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DIVORCE PROCEEDINGS AND THE RELEASE OF CONFIDENTIAL DOCUMENTS TO HMRC[1]

Barrie Akin

In March 2012, Coleridge J. heard an application by HMRC in the Family Division of the High Court for an order for the production of some of the confidential documents and of the transcripts of the private hearings in the well-known Charman divorce proceedings.[2]

Tax practitioners can be forgiven for being unfamiliar with such applications: they are rarely made and are rarely successful. This one failed also, but is of considerable interest because it marks an attempt by HMRC to enlarge the circumstances in which the Court may order disclosure of documentation normally protected by confidentiality. It also serves as a timely reminder for family law practitioners of the approach generally adopted by the court to tax irregularities that emerge in the course of divorce proceedings.

Put shortly, the few authorities show that disclosure to HMRC is ordered only where there is an admission of tax evasion. But in *Revenue and Customs Commissioners v Charman3* HMRC made it clear that they were not alleging any form of impropriety on the part of Mr. or Mrs. Charman in their tax affairs. HMRC nevertheless sought an Order for disclosure of the transcripts and other confidential documents because they, "will be of assistance in presenting the full facts to the First-tier Tribunal",[4] or, in Coleridge J.'s words[5]:

> "Mr. Nawbatt (for HMRC) contends that it is always in the public interest for the right amount of tax to be paid by tax payers and that these documents are directly relevant to the matters in issue before the tribunal. In

> particular, they would be helpful to the rebuttal of any case advanced by the husband if it differs from his case previously advanced before me. In other words, specifically, he wants to be able to use the transcripts and documents for the purposes of cross examining the husband especially if he seems to be presenting a case which is factually different to the one relied on by him."

To understand why Coleridge J. refused HMRC's application requires some understanding of the divorce law background. Financial remedy (formerly called ancillary relief) hearings in matrimonial disputes are still held in private. The authorities establish unequivocally that the reason for this is to encourage full and frank disclosure in what are semi-inquisitorial proceedings.[6] Further, the parties cannot choose what information they wish to rely on – they are compelled to disclose all relevant information.[7]

Accordingly, documentation produced under such compulsion, including documents created for the purposes of the financial remedy proceedings, are also confidential, as are transcripts of the proceedings and of any judgments issued in private. The Family Procedure Rules 2010 r.29.12 says:

> "Except as provided by this rule or by any other rule or Practice Direction, no document filed or lodged in the court office shall be open to inspection by any person without permission of the court and no copy of any such document shall be taken by, or issued to, any person without such permission."

The Court has a discretion as to whether to permit disclosure of such confidential documents to third parties.[8] As regards disclosure to HMRC, the three significant High Court decisions are *S v S (Inland Revenue: Tax Evasion), R v R (Disclosure to Revenue)9* and *A v. A; B v B.*[10]

In *S v S,* Wilson J. had already held, as part of the confidential ancillary relief proceedings, by inference from the evidence

(but with no actual admission by the husband) that the husband had been guilty of tax evasion. The wife's brother sent a copy of Wilson J.'s confidential judgment to the Inland Revenue. The Revenue very properly applied to the Court for permission to retain that document. Wilson J. refused the application. Dealing with the general principles, he said[11]:

> "It is greatly in the public interest that all tax due should be paid and that in serious cases, pour encourager les autres, evaders of tax should be convicted and sentenced. ... On the other hand it is greatly in the public interest that in proceedings for ancillary relief the parties should make full and frank disclosure of their resources and thus often aspects of their financial history. Were it to be understood that candour would be likely to lead – in all but the very rare cases – to exposure of underdeclarations to the Revenue, the pressure wrongfully to dissemble within the proceedings might be irresistible to a far bigger congregation of litigants than is typified by the husband in these proceedings."

He went on to weigh the public interest of due payment of tax and the punishment of tax evaders against the public interest in parties to ancillary relief proceedings making full and frank disclosure. His reasons for not permitting the Inland Revenue to retain the document were largely based on the fact that fraud was not admitted, but was inferred by the judge from surrounding circumstances. In those circumstances, the public interest in securing full and frank disclosure prevailed.

Wilson J. followed the same approach in *R v R (Disclosure to Revenue)*.[12] This time, however, tax fraud was admitted and Wilson J. ordered that HMRC could retain the documents.

The clear message from these decisions is that cases of admitted tax evasion may lead to disclosure, but that cases falling short of that level of culpability will generally not, because the public interest in full and frank disclosure will usually outweigh it.

In *A v A; B v B*,[13] two husbands had concealed from their wives that they were owners of the company that employed them and had taken steps through offshore arrangements to reduce the profits of that company. They initially maintained the deception in their divorce proceedings but eventually admitted the truth. It appears that HMRC were as ignorant of the true position as the wives had been. Charles J. accordingly considered whether the Court should of its own motion send papers in the case to HMRC. He decided not to do that on the footing that the respondents would themselves make disclosure to HMRC of certain matters "relating to the evasion or non-payment of tax". In a long and (admittedly obiter) judgment Charles J. made it clear that the same general underlying considerations should apply when the Court was considering the disclosure of papers of its own motion as in cases whether the third party was applying to obtain or retain the papers. He also agreed with Wilson J. that:

> "… decisions relating to disclosure involve and turn on an assessment of the weight of competing public interests in the circumstances of each case".

Following a thorough analysis of the principles, Charles J. concluded that:

> "… when a court is satisfied that there are liabilities to the Revenue, or material that ought to be disclosed to the Revenue to enable them to investigate whether there has been evasion or non-payment of tax, the private interests of parties to ancillary relief proceedings in avoiding disclosure to the Revenue of that conclusion, and the material on which it is based, so as to enable them to benefit from the non-payment of moneys lawfully due to the revenue … cannot found an argument that it would be unfair, or unjust, or contrary to the public interest for such disclosure to be made".

This approach differs from the one adopted by Wilson J.

in the circumstances of *S v S*. In refusing HMRC's application, Wilson J. gave the public interest of promoting of full and frank disclosure primacy, except where there is tax fraud – and admitted tax fraud at that. Charles J. weighed the competing public interests more evenly, without any bias in favour of the promotion of full and frank disclosure. In addition, in using the expressions "evasion or non payment of tax" and "liabilities to the Revenue" Charles J. appeared to contemplate the possibility of disclosure to HMRC in cases where tax evasion is not a factor.

However, "non payment of tax" is itself an ambiguous phrase and it is likely in the context of the case that Charles J. did not intend to draw a sharp distinction between "evasion" and "non payment". The straightforward failure to pay a liability that is admittedly due cannot be the kind of "non payment" that Charles J. had in mind and since Charles J. recognised that taxpayers cannot conceal liabilities from HMRC by silence, it is far more likely that his choice of words was intended to cover both the deliberate deception of HMRC by misrepresentation and the failure to draw liabilities to HMRC's attention by omission from returns – itself of course a criminal offence.[14] In *Clibbery v Allan,15* the Court of Appeal reviewed the authorities on the disclosure of confidential litigation material to third parties. Dame Elizabeth Butler-Sloss P., in discussing *A v A; B v B,16* made it clear that she considered that Charles J. was dealing with cases of "tax evasion or other tax impropriety".

The hearing of HMRC's application in *Charman* was in private and Coleridge J.'s published judgment does not say in terms that HMRC's argument was based on Charles J.'s formulation in *A v A; B v B*. However, in view of the approach of Wilson J. in *S v S* and *R v R,* it is difficult to see how HMRC's application could have had any realistic prospects of success without seeking to use Charles J.'s approach. In refusing HMRC's application, Coleridge J. summarised his view of the law by saying[17]:

> "As a general rule documents and other evidence produced in ... financial remedy proceedings ... are not disclosable to third parties outside those proceedings save that exceptionally and rarely and for very good reason they can be disclosed with leave of the court. The fact that the evidence may be relevant or useful is not by itself a good enough reason to undermine the rule."

He went on to say[18]:

> "I have no hesitation in finding that there is nothing rare or exceptional about this case which takes it outside the general rule ... I am fortified in this view by the fact that... there is no suggestion that the husband is guilty of tax evasion or criminal conduct in relation to his tax affairs. This is a routine tax assessment."

So Coleridge J.'s approach was essentially the same as Wilson J.'s in *S v S* and *R v R* and any suggestion that HMRC may have recourse to confidential divorce papers merely as a means of testing the evidence that may be adduced in the Tax Tribunal was firmly rejected.

A further issue was raised by the judge in the final paragraph of his judgment. He said:

> "If, of course the husband himself wishes to rely upon documents/evidence he produced during the hearing in front of me he may have leave to do so but in that event all relevant material must be produced to the Tribunal not just highlights he selects which support his case."

At face value, this may suggest that practical difficulties could arise for a taxpayer who wishes to rely on some confidential documents used in the divorce. If, in the tax appeal, he decides to rely on a document that was before the divorce court, does that not require all such documents to be brought in? That is not, it is submitted, correct.

The answer to this question lies in how confidentiality operates. Documents which exist independently of the financial

remedy proceedings (e.g. the husband's bank statements) do not become confidential for all purposes simply because they are put in evidence in those proceedings. It is the other party to the proceedings that is bound by confidentiality as regards those documents. This is generally referred to as the implied undertaking as to confidentiality. See, for example, *Clibbery*.[19] By way of contrast, evidence created for the purposes of or in the course of the financial remedy proceedings, such as experts' reports and transcripts of the hearings and confidential judgments are regarded as confidential for all purposes.

CONCLUSION

Coleridge J.'s judgment is a clear statement that it is only in exceptional circumstances that confidential divorce documentation will be disclosed to HMRC. It is consistent with the preponderance of authority and reflects the policy of the family courts to encourage full disclosure. It was a difficult, not to say a speculative application on HMRC's part.

In addition, the practical consequences if HMRC's application had succeeded could have been far-reaching. To what extent would it have become a matter of routine that the confidential financial aspects of divorces would have to be divulged to HMRC? Would there have to be a current tax investigation or enquiry or appeal? Who would decide which parts of the evidence should be disclosed as being relevant to a person's tax affairs and which parts should remain confidential? How would the decision-maker know enough about the person's tax affairs to know what was relevant? How would an aggrieved party (including HMRC) challenge the decision? For the moment at least these questions can remain hypothetical and need not be answered, so that practitioners can assume that the status quo will remain undisturbed.

Endnotes

1 This article was first published by Thomson Reuters (Professional) UK Limited in Private Client Business [2012] Issue [5] and is reproduced by agreement with the Publishers.

2 See *Revenue and Customs Commissioners v Charman* [2012] EWHC 1448 (Fam); [2012] B.T.C. 145. For the reported divorce proceedings, see *Charman v Charman* [2006] EWHC 1879 (Fam); [2007] 1 F.L.R. 593 and 1237 and 1246.

3 *Revenue and Customs Commissioners v Charman* [2012] EWHC 1448 (Fam); [2012] B.T.C. 145 (Judgment released May 29, 2012).

4 *Charman* [2012] EWHC 1448 (Fam); [2012] B.T.C. 145 at [10].

5 *Charman* [2012] EWHC 1448 (Fam); [2012] B.T.C. 145; [2012] S.T.I. 1838 at [9].

6 See the Matrimonial Causes Act 1973 s.25, which imposes a duty on the Court to have regard to all the circumstances of the case when deciding whether to exercise its ancillary relief powers.

7 See *Clibbery v Allan* [2002] EWCA Civ 45; [2002] Fam. 261.

8 *S v S (Inland Revenue: Tax Evasion)* [1997] 1 W.L.R. 1621; [1997] 2 F.L.R. 774 Fam Div.

9 *R v R (Disclosure to Revenue)* [1998] S.T.C. 237; [1998] 1 F.L.R. 922 Fam Div.

10 *A v A (Ancillary Relief)* [2000] 1 F.L.R. 701; [2000] 1 F.C.R. 577 Fam Div.

11 *S v S* [1997] 1 W.L.R. 1621; [1997] 2 F.L.R. 774 Fam Div at 777.

12 *R v R* [1998] S.T.C. 237; [1998] 1 F.L.R. 922 Fam Div.

13 *A v A; B v B* [2000] 1 F.L.R. 701; [2000] 1 F.C.R. 577 Fam Div.

14 See *R. v Mavji* [1987] 1 W.L.R. 1388; [1986] S.T.C. 508 CA (Civ Div).

15 *Clibbery* [2002] EWCA Civ 45; [2002] Fam. 261.

16 At [71].

17 [2012] EWHC 1488 (Fam) at [22].

18 [2012] EWHC 1488 (Fam) at [24].

19 *Clibbery* [2002] EWCA Civ 45; [2002] Fam. 261.

MANORIAL RIGHTS AND AGRICULTURAL PROPERTY RELIEF

Felicity Cullen QC

Under the Land Registration Act 2002 ("LRA 2002"), a number of rights over land are described as "overriding interests" to which a landowner's interest is subject, even if the rights are not mentioned in the land register.

Among the rights which constitute overriding interest, are rights to mines or minerals (which are usually manorial rights) and (as far as the Land Registry is concerned) the right to enforce liability in respect of chancel repairs.

The LRA 2002 seeks to limit the number of overriding interests and to replace as many or them as possible with register entries. Its overall objective is to make the register as complete a record of title as possible. (See further Land Registry Practice Guide 15.)

Section 117 LRA 2002 provides for various rights to lose their status as overriding interests after 12 October 2013.[1]

As time has marched towards 12 October 2013, there has reportedly been a marked increase in the number of overriding interests being asserted and in the number of investigations being undertaken to determine whether, for example, historic chancel repair liabilities exist and can be noted on the register.

Mineral rights are among the most significant manorial rights. It has been widely reported in the press that large landowners have been asserting rights to minerals which have become separated from the land under which they may be found; and affected landowners are being provided with draft provisions describing the extent of rights which will be registered by third parties who are asserting ownership.

In some cases mineral rights may be claimed or asserted because of their nuisance value. The rationale is that certain affected landowners are keen to have a clean title to their land and will often pay a premium for the surrender of the mineral rights by the person claiming to own them.

In other cases, the mineral rights may have present or potential innate value.

In some cases the claim in respect of mineral rights is being made not only to minerals which are deep under the surface of the land, but also to surface minerals.

In the context of agricultural land, the exercise of mineral rights could have potentially adverse effects on agricultural property relief ("APR") for inheritance tax ("IHT") purposes as explained below.

APR is available both to owner-occupiers and to owners who let their land to third parties who farm it.

In all cases, the purpose for which the land is occupied is fundamental to the availability of relief; and the occupation for the relevant purposes must be continuous.

HMRC's own Manuals describe the position as follows:-

"IHTM24070 – Occupation: Introduction

A requirement for the application of agricultural relief is that agricultural property (IHTM24030) that is occupied for the purposes of agriculture (IHTM24060) must have been either

- *occupied* by the deceased/transferor *for the purposes of agriculture throughout the two years preceding the transfer*,
- or owned by the deceased/transferor *throughout the seven years* immediately preceding the transfer and the property must have been *occupied* (IHTM24071) *throughout the period for the purposes of agriculture* (IHTM24060). The identity of the occupier does not matter, but *the continuity of such occupation is vital...* [s.117 IHTA 1984]

HTM24071 – Occupation: The occupation condition

To satisfy the first alternative condition in IHTA84/S117, *throughout the two years immediately before the transfer*

- the deceased or transferor must have occupied (IHTM24070) the property, and
- the deceased's or transferor's *occupation of the property must have been for the purposes of agriculture* (IHTM24060).

IHTM24100 – Ownership: Introduction

To satisfy the second alternative condition in IHTA/S117, the deceased/transferor must have owned the property concerned *throughout the seven years immediately before the transfer* and the property must have been *occupied* (IHTM24070) *throughout the period for the purposes of agriculture* (IHTM24060). The identity of the occupier is not material, but the *continuity of such occupation is vital...*" (my italics)

It is quite common for provisions relating to mineral rights to refer both to entry onto land for the purposes of investigation and surveys and to entry onto land for the purposes of extraction.

If the exercise of mineral rights prevents the occupation of land satisfying the purposes prescribed by IHTA 1984, APR will be either be lost or the relevant periods of time will stop and will be re-started on resumption of occupation satisfying the prescribed purposes. Depending on the facts and the duration of the exercise of the mineral rights, there is the risk of loss of APR resulting from cessation of the occupation for relevant purposes or from the re-starting of the period which is then not of adequate length. Relief would be lost if, for example, the 'clock' was re-started and the landowner (who may previously have accrued APR) died before the end of the new qualification period (in circumstances where there was no surviving spouse or civil partner in whose ownership the land could continue to accrue APR).

Surface investigations and/or surface extraction could clearly affect the availability of APR because of the impact on the occupation of the land for agricultural purposes.

Even where the rights permit no access to minerals from the

surface, but the rights refer to surface minerals, the extraction of the surface minerals could, in theory, be undertaken from below the surface and APR could be adversely affected.

Workings which are carried out exclusively underground may not adversely affect the occupation of the land and availability of APR, but might do so, depending on whether the land could continue to be used continuously for agricultural purposes.

Current landowners may be unable to control the time at which mineral rights may be exercised and, accordingly, cannot assume that exercise will take place at a time that will not have adverse effect.

Accordingly, in circumstances where APR is considered to be available or is a factor in a commercial decision to buy or retain land, it is vital for landowners to consider seriously the existence and potential impact of asserted rights. Landowners may seek to challenge the existence of the rights or to to seek to limit the scope of the mineral rights asserted and registered by third parties: they should at the very least do some digging.

Endnotes

1 In the case of land which was registered before 13 October 2013, unless the rights are protected by notice in the register, a person who acquires the registered estate for valuable consideration by way of registerable disposition after 12 October 2013 will take free from the relevant overriding interest.

An owner of land whose interest exists before 12 October 2013 and whose interest continues after that date will continue to be bound by the relevant overriding interest even if notice of it has not been entered in the land register.

In the case of unregistered land, the legal owner of the land will be bound by manorial rights up to the time of first registration of the land. On first registration the legal owner will hold free of the relevant rights unless they are protected by notice at the time of first registration (see generally the Land Registry's Practice Guide 22).

A TRAP FOR REMITTANCE-BASIS TAXPAYERS: THE SITUS OF CHOSES IN ACTION

Michael Firth

Choses in action are personal rights of property which can only be claimed or enforced by action, and not by taking physical possession.[1] As such these rights of property form the fundamental legal basis of almost all commercial transactions: each contracting party's contractual rights are a chose in action, debts are choses in action, as are shares, and even a cause of action arising from a breach of contract or a civil wrong is a chose in action.

Despite this fact, in many circumstances the potential tax consequences of the existence of contractual choses in action are not considered and this appears to be done with the tacit agreement of HMRC. For example, if a UK resident non-domiciliary agrees to purchase an asset to be delivered abroad, it is not usually analysed whether the chose in action that the taxpayer acquires under the contract is property received in the UK; instead the focus is on where the asset is delivered and where the money is paid. As long as HMRC are content to follow the "real" assets in these sorts of circumstances, no problems will arise in practice, even if as a matter of law things may be more complicated.

One situation in which the intermediate stage involving the choses in action cannot be, and is not, ignored, however, is where the vendor's chose in action is a right to contingent and uncertain consideration. This is a "*Marren v. Ingles* chose in action", after the famous case in which the taxpayer sold his shares for a fixed sum of money plus the right to receive further amounts if certain unpredictable events occurred, calculated by reference to the

value of the shares at that later time.[2] When that happens, the explicit capital gains tax analysis is that there are two disposals: first of the shares in return for the right to the uncertain future payment (which may not be worth very much) and second a disposal of the chose in action in return for whatever consideration is eventually received.

The correct remittance analysis of this type of scenario is considered in this article. At the first stage of analysis, the relevant question is whether the *Marren v. Ingles* chose in action has its situs in the UK according to the common law rules on the situs of assets and those rules are the subject-matter of the following section. Whilst an issue could arise as to whether the *Marren v. Ingles* chose in action is a debt for these situs purposes (even though it is not initially a debt for CGT purposes),[3] it will be seen that developments in the European law on jurisdiction are moving the law to a unified question of where is the chose in action enforceable? The previous distinction between a test of "where is the debtor resident?" for debts and "where is the chose in action enforceable?" for other contractual choses in action is thus gradually being eroded.

At the second stage of analysis (the disposal of the chose in action), however, before one even gets into the remittance rules it must be assessed whether the remittance basis can actually apply. That would require a foreign chargeable gain, which in turn depends upon the location of the asset disposed of, but at this point it is a different test of situs to the common law test and taxpayers and their advisers must be alert to that change in focus. This is discussed in the third section.

THE SITUS OF A CONTRACTUAL CHOSE IN ACTION WHEN APPLYING THE REMITTANCE-BASIS RULES

The statutory context

Whether the tax is income tax or capital gains tax, the rules

for determining when a gain or income is remitted are contained in ITA 2007 s.809K et seq.[4] The basic provision is that an individual's income or chargeable gains are remitted to the UK when:

a. money or other property is brought to or received or used in, the UK, by or for the benefit of a relevant person (such as the taxpayer); and
b. that property is or derives (wholly or in part and directly or indirectly) from the income or chargeable gains, (and, in the case of derivative property, it must be property of a relevant person).[5]

For present purposes it is condition (a) that is of interest because it requires property to be "brought to, or received or used in, the United Kingdom". Whilst a chose in action would not usually be "brought" to the UK, the courts have accepted that choses in action do have a situs and it ought to follow that they can be received in the UK. [6]

Further, the fact that choses in action may, necessarily, not be enjoyed in possession means that one has to apply a more appropriate definition of "used" which would include the whole or partial fruition of the legal rights that make up the chose in action. From this it follows that, for example, the receipt of money pursuant to a chose in action which is a debt is a "use" of the chose in action and if the debt was situated in the UK at the time, it will have been used in the UK.

In either case, therefore, the crucial factor is going to be where the chose in action is situated and because ITA 2007 does not provide any rules for determining where that is, one must turn to the rules of private international law.

The general rule on the situs of debts and rights of action in contract

The general rule for the situs of a debt which is not a specialty has, for over a century, been stated to be simply where the debtor is resident because that is where the debt can be enforced: [7]

> "…bills of exchange and promissory notes do not alter the nature of the simple contract debts, but are merely evidences of title, the debts due on these instruments were assets where the debtor lived, and not where the instrument was found. In truth, with respect to simple contract debts, the only act of administration that could be performed by the ordinary would be to recover or to receive payment of the debt, and that would be done by him within whose jurisdiction the debtor happened to be."[8]
>
> "It is clearly established that a simple contract debt is locally situate where the debtor resides — the reason being that that is, prima facie, the place where he can be sued: *New York Life Insurance Co. v. Public Trustee* [1924] 2 Ch. 101, 114, *per* Warrington L.J."[9]

And this is the rule that HMRC say is applicable,[10] although it should be noted that residence in this context means the private international law concept, not the tax concept. For example, a company is resident, for present purposes, where it carries on its business, where it is incorporated and where it has its registered office, rather than where it has its place of central control and management.[11]

On the other hand, the ordinary rule for a chose in action which is a right of action in contract, but not a debt, is that it is situated in the state where the action may be brought.[12]

Whilst both of these rules appear to be concerned with locating a place where the debtor can be sued, with "residence" being a shortcut to the place where the debt can be enforced, that is not entirely correct and the issue of situs is not as simple as saying that there is a single rule based on enforceability.

In the first place, the fundamental principle of common law jurisdiction in England is (and was) based on the presence of the defendant within England at the time that the claim form (previously the writ) is issued:

> "The root principle of the English law about jurisdiction

> is that the judges stand in the place of the Sovereign in whose name they administer justice, and that therefore whoever is served with the King's writ, and can be compelled consequently to submit to the decree made, is a person over whom the Courts have jurisdiction. In other countries that is different; in Scotland jurisdiction is to a considerable extent made dependent upon the presence within the jurisdiction of property of the defender who may be outside the jurisdiction."[13]

Residence is not and has never been recognised as a sufficient basis for the English courts taking jurisdiction over a defendant – if the Defendant was nimble footed enough to escape the country before the writ could be issued, the Claimant would have to wait for him to return or else seek permission to serve the writ outside of the jurisdiction (a permission which is granted at the court's discretion). Conversely, a non-resident who happened to be in England, no matter how fleetingly, could be served with a writ and subjected to English jurisdiction.[14]

It is more than a little odd, therefore, that the notion that residence is the touchstone for jurisdiction has become so embedded in the case law on the situs of choses in action. One explanation could be that when this area of law was developing it was not unreasonable to suppose that a person would be present where he was "resident" because international travel was a far more lengthy and involved process than it is today. Alternatively, it could be that "residence" was thought to be the best approximation of the varied global rules on jurisdiction. The case law does not provide any clear guidance on this question.

Another reason why "residence" is not simply a derivation from the general rule the contractual choses in action are situated where they are enforceable is that a principle appears to have developed in the case law that a debt cannot be situated in a jurisdiction which would enforce the debt, if the debtor is not also resident there. In other words these cases hold that

"residence" has taken on a life of its own and has completely supplanted the original logic.

The origins of this questionable principle can be found in *Deustche Bank und v. Banque des Marchands de Moscou*, where Romer LJ said:[15]

> "The reason for assigning this locality to a simple contract debt was that the place where the debtor resides was in nearly every case the place where it was recoverable. Even in earlier times, it might, of course, occasionally have happened that judgment could be obtained against a debtor in a country where he did not reside. But it was probably thought desirable for the sake of uniformity to adopt in all cases the test of residence rather than the test of recoverability. However, whatever the reason may have been, the rule was laid down, as I have stated it in Attorney-General v. Bouwens…and was recognized by this court as still being the rule in the case of *New York Life Insurance Company v. Public Trustee*…"
>
> "But I know of no authority for the proposition that a simple contract debt is situate in this country at a time when the debtor is not resident here merely because he can be sued by putting into operation the provisions of Order XI. It would be strange if it were so. For it is always in the discretion of the court in cases coming within the rule to give or refuse leave for service out of the jurisdiction, a discretion depending upon the balance of convenience."

One can agree that a debt ought not to be situated in a state where jurisdiction over that debt would only be taken on a discretionary basis, but if jurisdiction would be taken in a state where the debtor was not resident, on a non-discretionary basis, there is no reason (other than pure convenience) to reject that particular jurisdiction as a possible location of the debt. Indeed, the use of an exclusive jurisdiction agreement could mean that the debt is only enforceable in, for example,

the state of residence of the creditor, not that of the debtor, in which case the rule based on residence would become completely detached from the rule based on enforceability.

The potential for detachment between a rule based on residence and an explanation based on jurisdiction/enforceability has become even more apparent since the English common law rules on jurisdiction were replaced in many private law circumstances, by the European rules on jurisdiction. Those rules originally came into force in the UK in 1978,[16] and the current rules can be found in Brussels I Regulation (Council Regulation (EC) No 44/2001).

Under the Brussels Regulation, the general basis of jurisdiction is the defendant's domicile, if he is domiciled in an EU Member State.[17] For individuals, the national law definition of domicile is applicable, which in the UK requires a person to be resident in the UK and to have a substantial connection with the UK.[18] For corporations there is an autonomous EU definition which provides that a company is domiciled in the place where it is incorporated, where it has its central administration *and* where it has its principal place of business.[19] The general rule is also supplemented by a number of restrictive and expansive rules. Thus, for example, the Claimant can choose to sue the Defendant in a matter relating to a contract in the courts of the place of performance of the contractual obligation in question.[20]

Given the overhaul of jurisdiction rules in Europe which the Brussels Convention and Regulation have led to, it ought to be expected that this change has or will precipitate a change in the approach of the English courts to the situs of debts and there are, indeed, signs that that is happening. For example, in *Hillside (New Media) Ltd v. Baasland*, Andrew Smith J noted the old rule based on residence but said that the new primary ground of jurisdiction was domicile and thus situs depended upon the debtor's domicile:

> "The general rule stated in Dicey, Morris & Collins in The Conflict of Laws, 14th Ed, Vol 2, Rule 120 is that "Choses

> in action are generally situate in the country where they are properly recoverable and enforceable". Although at common law this principle led to the general rule that (with some exceptions that are irrelevant for present purposes) debts are situate where the debtor resides (see Dicey, Morris & Collins, loc cit, at para 22-026), its application in a case such as this, where the debtor is a corporation and the case is covered by the Lugano Convention, depends, as I see it, upon the debtor's domicil. That is the primary ground on which a court takes jurisdiction under article 2 of the Lugano Convention."[21]

Of course, references to residence in the case law post-Brussels Convention can still be found, but one needs to be careful when relying on them. For example, *Kwok* was a decision of the Privy Council in an appeal from the Court of Appeal of Hong Kong. Under the terms of the Brussels Convention at the time when the facts in *Kwok* occurred (and, indeed, when the judgment was handed down), Article 60 provided that the Convention only applied to the European territories of the signatory states.[22] There would have been no reason, therefore, for the Privy Council to express any view on the effect of the European developments in England.

Evidence of a developing area of law can also be found in Dicey and Morris, where the authors suggest that "residence" should be interpreted to fit with these new jurisdictional rules.[23] They say that for individuals, domicile (in the private international law sense) will very often coincide with residence and for corporations, although a company may be resident in a place where it is not domiciled, the result of applying the situs rule based on residence will normally be a state with jurisdiction over the debt because the debt is payable there, so situs and jurisdiction will coincide.[24]

This approach has the merit that old case law references to residence do not have to be abandoned, but also has a

number of disadvantages. First, there is an obvious risk that if the rule continues to be framed in terms of residence, those applying the law may not be alert to the change in meaning.[25]

Second, the aim of refining the definition of residence is to make it correspond with the jurisdictional rules in the Brussels Regulation, where they apply. Whilst it is fair to say that the domicile and residence of an individual will often match up when applying the UK definition of domicile, the Regulation requires domicile in each state to be established on the basis of the national rules of that state. Thus, domicile in France is determined by the national rules in France, even if the question is being asked in an English court. Establishing that the concepts of domicile and residence correspond in English law is not sufficient to show that they generally match up across the whole EU, and is therefore not sufficient to show that residence is still capable of coinciding with jurisdiction.[26]

Third, the possibility of an exclusive jurisdiction agreement significantly undermines the argument that jurisdiction will match up with residence because the parties may choose to give exclusive jurisdiction to a state where the debtor is not resident (for example, the place of the creditor's domicile). [27]

A full consideration of these issues may in future lead the courts to hold that "residence" is no longer the touchstone it once was and that either a new touchstone is to be used, such as domicile (which was the approach of Andrew Smith J in *Hillside (New Media)*) or that it would be more sensible to fall back on the principle that has, at least according to the case law, been the driving force all along: jurisdiction. In my view the latter approach is the most natural result because it would assimilate the rules for contractual choses in action and, as Greer LJ observed in *Sutherland v. Administrator of German Property*, there ought to be no difference in the rule applicable depending on whether one classes a contractual chose in action as a debt or otherwise:

> "The situs of the chose in action cannot be different when we are dealing with the case in which the obligation is to pay damages from that which it is where the obligation is to pay a sum of money as a debt." [28]

Further, domicile would itself be an imperfect approximation of jurisdiction because it is only a universal ground of jurisdiction in the EU (subject to restrictive rules such as those for exclusive jurisdiction agreements) and even for EU member states there are circumstances when the Brussels Regulation does not apply, and states must use their traditional rules of jurisdiction.[29]

One should not expect this development to happen overnight, it will most likely be an incremental change. In the meantime, taxpayers and their advisers can have the best of both worlds. On the one hand, HMRC's explicit position in their manuals is that debts are situated where the debtor is resident and they ought not to be able to decide otherwise where a taxpayer relies on that statement. On the other hand, if the residence test gives rise to an undesirable result, the taxpayer will be perfectly entitled to point out that the law on jurisdiction has moved on and HMRC's view on situs is no longer correct.

Multiple residences or multiple places of enforcement

Whether the test for situs is based on residence (for simple debts) and jurisdiction (for other contractual choses in action) or on jurisdiction alone, it is obvious that there will commonly be situations in which the debtor has multiple residences or there are multiple jurisdictions which can enforce the contractual obligation in question. For example, under the private international law rules on residence, a company is located wherever it carries on business, as well as where it is incorporated – if it carries on business in more than one state, it will be resident in more than one state. Similarly, under the Brussels Regulation, a person may be domiciled in more than

one state and other jurisdictional rules may give jurisdiction to states in which neither party is domiciled.

As a result of this potential problem, a tie-breaker test has been established which attributes the situs to the place where the primary obligation under the contract is agreed to be performable or, if there is no express or implied agreement on this point, where it would be performed in the ordinary course of business.

Thus in *Jabbour v. Custodian of Israeli Absentee Property*, where the cause of action was a claim for unliquidated damages, Pearson J held that:

> "Where a corporation has residence in two or more countries, the debt or chose in action is properly recoverable, and therefore situated, in that one of those countries where the sum payable is primarily payable, and that is where it is required to be paid by an express or implied provision of the contract or, if there is no such provision, where it would be paid according to the ordinary course of business; Rex v. Lovitt; New York Life Insurance Company v. Public Trustee."[30]

And similarly in *Kwok*:

> "At least, therefore, it is resident in Liberia and accordingly, making the above assumption, has two places of residence. In that situation it is clearly established that the locality of the chose in action falls to be determined by reference to the place — assuming it to be also a place where the company is resident — where, under the contract creating the chose in action, the primary obligation is expressed to be performed...In the instant case the expressed contractual obligation is to pay after 60 days in Liberia and upon presentation in the city of Monrovia."[31]

The difference between the reference in *Kwok* to the place of performance of the primary obligation under the contract and the reference in *Jabbour* to the place where the sum is payable is interesting but probably not material. One is considering the

situs of a chose in action owned by one party to the contract and thus its location ought to depend on the primary obligation under that chose in action rather than the contract as a whole.

The place of payment will normally be a place which would have jurisdiction over the chose in action,[32] but it is possible that the place of performance would not have jurisdiction, for example, if the parties entered into an exclusive jurisdiction agreement that gave "exclusive" jurisdiction to two states, neither of which was the place of performance. In those circumstances other supplementary tests would have to be applied.

Conclusion on the situs of contractual choses in action

On the basis that the law has moved or is moving towards a single test for the situs of both simple debts and other contractual choses in action, based on enforceability, the law may be summarised as follows:

a. the chose in action is located where it may be enforced.
b. if there is more than one place in which it may be enforced, it is located where the primary obligation is expressly or impliedly agreed to be performable.
c. if there is no express agreement as to where it must be performed, the chose in action is situated in the place where the primary obligation would be performed in the ordinary course of business.

A* Marren v. Ingles *situation

Consider the following situation: C, a UK-resident non-domiciliary owns shares in a company (X Ltd) which are situated abroad and which are pregnant with a large capital gain. C sells those shares to a foreign branch (in the EU) of a UK bank ("D") in return for an amount equal to the eventual sale proceeds of a UK property owned by X Ltd.

In this case, where there is a disposal for uncertain and contingent consideration, the stage involving the chose in

action is explicitly recognised for capital gains tax purposes pursuant to the decision in *Marren v. Ingles*:

> "I think that the Crown is correct in analysing this transaction into an acquisition of an asset (viz a chose in action) in 1970 [the time of the initial disposal] from which a capital sum arose in 1972 [the time that the contingency was satisfied] and that there is no question of a debt being disposed of at any time."[33]

One therefore needs to assess where that chose in action is situated in order to determine whether it is property received in the UK deriving from the gain. Whilst the chose in action is not initially a debt for capital gains purposes, "debt" is a word that takes its meaning from context[34] and it is possible that the chose in action could be a debt for situs purposes.

Under the residence test, the debtor (D) is resident in both the foreign country and the UK because it carries on business in both. Under the enforceability test, the right is enforceable in both the UK (because D is domiciled in the UK) and in the foreign country because the state of the foreign branch would have jurisdiction in relation to disputes arising out of the operations of that branch.[35]

The question is, therefore, where the obligation is to be performed and it is thus crucial for C to agree with D that payment will occur in the place where the branch is, in order to ensure that the chose in action is situated there – requiring payment outside the UK may not, by itself, be enough. This analysis would be further bolstered by giving the courts of that state exclusive jurisdiction over disputes in relation to the contract.

That is not the *Marren v. Ingles* trap, however. The trap arises when one comes to consider what happens when the chose in action is disposed of. Having just worked out that for remittance purposes the asset is situated outside of the UK, it would be tempting to conclude that the same must be true at the second stage. This would be a mistake.

Whilst ITA 2007 forces us into the private international law when determining whether foreign income and gains has been remitted, the question at this second stage is whether the chose in action gives rise to foreign chargeable gains within TCGA s.12. If the gain is not originally a foreign chargeable gain, then the rules on remittance never become relevant – it is a UK gain and subject to full capital gains tax.

A foreign chargeable gain means a chargeable gain accruing from the disposal of an asset which is situated outside the UK,[36] and for this purpose it is the TCGA rules on situs that are relevant, not the private international law rules. There are two rules that are potentially relevant. The first states that a debt is situated in the UK if the creditor is resident in the UK (s.275(1)(c)). The second provides that an intangible asset whose situs is not otherwise determined is situated in the UK if it is subject to UK law at the time it is created (s.275A(3)).

Based on *Marren v. Ingles*, there are good grounds for thinking that s.275(1)(c) only applies to assets which are debts when they are acquired by the asset-holder, not assets that subsequently mature into debts. The alternative would be that a chose in action could shift its situs at the time that the amount due under it becomes fixed and certain. In the event that the *Marren v. Ingles* chose in action is a debt for the purposes of s.275, however, it is on the present facts a debt owed by a person resident in the UK (because C is dealing with the foreign branch of a UK bank), and the gain is not a foreign gain.

In the more likely event that it is not a debt, but merely an intangible asset, the applicable law becomes relevant. Section 275B(3) provides that an intangible asset is subject to UK if it is governed by, otherwise subject to, or enforceable under the law of any part of the UK.

There is no guidance on what "governed by or otherwise subject to or enforceable under the law of any part of the UK"

means. Read literally it might be asking: could an interested party go to an English court and ask them to enforce rights relating to the asset? That, however, would be an extremely broad interpretation because English law (including its private international law) will enforce any legal right, subject to jurisdiction and certain exclusions (mainly relating to public policy).

Instead, it is submitted that s.275B is posing a choice of law question: which national law would be applied when deciding a claim seeking to enforce a right forming part of that asset?[37] For UK courts (which is presumably the correct reference point) in relation to an intangible asset which is a cause of action in contract, this will be decided by reference to the Rome I Regulation (EC) No 593/2008 (for contracts concluded after 17 December 2009). If the parties expressly choose the law, that will usually determine the issue. Failing that, if the terms of the contract clearly demonstrate a choice of law that is the law which will be applied.[38]

Where there is no express or implied choice of law, there are a number of specific rules (none of which would normally apply to the sale of shares as they are unlikely to be regarded as "goods" within Article 4(1)) and then, in default of those, it is the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence.[39]

Assuming that there is no choice of law in C's contract, the characteristic performance would be the transfer of the shares which is carried out by C.[40] There is no definition of the place of habitual residence for natural persons not acting in the course of business. Nevertheless, on the facts posited, C is resident in England (for tax purposes) and it is likely, therefore, that he is also habitually resident in England for the purposes of the Rome I Regulation. The law governing the contract would therefore be English law and the asset would be a UK situs asset for CGT purposes. The gain on disposal of that *Marren v. Ingles* chose in action would consequently not be a

foreign gain and would be chargeable to capital gains tax irrespective of whether the money is remitted.

The way to avoid this trap is to make sure that the contract for sale of the shares explicitly choses a non-UK governing law and it is crucial that advisers recognise this at the time of drafting the agreements because s.275A(3) looks to the time that the asset is created.

CONCLUSION

Once the potential traps that *Marren v. Ingles* type situations involve have been identified they are not especially difficult to avoid, usually by simply drafting the contract of sale to take them into account – the trick is identifying the risks in the first place. The more difficult question is whether these steps should also be taken in cases involving choses in action which do not normally feature explicitly in the tax analysis? A particularly cautious taxpayer might wish to do so, but for now, at least, there are no signs that HMRC have a general policy of analysing the contractual choses in action with a fine toothcomb.

Endnotes

1 *Torkington v. Magee* [1902] 2 KB 427 – reversed in the Court of Appeal on other grounds.

2 [1980] STC 500

3 It does later become a debt, when the contingency is satisfied and the amount becomes certain. The House of Lords, however, in *Marren v. Ingles* were not prepared to countenance the possibility that no chargeable gain could accrue at this later time due to what is now TCGA s.251 – their Lordships said that that provision only applies to assets which are debts when they are first acquired.

4 Applied by TCGA 1992, s.12 for CGT purposes.

5 See ss.809L(2), (3) – the above is, necessarily a summarised and abridged version of the actual rules.

6 There is also some merit in the idea that where the common law applies a fiction (that a chose in action has a situs), one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, by extension of the rule applying to statutory deeming provisions – see *Marshall v. Kerr* [1995] 1 AC 148 at 164 per Lord Browne-Wilkinson.

7 A different explanation of the debtor-residence situs rule was given in *Commissioner of Stamps v. Hope* [1891] AC 476, where Lord Field said that the reason was that the assets to satisfy the debt would "presumably" be where the debtor resided (at 482). Although quoted by Lord Macmillan in *English Scottish and Australian Bank Ltd v. IRC* [1932] AC 238 (at 257), this explanation seems to have fallen by the wayside. Presuming that a person's assets would be situated where he was resident was always slightly ironic given that, following the debt situs rule through, if the debtor was also a creditor, the situs of his debt assets could be anywhere and did not depend upon his residence. Now that a person's tangible and intangible assets can be spread throughout the world and do not have any necessary link with residence, the explanation has even less of a grip on reality.

8 *Attorney General v. Bouwens* (1838) 4 M & W 171 at 191-2 per Lord Abinger. See also Conflict of Laws, Dicey & Morris, 15th Edition, at Ch.22-026.

9 *Kwok v. Commissioner of Estate Duty* [1988] STC 728 at 732 per Lord Oliver.

10 IHTM27091

11 *Kwok* at 733.

12 Dicey & Morris at Ch.22-046.

13 *John Russell & Co Ltd v. Cayzer Irvine & Co Ltd* [1916] 2 AC 298 at 302, per Viscount Haldane.

14 For example, the defendant was visiting London for a few days in *Colt Industries Inc v. Sarlie (No.1)* [1966] 1 WLR 440 when he was successfully served.

15 (1931) unreported but cited and applied by Roxburgh J in *Banque des Marchands de Moscou (Koupetschesky) (No.3)* [1954] 1 WLR 1108. It was also mentioned in *Re Claim by Helbert Wagg* [1956] 2 WLR 183, but on a purely obiter basis, as Upjohn J recognised at 342.

16 Following the UK's accession to the Brussels Convention (OJ 1978 L 304/1).

17 Article 2.

18 Civil Jurisdiction Order 2001, Schedule 1(9). Note that this is not the common law conception of domicile that tax advisers are familiar with.

19 Article 60 – these are alternatives, so a company can be domiciled in more than one state.

20 Article 5(1).

21 [2010] EWHC 3336 (Comm) at paragraph 33. The Lugano Convention is a similar document to the Brussels Convention that applies between EU Member States and other members of the European Free Trade Area (Denmark, Iceland, Norway and Switzerland).

22 Except for certain French overseas territories. Article 60 was removed by Article 21 of the 1989 Accession Convention.

23 Ch.22-031, 22-032

24 See further below for cases where a debt or chose in action has multiple potential locations.

25 For example, Lord Hobhouse quoted passages from Dicey and Morris in *Societe Eram Shipping Co Ltd v. Compagnie Internationale de Navigation* [2004] 1 AC 260, including the statement that a debt cannot be situated in England if the debtor is not resident here, without mentioning that "residence" may require a special meaning (at paragraph 72).

26 The Jenard Report (published in the Official Journal of the EC in 1979, No C59/2) noted the difficulties that would be encountered in defining domicile and gave examples demonstrating the differences in rules from state to state. For detailed consideration of the definitions of domicile in other contracting states see European Civil Practice, Layton and Mercer, 2nd Edition (2004), Vol.2, chapters 47 – 64.

27 Exclusive jurisdiction agreements are enforceable under Article 23 of the Regulation, subject to certain form requirements. In truth, however, the residence test has never taken into account exclusive jurisdiction agreements.

28 [1934] 1 KB 423

29 There are also circumstances when the Regulation does apply but states are told to use their traditional rules. This will generally only occur when the Defendant is not domiciled in an EU Member State – Article 4(1).

30 [1954] 1 WLR 139 at 146

31 At 733.

32 For example, under Article 5(1) of the Brussels Regulation.

33 *Marren v. Ingles* [1980] STC 500 at 503, per Lord Wilberforce.

34 Ibid at 506 per Lord Fraser.

35 Article 5(5) of the Brussels Regulation.

36 TCGA s.12(4)

37 This is supported by the reference to "the law of any part of the UK". Jurisdiction is concerned with identifying a location where an action may be brought, not the law that will apply in that action. Thus, for example, a right may be enforceable under English law even if an action to enforce it can only be brought in, say, France. Conversely, English courts will enforce contractual rights that may not be enforceable under English law if the governing law is French law, assuming that they have jurisdiction. Only on a wide (and slightly misleading) interpretation of "English law" could this latter scenario be described as a right being enforceable under English law.

38 Article 3(1).

39 Article 4(2).

40 This is because most contracts involve payment of money, so the distinguishing feature of any particular contract will be what the money is paid for. In this case it is paid for the transfer of the shares.

THE CURRENT FOCUS ON TAX AVOIDANCE

David Goldberg

Let me ask you to picture the scene.

It is sometime in February of this year. I am in a restaurant in Hong Kong, having dinner with a friend of mine who works for the local revenue. A great truth is about to be revealed.

I have just remarked that it is rather nice to get away from the general doom and gloom of the United Kingdom to the vibrant Far East where, at any rate to the visitor, it seems that the focus is on the reality of life, the fact that life is actually quite hard, that there is a need to get, to provide the means of survival and a desire to spend.

In the West, on the other hand, the pathetic but constant cry is that everything must be fair.

I have never found the demand for fairness particularly compelling: some 40 or so years ago, another friend of mine complained that he did not have the good looks of Robert Redford and he found that very unfair, but he noted that that particular unfairness was – short of surgery which could very well make things worse – irremediable.

The Paralympics have just given us another example of how much of life produces irremediable unfairness and of how little good is achieved by crying that it is unfair: at any rate, the lives of the athletes would have been poorer if, instead of seeking to do something with their lives, something inspiring and uplifting, they had sat down and wept at the unfairness of losing a limb, of being mentally challenged or of being only partially sensed.

Life is more satisfying than it otherwise would be if we recognise that it is, inherently, unfair, and that attempts to make it fair will, inevitably, fail: all that they will do, if anything, is illogically change where the unfairness falls.

And so, in the picture, I am complaining to my friend about how stupid, how lacking in context, how meaningless the cry for fairness is.

My Hong Kong friend, to my surprise, said that it was the same in Hong Kong: the cry everywhere there, just as in the West, was that things had to be fair.

But, she added, I was wrong when I said that the concept of fairness was meaningless.

"Fair" she said "means what is in my interest".

That is the great truth which was revealed.

I am used to the idea that how a thing looks depends on where we are looking at it from: so far as physical things are concerned, the frame of reference is everything.

But the idea that the frame of reference is relevant to an idea or to a concept was new to me, and so I started to think about the frame of reference in relation to abstract concepts, like fairness.

It seems to me that the frame of reference – my position as I think about an idea – is relevant to the determination of what is tax avoidance.

One person's sensible tax planning is, viewed from another place or time, outrageous tax avoidance.

On occasion, I act for the Revenue and, when I do, I get very angry on behalf of the Revenue about some things which give me an uncomfortable feeling.

The uncomfortable feeling comes from my suspicion that, if a taxpayer had come to me proposing the thing which has angered me on behalf of the Revenue, I would have blessed it and even found it rather amusing.

Because the frame of reference affects everything, there is a huge difficulty in defining tax avoidance.

The newspapers refer to specific reliefs – for example those given to pension contributions – as loopholes.

Quite how it is possible to define a specific legislative relief as a loophole, I do not understand: the thinking seems to be

based on an assumption, which is quite contrary to the truth, that everything and everybody is automatically subject to tax unless there is some specific exemption – which can then be called a loophole.

The idea that that is the position is ludicrous to anybody with any knowledge of the matter.

How much tax is automatically payable? On what is it payable?

It is impossible to have anything like informed or sensible debate, when it is not understood by all parties to the debate that tax is an artificial construct with arbitrary boundaries.

The problem has been compounded by the attitude of our politicians.

Earlier this year the Chancellor – the Chancellor himself, who really really ought to know better – said that it was tax avoidance to give your money to charity and then to claim the relief from tax specifically given for such gifts.

I doubt if anybody with any commonsense would really call an out and out gift to charity tax avoidance, but we had our Chancellor actually saying it was.

Another point here is that, for a tax system to be fair – assuming that word to have any meaning – it must be fair in all ways: it must be fair as between taxpayers themselves, as between taxpayers and HMRC and as between HMRC and taxpayers.

I doubt if our tax system satisfies the last of those requirements.

To take one example, can anyone really justify the effectively retrospective application of the pre-owned assets tax, or the even more openly retrospective legislation that we have seen recently?

In any event, what is really important in a tax system is that it should be "right": it must at least produce a reasonably predictable and sensible answer.

However, the atmosphere has become febrile.

It is in this convulsive situation that cases come to Court, and it is proposed that we have a new provision to be known by the acronym of the GAAR.

I am concerned that rational debate is impossible in the current atmosphere, and that we are sleep-walking into a dangerous situation: is this a situation in which the tax system can be described as right?

Let me try and be a bit more particular about my concerns, by dealing first with what happens when a case, which has been stigmatised as being about tax avoidance, goes to Court, and then by considering some aspects of the proposed GAAR, which is the kind of provision which only small economies which do not think all that well of themselves have so far implemented.

One of the reasons for the GAAR is said to be the decision in *Mayes*[1].

As I am sure everybody here will know, Mr Mayes bought a second-hand life assurance policy which he surrendered; and he then claimed that he had made a form of loss for tax purposes.

The loss arose under the specific provisions of the legislation dealing with life policies, and it arose because, at various points in the existence of the policies, large premiums were paid up on the bonds and then withdrawn.

The argument for the Revenue was that, since the payment of the premium and its withdrawal were all part of a pre-conceived plan, they were, on a purposive construction of the legislation, to be disregarded for tax purposes.

Of course, if they were disregarded, the loss which Mr Mayes was claiming would not exist.

We all know that in a case like this the law is easy: all that is necessary is to apply the statute, construed purposively, to what happened, adopting a realistic view of the facts.

However, in the *Mayes* case, the legislation is very prescriptive: if, on a realistic view of the facts, a premium was paid and then withdrawn, the legislation provided for the loss which Mr Mayes was claiming; that is what the legislation said, and there is little room here for reading things into the statutory language or giving it a meaning which it does not naturally bear.

That is largely because the loss here is not some sort of a commercial loss: it is an entirely artificial construct of the legislation, so this is not the sort of case in which it is possible to have some kind of instinctive feeling as to whether there should be a loss or not.

Nonetheless, a factual issue still arises: on a realistic view of the facts, was the premium really paid and withdrawn, or was it, really, never paid at all?

The difficulty for the Revenue in saying that it was never paid was that they had agreed that, as a matter of fact, the premium had been paid.

They were arguing that, as a matter of law, the premium should be regarded as not being paid, but this was a bit inconsistent with their concession that, as a matter of fact, a premium had been paid.

It is important here that what was agreed was that a premium was paid: the Revenue did not merely accept that a sum of money which looked like a premium had been paid; they actually accepted that a premium had been paid.

It was this acceptance which made it difficult for a Court – a Court composed of judges who might not be expected to be sympathetic to tax avoidance – to say that a premium had not been paid.

Although most tax avoidance cases are said to be about what the statute means, they are very often really about what the facts are, and nearly every *Ramsay*[2] type case – I shall not go so far as to say all *Ramsay* type cases, but nearly all of them – can be explained as decisions on the facts.

Mayes is a relatively unusual case in that it involves provisions that do not relate to anything which might be called a commonsense situation: it is about what is plainly an entirely artificial construct of the legislation, and it is in that context that the factual concessions made by the Revenue made it difficult for the Revenue to win.

In a sense, *Mayes* became difficult for the Revenue because they had accepted that the facts were such that, on any natural reading of the legislation, Mr Mayes got his loss.

Nonetheless, they wanted to argue – and did argue – that, although the facts supported Mr Mayes' argument, the meaning of the legislation did not.

In *Mayes*, then, HMRC were arguing for a meaning of the legislation which diverged radically from their view of the facts.

In most cases of this sort, this dichotomy is absent: HMRC usually argue for a view of the facts which supports its interpretation of the legislation; in not doing that in this case they might have been over-cautious, insufficiently bold.

Because of the dichotomy present in *Mayes*, it cannot be regarded in any way as a representative case.

Moreover, the intensely specific nature of the statutory provisions engaged, and the inherently unnatural situation with which it deals make it unrepresentative.

Nonetheless, the case has been held up as a reason why we should have a GAAR, and it is perhaps worth pointing out – because this is relevant to some of the issues raised by the GAAR – that it might also be an example of a case in which it can be said that there are shortcomings in the legislation.

The taxpayer in *Schofield*[3] was not so fortunate as Mr Mayes: he lost his case that he had made a loss, perhaps – in part – because the facts at least raised the question of whether he had indeed made a loss.

The arrangements in *Schofield* involved options, and there is a lot of mumbo jumbo jargon involved in options which tends to confuse the position.

However, stripped of the jargon, Mr Schofield bought two assets, each of which was capable of going up or down in value, but on at least one of which it was more or less inevitable that he would make a loss.

This is a bit like betting on two horses to win in the same

race: it is something that you might do, but not something you are likely to do in a wholly commercial situation.

In order to raise the money to buy these assets and to balance the loss that was expected to arise on one of them, Mr Schofield sold, to the person from whom he bought the assets, two more options.

These sales were made in a way which did not attract any liability to tax, and, save to note that the sales took place, and that the assets sold balanced, in value terms, the assets purchased, we can put the details of the sales to one side.

As expected, one of the assets which Mr Schofield had bought went down in value, and he disposed of it for less than he paid for it.

He then emigrated, and, after he had become non-resident, he disposed of the other asset he had acquired, at a substantial gain, which was not taxable – only because he was non-resident and remained non-resident: the gain did not reflect the loss on the first asset and was, indeed, independent of it.

I think everybody knows that, if Mr Schofield had not successfully become non-resident, he would have been charged to capital gains tax on the gain made on the disposal of the second asset and would have had no defence to the charge.

However, it being convenient to them, the Revenue denied the existence of a gain on the second asset.

That was, of course, necessary to give their argument consistency, because, if there were a gain on the second asset, it is inevitable that there must have been a loss on the first asset.

Nonetheless, the Court, astonishingly – and I do mean astonishingly – has said that, on these facts, each and every one of the following is true: Mr Schofield never acquired an asset, never made a disposal and never made a loss.

Although the Court has said that each of these three things are true, it is quite apparent that the basis of the decision is that Mr Schofield did not acquire an asset.

That must be the case, because, if he did acquire an asset, then, since he no longer has it, he must have disposed of it, and, in that case, there must on the facts have been a loss on the first asset and a gain on the second asset.

In reaching this conclusion, the Court relied exclusively on *Ramsay,* taking the view that nothing since *Ramsay* was relevant: *Ramsay* allowed you to ignore things and the Court ignored them.

Most of us thought that the recent cases had made clear that *Ramsay* was not about ignoring things: indeed, that is exactly what *Mayes* says.

Mayes also says that it is not sensible to look to cases before *Barclays Mercantile*[4] to find out what the law is.

And yet, here in *Schofield*, we have a Court saying that you have to go back to *Ramsay*, a case which, factually, is not remotely like *Schofield*.

However one likes to look at it, *Mayes* and *Schofield* seem to adopt conflicting approaches.

An application for permission to appeal to the Supreme Court has been made in *Schofield* and we shall have to wait to see what happens to it.

But the contrast between *Mayes* and *Schofield* leaves the law in a mess.

Different judges were involved in each case but that, on its own, does not explain the different outcome in the two cases: that is explained partly by the concessions made in *Mayes* and not made in *Schofield*, and partly by the instinctive feeling that some people might have on the facts of *Schofield*, that Mr Schofield did not actually suffer a loss – a feeling that does not arise in *Mayes* in the same way, because the underlying question is so much more artificial – so much more obviously a question of what the statute provides than of what the commercial situation is.

I should say that, having thought about it all rather a lot,

I do think that Mr Schofield suffered a loss, just as I suffer a loss on a bet if I bet on two horses to win in a race, and one of them wins and the other loses: even though, overall, I might make a gain, I still have a loss on the losing bet.

The question which then arises is why what happened in *Schofield* creates so much distaste in the judiciary that it has – so far – been decided against the taxpayer, while what happened in *Mayes* – a case which could, as it seems to me, have been decided against the taxpayer on exactly the same basis as *Schofield* was decided against the taxpayer – does not seem to have aroused the same degree of distaste.

The question is relevant because the law is unclear, and, even without the GAAR, any tax adviser proposing a course of action needs to ask how a Court or Tribunal will react to it if it has to rule on it.

There can be no doubt that the identity of the judge is a large factor in determining how a case will be regarded and, indeed, decided, but it is clearly not the only determinant: I doubt if the difference between the judges in *Mayes* and in *Schofield* explains the different outcomes.

Before *MacNiven*[5], Lord Templeman was the leader of the judicial anti avoidance movement, and he made a distinction between transactions which had real economic consequences and those which did not.

It is tempting to think that this kind of formulation could provide a sound basis for determining what will work and what won't; and it is worth noting that a reference to economics appears in the current draft of the GAAR.

However, more thought shows that the distinctions between real and unreal consequences and between economic and non-economic consequences are illusory: like fairness, it is all a matter of opinion.

What Mr Schofield did, had – from my point of view – real economic consequences, consequences no less real than what

Mr Mayes did and, indeed, in some ways more real: it was just like bed and breakfasting which Lord Templeman said was acceptable and worked – see *Ensign*[6].

And it has to be said that there is no reference to economics in the judgments in *Mayes* or in *Schofield*.

So I doubt if references to reality or to economics are going to help provide any clarity here, any more than appeals to the supposed purpose of the legislation will do that.

Another point is that *Mayes* and *Schofield* were decided at different times and in different emotional climates.

When *Mayes* was decided, there was no general criticism of tax avoidance.

Schofield was argued when it was public knowledge that comedians had been taking the advice of accountants and the general clamour was for tax to be payable by everyone and on everything.

Ill-informed press reports should not affect judges but, like you and me, judges are human, and they are affected.

The law is without shape: it is a mess; and, on top of this blancmange, we are now, apparently unstoppably, to have a GAAR.

I have grave concerns about the form of GAAR which is presently before us: to my mind, it is an affront to the rule of law, a provision which, in its current form, no civilised state should be prepared to accept.

Strong words indeed. Can they be justified?

The full title of the GAAR is the General Anti-Abuse Rule, and the use of the word "abuse" rather than "avoidance" is meant to provide some reassurance that the rule will have a somewhat limited scope.

However, I doubt if that will turn out to be the case.

Moreover, the current draft of the GAAR is the wrong solution to a so-called problem which should not exist: it treats the wrong problem.

Our tax code contains something over 13,000 pages of primary and secondary legislation.

The purpose of a code that long is to set out detailed rules for every situation of which the draftsman could think: if the purpose is not to deal in detail with what might happen there is no need for such length.

Taxpayers then go through the rules and find things to do for which a certain outcome, favourable to the taxpayer, is prescribed by the details: that is what rules are for; there is no point in having rules unless they are to operate as rules.

On seeing what has happened, some observers claim that the outcome is unintended and offends some alleged spirit of the law – which is a fancy phrase, meaning no more than that the observer, for no very well-defined reason, does not like what the taxpayer has done.

That is the so-called problem: some observers do not like what the detailed rules allow you to do.

To the observer who says "I do not like what the taxpayer has done", the problem seems to be one of taxpayer behaviour which needs to be swatted like an irritating fly.

But what if the problem is caused by the tax code itself, has arisen because nobody has given any thought to what we want a tax code to do, has arisen because the tax code is doing the wrong things?

In other words, it is at least plausible that the problem is not taxpayer behaviour, but the tax legislator's behaviour.

In this country, we do not seem to have thought about what we want our tax system to do: we have just gone on happily adding to an overbearing tax code, until it is near the point of collapsing under its own weight; this year's Finance Act, filled with miserable and unprincipled tinkering, is a paradigm of what is wrong.

I have no fundamental objection to a GAAR, so long as its terms comply with the requirements of the rule of law, and it is adequately linked to a rational system of taxation.

The chief requirement of the rule of law is that law should be relatively certain: absolute certainty is unachievable, but clarity and a high degree of certainty are not.

A rational tax system is one which responds adequately to the concerns of those subject to it, while satisfying the needs of the State imposing it.

In order to see whether a tax system satisfies that requirement, we might ask a very large question. How would we design a tax system if we were starting today with a blank sheet of paper and no idea at all of the existing system?

I think we should want three things of the system.

First, it should be as nearly neutral in effect as it can possibly be, so that it does not require a decision, which ought to be taken on economic grounds alone, to be taken for tax reasons: for example, I should not have, or even wish, to acquire, to retain or to dispose of a particular asset because the tax system encourages me to do that.

Secondly, we should not ask the tax system to perform a social engineering function: tax systems quite often do that, but there are more honest ways of achieving government policy, and I think it would be better to use those methods (whatever impact that might have on national accounts) rather than to use tax to distort life.

Thirdly, we should endeavour to ensure that those subject to it find the tax system to be acceptable.

The acceptability, to those subject to it, of a tax is a function partly of its intelligibility, partly of the administrative burden which it imposes and partly of its rate.

Intelligibility of a tax is a function of simplicity: the simpler a tax system is, the more intelligible and, for that matter, the less administratively burdensome it will be.

Rate is a function of the amount of money which the system needs to collect and of the tax base, so the broader the base, the lower the rate can be.

The breadth of the base is a function of the basic charging provisions and of the reliefs given, so that the fewer reliefs, the broader the base.

Simplicity is a function of the breadth of the base, so that the broader the base, the simpler the tax.

The need for reliefs is a function of the tax rate, so the broader the base and the lower the tax rate, the fewer the necessary reliefs.

It follows that the fewer the reliefs, the greater the acceptability of the tax system.

That is because, if there are fewer reliefs, the base is broader, the tax is simpler and the rate lower than it would be with a greater number of reliefs.

Thus the removal of reliefs and the concomitant reduction in rate produces the three fundamental requirements for an acceptable tax system: intelligibility, ease of administration and a rate which people are willing to pay.

Acceptability, then, is achieved by simplicity: in order to achieve the third of the criteria which I set out for a good tax system, we need a simple system with a low rate and few reliefs.

Happily, a system in that form will also achieve the first two of my criteria: a low rate system will not force any particular economic decision and a system which has few reliefs will not be trying to affect behaviour.

Moreover, simple tax systems with their broad base and few reliefs make avoidance very hard: it is, after all, usually the manipulation of reliefs which is the tax avoider's weapon of choice.

A bad tax system creates the so-called problem of tax avoidance: a good tax system prevents it or, at any rate, by its fundamental design, limits the opportunities for avoidance.

Thus tax avoidance is not a problem of taxpayer behaviour, but a function of bad or, at any rate, inadequately thought-through legislation: just as bad money drives out good, bad law drives out good.

It seems to me, therefore, that the case for a simple low rate system is unanswerable.

Systems like that are quite often called *flat tax* systems, but that title mis-describes them. The important thing about a tax system is not that it is at a flat rate but that it is simple, so I think they would be better called *good taxes*.

A simple tax system can easily accommodate two rates of tax, one for those earning up to a certain level and another for those earning at a higher level, if that is thought to be a social or political necessity; and the broadening of the base would allow low earners to be taken out of the charge to tax, because it automatically collects in more revenue than a narrow base.

I might add that, if fairness is regarded as an essential element, and if fairness is taken to mean that "the rich must pay more" – the fiscal slogan which is the equivalent of the supermarket "Now costs less", a two rate tax system with limited reliefs achieves that.

I do not quite understand why the public and many of our politicians seem to believe – or are encouraged by some to believe – that our existing system does not provide for the rich to pay more, though I note that there are very few people who consider themselves to be rich, that being another comparative term.

However, no matter how the concept of being rich is defined, our tax system provides rather well – perhaps too well – for the rich to pay more, but it does not measure up to the criteria for a desirable tax system: it does not meet any of those criteria; it is verbose, parts of it are unintelligible to the point at which its complexity can literally make me weep, and most of it seems to me to be unnecessary.

It is so complicated that HMRC are not able adequately to police it, and the response has been to put an increasing burden on taxpayers to police themselves – which, of itself, makes the tax system less acceptable to those subject to it.

On top of that, it is full of reliefs which are an attempt to distort human behaviour (how many of us regret that, in one

way or another, we were effectively compelled to do something because of the fiscal incentives attached to it rather than because of its innate good sense) and which narrow the base, something made necessary because the tax is charged at relatively high rates.

Indeed, it is the reliefs which usually lead to the sort of tax avoidance schemes to which so many now object on the basis that this infringes some spirit of the law.

The question is whether the GAAR is an adult response to the situation.

The GAAR is going to be added to everything that we already have; and, by recommending or supporting the addition of a GAAR, those suggesting it somehow seem to accept that we have a wonderful tax system which needs to be protected by the fence of the GAAR.

So let me ask whether the addition of a GAAR is going to make our tax system more acceptable? Is it really going to stop riots in the streets as its author and chief proponent has claimed? Is it going to make our system work better?

There is a Japanese epigram:

"The sign on the fence says
Do not pluck these blooms,
But it is useless against the wind
Which cannot read"

The spirit of the law is like the wind: it cannot read and it cannot be read; and the addition of a GAAR to our over-complicated code is more likely to increase fraud than it is likely to improve tax collection.

On top of that, the current draft of the GAAR seems to me to be open to some fundamental objections.

It is, however, commendably short, and there is something to be said for brevity: indeed, those of us who have done any work with the Australian GAAR in Part IVA of their legislation will be grateful for the fact that this legislation, albeit still missing some parts, is only three pages long.

Nonetheless, brevity may bring with it an undesirable lack of clarity.

In order to fall within this provision, there must be, first, "tax arrangements" which are, secondly, "abusive".

The requirement that the tax arrangements be "abusive" is advertised as a limitation on the operation of the provision: the taxpayer is not caught just because he does something mainly to obtain a tax advantage.

In this respect, the draft resembles the sort of GAAR which can be found in some Commonwealth jurisdictions, which include what is called a "safe harbour".

But there are differences between that type of model and what we have here.

The chief difference is that most GAARs provide that whether an arrangement is done mainly for tax purposes is to be determined by reference to a list of factors.

Most GAARs apply if, by reference to the listed factors, it would be objectively concluded that tax avoidance was a main purpose of what was done.

In determining whether that sort of GAAR is to apply or not, the strain is taken by the main purpose test.

In this case, however, the determination that something has been done to obtain a tax advantage is to be made by reference to only one test: is it reasonable, in all the circumstances, to conclude that obtaining a tax advantage was a main purpose of the arrangement?

This requirement of reasonableness is, of course, meant to be a safeguard.

But I find the test rather elusive: reasonable to whom and by what standard? Not, I rather think, to the man on the bus or by his standard.

The draft GAAR contains no way of measuring what is reasonable and what not reasonable: it may be doubted if the word "reasonable" adds clarity to the test; it may obscure.

Because that is so, the question of whether a course of action is abusive or not is likely to play a large measure in the determination of whether something has been done for a tax avoidance purpose: if what has been done is found to be an abuse of the tax system, it is likely to be reasonable to conclude that it was done mainly to obtain a tax advantage.

At any rate, psychology plays a large part in law, and, psychologically, if something bears the hallmark of being an abuse, it is unlikely to be thought reasonable to do it.

The problem of reasonableness arises again in what has become known as the double reasonableness test in the determination of whether something is abusive or not: arrangements are abusive if they cannot reasonably be regarded as a reasonable course of action in all the circumstances.

Again, the question of 'reasonable to whom' arises. What is reasonable to a businessman may well not be reasonable to a Revenue official.

A judge is, no doubt, expected to sit neutral between the two sides, but how does he determine what is reasonable and what not?

That the burden of establishing that the GAAR applies is on HMRC ought, in theory, to help the taxpayer here, but experience suggests that, in practice, where the burden lies may not matter very much.

In determining whether there is an abuse, the indications in the draft section 2(4) are to be taken into account.

One of these indications is that the arrangements result in an amount of income for tax purposes that is significantly less than the amount for economic purposes.

There is no definition of economic purposes, and there is no provision anywhere in our tax code that taxes by reference to an economic outcome.

It follows that anything that is done which, when the detailed rules and the legislation are applied to it, produces a profit

less than the economic profit, will bear the hallmark of being abusive; and, assuming there to have been a tax advantage, the apparently unlimited power of counteracting tax advantages contained in the draft section 4 will then arise.

That power, as presently drafted, seems to me so wide that tax can then be imposed on an economic profit contrary to the whole tenor of the Yellow Book or the Red Book or whichever colour book you happen to use.

The point that that is the case is reinforced by the requirement, in the draft s.2(3), to take account, in determining whether arrangements are abusive, of any intention to exploit shortcomings in the legislation.

That seems to me to be a further indication that the power to counteract tax advantages is to be exercisable so as to enable the correction of shortcomings in the legislation.

Indeed, if the intention is that the power to counteract tax advantages is to be limited, so that it only allows tax to be imposed according to the detailed rules in the Yellow Book, it has to be asked why taking advantage of a legislative shortcoming, or the taxation of a profit less than the economic profit, are hallmarks of abuse.

If the only counteracting power is to tax in accordance with the rules, it cannot sensibly be said to be abusive to produce a profit which, although less than the economic profit, accords with the rules of computation, even if it takes advantage of a legislative shortcoming.

It might be argued that the requirement to have regard, in determining whether something is abusive or not, to <u>all</u> the circumstances including the relevant tax provisions, should limit concerns about the width of the indications of abuse.

However, the scope for elasticity in determining whether there are any "shortcomings" in the relevant tax provisions increases, rather than reduces, any concern that this GAAR floats like a butterfly above the wording of the legislation and,

in a very large way, gives a discretion as to what tax is to be paid, so that it might well sting like a bee.

Indeed, since the GAAR applies to IHT and one of the indications of abuse is that a transaction is carried out at other than market value, the case of a gift made for ordinary estate planning purposes needs to be considered.

I should hope that a gift by a parent to a teenage child (made outright rather than to a trust) would not be attackable under the GAAR.

However, the form of the gift suggests that it was made to avoid both an immediate and a later charge to IHT and, being a transaction at less than market value, it bears one of the hallmarks of abuse.

Thus the only reason why a gift like that is not caught by the GAAR is that it is a reasonable thing to do.

But why is it reasonable?

If it can be, as it was suggested a few months ago that it was, that to make gifts to charity – genuine gifts to genuine charities – was unacceptable avoidance, there can be no absolute reason why a straightforward gift to a child should not be caught by this rule.

But if there is no absolute rule, what is it that makes a gift to a child a reasonable thing to do?

I should be grateful if someone could explain that to me by reference to objective criteria and without reference to subjective likes and dislikes.

If the answer is that the legislation implicitly invites the making of gifts, the question which arises is why the Dawson family were not accepting a statutory invitation in *Furniss v Dawson*[7]? It turned out that they had gone to the wrong party, no doubt misreading the invitation and the reality is that, as the fuss over charitable donations shows, views of what a statute is inviting you to do can differ.

I doubt if there really is a rational distinction between the

apparent invitations in the IHT code and the then form of CGT code.

Does everything, then, depend on how many people like a particular course of action? Is something reasonable and non-abusive just because everybody does it?

This provision differs in its operation from the way GAARs in other countries work: most GAARs operate by reference to the determination, in accordance with a list of specified indicators, of whether something was done mainly for a tax avoidance purpose.

If it is objectively determined that it was, the power of counteraction then arises.

That power is to treat the taxpayer either as if he had not undertaken the offensive transaction, or in such other way as is just and reasonable.

That sort of power allows the taxing authority to tax the subject on the basis of a set of assumed facts, but the authority must then tax in accordance with the detailed rules set out in the relevant tax code, applying those rules to the assumed facts.

Conversely, this GAAR is lacking the list of specified indicators and is intended to operate chiefly by reference to whether what is done is an abuse.

That has been advertised as a narrowing of the scope of the GAAR: it is what is said to make the GAAR acceptable.

However, the definitions used in relation to the concept of abuse are so broad and so ill-connected to our existing code that it will, or is at least likely to, broaden rather than to limit the scope of the GAAR – and that is especially so, given that HMRC guidance is to be taken into account in determining what is an abuse.

Moreover, it seems to me that this GAAR does not just allow HMRC to tax in accordance with existing rules on the basis of assumed facts: it seems to me to allow the tax authority to make up the law; at any rate I think that the draftsman has not thought through what constraints on counteraction there should be.

It is my experience of dealing with GAARs in other countries that, no matter how dressed up they are, they always give a degree of discretion to the person charged with deciding whether the GAAR is to apply or not.

In the end, where there is a GAAR, an arrangement, which may be regarded as mitigating tax, works if the person deciding the matter finds it, by reference to unstated criteria outside the wording of the legislation, acceptable and does not work if he or she finds it unacceptable.

Where you have a system which is based on clear principles, the giving of a discretion in that form may – just may – be acceptable, because whether something accords with what the draftsman intended or not is fairly easy to see.

At any rate, where there are clear principles, it is fairly easy to tell whether an arrangement contradicts what was intended: for example, in a system which just taxes profits, there are only two ways of trying to reduce your tax bill: you can reduce receipts or increase expenses to un-commercial levels.

Both methods of "avoidance" are relatively easy to detect, and neither works or should work.

But with our system, there is no clear principle.

The thinking behind this GAAR is that there is a principle underlying our tax code; but the principles implied by the indications of abuse are far from anything that I can recognise as being enshrined in our legislation.

We should not and would not find this tax code acceptable:

> "(1) Everybody shall pay as much tax as the Revenue consider he, she or it should pay;
>
> (2) A person who does not agree with the Revenue's assessment may appeal to a judge who shall uphold the Revenue's assessment if he considers it to be reasonable or shall otherwise assess such figure as he considers right."

This GAAR, with its broad and undefined conceptions, comes dangerously close to reducing our 13,000 pages of

legislation to those two sections: in my view, in its current form it comes more than dangerously close to doing that; where it applies, it does it.

The only justification for 13,000 pages of legislation is that they contain rules which people can follow to determine what their tax liability is.

Our code does not do that job very well, but that does not justify a rule which requires us to self-assess ourselves (with penalties for failure to do so), on the basis that it applies if we think we have acted in an abusive way, and which takes precedence over the other rules *and* provides that tax can be charged by reference to some test of economic equivalence.

When the mob howls, the rule of law – not the spirit of the law, but the rule of law in all its majesty and strength – must speak. It does not like provisions which are as wide and uncertain as this.

It is time to re-think our tax system, not patch and mend it. It is broken, it needs wholesale reform, not a GAAR. The problem has been misdiagnosed and the GAAR is not a cure for it: it will make the real problem – the slovenly behaviour of the legislature – worse because it will encourage just that sort of thing.

Endnotes

1 *Mayes v HMRC* (2011) STC 1269

2 *Ramsay (WT) Ltd v IRC* [1982] AC 300

3 *Schofield v HMRC* [2011] UKFTT 199 (TC)

4 *Barclays Mercantile Business Finance Ltd v Mawsom* [2005] 1 AC 684

5 *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2003] 1 AC 311

6 *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655

7 *Furniss (Inspector of Taxes) v Dawson* [1984] AC 474

ONSHORE: THE NEW OFFSHORE

Milton Grundy

In this article, my thesis is essentially this, that offshore vehicles are wonderful things, but nowadays – at any rate as far as the private client is concerned – we should always ask ourselves, "Can we not manage perfectly well with an onshore vehicle?" I say, "nowadays", but has that not always been wise? To some extent I think it has. The taxman looking at the taxpayer's file comes across a reference to a company incorporated in the Bahamas. His instinct is to make further enquiries. But if he comes across a company incorporated in England, he may well turn over the page. Some countries discriminate against offshore vehicles – blacklisting certain jurisdictions and imposing withholding taxes on outgoing payments or denying deductions for them. What I think is new about "nowadays" is that the offshore jurisdictions have been, if I may use the expression, *rumbled*: they allowed themselves to be used for a lot of business which depended simply on never being found out. But it was. Of course, as we all know, a lot of respectable business has been done – and is being done – through the offshore jurisdictions. But their image has taken a battering. The press and the public do not understand the difference between 'evasion' and 'avoidance'. (Some judges, unfortunately, do not seem to understand it either.) We complain about that, but I see no prospect of it changing, and I think that nowadays, in advising the individual client about any new matter – especially if the client is in any way a public figure, we need to take into account the public perception of the steps we are advising him to take. If the client is the non-resident wife, about to receive massive dividends from shares in a UK company whose chairman is UK-resident and her husband,

should one not consider interposing a UK company or trust, just for "cosmetic" reasons?

This is really quite a difficult topic to address. I am talking about not telling the world what you are doing. This is not a substitute for making sure that what you are doing is lawful and proper. "Cosmetics" are an addition to tax planning. They are not a substitute for tax planning. Once I have made sure that I have the right and proper solution to the problem – whatever it is, I do not want some journalist to start a press campaign, I do not want some competitor – or some dissatisfied employee or perhaps even some disaffected spouse – to find some way to make trouble, and least of all do I want some tax official to think that making an example of me will be an astute career move.

Let me start with an example. I am a company planning to do some business in Madrid. A Spanish company will not do business with me if I am "offshore". But suppose my name is "Milton Grundy Société Anonyme" and my office is in Paris, or my name is "Milton Grundy Inc." and my office is in New York. I am in fact incorporated in Belize, but to the Spanish company I am French or American. Using an agent is a similar manoeuvre. I remember a case where an Austrian company received a lot of payments from Spain. The Austrians told nobody in Spain they were acting as agents for a Panamanian company – though they happily told the tax department in Vienna, which charged them tax simply on the fee they charged for handling the payments. The nominee company in Canada plays a similar role. These are rather primitive manoeuvres, and may depend for their effectiveness on the truth never being discovered, and one thing we have learnt from the wretched Swiss bankers, is that electronic information travels very easily, and there may well be a disaffected or bribable employee who will help it to travel.

A much better solution to this kind of problem is the limited

partnership. The limited partnership has the charm that it is in some way recognised as having an existence in the jurisdiction in which it is established, being registered with some government authority and the registry open to public inspection, while being transparent for tax purposes. There are several jurisdictions in which limited partnerships of one kind or another can be established. These include the United Kingdom and the United States – both of which jurisdictions can well be described as "cosmetic". The upshot is that so long as all the partners are resident outside the jurisdiction in which the partnership is established, and so long as the source of the income is outside that jurisdiction, there is no tax liability in that jurisdiction. This is broadly true of the United Kingdom, the United States and elsewhere. The Scottish version of the limited partnership is different from the English version in that it has a form of corporate identity, separate from that of the partners[1]. But it is still, like the English version, transparent for income tax, and not in itself taxable. It seems anomalous that we have a British corporation expressly excluded from the UK tax regime. It cannot be used as a treaty-shopping vehicle, though it has interesting possibilities in domestic tax planning, but it is undoubtedly "cosmetic". I had one interesting experience with a Scottish partnership, which may be worth a mention. The clients wanted a zero-tax trust company, quickly and at minimum cost. When I first started to practise at the Bar, you could ring up someone in any one of half a dozen common law jurisdictions, and have a trust company by tea-time. But what with issued capital requirements, money-laundering, licensing and finding willing bodies on the ground, the whole thing had become a huge performance, whereas registering a partnership agreement in Edinburgh was quick and easy.

The Delaware Limited Liability Company is a very similar entity, "cosmetic" in the same way: if the income arises outside

the United States and the members are not US taxpayers, the LLC is effectively an offshore entity with an onshore face. And the LLC does not have to be in Delaware: Delaware is a much-favoured State for the establishment of corporations, because of its low State tax on corporations, and this has given the State a certain aroma of tax avoidance. But there are plenty of other States to choose from. I have used Texas quite a lot – not a State associated with anything so fancy as tax avoidance.

Another way of providing a "cosmetic" image is to incorporate somewhere nobody has ever heard of, or at any rate, somewhere not generally known to offer a zero-tax facility. My favourite jurisdiction in this category is Botswana. Not many people know quite where it is on the map, let alone what kind of fiscal regime it enjoys. It has, in fact, the simplified version of the UK tax system which we in Britain exported to our colonies, in the form of what was known as the "Colonial Office Draft". One important feature of this was the basic concept that the criterion of taxability of a company is its *residence* in the territory, whether or not it is incorporated there. This opens the door to the use of the non-resident company. The English non-resident company, and later the Irish non-resident company enjoyed a great vogue, until the door was firmly shut – under pressure, I believe, from our European partners, to whom the whole concept no doubt seemed faintly absurd. It was in this context that I first encountered Botswana. There was a company incorporated in Botswana, but holding its directors' meetings in (if I remember rightly) Monaco. Since its income did not arise in either of these countries, it was wholly tax-free. There must be lots of former British colonies and ex-colonies with their own versions of the Colonial Office Draft, where companies are taxed by reference to their residence and not their place of incorporation. I have never had the patience to do the research, but logically there must be out there a whole heap of jurisdictions capable of hosting non-resident companies. I

said a moment or two ago that the United Kingdom shut the door firmly on the UK non-resident company. Actually, it was only a few years later that the door was discreetly opened again. If the English company – or the Scottish company or the Northern Irish company – is resident in a country with which the United Kingdom has a tax treaty, it can once again be treated as non-resident for UK tax. The statutory provision in its present form is s.18 of the Corporation Tax Act 2009. It would of course be silly to opt for residence in another country if the result was that the company had to pay a significant amount of tax. My favourite country of residence, in this context, is Barbados. This is not because the rate of company tax is lower in Barbados. (It is not.) But because Barbados has an element of territoriality in its system – another legacy from the Colonial Office Draft. In Barbados, they have the rule we have in the United Kingdom, that the non-domiciled pay tax on their foreign income only to the extent that they remit it, but – unlike us – they apply this to companies as well as to individuals. It follows that a company incorporated in any part of the United Kingdom can be treated as non-resident for UK purposes, if it is managed and controlled in Barbados, but will not be taxed in Barbados on its unremitted foreign income. An offshore vehicle in all but name. This element of territoriality – derived from the Colonial Office Draft, is something we find elsewhere in the Commonwealth – notably in Malaysia and Singapore. It is also a feature of the income tax code of Botswana, which means that – to go back to my earlier example – so long as the income arises outside Botswana and is not remitted to Botswana, there is no local tax liability, whether the company is resident or not. In fact, one can say as a general rule that any country with a territorial system can function as an offshore jurisdiction. Panama has perhaps exploited this advantage too much to be considered nowadays as "cosmetic", but maybe Costa Rica has not, and I am sure Uruguay has not.

Uruguay also comes into a separate category – countries which offer zero-tax facilities, but are not generally known for doing so. Top of my list in this category is the United Arab Emirates. They have achieved the amazing trick of levying no income tax, but persuading other countries to enter into Double Taxation Agreements! I know that doing business there is not very straightforward, but Dubai probably meets the criteria I am talking about here, and Ras Al Kharma and Qatar, each of which at this stage are a kind of wannabe Dubai, undoubtedly do.

Which brings me to what I think is the most interesting and versatile 'cosmetic' vehicle of all, which is the trust. Let us suppose that our Spanish company is asked to pay commission to a New Zealand company. New Zealand is not on the Spanish blacklist, and there is no problem. Let us also suppose that the New Zealand company is acting in its capacity as trustee of a settlement made by a non-resident. The Spanish company does not have to know this. Indeed, no outsider is entitled to know this. But the New Zealand trust is not taxed on income arising outside New Zealand, and can therefore be in effect a zero-tax vehicle as regards the commission. And I think it is worth remembering that a company acting as trustee does not have to have a name with "trust" in it. Indeed, if "cosmetics" is what we are aiming for, the corporate trustee should avoid having "trust" or "trustee" as part of its name. And the trustee does not have to limit its activities to holding investments, but can carry on a trade or business as trustee, so long as the trust instrument empowers it to do so. The New Zealand trust is effectively "offshore", but appears to be onshore. I believe the same result can be achieved in Australia, Ireland or Israel. People have for many years achieved the same result with a Canadian branch of, for example, a Cayman company, but the recent *Fundy* decision[2] now opens the door to using a Canadian company. And, coming to my own front doorstep,

it can undoubtedly be achieved with a UK company. As well as a non-resident settlor, you need a non-resident co-trustee, as you will see from the statutory provisions – ss.474 – 476 of the Income Tax Act 2007. But the co-trustee really is a formality: it does not matter where the co-trustee is resident, so long as it is outside the United Kingdom, and there is of course no reason for it to participate in any of the business done on behalf of the trust, or for its existence – or, for that matter, the existence of the trust – to be known to any customers or suppliers. I am a great fan of the UK "offshore" trust: apart from its cosmetic advantages, it is valuable also as a treaty-shopping vehicle. And it does not necessarily have to be governed by English law: with a BVI co-trustee, you can incorporate the VISTRA regime, or with an appropriate co-trustee you can establish a UK-based charity which is not answerable to the dictates of the Charity Commission.

It is also perhaps worth remembering that a trust does not actually have to benefit someone other than the settlor. In the classic "Thin Trust", I settle an asset on trust to pay the income to myself for life and subject thereto as I may by deed or will appoint. The trustee is now the owner of the asset: he can sue anybody for damages and can take advantage of any capital gains tax exemption in a treaty with the country in which the asset is situated. But I can get the asset – or the proceeds – back into my own hands at any time, simply by exercising the power of appointment in my own favour. While the trust exists, I am entitled to the income, and for tax purposes it is treated as my income, and not the income of the trustee. So, for example, the trustee may be UK-resident but the settlor-beneficiary non-resident. If the trust income has a non-UK source, there will be no UK tax liability – not because the trust is treated as non-resident, but because it is transparent. I think the Thin Trust has lots of uses. I remember a case where a Cayman company wanted a cosmetic vehicle to make a significant

investment in a European country. It created a UK thin trust, making the investment in the name of the UK corporate trustee, which was called something like *Amalgamated Ironfounders Ltd*. If in due course a non-resident co-trustee was appointed, the trust could look forward to enjoying treaty exemption on the capital gain when the investment was sold. There was also a rather unexpected extra benefit: some of the ultimate owners of the Cayman company were UK residents, and whereas there is machinery for attributing capital gains of non-resident companies to UK residents, even via intervening trusts, and there is machinery for attributing capital gains of non-resident trusts to resident beneficiaries, there is no machinery for attributing the gains of non-resident trusts to non-resident companies, so that the gain of the Thin Trust in this case would have no tax consequence for the UK owners.

My focus is on onshore vehicles which have "cosmetic" advantages which offshore vehicles do not have. But there is one offshore vehicle which does to my mind have cosmetic advantages – at any rate to some degree, and that is the company limited by guarantee. It is enough for present purposes to say that an offshore company limited by guarantee can be more like an offshore investment company or more like an offshore discretionary trust, depending on how its constitution is framed, but, unlike the offshore investment company and the offshore trust, it does not necessarily carry the label "tax avoidance". For example, suppose it became known to the tax authorities that your client was a member of the Aquarius Society. Would that trigger an enquiry? I suspect not. But the Aquarius Society could be a company limited by guarantee incorporated in the Cayman Islands which only family members were able to join and which owned investments, or an island, or a yacht. You will notice that the name of the company in my example does not end with the word "limited". I think that has a certain cosmetic charm, and that is why I chose the Cayman Islands

for my example – because an exempted company there has the right to do this, and the Cayman Islands and the Turks & Caicos Islands are, as far as I am aware, the only places in the world which afford this right.

I now want to look at two transactions where one might automatically reach for an offshore vehicle, but where an offshore vehicle would serve the purpose just as well. Assiduous readers of the GITC Review may recall that recent issues have included stories about taxpayers who had taken active steps to reduce their tax liabilities by taking advantage of various offshore facilities. I would now like to revisit them briefly, and see if one cannot achieve the same result, using only jurisdictions which carry no overtones of tax avoidance.

The *Fable* entitled "Le Lac"[3] plays with the rule that transactions between connected parties are deemed to take place at market value. The object of the rule is to penalise the person who transfers an asset for less, by taxing the amount of the undervalue, but it of course benefits the transferee to the same extent, because to him the asset has a base cost inflated by the same amount, so if he sells it for full value the next day, he makes a real gain but not a taxable gain. The *Fable* worked by having the transferor offshore but the transferee onshore – in the United Kingdom in this case. It did not matter that the transferor was deemed to sell for more than he got: he was not liable to UK tax. But the transferee still got the high base cost for the asset, so did not have any tax to pay on *his* gain. In my *Fable*, I did not actually say where the Bank was located, but the implication was that it was somewhere offshore, because it is an essential feature of the transaction that the Bank does not have to pay tax on a notional profit. And I think this is one of those cases where one would naturally approach an offshore bank in the first instance, because they may be expected to be receptive to a tax-driven transaction. But does one have to use an offshore bank? The parties were "connected"

for UK tax purposes because of the UK definition of "connected" is quite artificially wide[4]. Suppose we could use – say – a German bank. Or a Canadian bank. Would not that look better?

My second *Fable*, which was entitled *Nigel*,[5] is one which does not depend on the niceties of UK statutes, but on more general concepts. We are all familiar with the discretionary trust. Suppose I have an interest in a discretionary trust with assets worth £10m. What I have – taken by itself – has no ascertainable value. But if all the other beneficiaries are, say, my brothers and sisters, the family as a whole would have an asset worth £10m. And if we could sell our interests to a single purchaser – call him "Mr. X", Mr. X could bring the trust to an end and collect the £10m. Now let me play that sequence in reverse. Mr. X has all the interests in a discretionary trust with assets of £10m. My siblings and I buy all the interests for a total price of £10m., plus – of course – a little profit to Mr. X. Suddenly, my siblings are all poorer, and so am I. The taxman wanting wealth tax or inheritance tax may think I made a poor investment. So may my creditor, or estranged spouse. But the decline in my net assets is real. From a UK point of view, such a transaction is especially interesting, because it side-steps a lot of attribution rules for income tax and capital gains tax, but its effectiveness for estate taxes does not depend on any technical rules, but follows from the simple facts of the situation.

Can we now shift our gaze from the discretionary asset to the discretionary liability? In this *Fable*, the story is that a company was doing business in a high-tax country. I did not say which country it was, and it did not really matter, though I guess my unconscious model was the United Kingdom. The company was marketing the services of a resident individual, whom I called "Nigel". Nigel might have been a pop singer who wrote his own songs or an IT consultant who wrote his own programmes: the essential feature of him was that there

were different aspects to the overall services he provided – three in this case. Each aspect was vested in a separate Thin Trust for him and his family, and each of the three trustees contributed its own aspect to the marketing company, so that the marketing company could sell all aspects of Nigel's services. The trustees now grant a five-year licence of Nigel's services to the marketing company, so that the marketing company has to pay Trust A for the A services, Trust B for the B services and Trust C for the C services. The aggregate amount payable to all three of them is agreed. In my example, it is 80% of what the marketing company receives from sub-licensing the services. But the way in which that aggregate amount is to be divided between the three trusts is left for later agreement.

The five years now pass. The marketing company has collected £10m. and owes £8m. to the trustees. The £8m. has not been taxed – not in the hands of the marketing company, for which it ranks as a deduction, and not in the hands of the trustees, because none of them is entitled to any of it. Now Nigel has found a purchaser, who will buy his three trust interests for £8m., less a turn for itself. In the original version of the story, Nigel was a UK resident, so I worried that the proceeds of sale might be caught by the provisions which tax capital sums derived from services[6]. So I sent him off to be resident in Barbados during the tax year in which the sale took place. As it turned out, this was the only offshore element in the transaction, but, interestingly, I originally devised the transaction as one which would take place wholly offshore, and I only gradually realised that it could equally well be done onshore.

Well, so much for my *tour d'horizon* of onshore vehicles effectively functioning as offshore vehicles. Before I get lynched by half the practitioners in the field, let me hasten to add that I am not in any way hostile to offshore vehicles: I have spent a lifetime working with them, and I know that offshore business keeps the wheels going round to an extent of which the general

public has no idea whatsoever. Mrs. Thatcher was known for the expression TINA – There is No Alternative. The burden of my song here is that Mrs. Thatcher's acronym has no application to the world of international tax planning: where we feel that an onshore alternative may be appropriate, there may well be a suitable one.

Adapted from a talk given by the author to the ITPA in Cannes in June 2012

Endnotes

1 Partnership Act 1890 s.4(2).

2 *Fundy Settlement v. Canada* 2012 SCC 14.

3 GITC Review Vol IX No 1.

4 TCGA 1992 s.286

5 GITC Review Vol X No 1.

6 ITA 2007 ss.773-789.

BREAKING THE DEADLOCK – RESOLVING SME AND INDIVIDUAL TAX DISPUTES BY ADR[1]

Hui Ling McCarthy and Andrew Gotch [2 3]

This article reviews the success of HMRC's Alternative Dispute Resolution (ADR) pilot for Small and Medium Enterprises (SMEs) and individuals.

Imagine that you have a client, Mrs. Giles, who has been embroiled in a dispute with HMRC for a number of years over whether the bed and breakfast business she runs from her farmhouse should be jointly registered for VAT with her husband's farming business. It is plain (to you, at any rate) that the two businesses are run separately. HMRC, on the other hand, have adopted an intransigent position and contended from the outset that the farm and the B&B are not sufficiently at arm's length from each other: the reality is, say HMRC, that they are in fact one business and should be VAT registered as such.

The position is deeply unsatisfactory: the dispute has been running for so long that there are four years of assessments currently on the table. Mrs. Giles is very upset by all this. If the businesses are jointly registered, it will mean that she will be at a competitive disadvantage to the other B&Bs in the village because she will have to increase her prices to her customers in order to cover the VAT liability each quarter. If the B&B remains separate to the farming business, it will be below the VAT registration threshold, so there will be no need for Mrs. Giles to account for VAT. No one else seems to have the same problem and Mr. Giles is starting to blame you for failing to sort it out. Fairly early on in his enquiries, you and Mrs. Giles had a meeting with the officer at HMRC's offices. However, Mrs.

Giles became upset when the officer made a comment about her inability to run a business without her husband's financial support. Since then, relations have been frosty and the parties have stuck to letter writing. Lately, you feel that HMRC have become entrenched: the officer cannot see beyond the fact that Mrs. Giles does not pay her husband any rent to run the B&B from their home thereby proving (to HMRC at least) that the two businesses are not being run on arm's length terms.

It is not obvious how this impasse can be broken. Mrs. Giles has neither the money nor the desire to fight this case before the Tribunal. Indeed, she has recently been treated for depression by her GP and has no desire whatsoever to be called as a witness. She is thinking about shutting down her B&B altogether.

SOUNDS FAMILIAR?

The farming sector has been at the centre of many an enquiry in recent years with HMRC's Rural Diversification Project in 2009 following hot on the heels of their Shoot Project in 2006. Cases slide inexorably towards a hearing at a tribunal,[4] but:

- from your client's perspective, litigation is costly, time-consuming and stressful – and will be all the more painful if you lose; and
- from HMRC's perspective, the appeal process is equally costly and time-consuming and a decision is unlikely to add much value in terms of elucidating the law.

Another problem with litigating a dispute such as this is that the Tribunal procedure is itself very rigid. Once an appeal has been notified to the Tribunal, attention naturally turns to complying with the case management timetable (Statements of Case, lists of documents, witness statements, skeleton arguments and the like) and away from focussing on whether the dispute can still be resolved without a hearing. Whilst it is often the case that very high value disputes will have a

separate settlement team conducting ongoing negotiations with HMRC right up to the door of the tribunal, there simply isn't the resource to do that in most SME matters.

Litigation should be the last resort for both sides.

A NEW APPROACH

In 2010, HMRC launched an initiative to test other ways of resolving disputes of this kind via ADR.[5] In the context of SME tax disputes, ADR usually takes the form of mediation, in the sense that a third party who has not previously been involved with the dispute will be brought in to facilitate negotiations with the hope of reaching an agreement.

ADR can be particularly helpful in a case such as Mrs. Giles's where, for example:[6]

- the negotiations have become side-tracked, because, say, HMRC are failing to take account of relevant factors or are taking into account irrelevant ones (in our example, HMRC are focusing solely on a single financial factor and have lost sight of everything else);
- the relationship between the parties has broken down; and/or
- the negotiations appear to have reached deadlock.

The first phase of HMRC's pilot had two tracks – one for Large and/or Complex cases, and one for SMEs. During the consultation process HMRC have encouraged active and cooperative dialogue with professional bodies on the development of the pilot models through working groups.

The large business pilot is for both Large Business Service and for Local Compliance large and complex disputes. It has seen some high-value, long-running disputes resolved through structured, facilitated negotiations or by using independent mediators accredited by organisations such as the Centre for Effective Dispute Resolution (CEDR).

The SME pilot is different in structure, but the results are equally encouraging. The principal difference is that for the SME pilot, HMRC have trained a small team of their own staff, known as "facilitators", to act as mediators. The facilitator will work with the taxpayer and/or the taxpayer's representative and the original HMRC officer to try to reach an agreement and resolve the dispute. The facilitator will have had no prior involvement with the case and will not know the other HMRC personnel involved.

An early criticism made by those not involved in the SME pilot has been the use of HMRC staff to act as facilitators. How can they be said to be truly independent? Whilst at first sight that seems a reasonable cause for concern, to date, that concern has been unfounded. Each facilitator has received proper training in ADR techniques and, in the writers' experience, takes their role as facilitator seriously. In the event, not a single taxpayer or adviser involved in the first phase of the pilot complained about a perceived lack of independence – a testimony to how successful the HMRC facilitators have been in achieving even-handedness and independence. One unrepresented taxpayer commented enthusiastically:

> "A very useful service and my advice to anyone who has a dispute is to use this free service as you would find it valuable to talk to someone who is both very knowledgeable and impartial to either party".

This mirrored the feedback from the HMRC facilitators themselves, with one commenting:

> "It was an enjoyable and rewarding role. It was good to be able to battle the perception that HMRC don't want to help".

HOW CAN ADR HELP SME CLIENTS?

Turning back to Mrs. Giles's dispute, ADR might work something like this:

- The facilitator would call you to explain how the ADR process works and discuss your client's case. In particular, he would explore the reasons why you consider Mrs. Giles's business to be separate from her husband's farming business.
- Next, the facilitator would speak to the officer to ascertain his position.
- The facilitator may then suggest that each side considers how they might put their case to a tribunal. What evidence supports their case? What evidence is missing? To what extent will the missing evidence cause a problem to their case? In particular, the facilitator would encourage both parties to consider all factors, not just the financing of the business (something you have been saying to the officer from Day One).[7]
- The facilitator would then talk through the officer's case with you and identify the officer's key concerns – in particular, the fact that Mrs. Giles does not appear to be paying any rent to her husband for the use of the farmhouse. During the ensuing discussion, it may emerge that the reason for that is because the Gileses co-own the farmhouse. Moreover, Mr. Giles has his own farm office in a separate building and none of the farm business is carried out from the farmhouse at all.
- The facilitator would repeat the exercise with the officer – discussing your client's case and your/Mrs. Giles's concerns. In particular, the fact that the farmhouse is jointly owned and not in fact used by the farming business would be brought to the officer's attention. The officer would be encouraged to go back over his notes and look at other factors which would influence whether the businesses were being run separately, for example:
  * Does Mrs. Giles have her own bank account and records?
  * Is Mr. Giles involved in the B&B in any way – for example, cleaning rooms, cooking meals, taking bookings?
  * What happens if Mrs. Giles is ill or on holiday – are bookings cancelled or does Mr. Giles step in?

  * How does Mrs. Giles account for tax on the B&B takings – are B&B profits included on her tax return or on her husband's?
  * How does Mrs. Giles advertise the B&B? How are things such as food and cleaning costs paid for – from the B&B's funds or from the farming business?
- There might then be a conference call involving you, the officer and the facilitator. The facilitator would play a central role in this telephone call, inviting each party to explain how they see the factual position. During the call, it might become clear that the reason that Mrs. Giles set up the B&B business was because she enjoyed hosting people and wanted to make some money for herself. Indeed, she had in fact run a B&B from her former house in a seaside village before she met and subsequently married Mr. Giles.
- During the call, it might become apparent that most other factors point towards the B&B being run as a separate business. The officer might identify some gaps in documentary evidence currently before him. For example, he may not previously have been aware that Mrs. Giles designs her own leaflets to advertise the B&B, nor that the B&B had its own headed notepaper on which things like invoices and bills for guests are printed. The officer may wish to see these.
- The call would conclude with the facilitator setting an agreed timescale for the provision of further documents and a time by which the officer would be expected to have reviewed his position (say, 28 days after receiving the further information).
- After the call, further discussions might take place between you and the facilitator and the facilitator and the officer to tie up loose ends. The misunderstanding about the use of the farmhouse has been cleared up, some new evidence has

come to light and the officer has been encouraged to look more broadly at the situation. As a result, the officer is now satisfied that the B&B is being run as a separate business and does not need to be joined to the farm's VAT registration.

There is no set format for a facilitated negotiation such as this. The facilitator's role is as much about working out a suitable process which both parties are happy with, as it is about helping the parties to find a mutually acceptable solution to the tax dispute. For example, in our case study it may be felt by all concerned that it might be helpful to try another face-to-face meeting with the facilitator present. This time, the meeting might take place at the farmhouse. This would let the officer see how the B&B is run on the ground and the degree to which it is in fact separate from the farming business. Unlike an HMRC compliance visit, meetings in this context would only take place if your client was happy to agree to it.

NO SUCH THING AS WASTED ADR

Both writers believe that even if a final resolution is not found in the course of negotiation, the ADR process still confers real practical advantages on advisers and clients (provided of course that it is handled properly – clearly it is a waste of everyone's time if, for example, a taxpayer or an adviser signs up to the process then fails to answer the facilitator's telephone calls).

What if Mrs. Giles's dispute had not settled and had ended up in front of the tribunal?

- There is no doubt that the relevant issues in dispute would have been more clearly identified so there would be less to debate, or a more focussed debate, in front of the Tribunal. In one recent case, an anticipated 5-day hearing was reduced to 2 days following ADR – saving potentially thousands of pounds of costs and a corresponding amount of time and stress.

- Each party would have a better idea of the viability of their and the other party's case.
- A fresh review of the facts might have meant that by the time the hearing took place, only a narrow question of law remained in dispute. On that basis, HMRC might be prepared to agree a Statement of Facts and be willing not to call Mrs. Giles for cross-examination.

So ADR will have meant that Mrs. Giles is better off than before she embarked on the process, whether or not the dispute settles.

A SUCCESS

The first phase of the SME pilot ran from February to November 2011. Within that period:

- HMRC offered 149 taxpayers the opportunity to take part in the ADR pilot. 143 taxpayers – 96 per cent – took up the offer. (33 cases were subsequently withdrawn for reasons of HMRC policy or taxpayer disengagement);
- 95 facilitations were completed;
- 60 per cent of disputes were wholly or partly resolved to the mutual satisfaction of both sides;
- Resolving a case via ADR took HMRC (caseworker and facilitator combined) approximately 15 per cent of the working hours that would on average be spent taking a straightforward case to litigation. It is likely that the figures for taxpayer and adviser time saved would be comparable, which is particularly valuable since it often takes far longer for a taxpayer to prepare for an appeal to the First-tier Tribunal because it is the taxpayer's appeal.

Given that these were not simply cases selected at random but were all cases where negotiations had previously stalled, this is a remarkable result. In addition, ADR will have saved or reduced the cost of preparing for an appeal for both sides

and removed or lessened the scope for antipathy between taxpayer, adviser and HMRC.

A NEW OPPORTUNITY

The second phase of the pilot began in January 2012. Selection criteria have been expanded and in particular ADR can now be applied for by taxpayers, or suggested by HMRC caseworkers, in live disputes where an appealable decision has not yet been issued. The facility has been expanded in its scope and is open both to SMEs and to individuals. Applications are now accepted from any part of the United Kingdom.

HMRC's current approach is that not all cases are suitable for facilitated negotiation within the ADR pilot, for example where:

- resolving the case would be a departure from HMRC's established technical or policy view;
- the case cannot be settled within the framework of the revised principles of the LSS;
- the issues contained within the case requiring clarification are of interest to or may impact on the wider public; or
- the issues contained within the case are linked to other cases or appeals.

However, even where you feel that one of those exclusions might be relevant, the very act of applying to the ADR pilot opens up the avenue for fresh discussion. For example, if the issues currently on the table cannot in fact be settled within the LSS, are there other ways of looking at the problem which might offer up an LSS-compliant route to settlement? The essence of ADR is discussion at every stage in the process, so advisers and taxpayers should not take too pessimistic a view of their chances without running the facts past HMRC's pilot team first.

In our view, all professional advisers acting for SMEs and individuals should be reviewing their files now for suitable cases for ADR within the second phase ADR pilot. There is

little time left to use the facility but it deserves professional support. If you think you have identified a suitable case, visit www.hmrc.gov.uk/adr/index.htm and apply online.

USE IT OR LOSE IT

ADR is a costly facility for HMRC to run. In-house facilitators have to be specially trained, and are taken away from front-line compliance roles. While the future of ADR for the Large and/or Complex cases seems assured, its future in the SME and individual sectors depends on the current pilot demonstrating that it is a viable and effective means of settling disputes.

That means that all professional tax advisers should do what they can to enable HMRC to validate the use of ADR in SME and individual cases. The cost/benefit analysis for both sides should be favourable, but if there are insufficient statistics to support it, the facility may well be lost forever to the millions of taxpayers in the SME and individual sectors who might be able to use it to their benefit.

And consider the bleak alternative: without ADR, a taxpayer would be left with only the statutory internal review process if he wants his case reconsidered before a Tribunal hearing. Statutory review is a very different proposition and has been widely criticised by many who have experienced it. The principal disadvantages are that:

- it is available only after the dispute has run into deadlock and an appeal has been made; and
- decisions are imposed by HMRC reviewers often without any dialogue, leading to a perception that the process is little more than a rubber-stamping exercise in many cases.

It is plainly an inferior alternative to ADR, which emphasises and facilitates bilateral dialogue and gives the parties the chance to come to their own resolution to their dispute.

ADR has the potential to be a step along the road to working

together better, and one which confers obvious advantages on taxpayers, advisers and HMRC. HMRC are to be congratulated in having taken the first step in that direction. Our job is to persuade ourselves and our clients that we should at least consider following them down that road.

Endnotes

1 This article was first published by Thomson Reuters (Professional) UK Limited in Private Client Business [2012] Issue 5 and is reproduced by agreement with the Publishers.

2 Andrew Gotch is principal of Chartered Tax Advisers TaxFellowship.

3 Both writers are CEDR accredited mediators.

4 See *A, D and J Forster v HMRC* [2011] UKFTT 469 (TC) for an example of a recent case on precisely this issue.

5 See http://www.hmrc.gov.uk/adr/index.htm for a summary of the results from the first phase of the pilot and information on the second part of the trial.

6 See http://www.hmrc.gov.uk/adr/appendix-a.pdf for further examples of cases which HMRC consider suitable for the ADR pilot.

7 This would have been a particularly helpful exercise for HMRC to have done in *A, D and J Forster v HMRC* [2011] UKFTT 469 (TC). During the course of cross-examination of HMRC's officer, he was referred back to 14 factors identified in his visit notes. On closer inspection, it became clear that most of the factors weighed in favour of treating the B&B separately from the farming business (see para.24).

VODAFONE, HYDRA AND HERCULES' SECOND LABOUR REVISITED

Nikhil V. Mehta

INTRODUCTION

Who said only two things in life are certain? I doubt if it was the Indian Government. Indeed, the Government appears to have gone out of its way to disprove this proposition in relation to taxes. The *Vodafone* saga in India has turned into an incarnation of the serpent Hydra. In Greek mythology, the Hydra had innumerable heads, so many in fact that painters of vases had difficulty capturing its portrait(s) fully. For each head which was cut off, it grew two more. It seemed impossible to defeat. That was until it met Hercules, whose Second Labour was the task of killing it. Hercules hatched a cunning plan, which involved cauterising each stump left behind after a head rolled, so that the Hydra finally became headless and perished.

A new Hydra has arisen out of the *Vodafone* tax litigation in India. Enough attempts have been made to kill this Hydra (both by the taxpayer and by the tax authorities), but today it still continues to grow heads. There is, however, some prospect that Hercules may have arrived in the form of India's latest Finance Minister, Mr P Chidambaram. But there is still the "labour" to be performed.

A look at the twists and turns in 2012 alone shows the serpent-like nature of the beast and its formidable powers of regeneration:

- 20th January: Supreme Court of India decides unanimously in favour of Vodafone.
- 17th February: Indian Government files a review petition requiring the Supreme Court to review its own judgment.

- 9th March: Parliamentary Standing Committee on Finance publishes it Report on the Direct Taxes Code Bill ("DTC") including relaxations to the proposed *Vodafone* tax charge.
- 16th March: Indian Budget contains provisions to bring Vodafone-type offshore share sales within the Indian tax net with retrospective effect from 1st April 1962, thereby taking the charge out of the DTC and accelerating its introduction. The Standing Committee's recommendations are ignored.
- 20th March: The Supreme Court dismisses the review petition.
- 28th May: The Finance Act 2012 is enacted, containing provisions to tax indirect transfers of Indian assets through offshore sales of shares in foreign companies and imposing withholding tax obligations on offshore purchasers, irrespective of whether or not they have an Indian presence. These provisions are described as "clarificatory" and introduced with retrospective effect from 1st April 1962. They effectively negate the Supreme Court's judgment.
- 17th July: the Government appoint an Expert Committee to look at India's new general anti-avoidance rule, also introduced in the Finance Act but with effect from next April. This committee is known as the Shome Committee after its Chairman, Mr Parthasarathi Shome.
- 22nd July: Mr Pranab Mukherjee, the Finance Minister responsible for the Finance Act changes, becomes President of India.
- 30th July: the Shome Committee's remit is extended to review the *Vodafone* provisions in the Finance Act, but only from the viewpoint of foreign institutional investors who invest in India on a portfolio basis: this was clearly a direct response to international institutional pressure.
- 31st July: Mr P Chidambaram leaves the Home Ministry to become Finance Minister for the third time. Since he was one of the original architects of liberalisation in 1991, his appointment is welcomed by the foreign investment community.

- 1st September: the Shome Committee's remit is further extended to review the *Vodafone* provisions in the context of all non-residents.
- 9th October: the Shome Committee's draft report is published, recommending radical changes to the *Vodafone* provisions, particularly regarding their retrospective effect.

So, what has all the Finance Act fuss been all about? I do not intend to go over all the *Vodafone* history up to the Supreme Court decision, which was covered in the last edition of the GITC Review. The Government decided to negate the *Vodafone* decision by introducing the following changes to the Indian Income Tax Act 1961 ("ITA"):

- Amending Section 9 (which, inter alia, is the principal charging provision for charging tax on capital gains made by non-residents) so that it expressly extends to sales of shares in foreign companies by non-residents where the underlying assets are in India;
- Amending the definition of "capital asset" to include management and controlling rights over an Indian company;
- Amending the definition of "transfer" in relation to a capital asset to include rights created by agreement which are dependent upon an offshore share transfer;
- Imposing a withholding tax obligation on a non-resident purchaser of offshore shares irrespective of whether the purchaser has any presence in India.

I refer to these as "the *Vodafone* changes". The *Vodafone* changes are deemed to have had effect from 1st April 1962. In addition, there is a "validation clause" which effectively blesses all actions taken by the tax authorities in the context of offshore share sales irrespective of judgments like *Vodafone*. So, any action taken in other cases prior to the Supreme Court's decision in favour of *Vodafone* is deemed to be valid, and does not require the tax authorities to start again following the enactment of the *Vodafone* changes.

The other major controversial area in the Finance Act is the introduction of the general anti-avoidance rule. That has nothing as such to do with *Vodafone*, other than perhaps as a visceral reaction by the Government to what it regards as unacceptable tax avoidance. The *Vodafone* changes in the Finance Act operate independently of the GAAR. Although the GAAR has been enacted and is due to come into operation from 1st April 2013, the Shome Committee has recommended a 3-year moratorium. The Government's response is awaited.

I ought to explain why the proposed retrospection goes back fifty years. India's first Prime Minister, Jawaharlal Nehru, still held office on 1st April 1962 and President Kennedy was in the White House. That was the date when the Income Tax Act 1961 came into force. With the magic and flourish of a draftsman's pen, the provisions are deemed always to have been there in the legislation. Somewhat disingenuously, the Government of India justified this as no more than a matter of clarification of legislative intent and for the removal of doubt. If clarification is all that was needed, one cannot help wondering why the Hydra got as big as it did.

I now turn to consider the *Vodafone* changes.

SECTION 9

So far as is relevant to capital gains, Section 9 currently brings the following into the tax charge:

> "all income accruing or arising, whether directly or indirectly, through the transfer of a capital asset situate in India".

The *Vodafone* judgment made it clear that the words "directly or indirectly" qualified the accrual of income, not the transfer of a capital asset. To counter this, the Finance Act has introduced two "Explanations" of this wording. The first says:

> "For the removal of doubts, it is hereby clarified that the

> expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of"".
>
> The second one says:
>
> "For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."

It is difficult to see how the first Explanation affects *Vodafone* since, whether something is done through, by means of, in consequence of, or by reason of, it must at the least involve the transfer of a capital asset situated in India. If there is no actual transfer, this Explanation certainly does not deem one to have occurred. The second Explanation hits the target, however. This deems the offending foreign share to have an Indian situs. So perhaps that is where the first Explanation gets its teeth. Once the foreign shares are deemed to be Indian, anything arising "through" their transfer as expanded by the first Explanation, is caught.

The DTC contains materially different wording to deal with the *Vodafone* effect. It purports to expand the territorial net to offshore share sales, but to exempt those where the fair market value of the underlying Indian assets is less than 50% of the value of all the underlying assets. The 50% threshold has gone. Instead, if the value of the underlying assets is "substantially" derived from Indian assets, then the offshore shares have an Indian situs. There is no guidance on how to measure "substantially". As we know, it means different things in different contexts. But if the expression is satisfied, then the transfer of the offshore shares will be fully taxable in India even if part of the underlying value – i.e. the part other than

the substantial part, is derived from non-Indian assets. This seems, frankly, bizarre.

CHANGING THE DEFINITION OF "CAPITAL ASSET"

The expression "capital asset" is defined as meaning "property of any kind…" : section 2(14) ITA. A new Explanation introduced by the Finance Act states, again "for the removal of doubts", that the word "property" includes and shall be deemed always to have included:

> "any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever".

This change appears to relate back to the tax authorities' contention in *Vodafone* that the share sale in fact involved the sale of a bundle of rights including rights to run the Indian business. So, if a control premium is being paid on a share sale, the authorities may try and allocate that premium to rights outside the shares. If they do, that would be deeply disappointing as it revives the confusion of the Bombay High Court as to identifying what assets were sold and how to construe sale documentation.

EXTENDING THE MEANING OF "TRANSFER"

Perhaps the most disturbing change is a new Explanation to Section 2(47), which contains the definition of "transfer" for capital gains purposes. The language of the new Explanation is so remarkable that it deserves reproduction *verbatim*:

> "For the removal of doubts, it is hereby clarified that "transfer" includes and shall be deemed always to have included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely

> or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India."

This wording is so wide that it deserves to be struck down for uncertainty. Further, to suggest that it is there for the removal of doubts as if everyone ought to have known (from 1962!) about this extended meaning of "transfer" is disingenuous in the extreme. It again seems to reserve the tax authorities' right to tax the transfer of something other than the sale of foreign shares. For example, does involuntary parting of an asset (or even voluntary for that matter) catch the right to carry on a business, which inevitably disappears when a seller sells shares in the company owning the business? And even if it does, why should that matter if the sale of the foreign shares is deemed to have an Indian *situs*?

The most worrying aspect of both this amendment and the earlier one regarding the meaning of "property" is that it could negate the implicit exemption in the second Explanation to Section 9. To illustrate this by an example: suppose a multinational group transfers a global business division by selling shares in an intermediate holding company. There is an Indian business carried on by an Indian company which forms a very small part of the division to be sold. It is so small that it cannot on any rational basis result in the offshore holding company shares being deemed to have an Indian *situs* under the second Explanation. But, under the extended definition of "property", the rights of management or control of the Indian company might be said to be a separate capital asset. Even though there is no actual transfer of the shares in the Indian company, there is undoubtedly a parting with the Indian asset *viz.* the right of management or control, which is characterised as being effected by the offshore share sale.

Taking this through to its logical conclusion, in such a share sale, the Indian tax authorities could seek to assert that part of the transaction is taxable in India.

If this is right, then there can be no situation involving the sale of an Indian business, however small, which falls outside the Indian tax net-even if the subject-matter of the sale is "substantially" of non-Indian assets. This is an alarming conclusion. It is cold comfort that if the Indian tax authorities insist on this sort of approach, they will make an enormous rod for their own backs on valuation matters.

THE VALIDATION PROVISION

For reasons I cannot explain, the validation provision (Section 119) appears in the Finance Act at the end of a section entitled "Wealth-tax". It has only one sentence as follows:

> "Notwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority, all notices sent or purporting to have been sent, or taxes levied, demanded, assessed, imposed, collected or recovered or purporting to have been levied, demanded, assessed, imposed, collected or recovered under the provisions of Income-tax Act, 1961 (43 of 1961), in respect of income accruing or arising through or from the transfer of a capital asset situate in India in consequence of the transfer of a share or shares of a company registered or incorporated outside India or in consequence of an agreement, or otherwise, outside India, shall be deemed to have been validly made, and the notice, levy, demand, assessment, imposition, collection or recovery of tax shall be valid and shall be deemed always to have been valid and shall not be called in question on the ground that the tax was not chargeable or any ground including that it is a tax on capital gains arising out of transactions

> which have taken place outside India, and accordingly, any tax levied, demanded, assessed, imposed or deposited before the commencement of this Act and chargeable for a period prior to such commencement but not collected or recovered before such commencement, may be collected or recovered and appropriated in accordance with the provisions of the Income-tax Act, 1961 as amended by this Act, and the rules made thereunder and there shall be no liability or obligation to make any refund whatsoever."

The draftsman deserves a "long sentence" award! This provision essentially validates all assessment, collection and enforcement action taken by the tax authorities in relation to capital gains on offshore share sales. This is irrespective of any judicial decision to the contrary, such as *Vodafone* itself. It precludes any technical challenge on the merits or otherwise. Despite the retrospection back to 1962, the tax authorities have to observe statutory time limits. But any action taken within those limits is validated. It effectively means that the tax authorities may proceed to collect tax not just from Vodafone, but all the other taxpayers whose cases are pending and which have the same controversy.

WITHHOLDING TAX ON PAYMENTS TO NON-RESIDENTS

One of the points argued in *Vodafone* was the extent to which a non-resident payer could be subject to Indian withholding tax obligations where the payment is made to a non-resident outside India. The general rule in Section 195 ITA is that withholding is required from amounts chargeable to tax where the recipient is a non-resident. The provision says nothing about the status of the payer. The Supreme Court cited with approval English cases like *Clark v Oceanic Contractors Inc* [1983] STC 35, and *Agassi v Robinson* [2006] STC 1056 in holding that the withholding obligation under Section 195 required

the payer to have a relevant presence in India.

Section 195 was duly amended by the Finance Act 2012. It now says that a payer has a withholding obligation in relation to amounts chargeable to tax irrespective of whether the payer has a residence, place of business, business connection or any other presence in India.

This of course begs the question how the obligation can be enforced where a payer really has absolutely no connection in India. Nevertheless, the territorial extension is on the statute book.

THE SHOME COMMITTEE

The last entry on my timeline is the "Draft Report on Retrospective Amendments Relating to Indirect Transfer", published by the Shome Committee. As the title states, this report is still in draft and, after some consultation, will be finalised and submitted to the Indian Government. The Shome Committee was appointed to review the *Vodafone* changes in response to the huge outcry amongst the foreign investment community. The Committee has not disappointed with its recommendations. These include:

- Retrospective legislation should only be introduced in exceptional circumstances for genuine clarification or to attack highly abusive schemes (the *Vodafone* changes did neither);
- The *Vodafone* changes should be prospective, not retrospective;
- If they remain retrospective, then no-one should be subject to interest or penalties for not complying with the provisions prior to their introduction;
- Shares in a foreign company should be deemed to have an Indian *situs* only if more than 50% of the underlying assets are situated in India: this does away with the rather nebulous concept of "substantially"; further, the tax charge should only be by reference to the consideration payable for the Indian assets;

- The tax charge should not extend to minority shareholders in offshore companies even where the underlying assets are predominantly Indian; "minority" here means having 26% or less of the voting power or share capital;
- Listed companies whose shares are "freely traded" on "recognised" stock exchanges should not be within the tax charge on indirect transfers, so shares in such companies can trade without sellers worrying about Indian tax liabilities and purchasers wondering whether to withhold. Recognised stock exchanges and freely traded will be defined by reference to regulatory laws;
- Intra-group transactions should be tax neutral;
- Non-residents investing in Indian equities through foreign institutional investors should not be exposed to the tax charge;
- Private equity investors should similarly be excluded;
- The effect of saying that shares in a foreign company have an Indian *situs* is that dividends paid by those companies have an Indian source. It should be made clear that such dividends should not be subject to Indian taxation;
- The application of the wide definition of "transfer" in Section 2(47) should be curtailed;
- It should be clarified that a non-resident seller entitled to capital gains treaty exemptions in relation to sales of shares in Indian companies should also get treaty relief when selling shares in an offshore company with underlying Indian assets.

At the time of writing, the consultation period has just ended. The hope, of course, is that the Government will respond to the final Report by making significant relaxations to the *Vodafone* changes, probably in next year's Finance Act.

CONCLUSION

As I hope is clear, the new Hydra continues to survive, although the most recent developments suggest that it is under threat.

If Mr Chidambaram accepts the recommendations of the Shome Committee, that would result in an extraordinary *volte face* by the Indian Government. One can only speculate as to what effect that will have on the attitude of the Indian tax authorities to foreign investors. They have already expressed great displeasure at the Committee's conclusions, and are vehemently opposed to the 3-year GAAR moratorium proposal. Meanwhile, other challenges to the retrospective changes are pending in the courts.

But we do know that the charge on indirect transfers is here to stay at least on a prospective basis with effect from 1st April 2012, as is the obligation to withhold taxes irrespective of an Indian presence. There may be a horse trade done on the length of the GAAR moratorium to appease the tax administration while not provoking the private sector.

Earlier this year, when the Budget proposals containing the *Vodafone* changes were announced, the uncertainty related to whether draft legislation would in fact become law. Now, with the enactment of the Finance Act followed by the two reports of the Shome Committee on the GAAR and on indirect transfers, the uncertainty lies in whether existing legislation will be unwound. This is a curious paradox for the legislature.

For those foreign investors looking at potential investments, much can be done on the planning front as we know broadly what the prospective parameters are, even though there is still ambiguity in the detail. The key is the efficient use of tax treaties with entities which have substance (and substance should of course be proportionate to the activity). Establishing beneficial ownership of assets in the treaty entity is another important consideration.

For those investors who own Indian assets, a careful review of current structures is important, particularly for those contemplating an exit in the not-too-distant future, particularly with a view to doing so before the GAAR becomes operational next year (as currently enacted!).

So, I do not know when the Hydra will finally perish, but the one piece of comfort I can give is that there are ways of living with it!

THE TAX ATTRACTIONS OF A DEEPLY DISCOUNTED SECURITY

Patrick Soares

The issue of a deeply discounted security to raise money instead of the taking of a loan can be very attractive, because the discount which is paid on the redemption of the security is not interest for tax purposes and can thus be paid "gross" by a UK resident person to the non- UK resident person who provided the monies.

Furthermore, under general principles, the discount in the hands of a non-resident person is generally tax free under the disregarded income provisions (in ITA 2007 s.813), even though the discount has a UK source.

In addition, the discount is tax deductible in any UK tax computations if the monies were raised for the purposes of a trade, for example, or a UK letting business (within ITTOIA 2005 s272).

Thus if the discount is tax deductible in the UK, tax free under general principles in the hands of the recipient and can be paid gross, it is no wonder that this instrument (called a DDS) has been found by many to be attractive.

TYPICAL SITUATION WHERE AN INDIVIDUAL ISSUES A DDS

An individual resident in the United Kingdom wants to borrow monies – £1m, paying rolled-up interest in say 7 years' time of £0.5m when the loan is repaid – from a non-resident person, perhaps from an overseas structure where the income can be assessed on him under ITA 2007 s.730. He wants to pay a full rate of interest.

The interest will almost certainly be annual interest, and

tax must be deducted at source under ITA 2007 s.874, if the lender's usual place of abode is outside the United Kingdom.

On the other hand, if the UK resident individual issues a deeply discounted security to the overseas provider of the monies which has a face value of £1.5m, but a present market value of £1m – because the security is to be redeemed in (say) 7 years' time for £1.5m, the £.5m difference (the discount) is not interest. It is paid gross in 7 years' time. It is deductible for tax purposes from any trading or property letting profits (for example) of the UK taxpayer, if he or she took the monies out for the purposes of the trade or property letting business. Moreover, under general principles, the discount is tax free in the hands of the overseas subscriber.

YOU'VE CAUGHT MY INTEREST: SO WHAT IS A DDS?

ITTOIA 2005 s.430(1) states that a security is a deeply discounted security if at the time it is issued the amount payable on maturity or any other possible occasion of redemption (A) exceeds or may exceed the issue price by more than A x 0.5% x Y, where Y is the number of years in the redemption period or 30 whichever is the lower. "Redemption" period means the period between the date of issue and the date of the redemption in question. If the discount is not a deep discount it is taxed as interest: see ITTOIA 2005 s.381.

Thus, in a typical situation, Mr X in the UK would *issue* (terminology is important here) the deeply discounted security, and the amount payable on maturity would be £1.5m – taking the above example. The overseas individual, company or settlement would *subscribe* for the security. In – say – 7 years time the security would be *redeemed*. Mr X would pay £1.5m.

There could be no doubt that the courts have struggled with the question of what is the difference between a deeply discounted security and a loan with a rate of interest being charged.

The courts have held that a discounted security is a security

under which X agrees to pay monies on a particular date to the holder of the security and he sells that security. X sells a promise to pay monies. The buyer (subscriber) is not making an advance of monies: he is buying a bill or security.

In *Torrens v IRC* 18 TC 262, the issue was whether a bank which purchased a promissory note was in effect making an advance to the vendor of the promissory note. Best, LJ, at 267 stated:-

> "It appears to me that the purpose of the transaction being to put the Appellant in possession of funds, the method used was, as the certificate to the bank says, by the negotiation of bills and promissory notes and not by making advances on which the Appellant is chargeable with interest. The bank, instead of making an advance or allowing an overdraft in the ordinary way and charging interest from day to day on the amount of such overdraft, discounted the notes and dealt with them in the way described; and when a banker discounts a bill for a customer, giving him credit for the amount of the bill and debiting him with the discount, there is a complete purchase of the bill by the banker, in which the whole property and interest in it vest, as much as in any chattels he possesses... There is no difference in principle, in this connection, between the discounting of bills and the discounting of promissory notes and, in my opinion, it follows that the bank in this case did not make an advance to the Appellant, that he did not pay interest to the bank on such advance..."

In *Willingale v International Commercial Bank Ltd* 52 TC 242, Lord Salmon, dealing with a discounted security, stated at page 270:-

> "Although there may be some superficial similarity between (a) lending £10,000 for five years at a rate of interest of £X per cent on the terms that none of the interest amounting in all to £5,000 shall be payable until the principal becomes repayable and (b) buying a foreign bill of exchange with

a face value equivalent to £15,000 for a price equivalent to £10,000, the two transactions are, in my view, essentially different from each other in character. The vendor is entitled to be paid £15,000 at the end of 15 years; no more and no less. The purchaser of the bill is entitled to sell the bill when he likes or keep it until maturity".

The distinction can be a fine one and both of the above decisions were split decisions although the taxpayer won in both the cases.

In the recent case of *Pike v R&CC* [2011] SF TD 830 a company issued loan (the term "loan" is an anathema in the DDS world) stock repayable after 13 years, and the redemption proceeds were to be the aggregate of the principal loan and the amount calculated as a percentage of the principal (the additional payment). It was held the additional payment was interest properly so called. The loan stock did not amount to a relevant discounted security.

It is felt that a deeply discounted security is a document under which the issuer declares in – say – 7 years time, he or she will pay the holder of the security £1.5m; he or she then asks how much will the proposed subscriber pay now for the same. The subscriber will look at interest rates and risks and other matters and will purchase the promise.

HOW DOES THE PAYER GET TAX RELIEF FOR THE DISCOUNT?

If the monies are raised by the taxpayer for the purposes of his trade or for example the letting of properties on a commercial basis the discount is tax deductible. It may be subject to transfer pricing constraints.

WHY CAN THE DISCOUNT BE PAID GROSS?

The discount can be paid gross because it is not interest. There are no provisions requiring tax to be deducted at source from a discount.

WHY IS THE DISCOUNT TAX FREE IN THE HANDS OF THE RECIPIENT?

Under general principles, the discount may well have a UK source, because the payer is in the UK but the disregarded income provisions in ITA 2007 s.813(1)(a) and s.825(2)(c) restrict the UK tax payable to the amount deducted at source, and of course no tax is deducted at source.

Thus in the hands of a foreign company under general principles the discount is tax free.

Note that if the subscriber to the discount is a foreign settlement, and there are UK beneficiaries amongst the class of beneficiaries or people who can benefit, then the discount is not tax free in the hands of the trustees: see ITA 2007 s.812(2) and s.815. Thus in an appropriate case where there is an overseas settlement with an underlying company, it will be prudent for the underlying company (subject to any shadow directorship concerns: ITEPA 2003 s.173 and s.67) to subscribe for the deeply discounted security rather than the settlement.

Although the discount may be tax free under general principles in the hands of the overseas company or trust, in an appropriate case, one must nevertheless consider the anti-avoidance provisions to see whether HMRC can pick up charges under, for example, the Income Tax Settlement Code in ITTOIA 2005 s.626 or under ITA 2007 s.720.

A UK COMPANY ISSUING A DDS

There are similar provisions dealing with the case where a UK company issues a DDS (CTA 2009 s.406 et seq).

The general rule with regards to debits is that one brings in only those debits which are recognised for the purposes of determining the company's profits or losses under generally accepted accounting principles (CTA 2009 s.307(2)).

On the other hand, if there is a connection between the subscriber and the issuer of the deeply discounted security, the generally accepted accountancy practice rules do not apply and a debit "is brought into account for the accounting period in which the security is redeemed" (s.407(2)(b)).

As to whether there is a connection between the parties is determined under s.408.

Under that section there is a connection between the companies if condition A or B is met (see CTA 2009 s.408(1)).

Condition A is there is a time in the period when one of the companies has control of the other or a major interest in the other.

Condition B is there is a time in the period when both companies are under the control of the same person.

For these purposes control in relation to a company means the power of a person to secure that the affairs of the company are conducted in accordance with the person's wishes, by means of the holding of shares or the possession of voting powers in relation to company or as a result of any powers conferred by the Articles of Association or other document regulating the company (s.472(2)).

For the purpose of determining whether A has a major interest in B, CTA 2009 s.473 states that A has such a major interest if-

a) A and one other person (C) taken together, have control of B and
b) A and C each have interests, rights and powers representing at least 40% of the holdings, rights and powers as a result of which A and C are taken to have control of B.

If relief is restricted to periods of redemption one can issue a number of securities and redeem at different times (and get tax relief) and refinance if needs be (*MacNiven v Westmoreland Investments* [2001] STC 237).

Transfer pricing would have to be taken into account and there is an Unallowable Purpose anti-avoidance provisions but

this should not be applicable in the normal case (CTA 2009 s.442(5)).

Thus it may be advantageous for a UK trading company or for example a property letting company to issue a DDS to an overseas financier to raise monies rather than taking a loan and paying interest and deducting tax at source.

CHANGES IN THE PIPELINE

The Government is proposing to make changes with regards to the rules on interest. The latest paper is "Possible Changes to Income Tax Rules on Interest, Summary of Responses, October 2012".

One of the rules they propose to introduce with regards to income tax is a general anti-avoidance provision to catch "disguised interest". The point is whether HMRC may decide to treat a discount as disguised interest. There is nothing to indicate that that approach is to be adopted by HMRC, and they state that the proposed new disguised interest provisions are to be modelled on the corporation tax provisions in Chapter 2A of Part 6 of CTA 2009 and those rules do not seek to treat a discount properly so called as interest.

CONCLUSION

Deeply discounted securities properly drafted and with appropriate background correspondence showing the true nature of the transaction are attractive financial vehicles.

MEMBERS OF CHAMBERS

Milton Grundy (Head of Chambers)
Michael Flesch QC
David Goldberg QC
David Goy QC
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Patrick Way
Nikhil Mehta
Aparna Nathan
Conrad McDonnell
Michael Thomas
Marika Lemos
Hui Ling McCarthy
Michael Jones
Laurent Sykes
Imran Afzal
Michael Firth

Senior Clerk: Chris Broom

Gray's Inn Tax Chambers
3rd floor, Gray's Inn Chambers,
Gray's Inn, London WC1R 5JA

T +44 (0)20 7242 2642
F +44 (0)20 7831 9017
E clerks@taxbar.com