneficiary and most chose their spouses. The arrangements worked in such a way that the employees could benefit, so the Revenue argued,

directly (through payments out of the trust into joint bank accounts or for the purchase or discharge of loans on joint properties) and the full amount of each bonus to an employee was allocated to his nominated beneficiary.

In the end, the Special Commissioners sided with the Revenue. Since the relevant definition was by reference to a "trust *scheme or other arrangement for the benefit of employees*" the whole phrase indicated that a much wider meaning was to be given to the words used. The employees benefited indirectly where the payments were made to their families, and directly where the loans by the trustees to the nominated beneficiary were paid into joint accounts with the employee or to discharge loans on jointly owned property. There was an arrangement for the benefit of employees.

Conclusion

In many ways as a result of what might be called rather unhelpful facts, there must be a concern that the use of *any* family benefit trust runs the risk of falling within the EBT legislation. But this would seem to be harsh. After all, imagine that instead of there being *one* single family benefit trust for *all* employees, by contrast each of the employees had set up their *own* family benefit trust exclusively for the benefit of their own family, and let us also imagine that some of these trusts were already in existence. Let us assume also that the steps involved would be, in effect, a bonus payment *once and for all* being made into an *existing* separate family benefit trust which would then continue to be run as it had been previously (as a family benefit trust) *with no*

involvement of the company, and with no *special trustees* running other trusts. Let us also assume that no further payments were envisaged. In this situation, there are good arguments for saying, given that there must be a distinction between a family benefit trust on the one hand and an EBT on the other, that this situation would not fall within Schedule 24.

One can put it this way: before the decision in *Sempra*, there was no reason why a bonus that could have gone to an individual but went to a family trust would be an EBT contribution. Whilst it is probably precarious to do this for the future, if you have already done it then you certainly should stick to your guns: such a payment on the right facts is capable of falling outside FA 2003 Sch.24.

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[1] [2008] STC (SCD) 1062 (SpC 698).
[2] 77 TC 146.
[3] Vol 5 No.1.
[4] SpC [1998] SCD 236 (SpC 170).
[5] 10 TC 155.
[6] (1975) AC 774.
[7] [1982] Ch.294.

LETTER TO THE EDITOR

Dear Mr Grundy

I was most interested in your article in the latest issue of the Grays Inn Tax Chambers Review on the *Smallwood* case.

I wonder if I can comment on another anomaly arising from the construction put on Article 4 of the former Double Taxation Agreement with Mauritius.

Article 4(1) defines the term 'resident of a Contracting State' as meaning any person who, under the law of that State, is <u>liable to taxation</u> therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.'

We have here a situation where a trust only had UK trustees for a few days at the end of the year in which the Mauritian trustees had realised a substantial capital gain. It is said that the fact that the trust had UK trustees for part of the tax year means that it is to be regarded as UK resident for the whole of the tax year.

However, an anomaly arises here in that the UK trustees were not themselves liable for capital gains tax, the liability fell on the settlor under section 77 TCGA 1992. Furthermore, because the settlor was a beneficiary, the whole of the trustees' income was treated as the settlor's income rather than the trustees' income. It might therefore be argued that the trustees were not liable for tax by reason of their residence in the UK and were only

liable for tax in Mauritius. Put another way, whilst they might be UK resident according to our domestic law, they were not a resident of the UK as defined in Article 4.

…………in which case, the tie-breaker provisions which relate to the place of management may not be relevant?

Tony Foreman

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MG comments – I suppose the opposite view is that a distinction is to be made between "liable to tax" and "liable to taxation", and by using the abstract noun, the treaty draftsman is describing not a person but a class of persons, those who are, so to speak, in the line of fire – on account of residence etc. On this analysis, it does not matter whether or not the person in question has any actual tax liability in that year: his income may be too small, say, or he may have carry-forward losses. It is enough that his residence etc is such that he would have a liability in other circumstances. "Other circumstances" in the *Smallwood* case could have been the death of the settlor or the failure of the settlor to pay his income tax.

Of course, the debate only becomes relevant if you accept (which I do not) that a trust has a residence. In my view, only persons can be resident and a trust is not a person. The Commissioners may have been

(unconsciously) influenced by the concept of deemed trustee in the CGT legislation: that is only a domestic fiction and has no place in the interpretation of a tax treaty.