SOME THOUGHTS ON AVOIDANCE

Milton Grundy

We learned at mother's knee, that while tax evasion is bad, tax avoidance is OK. And now, suddenly, we find ourselves in a world where tax avoidance is no longer OK: the perceived tax avoider is reviled in the press and perused by tax authorities. Is there a clear limit to the concept of 'avoidance', beyond which there are possibilities for legitimate tax planning?

The British statutes talk about "tax avoidance" and about obtaining a "tax advantage". I think they are the same concept in different words, and the essential feature of the concept is that it is *comparative*. Take that well-known passage from Lord Wilberforce's speech about *advantage* in *IRC v Parker* 43 TC 396 at 441, HL.

> "…there must be a contrast as regards the receipts between the actual case where these accrue in a non-taxable way with a possible accruer in a taxable way, and unless this contrast exists the existence of the advantage is not established…"

I do not read this as a statement of the law of England, but rather as an explanation of the meaning of the concept. If I am right about that, then what I say here about avoidance and obtaining a tax advantage is going to be either true or not true, whatever system of law we are talking about.

I said we "suddenly" find ourselves in a new world. But actually it has been coming for a long time – in the United Kingdom, at any rate. The first straw in the wind was the decision in *Black Nominees* [1975] STC 372. This involved a well-known film star called Julie Christie (although her name is mentioned only obliquely in the report of the case). She had put herself under contract with the trustees of a newly-created trust at a small salary. She then sold her interest in the trust to – as it happens – clients of mine, for a price which represented 82% of her earnings as an actress, and this was paid to her in instalments, as and when the earnings came in. It seemed to her like a great deal, because her earnings from acting were liable to income tax at 83%, whereas there was no tax on gains from sales of interests in trusts. The Inland Revenue were of course less pleased. And I believe that what really got up their nose was that the purchasing company did not pay tax on the fees either, because they treated what they paid Miss Christie as a trading expense! Everybody was very shocked when the court decided that what appeared to be instalments of the sale price of a trust interest were really her income as an actress and taxable accordingly. The *Black Nominees* case was decided in 1975, and I do not think anyone coming across the decision for the first time today would be in the least bit shocked. If I can write the script for my imaginary newcomer to the case, he might say - taking, he would say, a realistic approach to the situation, "Of course the money Julie Christie got came from acting in movies. Wherever else? And money film stars get from acting in movies is taxable income. I wonder why she bothered to appeal?"

The courts in the United Kingdom have had many opportunities of considering questions of this kind since the days of *Black Nominees*. A list of the leading cases is in Appendix I, and the upshot – and forgive me if I take here a very broad brush – is that this kind of 'realistic' approach has become part of our law, to the point that when the draftsman of Finance Act 2013 wanted a definition of arrangements which could be classed as "abusive" under the General Anti-abuse Rule, he would refer to those which sought to confer a *tax advantage*, and the concept was already a familiar one from the decided cases: if I engage in a transaction for the purpose of obtaining a tax advantage, the law will deny me the advantage. The concept is not unique to the United Kingdom: it was expressly embodied in many of our colonial statutes; I have had American lawyers explain to me the decision in *Aikens Industries* [1971] 56 TC 925, and it seems the Americans have had a similar doctrine for years; it is not essentially different from the concept of *abus de droit* in civil law countries; and it informs much of the thinking behind the OECD initiatives.

How does this affect the advice we can give our clients? I think we can take the expression "tax advantage" as the frontier between what we can advise and what we cannot. On this side of the frontier is legitimate tax planning. On the other side is the scheme which is not going to work, and which – in the United Kingdom – can penalise me for helping the client to do it. I should say straight away that not every series of events which results in the Treasury collecting less tax means that somebody has been engaging in tax avoidance. It is a mistake a lot of people make – journalists especially. Take the case – much in the news a few years ago – of Sir Philip Green. He gave his wife some shares in a UK company, so that after the gift she enjoyed the dividends declared by the company – which sounds altogether harmless, until you know that while Sir Philip resided in England, his wife lived in Monte-Carlo, with the result that the effect of the gift was that no UK tax was paid on the dividends. The Press were up in arms. 'Wicked tax avoider;' they cried. There were other aspects of Sir Philip's behaviour which were criticised, but they are not to my purpose here. The question I want to ask is, 'Did he avoid any tax?'

As I say, *Avoidance* and *Advantage* are comparative concepts. An "advantage" cannot exist on its own: there has to be something less advantageous you can compare it with. So also with "avoidance". Consider the sentence, "You can take the autoroute* to Nice airport and avoid the traffic in the Promenade des Anglais." That tells us that there *is* another route, which goes along the Promenade des Anglais. It may be the shorter route. And were it not for the heavy traffic at the height of the season, you might well take it. But you can go a longer way round and so avoid the traffic. To put it in general terms: if there is a Route A which avoids, there has to be a Route B (which may be the shorter route) to the same destination but does not avoid. If you took the wrong turning on the autoroute and went instead to Ventimiglia, you would not say, "I found a way to get to Ventimiglia, avoiding the Promenade des Anglais", because there is no route from here to Ventimiglia which includes the Promenade des Anglais. The same is true of avoiding tax. If I engage in a transaction by which I avoid tax, that is my Route A, and it posits the existence of a Route B, which may be the obvious way to go but would involve a higher tax liability. Let us go back to the case of Sir Philip Green. He gave shares to his wife and paid no tax on the dividends. That was his Route A. If the transaction were to constitute tax avoidance, there would have to be a Route B, which would lead him to the same destination, but involve a tax liability. It seems to me that Sir Philip had no Route B. There is no way under our law for a man to make an outright gift of shares to his wife and remain liable for tax on future dividends. You might say that Sir Philip's gift to his wife was not like going to Nice airport, where you have the choice of going along the Promenade des Anglais or not. It was more like going to Ventimiglia, where there is no Promenade des Anglais to avoid. And I am comforted in the correctness of my view, by the fact that Her Majesty's Revenue and Customs evidently are of the same opinion, for no proceedings appear to have been taken against Sir Philip in respect of this transaction.

I should now like to look at a few transactions which have benign tax consequences, and try to see whether they are Nice Airport transactions, avoiding the Promenade des Anglais, or Ventimiglia transactions, with no Promenade des Anglais to avoid. Let me start with the dilemma faced by a UK resident individual who has an asset which has appreciated in value and plans to go and live in the United States. He does not want to sell the asset before he leaves, because that way he will pay UK tax on the gain, which does not seem fair, because he will be contributing to the cost of UK government services he is not going to be in the United Kingdom to enjoy. But if on the other hand he sells the asset when he is a resident of the United States, he will have to pay US tax on the gain, which does not seem very right to him either, since the gain will have accrued before he becomes resident in the United States. What he does is this. While he is still UK resident, he transfers the asset to a partnership in which he and his wife are partners. That occasions no charge to tax. Once he has become US-resident, the partnership sells the asset. That gives rise to no gain, because the Americans treat the base cost to the partnership as the market value of the asset when the partnership acquires it from the partner. Does he avoid tax? Of course, neither the US Treasury nor the UK Treasury collect any tax, but that, as I have said, is not the answer to the question: we have to look at what he has done and whether he could have done it in a way which would have cost him more tax. What he did in the United Kingdom was to transfer his asset to a partnership and then become non-resident. This was his Route A, and there was no tax cost. But there was no Route B: there was no way he could have incurred a tax charge by giving his wife a share in the asset. So – no avoidance. Similarly, from a US perspective, there is no way the partnership could have disposed of the asset and triggered a tax liability. This example may, I think, serve as a model of the kind of planning that is still open to us.

Let me turn now to a case which has an offshore element. As I have said, this always tends to make people assume that some kind of avoidance is going on. But let us see. I have of course changed the names to protect the innocent, but otherwise the facts are these. Mr X is a UK resident and has three cousins resident in other places. His cousins are planning to create a fund for the benefit of the family as a whole. A Cayman bank owns all the units in an offshore accumulating discretionary unit trust. The proposal is that the four cousins buy all the units from the bank, keeping some units for themselves and giving others to younger members of the family. Non-UK readers should know that if Mr X transfers assets to an offshore entity and has what the statute calls "power to enjoy" the income of those assets, the statutory provisions have the effect of attributing the income of the offshore entity to him. But in this case he transfers nothing to the unit trust. He purchases the units from the bank and pays the price to the bank. This does not bring him within the statutory wording: these require the taxpayer to have "power to enjoy" the income from the assets he transfers or assets derived from them, and Mr X does not in any sense have power to enjoy any income arising from the assets transferred. What he has power to enjoy is the income of the assets which the trustee of the unit trust owned before he came on the scene. In the past, my view would have been that Mr X does not come within these provisions at all. But now? Now I think we have to ask ourselves whether Mr X could have achieved his objective in a more tax-prone way. By purchasing the units, he gets to share in a fund which can accumulate income tax-free and to which family members can call upon for help if needed, but the units have no value to a creditor or a disaffected spouse or indeed anyone outside the family. The transaction may have the "feel" of avoidance, but what tax exactly does Mr X avoid, and how could he have achieved he same ends and incur a tax liability? I think Mr X can truly say that he has no Route B.

The question we need to ask ourselves each time is, "Is there a Route B with a tax charge along the way?" Sometimes there is no Route B because the tax authorities, by legislation or practice, do not provide one. Suppose I, as a UK resident, buy an offshore "bond", which is essentially a wrapper for a portfolio of investments, plus a tiny amount of life assurance. I draw down 5% of the premium each year, and pay no tax until the policy matures, in 20 years' time. Even assuming we have income tax in 20 years' time, it is still quite a *coup* to postpone payment of tax for, on average, 10 years! But there is no Route B, with a tax charge, because the legislation expressly provides that there should not be. Sometimes there is no Route B, because the tax has never been enacted. There is, for example, no tax on unrealised capital gains. So I do not have to look for a Route B if I buy leases at peppercorn rents, or shares that declare no dividend, and wait for them to increase in value. The legislation does not require me to pay tax while I wait. This is a proposition which people find easy to accept when the assets in question are blocks of flats in Mayfair, but more difficult to accept where the investments purchased are units in a unit trust in the Cayman Islands. But the location of the assets is immaterial: I cannot obtain a tax advantage by buying assets which yield no income, wherever they are located. Of course, I may run up against anti-avoidance provisions which attribute to me income which is not really mine; but in that case I pay tax because the legislation says so, not because of any general anti-avoidance rule. Just as there is no Route B for the investor in non-income-producing assets, so there is similarly no Route B for the non-UK domiciled individual who goes to live in the United Kingdom or for the non-Italian who goes to live in Italy, or for the non-UK resident who stays in the United Kingdom for no more than 89 days each year.

There are some transactions which strike one as a bit too good to be true, which suggests that they may be struck down as avoidance. I recall the case of the US citizen living in

London, who wanted to make charitable donations. He was of course liable for both UK and US tax. If he gave to a UK charity he got no US tax relief, and if he gave to an American charity, he would – as the law stood then – get no UK tax relief. His solution was to establish a US charity with a UK charitable company as a subsidiary and give to the UK company. That satisfied the requirements for tax relief in both countries. And if we are going to apply the "Is there a Route B with a tax charge?" test, we can start by applying it to the UK tax result. And the answer is that he made a gift to a UK charity, and obtained UK tax relief for doing so, and there just is not a way he could have made that gift and not obtained a UK tax benefit by doing so. I understand that the US charity would make an election under s.7701 of the Internal Revenue Code, with similar consequences in the United States. I believe that the transaction was in fact blessed by HMRC and the IRS, which is a comforting piece of information.

It is sometimes said that conduct is avoidance if it reduces your liability to tax in a way that conflicts with the policy objectives of the relevant legislation, and that is why giving up smoking is not tax avoidance. Well, you can argue about the policy objectives of tobacco duty. How much is it about reducing smoking and how much about raising revenue? But – to pursue my analysis – the reason giving up smoking is not avoidance is because there is no Route B: there is only one route to becoming a non-smoker, and that involves saving on tobacco duty; there is not another route whereby you can become a non-smoker and still pay tobacco duty!

But there are cases where policy objectives seem more relevant. The United Kingdom, like many other countries, taxes lifetime gifts. But it offers an exception for taxpayers who make gifts and survive seven years. A typical problem here is the father who would like to give assets to his son, but fears they will be dissipated in Ferraris and blondes before the son reaches an age of discretion. Up to a decade or so ago, father would often solve this problem by settling the assets for the benefit of the son, but the tax costs of the settlement route now makes this unattractive. Life insurance offers a solution: father's gift is an insurance policy which gives the policyholder limited access to funds for an initial period. This seems an ingenious solution to the problem created by the effective demise of the family settlement, but actually, it is plain vanilla inheritance tax planning, and there is no Route B, where the parties could achieve the same result and incur a tax charge. The discounted gift policy is a variant of this. Father takes out a policy which confers on the policy holder two rights – the right to a sum on maturity and the right to draw down 5% of the premium each year for 20 years or until he dies. He gives the first right to his son, and he retains the second. The gift is taxable, if father fails to survive seven years, but the value of the gift may be much lower than what the donee ultimately receives. Here again, there does not appear to be any more taxable way of achieving the same result.

If I am going to be guilty of avoidance, do I have to do something myself, or is it sufficient that trustees of a settlement of which I am a beneficiary, or directors of a company in which I am a shareholder, take some steps to shield me from a tax liability? We generally think of an avoidance transaction as one in which the taxpayer participates – he borrows some money, say, or joins a partnership, and then receives a benefit which he hopes will not be taxable. But that is not necessarily the pattern. Let me take an example. Readers from outside the United Kingdom should know that we have a provision which attributes the capital gains of non-resident companies to resident shareholders, or to resident beneficiaries of settlements whose trustees are shareholders. This cannot be circumvented by the company having a subsidiary, because the capital gains of the subsidiary are attributed to the parent, and thence to the trust and thence to the beneficiary. But suppose the offshore company substitutes for its subsidiary a Thin Trust.

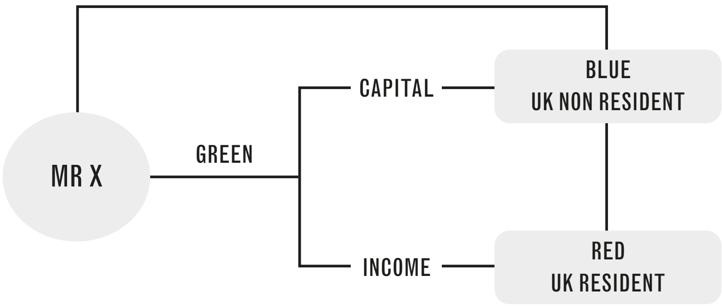
"Thin Trust" is my shorthand for a trust which has effectively only one beneficiary but is not a nomineeship. In this structure, the gain is made by the Thin Trust, of which the offshore company is the beneficiary, and while there is machinery for attributing gains of companies to trusts, there is no machinery for attributing the gains of trusts to companies. So, since the gains of this Thin Trust cannot be attributed to the offshore company, there is nothing to attribute to the offshore trust, and in turn nothing to attribute to the resident beneficiary. Is the concept of avoidance broad enough to cut through the Thin Trust and visit the capital gains tax liability upon the beneficiary? The offshore company, it may be said, took the route of establishing the Thin Trust, to make the investment which yielded the gain (Route A), when it had the perfectly good alternative of making the investment itself (Route B), and did so in order to obtain a tax advantage for the resident beneficiary.

Is that avoidance? That is a difficult question, and I have not been able to find anything in the UK cases which throws any light on it. If I had to form a view, I should say that it depends on the part the Beneficiary played in the transaction: if the trustees acted at his behest, I should say he avoided, and if not, not. I am strengthened in this view by the wording of our General Anti-Abuse Rule. The Rule talks about the taxpayer who *obtains* a tax advantage. That indicates some *act* on the part of the taxpayer. You cannot *obtain* anything unless you do something to get it. So, if I am the beneficiary of an offshore trust, and the trustees – quite without my knowledge – do something which gives me a tax advantage, I do not think I "obtain" that advantage.

Let me consider the rather complicated structure I have in the past called the "Double British". This is a structure designed to take advantage of the tax treaties to which the

United Kingdom is a party, in order to reduce the withholding tax levied by other countries on dividends arising in those countries. Most countries levy withholding tax on outgoing dividends, but tax treaties generally provide that tax is either not charged or is charged at a reduced rate on payments to a UK company. A UK company, however, pays no tax on incoming dividends and charges no tax on outgoing dividends. It follows that the investor living in – say – Monaco can receive dividends from a UK investment company which represent non-UK dividends taxed only at the tax treaty rate. The fly in the ointment is that UK companies pay tax in their capital gains. So what the "Double British" structure does is use two UK companies – one beneficially entitled to the dividends and the other holding the capital as co-trustee of a trust of which the non-resident is the settlor.

The structure looks like this.



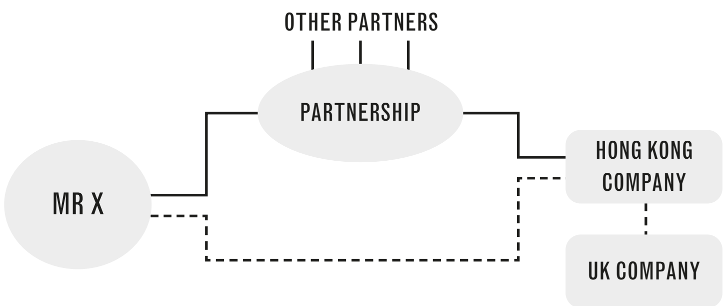
The circle on the left of the diagram is our Mr X – this time an individual resident in Monaco. He owns an offshore company, represented here by the rectangle marked BLUE, which in turn owns a UK resident company – the rectangle marked RED. Mr X has made a "Thin Trust" – which I show marked GREEN, settling the sum to be invested on the Blue

Company and the Red Company as trustees, on trust to pay the income to the Red Company for its own benefit and subject thereto for the Blue Company. The two companies agree that trust investments will be made by the Red Company as joint trustee. Dividends flowing from UK companies and companies in treaty countries are beneficially owned by the Red Company and not subject to tax in the United Kingdom. But the Red Company is a "resident of the United Kingdom" for treaty purpose and is entitled to receive dividends from treaty countries with no withholding tax or a lower rate of withholding tax, as prescribed by the relevant treaties. The Red Company makes an onward declaration of dividend to the Blue Company – there being no tax liability on the way. When a capital gain is realised, this accrues to the Red Company as joint trustee, which can, it seems to me, if necessary take advantage of the capital gains article in the relevant treaty. The Red Company is acting in two capacities. It receives as beneficial owner the dividends arising from the trust investments, and enjoys the UK's benign corporation tax regime for companies receiving and paying dividends. It receives the capital gains from the sale of trust investments as trustee of a settlement made by a non-resident settlor and enjoys the UK's equally benign capital gains tax regime for gains arising from the sale of the trust investments. And the Red Company has treaty protection in both capacities. It declares dividends (representing the trust income) to the Blue Company, which declares dividends (representing the capital gains and the dividends from the Red Company) in favour of Mr X.

Is this structure vulnerable to attack as "avoidance"? Suppose the Red Company is entitled to a dividend from a US corporation. Can the IRS argue that the Red Company is not entitled to the lower rate of withholding tax provided by the UK/US Tax Treaty, because the individual in Monaco always had a possible Route B: he could perfectly well have made the investment in the US corporation in his own name, and only used the UK company to obtain a treaty advantage? The argument is tempting, but I think wrong. This alternative is not a route to the same destination – there is all the difference in the world between running a business oneself – even an investment business, and being a shareholder in a company running a business. Once again it seems to me that each of the parties is paying the tax it should, and one cannot actually point to an avoider.

I am thinking of this structure primarily in terms of portfolio investment. But it is applicable to direct investment, and one additional advantage the use of the UK company provides is the benefit of the Investment Protection Treaties to which the United Kingdom is party. They are not very well known to tax specialists, but they can be very valuable where investment is made in a politically unstable place, and can offer a very good non-tax reason for taking a Route A as opposed to a Route B.

In the next example, the taxpayer is planning to start a new business which he expects to sell after a few years at a substantial gain. He can see a way for the business to have a high base cost, so that he would have no capital gains tax to pay when he sold out. He has had a long history of doing business with a company in Hong Kong, and they were both partners in a partnership which carried on a separate business in Hong Kong.



Mr X is a UK resident. He is in partnership with (among others) the Hong Kong Company. The Hong Kong Company forms a UK company and makes a contract with Mr X, shown as a dotted line, under which Mr X can buy the UK company in ten years' time, subject to some condition – perhaps that Mr X has not in the meanwhile resigned from the partnership. The price Mr X agrees to pay will of course allow the Hong Kong Company to make a profit, but – all being well – the price will be a mere fraction of the value of the company at that time. Nevertheless, the acquisition cost of the shares to Mr X, for capital gains tax purposes, will be their market value at that time, which means that the growth in value of the shares over the ten year period will effectively escape tax. The key to this effect is that Mr X and the Hong Kong Company are "connected persons", and they are connected because they are in partnership together – even though the partnership business has nothing to do with the share purchase. In Appendix II is a note of the relevant UK statutory provisions. But I believe many jurisdictions treat transactions between connected persons as taking place on arm's length terms, whatever may be the actual terms agreed between the parties. In most cases, the effect of this is to increase the amount of tax payable. But here it has the opposite effect: Mr X has a base cost for his shares in the UK company equal to market value, even though he has acquired them for a trifling sum.

Does this still work? A few years ago, I would have given it a clean bill of health – from a UK point of view – without a second thought. Now, one needs to look at it more carefully. Could not Mr X simply take the route along the Promenade des Anglais, instead of going via the motorway? Is there any point in involving the Hong Kong Company at all? I think this last question gives us the clue to the answer. If there is some commercial reason for involving the Hong Kong Company – if the Hong Kong

Company provides finance or marketing or has some other non-tax function, then I think the structure still works.

Lastly, I should like to apply the *avoidance* test to a transaction I mentioned briefly in chapter 4 of my *More Essays* (Key Haven Publications PLC 2007). It related to UK capital gains tax arising from the sale of a Canadian oil field, but I have come to realise that it had much wider application, notably in relation to the sale or flotation of a company which the owner has built up from nothing, but I have given it the name "Vancouver Manoeuvre" in memory of its beginnings, I discuss the Manoeuvre here in terms of its UK outcome, but in other countries with legislation similar to s.18 of our Taxation of Chargeable Gains Act 1992, it may be similarly effective.

The entrepreneur in this case – Mr E – owns all the shares in a company ("UK Co"). Their cost is £C, and the gain he foresees is £G. He plans to flote the company on the Vancouver Stock Exchange, and he forms a Canadian Company ("CanCo") to manage the flote. He borrows £C + 2G from a bank and subscribes for all the shares in CanCo. When the flote is ready to go ahead, he sells his shares in UK Co to CanCo for £C + 2G. The UK Co shares fetch only £C + G, and before the tax year is over, or, if earlier, if the share price shows signs of rising above £C + G, he liquidates CanCo and the proceeds of sale together with any remaining UK Co shares are distributed to him. He has made a gain of £G on his UK Co shares, but a loss of the same amount in his CanCo shares. Mr E has certainly made a tax saving, compared with the tax cost of a simple sale, but if he can show that the Canadian company had a commercial purpose – in facilitating the flotation – he should be in the clear.

**This essay is adapted from a talk given at an Itpa meeting in Monte-Carlo.*

Appendix I

UK Decisions 1975 - 1997

Black Nominees v Nicols [1975] STC 372

Floor v. Davies [1978] STC 436

IRC v. Plummer [1979] STC 793

IRC v. Burmah Oil [1982] STC 30

Furniss v. Dawson [1984] STC 153

IRC v. Challenge Corporation [1987] AC 155

Craven v. White [1988] STC 476

Ensign Tankers v. Stokes [1992] STC 226

IRC v. McGuckian [1997] STC 908

Appendix II

His acquisition occurs when contract becomes unconditional.

Taxation of Chargeable Gains Act 1992 ("TCGA") s.28(2).

> If the contract is conditional (and in particular if it is conditional on the exercise of an option) the time at which the disposal and acquisition is made is the time when the condition is satisfied.

Mr X "connected" with Hong Kong Co.

TCGA s.286(4).

> Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership…

Mr X's acquisition cost of shares is market value.

TCGA s.17(1).

> Subject to the provisions of this Act, a person's acquisition or disposal of an asset shall for the purposes of this Act be deemed to be for a consideration equal to the market value of the asset –
>
> (a) where he acquires or, as the case may be, disposes of the asset otherwise than by way of a bargain made at arm's length…

TCGA s.18(1) and (2)

> (1) This section shall apply where a person acquires an asset and the person making the disposal is connected with him.
>
> (2) Without prejudice to the generality of section 17(1) the person

> acquiring the asset and the person making the disposal shall be treated as parties to a transaction otherwise than by way of a bargain made at arm's length.

Something of a newcomer to the scene is what has been called the *Family Bond*. This is a unit-linked offshore bond, which is like any other unit-linked offshore bond, except that the unit to which it is linked is a unit in a discretionary unit trust. No attempt is made in practice to tax the holder of a unit-linked bond on the income or gains of the unit trust fund, under s. 720 of the Income Tax Act or otherwise, and there seems no reason why the Family Bond holder should be treated differently from other offshore bond holders. In this respect the Family Bond holder enjoys no "tax advantage" over the holder of any other offshore bond. But an important difference lies in the value of the bond: the investment value of the Family Bond - unlike that of regular unit-linked bonds - is not related to the value of the underlying investments of the units to which it is linked, but reflects only the value of the discretionary unit held by the bond issuer, and that unit (like any interest in any other discretionary trust) has no ascertainable value. This opens the door to tax planning, both for capital gains tax and inheritance tax. The issue of the Family Bond, however, is a commercial transaction and confers no benefit on any third party, and subsequent "transfers" or "disposals" generate no tax liability. And there do not appear to be any alternative hypothetical transactions in comparison with which they could be "avoidance".

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