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RUDGE REVENUE REVIEW

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‘THE PHILOSOPHER’S STONE, OR THE EMPEROR’S NEW CLOTHES’

AN OLD CONUNDRUM

The proposal that the United Kingdom should enact a general anti-avoidance rule (a “GAAR”) has recurred regularly during our careers in taxation.[1] Such proposals have always foundered on the competing preoccupations of the Revenue authorities and of business. The Revenue authorities, of course, find a GAAR tempting because it would be a significant new weapon in maximising tax revenues, not simply because it would enable them to frustrate highly artificial tax avoidance but because, what everybody has always considered would be the uncertainty of its application, would confer on them a de facto power of discretionary taxation. It is that very uncertainty, however, which accounts for the opposition of business and the professions which have always been successful in convincing ministers that the economic damage resulting from the uncertainty which a GAAR would introduce into our tax system would outweigh any direct increase in Government tax revenues resulting from the GAAR. Until now, it has been accepted that the only way of decreasing that uncertainty is to introduce a comprehensive pre-transaction clearance system which would be extremely expensive and time consuming for the Revenue authorities.[2] However tempting the Revenue authorities have found the prospect of a GAAR, they have not been willing to pay the price of operating a comprehensive clearance system.

Defining the dividing line

The uncertainty, of course, arises from the difficulty of defining with sufficient precision the difference between the sort of tax planning which the Government finds unacceptable and wishes to nullify with a GAAR and the sort which it is willing to tolerate. Defining the difference is particularly difficult because Government regularly provides incentives by giving tax reliefs for particular forms of behaviour. Such behaviours are inevitably ones which taxpayers would not undertake if the relief were not given or there would be no need for Governments to provide the incentive. Any attempt, therefore, to define the dividing line by reference to a fiscal purpose risks the GAAR applying to the very categories of transactions which the Government wishes to promote.[3]

[1] Before the present review the most recent proposal was made in a consultation document issued on 5th October 1998 entitled “A General Anti-Avoidance Rule for Direct Taxes: A Consultative Document.”

[2] Even then, such a system raises considerable problems in respect of the timing of transactions, the reliability of the clearances and the costs imposed on taxpayers and confers a de facto discretionary power on the Revenue authorities

[3] See para 5.14. All references, unless otherwise stated, are to Mr Aaronson’s Report of the 11th November 2011 entitled “GAAR Study: A Study to consider whether a General Anti-Avoidance Rule should be introduced into the UK Tax System”

HAS THE GORDIAN KNOT BEEN CUT?

The Revenue authorities, however, have not given up hope of having their cake and eating it; having a GAAR without a clearance system. The Government, therefore, turned to the intellectual brilliance of the Revenue Bar to solve their conundrum and, in particular, to Graham Aaronson QC.

Mr Aaronson was asked in December 2010 "to lead a study programme to establish whether a GAAR could be framed so as to be effective in the UK tax system and, if so, how the provisions of the GAAR might be framed." Mr Aaronson's terms of reference were to consider:-

> "… whether such a GAAR could –
>
> (i) provide the Government with an effective means of deterring and countering tax avoidance;
>
> (ii) ensure that the rules work fairly;
>
> (iii) ensure that the rules would not erode the UK tax regime's attractiveness to business;
>
> (iv) ensure that sufficient certainty about the tax treatment of transactions could be provided without undue compliance costs for businesses and individuals;
>
> (v) keep any increase in resources for HMRC to an acceptable level and ensure that there would be a minimal need for resources to be diverted from other priorities."[4]

To advise him, Mr Aaronson formed a small committee of individuals distinguished in the field of taxation[5] and he held private discussions with a small number of representative bodies.[6]

After a year's work Mr Aaronson's Report has concluded that what he calls "a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system."[7] Instead he strongly recommends what he calls a "specifically targeted anti-abuse rule" because it would confer benefits which "are substantial and valuable."[8] He concludes that "it should be possible to draft

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[4] Para 2.2

[5] Although unfortunately it was unbalanced by the fact that one of its members was an outspoken advocate of a GAAR and it contained nobody who was currently practising in providing taxation advice directly to taxpayers

[6] Although the list of bodies consulted included some which one would have expected to be consulted, such as the Chartered Institute of Taxation and the Revenue Bar Association, the list was somewhat eccentric. Mr Aaronson held discussions, for example, with the Tax Committee of the Trade Union Congress but not with the Society of Trust and Estate Practitioners. See page 2

[7] Para 1.5

[8] Para 1.8

such a rule so that it would operate effectively and fairly”[9] and appends to his Report:-

> “… an illustrative draft of a general anti-abuse rule and an accompanying Guidance Note (Appendix II) which must be read with it. These incorporate principles which should enable abusive schemes to be specifically targeted and appropriately counteracted. The draft GAAR includes a series of important safeguards to ensure that the centre ground of responsible tax planning is effectively protected….”

So, although he mainly refers to his draft rule as an anti-abuse rule, he expressly accepts that it is a draft GAAR although clearly Mr Aaronson does not regard it as a “broad spectrum” GAAR. Although he does not say so expressly, he is to be presumed to put it forward as satisfying the detailed terms of reference under which his study programme operated.

He asserts, without recording any evidence on which his conclusion is based or, indeed, even the process of reasoning by which it was reached, that:-

> “… An anti-abuse rule which is targeted at contrived and artificial schemes will not apply to the centre ground of responsible tax planning. Consequently there will be no need for a comprehensive system of clearances, with the resource burdens which such a system would require.”[10]

So, if Mr Aaronson’s recommendations are implemented, it would appear that HMRC will finally be granted a GAAR without a clearance system. Will the body of individual and business taxpayers be subject to a GAAR which ensures “that sufficient certainty about the tax treatment of transactions could be provided without undue compliance costs for businesses and individuals”[11] and “that the rules will not erode the UK tax regime’s attractiveness to business”?[12]

A FINAL TEST?

Certainly, one would say that if one of the leading QCs currently practising at the Revenue Bar advised by a committee including a former Lord of Appeal, a Judge of the Chancery Division, a Judge of the First-tier Tribunal, two distinguished academic specialists in tax from our leading Universities and another distinguished expert in taxation cannot, after a year’s work, draft a GAAR which provides reasonable certainty of application, then it cannot practically be done. As Mr Aaronson accepts that the purpose of his draft legislation is “to demonstrate that it is possible to incorporate in the form of legislation the principles which [he considers] must govern a general anti-abuse rule if it is to be beneficial for the UK”[13] it is surely not unreasonable to

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[9] Para 1.11
[10] Para 1.7(vi)
[11] Para 2.2(iv)
[12] Para 2.2(iii)
[13] Para 1.12

suggest that the converse must also be true; that is, that if the draft legislation, on examination, does not meet the criteria set out in his terms of reference it is not possible, in practice, to draft such legislation.

So in this article, we examine the draft legislation and test it against two sets of transactions[14] which would not, we think, normally be classified as contrived and artificial schemes of tax avoidance and which, if the draft legislation fulfils its purpose, should surely not fall within the ambit of its provisions. In Example I, Mr Domus' transactions take place in the present. To help us test the concept of reasonableness, Mr Aedificator's transactions in Example II take place some years ago and relate to provisions which were later repealed by the Labour Government on the ground that they were being exploited for tax avoidance purposes.

One of the disappointments of Mr Aaronson's Report is that, although it refers in a tone of high moral indignation, to "abusive arrangements,"[15] "to contrived and artificial schemes which are widely regarded as an intolerable attack on the integrity of the UK's tax regime"[16] and to "egregious tax avoidance schemes"[17] he nowhere attempts to define what they are and, therefore, what is the target of his legislation. He provides only one example of such schemes; the scheme considered in the case of *Mayes v HMRC*[18] which concerned transactions which took place in the fiscal year 2003/2004 when the DOTAS provisions were very much more restricted than they are today. So even though the two examples seem to us to fall clearly within what Mr Aaronson calls "sensible and responsible tax planning … [which is] … an entirely appropriate response to the complexities of a tax system such as the UK's"[19] it may be that the response of Mr Aaronson and some of our readers will simply be that the sort of tax planning to which a GAAR should apply includes the planning in the examples. If that were so, it would be clear that the scope of the GAAR would be very much more far-ranging than one would imagine from the tone of Mr Aaronson's Report and it would amply demonstrate the difficulty of predicting what any individual will consider to be reasonable tax planning.

THE SCOPE OF THE PROVISIONS

The new rules are to apply initially only for the purposes of Income Tax, Corporation Tax, Capital Gains Tax and Petroleum Revenue Tax.[20] Mr Aaronson also says, however, that it should also cover National Insurance Contributions which, he says, "require[s] separate legislation."[21]

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14 See the boxed examples at the end of this article
15 Para 1.7
16 Para 1.7(i)
17 Para 3.20
18 *Mayes v Revenue and Customs Commissioners* [2011] EWCA Civ 407
19 Para 1.5
20 Appendix I. Section 1(1)
21 Para 1.9

His terms of reference, however, only extend to tax.[22] In para 5.44 he says that National Insurance Contributions “are not regarded as a tax”.[23] Either National Insurance Contributions are or are not a tax. If they are not, in suggesting that the GAAR should also apply to them Mr Aaronson seems to have exceeded his terms of reference.

THE CHARGE TO TAX

Section 8

Section 8 of the draft legislation provides that an abnormal arrangement which is contrived to achieve an abusive tax result is to be counteracted as set out in that section.[24]

ABNORMAL ARRANGEMENTS

Abnormal arrangements are defined in sections 6 and 7. Section 6 provides:-

> “(1) For the purposes of this Part an “abnormal arrangement” is an arrangement which, considered objectively –
>
> (a) viewed as a whole, and having regard to all the circumstances, has no significant purpose apart from achieving an abusive tax result (so that in the context of such an arrangement all of its features shall be regarded as abnormal); or
>
> (b) has features which would not be in the arrangement if it did not also have as its sole purpose, or as one of its main purposes, achieving an abusive tax result.
>
> ……..
>
> (3) For the purposes of this Part “abnormal features” are the features referred to in sub-section (1)(b) read together with section 7.”

Section 7(3) sets out various features “which in the context of the particular arrangement may be regarded as abnormal features, and which accordingly may be taken into account in determining whether that arrangement [was] an abnormal arrangement.”[25] Other features, however, may be taken into account in determining whether an arrangement is an abnormal arrangement[26] and the fact that the arrangement “has one or more of the features set out … shall not necessarily lead to the conclusion that the

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22 Paras 2.1 and 2.2

23 Although he qualifies this by adding “for the purposes of Parliamentary procedure”

24 There seems to be a contradiction between section 8 and the summary of it which is given in section 2. Section 2 says that section 8 will counteract abnormal arrangements which would otherwise “achieve an abusive tax result from the application to the arrangements of the provisions of the Acts <u>and</u> [emphasis added] which are contrived to achieve such a result. Section 8(1) merely says that they must be contrived to achieve an abusive tax result and not that they would actually be successful were it not for the GAAR

25 Appendix I. Section 7(1)

26 Appendix I. Section 7(2)

arrangement is an abnormal arrangement."[27] So, neither the fact that a set of arrangements has one or more of these features nor the fact that it does not is determinative as to whether it is abnormal or not. Presumably the Courts will give particular weight to these features but what weight is to be given and how they will weigh one listed feature against another is unclear.

Are Mr Domus' arrangements abnormal? It is quite clear on the facts that Mr Domus takes up residence in the flat in order to gain Main Residence Relief. This is the sole or, at least, the main purpose of his residence. If that is an abusive tax result (see below) then the arrangements under which he takes up residence in the flat before selling it are abnormal arrangements because it is a feature "which would not be in the arrangement if it did not … have … as one of its main purposes, achieving an abusive tax result".

Similarly, Mr Aedificator incorporates his trade in order to reduce the direct tax and National Insurance Contributions charged directly and indirectly on his trading profits. Again if that is an abusive tax result then it is clear that his arrangements are abnormal arrangements.

ABUSIVE TAX RESULT – SECTION 3

An abusive tax result is an advantageous tax result which will be achieved by an arrangement that is neither reasonable tax planning nor an arrangement without tax intent.

We might note at this point that the legislation uses a phrase which in ordinary English usage would only apply to extreme or morally dubious transactions but defines that phrase in such a way that it applies to transactions to which it would not be applied in ordinary usage.

An advantageous tax result

An advantageous tax result is defined in section 15(2) as a result which:-

"(a) achieves a significant reduction in receipts or a significant increase in deductions taken into account for the purpose of computing or charging any of the taxes;

(b) achieves a significant deferral of the time when receipts are so taken into account, or a significant acceleration of the time when deductions are so taken into account; or

(c) achieves a significant reduction in the rate of tax chargeable."

In respect of Mr Domus it is not clear whether the arrangement under which he sells the flat after having taken up residence in it for a short period of time is an advantageous tax result. It doesn't seem to fall within (b) or (c) of section 15(2). It is not clear that it falls within section 15(2)(a). Relief under

[27] Appendix I. Section 7(2)

TCGA 1992 s.223 operates by providing that a gain which would otherwise be chargeable to Capital Gains Tax is not so chargeable either in whole or in part. That does not seem to be aptly described as a significant reduction in receipts or an increase in deductions. There is no deduction involved in the relief. The gain is not reduced, it is merely wholly or partly not chargeable. Nonetheless such a construction would clearly represent a major loophole in the provisions, not simply in respect of Mr Domus' transaction, but also in respect of a wide range of other transactions. A Court allowing itself a wide latitude in applying a purposive construction might well find that a provision which exempts the whole or a part of a gain from chargeability involves an increase in deductions taken into account for the purpose of computing or charging any taxes.

Mr Aedificator's incorporation of his trade, is clearly contrived to achieve an advantageous tax result because it results, and is intended to result, in a significant reduction in the overall rate of tax chargeable. The fact that the profits which would otherwise be charged to Income Tax are charged partly to Corporation Tax and partly to Income Tax does not affect the matter. Section 15(2)(c) doesn't require the tax to be the same, merely the rate to have been reduced.

So it appears that Mr Aedificator certainly and Mr Domus, possibly, have undertaken arrangements which were contrived to achieve an advantageous tax result. Before considering whether they are prevented by sections 4 and 5 from being treated as achieving an abusive tax result we must complete our examination of section 3 by looking at sub-section (2) ibid.

Section 3(2)

Section 3(2) provides that:-

> "For the purposes of this Part an abnormal arrangement is contrived to achieve an abusive tax result if, and only if, the inclusion of any abnormal feature (see sections 6 and 7) can reasonably be considered to have as its sole purpose, or as one of its main purposes, the achievement of an abusive tax result by –
>
> (a) avoiding the application of particular provisions of the Acts, or
>
> (b) exploiting the application of particular provisions of the Acts, or
>
> (c) exploiting inconsistencies in the application of provisions of the Acts, or
>
> (d) exploiting perceived shortcomings in the provisions of the Acts."

It is not at all clear what function the word "exploiting" has in these provisions. The word 'exploit' in some contexts undoubtedly has the pejorative sense of taking an improper advantage. In others it has the purely neutral meaning of

"to make use of" without any sense of impropriety. It is not clear whether it is possible to achieve an abusive tax result by the application of particular provisions of the Acts and yet not to satisfy the conditions of sub-section (2) because in doing so one is not exploiting their application. What is clear is that there is a further significant uncertainty in the legislation here.

Mr Domus certainly exploits the provisions of TCGA 1992 s.222(5) in the sense of making use of them and in doing so avoids the full application of TCGA 1992 s.1. If 'exploit', however, includes the sense of improperly taking advantage of the legislation it would require another difficult act of judgement, akin to the test required by section 4, to determine if Mr. Domus' transactions are contrived to achieve an abusive tax result. Nothing in Mr Aaronson's Report, including his draft guidance, suggests that section 3(2) is to be construed in this way.[28]

NO TAX INTENT - SECTION 5

Are either of the advantageous tax results arising from the arrangements in our examples prevented from being treated as achieving an abusive tax result because they are without tax intent within section 5? Clearly they are not. Mr Domus' assumption of residence in the flat and Mr Aedificator's incorporation of his trade were both undertaken solely with the intention of reducing their tax liabilities.

REASONABLE TAX PLANNING - SECTION 4

Are they arrangements which are "reasonable tax planning within section 4"?

Section 4 provides:-

"(1) An arrangement does not achieve an abusive tax result if it can reasonably be regarded as a reasonable exercise of choices of conduct afforded by the provisions of the Acts.

(2) Accordingly, section 8 (counteraction) shall not apply to such arrangements.

(3) Such arrangements are in this Part referred to as "reasonable tax planning".

"… reasonably be regarded as a reasonable exercise…"

We are given no standard by which to judge reasonableness. Whose idea of reasonableness are we to consider? Normally, reasonableness criteria in the law are judged by reference to the ordinary, reasonable man; the man on the Clapham omnibus. Such a test would present great difficulties in respect of complex tax planning because the ordinary reasonable man is unlikely to be sufficiently familiar with tax law to be capable of understanding the planning's

[28] Para 6.3(i), Appendix II, para 20

technical effects. On the other hand, if we don't posit an ordinary man whom do we posit? Often clients who implement tax planning will themselves rely on their advisors to understand the details. Yet surely the standard of reasonableness cannot be the opinion of an hypothetical ordinary reasonable tax adviser? Nor surely can it be that of an hypothetical ordinary HMRC official who has a strong interest in regarding tax planning as unreasonable. Perhaps one has to posit an otherwise ordinary, reasonable man, who neither practises taxation nor is involved in implementing the type of tax planning concerned nor is an employee of HMRC but who has nonetheless a detailed acquaintance with tax law[29] and the intellectual capacity to understand its application to transactions of all levels of complexity. If that is the case then that would be a very artificial standard, indeed, by which to judge reasonableness.

Nor are there any principles specified against which the reasonableness of an exercise of choice can be judged. In the absence of a clear standard and of any guiding principles how is one to guess how a Court will decide reasonableness?

"… choices of conduct afforded by the provisions of the Acts"

What are "choices of conduct afforded by the provisions of the Acts?" One can say of Mr Domus that he had a choice of whether to move into his flat or not. But the Taxation of Chargeable Gains Act 1992 did not offer him a choice between those two alternative actions. It simply provides that if a particular set of conditions are satisfied then Main Residence Relief will be available. Similarly, with Mr Aedificator, the relevant legislation does not offer a choice between incorporating his company and not doing so. It simply provides that company profits, salary payments and company distributions are taxed in certain ways and that an individual earning trading profits is taxed in another. There are all sorts of ways in which a business might be carried on. It might be carried on through a limited liability partnership, a limited partnership, a company limited by guarantee, a joint venture arrangement or through any number of foreign legal forms. Taxation legislation doesn't offer a choice between these – it simply imposes tax consequences on different legal persons undertaking different legal transactions.

Mr Aaronson places great emphasis on the phrase "if it can reasonably be regarded". In paragraph 5.2, for example, he says that the overarching principle of the GAAR "must be supported by the simple proposition that where there can be reasonable doubt as to which side of the line any particular arrangement falls on [sic], then that doubt is to be resolved in favour of the taxpayer …". That, however, is not what this phrase in section 4(1) does. It simply asks of any particular arrangement whether it can reasonably be regarded as a reasonable exercise of choices etc". So, under section 8, HMRC must show, on the balance of probabilities, that by some standard of reasonableness which, as we have seen, is undefined, not only would the

[29] One doubts whether a man who has acquired such knowledge for no purpose could properly be described as reasonable

choice be unreasonable but also that it would be unreasonable to regard it as reasonable. That is the civil burden of proof. It is not correct, although Mr Aaronson suggests in para 5.2 that it is, that the GAAR will not apply if there is reasonable doubt (the criminal standard of proof) that the particular arrangements do not fall within section 4.

Application of Section 4 to Mr Domus

So if we apply section 4 to Mr Domus, is this a reasonable exercise of his choices? One might say that the legislation allowed Mr Domus a certain tax result if he was willing to put up with the inconvenience of taking up residence in his flat and of foregoing a certain amount of rental income for a limited period and that he availed himself of that choice. Alternatively, one might say that the purpose of s.222(5) is to provide relief in circumstances where a person has two residences in ‘reality’, that is for non-fiscal reasons, and that it is unreasonable to engineer circumstances which fall within the terms of the relief simply in order to exploit TCGA 1992 s.225(5).

Exploiting the main residence exemption achieved a certain notoriety during the revelations concerning MP’s expenses claims. Journalists and many members of the general public plainly felt that the sort of tax planning undertaken by Mr Domus was unreasonable when undertaken by MPs. Indeed, it became so notorious that it achieved its own popular nickname, “flipping.” Would a Court, similarly, find Mr Domus’ choice of action unreasonable? Mr Aaronson’s draft legislation gives one no means of knowing.

Application of Section 4 to Mr Aedificator

Was Mr Aedificator’s choice to incorporate his business a reasonable exercise of a choice of conduct afforded by the provisions of the Act? One might say, as many commentators did when the small companies rate was repealed, that if the Government imposes a significantly lower rate of tax on one form of business organisation rather than another, it is entirely reasonable, and, accordingly, the Government should not be surprised, if businessmen choose that form of organisation rather than the other. Nonetheless, in its Discussion Paper on “Small Companies, the Self Employed and the Tax System” which the Treasury issued in December 2004 the Government said that it:-

> “… believes that the choice of legal form that a small business takes should reflect commercial rather than tax considerations. In Budget 2004, the Government expressed its concerns about the increasing numbers of self employed individuals adopting the corporate legal form for tax reasons rather than as a step to growth, often as a result of marketed tax avoidance schemes.”

Mr Aedificator’s decision to incorporate was entirely driven by the desire to gain a tax advantage. We ourselves would not regard that as unreasonable but then, nor would we regard Mr David Maye’s decision to enter into the transactions which gave rise to the allowable Income Tax loss which was the

subject of *Mayes v HMRC* to be an unreasonable exercise of the choices available to Mr Mayes. The Government was obviously surprised and annoyed to find that small-business men incorporated their businesses so as to take advantage of the nil starting rate of Corporation Tax. Whether a Court would find such an artificial transaction to be a reasonable exercise of the choices of conduct afforded by the provisions of the Acts remains uncertain.

So, both Mr Domus' and Mr Aedificator's transactions, were they to have taken place when Mr Aaronson's GAAR was in force, might have been subject to counteraction.

COUNTERACTION

What might that counteraction be? If the arrangement viewed as a whole is contrived to achieve an abusive tax result, and has no significant purpose apart from this or if it does have another significant purpose but it is not possible to determine a "corresponding non-abusive arrangement" the arrangement is to be counteracted by computing and assessing the receipts and deductions of the advantaged party "in such a manner as is reasonable and just."[30] If, however, that is not the case, the receipts and the deductions of the advantaged party are to be computed and assessed as if the corresponding non-abusive arrangement had been carried out instead of the actual arrangement. In such cases, the counteraction need not be reasonable and just.[31]

How do these provisions apply to our examples? In Mr Domus' case, one might argue that the arrangement, which includes the disposal of the property, includes a significant purpose, making that disposal, apart from being contrived to achieve an abusive tax result. Because of that, one must see if one can identify a corresponding non-abusive arrangement. That corresponding non-abusive arrangement might be the situation which would have applied had Mr Domus not taken up residence in the property. But in what sense can one say that not residing in a property for six months corresponds to residing in it for six months? For Mr Aedificator, one might suggest that the corresponding non-abusive arrangement was to carry on trading as a sole trader but could one really say that one corresponds to the other? After all the legal consequences to Mr Aedificator of having incorporated his trade are extensive.

SIGNIFICANT UNCERTAINTY

Not only is there a significant uncertainty as to whether Mr Domus' and Mr Aedificator's transactions fall within the GAAR but there is also significant uncertainty as to how, if they do, they will be charged to tax under the Counteraction Provisions.

[30] Appendix I. Sections 8(2) and (5)
[31] Appendix I. Section 8(3)

Readers at this point may simply say "surely HMRC isn't going to try to apply the GAAR to arrangements like this." The application of the GAAR, however, is not discretionary. If arrangements satisfy the conditions for its application, HMRC has no special discretion in the matter. It will be under a duty to collect tax on the basis of the law; in these circumstances, on the basis that the GAAR applies.

What is more, one of the very strong representations made to Mr Aaronson was the danger that the GAAR would, in practice, give the Revenue authorities a great deal of discretionary power in that they might use their financial might to force taxpayers to pay more tax than they otherwise would by assessing on the basis that the GAAR applied and leaving it to taxpayers to take the financial risk of appealing against the assessment. Practitioners who deal with the Revenue directly on behalf of clients know that if HMRC is granted a power, they will always exploit it to maximise their revenue yield.[32]

THE SAFEGUARDS

Mr Aaronson does acknowledge the possibility that HMRC officials might invoke the GAAR in a wider range of cases than he would think appropriate and he places great emphasis on what he refers to as 'safeguards'.

Authorisation by Designated Officer

Section 13 provides that any counteraction under section 8 must be authorised by an officer of HMRC who is designated by the Board for the purpose. The party that is advantaged by the arrangements must be notified of the officer's intention to take counteraction measures.

No doubt this provision will prevent individual employees of HMRC from invoking the provisions in circumstances which are outside the general policy of HMRC. It will not prevent HMRC as a whole from using the GAAR as a weapon to coerce settlements by the taxpayer.

The Advisory Panel – Section 14

Section 14 provides for an Advisory Panel to be constituted in accordance with regulations made under the section. Where a taxpayer has been notified by HMRC that counteraction may be applicable, the taxpayer may make representations within six weeks of receipt of that notice. If he does so, the designated officer must send to the advisory panel the notification, the taxpayer's representations and any comments he cares to make in respect of the representations. The advisory panel must then advise the designated officer within six weeks whether in its opinion it would be reasonable for the officer to authorise counteraction under section 8.

[32] See the Report of a talk by Dave Hartnett of HMRC given on 17th March 2008 and reported in *Taxation*, issue 4150, 3rd April 2008, "The Dave Channel"

As an aside this is very peculiar. Why does the draft legislation not provide that the Panel must give its opinion as to whether the GAAR applies to the circumstances? HMRC is given no discretion, beyond its general, narrow discretion in the administration of taxes, as to whether to tax on the basis of the GAAR. If the GAAR applies, counteraction under section 8 is mandatory. That being so, if, in the opinion of the Advisory Panel, the GAAR applied, it would always be reasonable for the designated officer to authorise counteraction and, if it did not, it would not.

The designated officer has a duty to consider the opinion of the Advisory Panel but need not adopt its opinion. The Court may consider any published guidance or determinations of the Advisory Panel[33] but it need not do so.

If Mr Domus or Mr Aedificator is issued by HMRC with notices that HMRC consider that the GAAR applies to them they will be faced with a choice as to whether to make representations. A taxpayer in that position would be foolhardy to make the representations themselves. So making a representation would mean incurring further professional fees. Our taxpayers in our examples would be faced with the possibility that they could incur those fees, receive a favourable opinion from the Advisory Panel, and still face the costs and uncertainty of an appeal to the Tribunal.

Mr Aedificator is in a particularly difficult position. His advantage from incorporation lasted for only two years before the starting rate of Corporation Tax was restricted to undistributed profits and so his tax at stake would be, perhaps, only about £7,000. He is highly unlikely to incur the cost of making representations once he has received a notification from HMRC that the GAAR applies.

Within a few years of the GAAR being introduced, the temptation for HMRC to use it as a weapon to raise additional tax revenue from taxpayers with modest amounts of tax at issue is likely to be irresistible.

THE GUIDANCE

Section 10 provides two rules of evidence.

Additional Material – Section 10(1)(b)

Section 10(1)(b) provides that material listed in sub-section (3) may be taken into account in determining:-

> “(a) whether the arrangement is an abnormal arrangement;
> (b) whether any particular feature is an abnormal feature;
> (c) whether the arrangement constitutes reasonable tax planning;
> (d) whether the tax result is an abusive tax result; and

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[33] Section 10(3)(b)

(e) what is to be taken as the corresponding non-abusive arrangement."

For the most part, this provision has little effect as the material listed would be available to the Court in any event. The exception is any Parliamentary material which would not be admissible under the principle in *Pepper v Hart*.

<u>The Guidance – Section 10(1)(a)</u>

Sub-section (1)(a), however, is of significant effect and, if enacted, would be an innovation in tax legislation. Guidance notes, summarising and commenting on the legislation, are included in a schedule to the draft legislation and section 10(1)(a) provides that in determining the matters listed in sub-section (2), the Guidance Notes are to be taken into account. The provision is, therefore, mandatory.

Application to our Examples

It is of little help to the taxpayers in our examples. Nothing in the guidance makes it easier to decide whether their arrangements "can reasonably be regarded as a reasonable exercise of choices of conduct afforded by the provisions of the Acts." The only comment which is at all relevant to them is the very general statement that "the new general anti-abuse rule … is designed to deter and counteract abnormal arrangements which go beyond reasonable tax planning and which are contrived to achieve an advantageous tax result." The trouble with this is that the Guidance uses two phrases, "abnormal arrangements" and "advantageous tax result" which are given a special meaning in the legislation which clearly bear little relationship to their meaning in ordinary English usage. The phrase "beyond reasonable tax planning" does not appear in the legislation and therefore might bear its ordinary meaning but it still begs the question of how one determines what is reasonable tax planning.

Uncertainty added to uncertainty

Section 10(1)(a) does, however, considerably add to the uncertainty of the legislation. How is the Guidance Note to be taken into account? What weight will the Court give to the Guidance? The Guidance does not give any examples of the operation of the legislation but rather attempts to summarise its effect with occasional statements about its purpose. Where it's summary closely follows the wording of the legislation it adds nothing to it. Where it does not, the question arises as to how contradictions between the Guidance and the legislation are to be resolved? Some parts of the Guidance do not seem to be consistent with the legislation and are not natural readings of the legislation.

Paragraph 30

For example, at para 30 of the Guidance in respect of the reasonableness test in section 4, it says:-

> "What can in any particular case reasonably be regarded as a reasonable response will, of course, depend on the precise circumstances. In exceptional circumstances this could include taking steps to avoid a wholly inappropriate tax *disadvantage* which might otherwise arise from carrying out an entirely commercial transaction."

Does this imply that in circumstances which are not exceptional, a taxpayer who took steps to avoid a wholly inappropriate tax disadvantage which might otherwise arise from carrying out an entirely commercial transaction, would not be making a reasonable choice within section 4? Does it mean that there will be some circumstances in which a taxpayer who takes steps to avoid a wholly inappropriate tax disadvantage which might otherwise arise from carrying out an entirely commercial transaction would not be making a reasonable exercise of choice within section 4? The Guidance at least implies that only in exceptional circumstances would steps taken to avoid a wholly inappropriate tax disadvantage not fall within the GAAR and not always then even in those circumstances.

Paragraph 33

Paragraph 33 of the Guidance says that section 5:-

> "protects taxpayers from the risk of counteraction in cases where they enter into transactions solely for business, investment, family or philanthropic reasons, without any thought being given to the possibility of achieving an advantageous tax result."

Read literally that is true, but it might suggest that section 5 is restricted to transactions entered into solely for business, investment, family or philanthropic reasons when in fact it contains no such restriction. Will the Courts, taking account of the Guidance in construing section 5, so restrict it?

Paragraph 40

Paragraph 40 of the Guidance says that section 7(2) makes it clear that the list of features in sub-section (3) ibid is intended only as a guide. But in fact section 7 does not say that those features are to be taken as a guide. Sub-section (1) merely says that they "may be taken into account in determining whether … [an] ... arrangement is an abnormal arrangement" but other features may also be taken into account[34] and the fact that the arrangement has one or more of the features set out in sub-section (3) "shall not necessarily lead to the conclusion that the arrangement is an abnormal arrangement."[35] It may be that a Court, in construing this legislation, would, in an attempt to avoid redundancy, come to the conclusion that the list is intended as a guide but by putting that statement into the Guidance rather

[34] Appendix I. Section 7(2)
[35] Appendix I. Section 7(2)

than in the legislation a contradiction is created between the literal meaning of the legislation and the Guidance.

Paragraph 50

Paragraph 50 of the Guidance says that section 10(3):-

> "… addresses concerns that the GAAR might otherwise be used by HMRC to counteract arrangements where official material, or evidence of widespread practice, could reasonably be considered as demonstrating that the arrangement was not at the relevant time regarded by HMRC or other Government departments as abnormal or abusive."

This is very worrying. Sub-section (3) lists various material which may be taken into account in deciding whether various conditions for the application of the GAAR are satisfied; in particular, in considering whether the arrangement constitutes, loosely, reasonable tax planning. Were it not for the Guidance the test of reasonableness in the draft legislation is not whether an arrangement is abnormal or abusive (and certainly not whether HMRC, or another Government department, thinks that it is). It is quite the other way around. Before applying the reasonableness test one has to have what would otherwise be an abnormal arrangement contrived to achieve an abusive tax result as these phrases are defined in the legislation. If that condition would otherwise be satisfied, one then treats that arrangement as not achieving an abusive tax result if, under section 4, it can reasonably be regarded as a reasonable exercise of choices of conduct afforded by the provisions of the Acts. In making that judgement as to reasonableness, there is nothing to suggest that the view of HMRC or of other Government departments is of primary significance. In the light of the statutory force given to the Guidance by section 10, however, the Courts might regard para 50 as importing such a construction.

This worry is compounded by para 51 of the Guidance which says:-

> "in the case of any practice relied upon by the taxpayer its [probative] value will be affected by consideration of whether HMRC were aware of it at the time of the arrangement and, if so, whether HMRC had explicitly or tacitly led taxpayers to believe that such practice was unobjectionable."

This comment seems to convert the reasonableness requirement into a test of whether HMRC consider any particular arrangement objectionable or not. If the application of the legislation is to be determined by whether HMRC consider arrangements to be objectionable, then it will confer on HMRC a discretionary power to tax which Mr Aaronson appears to accept "would be wrong as a matter of constitutional principle".[36]

[36] Para 5.26

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So undoubtedly, both the decision to give the Guidance statutory force and the decision to provide that the counteraction, in two of the three categories, must be "in such a manner as is reasonable and just", increases the uncertainty of the application of the draft legislation. The fundamental problem with the legislation, however, is that its application depends primarily upon a judgement as to whether any particular arrangements "can reasonably be regarded as a reasonable exercise of choices of conduct afforded by the provisions of the Acts". We have seen that the definition of 'abnormal arrangements' and the exclusion of arrangements without tax intent will not normally exclude arrangements which involve an element of tax planning. So the reasonableness test of section 4 is the only mechanism by which the legislation attempts to distinguish what Mr Aaronson calls "the centre ground of responsible tax planning from "contrived and artificial schemes."

Because no standard of reasonableness and no principles by which reasonable choices may be distinguished from unreasonable ones are provided, we are left to guess how the Courts will make an unguided judgement of reasonableness which, in practice, must be highly subjective. In effect, Mr Aaronson has not solved the problem of distinguishing unacceptable from acceptable tax planning in order to negate the former. His proposal gives a discretionary power to the Courts to do so. Perhaps over many years the Courts will develop a set of principles to remedy the legislation's lack. But in doing so they will be left with the very same problem which Mr Aaronson, like all his predecessors, has been unable to solve; what distinguishes unacceptable tax planning from acceptable? If the GAAR is enacted, the bill for his failure will fall on the taxpayer and the UK economy.

Example One

David Domus purchased a house in the country on the 1st April 2002 for £2m which he occupied as his main residence. It is now worth £4m. On the 30th April 2009 he purchased a flat in London for £500,000 which he let. By the Spring of 2011 it had a market value of £750,000 and he was considering selling it.

On his accountant's advice and in order to save Capital Gains Tax, when his tenants moved out of the flat in October 2011 he did not re-let it but, rather, began to stay regularly in the flat during his frequent stays in London, whereas previously he had stayed at his Club. His occupation of the flat was just enough to establish that it was a residence in respect of him for the purposes of TCGA 1992 s.222. He made an election under TCGA 1992 s.222(5). He was able to do so because, although he had owned the flat for more than two years, it had not previously been his residence so the period in TCGA 1992 s.222(5)(a) had not previously begun.

On the 30th April 2012 he sold the flat realising a gain of £250,000 (£750,000 - £500,000). Although the flat had only been his residence for six months, it was treated as having been his main residence for its final three years of ownership (TCGA 1992 s.223(1)) and the entire gain on the flat was exempt. His country house was treated as not having been his main residence for a period of only six months and so, in the event that he sold it, the restriction of his main residence relief would have been modest.

Example Two

Bob Aedificator had been a self-employed builder for many years. He regularly made profits of £35,000 out of which, after paying his Income Tax and National Insurance contributions and living expenses, he saved £5,000. His accountant told him about the reduction in the starting rate of Corporation Tax announced in the 2002 Budget Speech and told him that by incorporating his trade, paying himself a salary equal to the earnings threshold for National Insurance contributions purposes and distributing the remainder of the money he required for his living expenses by way of dividend, he could reduce his Income Tax and National Insurance contributions for the year from £8,643.95 to £5,095.00. He duly acquired a new company on the 1st April 2002 and transferred his trade to it on that date. The envisaged advantages were short lived. The starting rate of Corporation Tax was restricted to undistributed profits with the introduction of the non-corporate distribution rate for the financial year 2004[37] and was abolished with effect from the financial year 2006.[38]

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[37] FA 2004 s.28
[38] FA 2006 s.26