A Nelsonian eye

SIMON MCKIE explains why he believes that the extended disclosure rules for tax avoidance schemes hold dangers for all tax practitioners.

IN 2006 I wrote an article for *Private Client Business*, 'Suggestio Falsi', on the extension of the rules for the disclosure of tax avoidance schemes which was later summarised in *Taxation* (19 October 2006, page 53). I concluded that the effect of the new rules was that 'almost all the advice which [tax advisers] will give in relation to the prescribed taxes [income tax, capital gains tax and corporation tax] will be disclosable' and I demonstrated this by showing that an example of entirely routine tax planning advice (the 'Cordelia strategy') would fall under the extended rules.

Professor Redston, coming to HMRC's defence (see 'A tablespoon of falsehood', *Taxation*, 25 January 2007, page 77), responded that:

> 'The [disclosure] rules were ... subject to significant consultation and are … both proportionate and workable.'

Professor Redston professes herself concerned that if my view is widely accepted the 'disclosure regime may fail in its underlying purpose of discouraging structured tax avoidance'. My concern is that a major new compliance burden has been imposed on the tax profession which tax advisers are widely ignoring as a result of misinformation put out by HMRC. The result of that is that advisers are unwittingly creating very substantial contingent liabilities and will be reliant on the goodwill and forbearance of HMRC not to impose those liabilities.

In this article I examine the validity of Professor Redston's criticisms of my analysis of the application of the disclosure rules to the Cordelia Strategy (see below). I refer throughout to my original article as it appeared in *Private Client Business* to which readers of the abridged version were referred.

The failure to make a disclosure required under the disclosure rules is punishable under TMA 1970, s 98C with a penalty not exceeding £5,000.

KEY POINTS

- The price of non-disclosure.
- Analysis of a tax-planning exercise.
- The extent of FA 2004, s 306.
- The confidentiality tests.
- The prudent approach to disclosure.

This penalty applies to each failure. In the event that Professor Redston is wrong, an adviser who follows her views will find himself with a potential liability to multiple penalties. If I am correct, a sole practitioner offering a mixture of tax compliance and advisory services giving, perhaps, 50 pieces of routine advice in a year who assumes that these rules can have no application to him may be creating a potential annual liability of

The Cordelia Strategy

Old Reliable & Co ('ORC') are a long established City firm of accountants specialising in services to private clients. They have an enviable reputation for competence in relation to all matters affecting the private client including taxation. Following the passing of the FA 2006, Old Reliable & Co had their standard trust precedents and pro-forma hold-over elections for the purposes of s 260 updated and settled by counsel.

They are consulted by Lord Marchmain who wishes to make a gift of an asset worth £250,000, which has an inconsiderable base cost, to his daughter Cordelia. Mr Smith, a partner of ORC with particular expertise in taxation, advises him that if he were to make the gift he would realise a substantial chargeable gain. Lord Marchmain says that he would not wish to make the gift if he was going to suffer tax of nigh on £100,000 (£250,000 at 40%).

Mr Smith then advises that Lord Marchmain could achieve a very similar effect by settling the asset on his daughter to hold as trustee on trusts under which she has an interest in possession and the trustee has broad powers of appointment and advancement in favour of a beneficial class consisting of the issue of Lord Marchmain living during the trust period.

Under the changes to the inheritance taxation of trusts made by FA 2006, Sch 20, such a settlement was an immediately chargeable transfer whilst an outright gift would have been a potentially exempt transfer. That did not create a tax disadvantage, however, because the gift was charged at 0% as Lord Marchmain had not utilised his nil-rate band.

Lord Marchmain went on to implement the advice. ORC drafted the trust deed and hold-over claim using its standard precedents.

The advantage of the structure, however, was that hold-over relief under TCGA 1992, s 260 would be available on the transfer into settlement and on a subsequent transfer out of the settlement. It was not intended that the asset would be advanced out of the settlement, but the possibility of doing so was of importance in the event that by the first occasion of charge under IHTA 1984, s 64 on the tenth anniversary of the settlement, the value of the property had risen above the amount of the nil-rate band.

up to £250,000. For a five-man tax advisory practice delivering, say, 500 pieces of advice a year, this figure becomes £2,500,000.

So, if there is a reasonable uncertainty as to whether a disclosure is required by the law or not, a prudent adviser will disclose. Professor Redston does not give due weight to the fact that it is just as damaging for the law to be uncertain in its scope as to impose an unequivocal duty to disclose.

In order to be disclosable, notifiable arrangements must fall within FA 2004, s 306(1)(a) to (c). Notifiable proposals are defined by reference to notifiable arrangements. Professor Redston does not expressly dispute my conclusion that virtually all tax planning advice will fall within s 306(1)(b).

Section 306(1)(c)

Professor Redston considers, however, that s 306(1)(c) 'is a useful limitation on the scope of the disclosure provisions'.

In order to demonstrate how difficult it is to decide unequivocally whether or not any particular arrangements fall within s 306(1)(c), I first applied the provisions of that sub-section to the facts in the well known tax avoidance case of *Furniss v Dawson* [1984] STC 153. I demonstrated that there were arguments on both sides suggesting that these arrangements might or might not be disclosable. I further showed that the guidance published by HMRC gave no useful help at all in deciding the matter. I concluded that:

> 'If one cannot even determine how the provision applies to the facts of one of the leading *Ramsay* cases then it is clear that the application of the condition is very far from "obvious".'

> *"The example does raise difficult questions of how one identifies the boundaries of the arrangements concerned.*

Professor Redston's comment on this is that:

> 'Since *Furniss v Dawson* was a structured tax avoidance scheme, it is hardly an appropriate benchmark against which to test ordinary tax planning.'

But if a piece of tax avoidance on which a quarter of a century's jurisprudence has been based is not clearly caught by legislation designed to compel the disclosure of tax avoidance schemes, the legislation cannot be clear in its application.

I then went on to consider whether the routine piece of tax planning in the example fell within s 306(1)(c). Professor Redston found the question easy because:

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> '... the trust structure (as distinct from the gift) was only implemented in order to achieve a tax advantage.'

But in my example there is no gift other than the gift into trust. There is no trust structure distinct from the gift. So Professor Redston's distinction cannot be made. The example does raise difficult questions of how one identifies the boundaries of the arrangements concerned and the relevant benefits which arise from them. Because it was unclear whether the proposed arrangements fell within s 306(1)(c), it was prudent for the adviser, ORC, to proceed on the basis that it would make a disclosure of the transaction if it fell within the provisions of s 306(a).

So in relation both to a tax avoidance transaction and to a perfectly routine piece of tax planning I showed that one cannot say unequivocally whether or not s 306(1)(c) applies. Section 306(1)(c) can hardly be 'a useful limitation on the scope of the disclosure provisions'.

Subsection 306(1)(a)

Subsection 306(1)(a) provides that notifiable arrangements must fall within descriptions prescribed by regulation. It is now provided that arrangements which fall within any one of seven hallmarks, fall within the prescribed description. I showed that ORC's advice fell within three of those hallmarks. Professor Redston takes issue with my conclusions on all three.

The relevant hallmarks were the confidentiality hallmark (the 'First Hallmark'), the premium fee hallmark (the 'Third Hallmark') and the standardised tax product hallmark (the 'Fifth Hallmark').

The First Hallmark

The First Hallmark subdivides into two separate tests; confidentiality from other promoters and confidentiality from HMRC.

'Confidentiality from promoters'

This test is satisfied if:

> '... it might reasonably be expected that a promoter will wish the way in which that element [which gives rise to a tax advantage] of those arrangements secures a tax advantage to be kept confidential from any other promoter at any time in the period ...'

In my original article I had said:

> 'The condition will be satisfied if any one of that massive population of possible promoters might reasonably be expected to wish the way in which that element of those arrangements secures a tax advantage be kept confidential from any other promoter ... if any two firms ... operating in competition in any place would wish to prevent the other from knowing how an effective gift of an asset may be made without triggering a capital gains tax charge then the condition is satisfied ... there are many tax advisers who are not aware of all the available standard planning techniques and if another adviser could ensure that that adviser was kept in his state of ignorance he would maintain his competitive advantage.'

Professor Redston comments:

> 'There is, however, a difference between "kept confidential" and "ignorance". Firm A ... has a competitive advantage over Firm B ... But if Firm B chooses to find out how the Cordelia structure works, it can do so, because the information is not "kept confidential": it can be found by phoning a friend, attending a lecture or buying a book.'

Now confidential is defined as 'intended to be kept secret' (*Compact Oxford English Dictionary; Second Edition*). My hypothetical tax adviser will wish his competitor to remain in ignorance of the technique utilised by ORC. The competitor will remain in ignorance if the technique is kept secret. Plainly a secret is not a thing known to nobody. It is a thing known to somebody and not to somebody else. If information about the technique is denied to the competitor, it is kept secret. It is not a requirement of the condition that the hypothetical promoter who knows of the technique keeps it secret, but just that he wishes it to be kept secret from a promoter who does not. Nor are we asked by the rule to consider the degree of possibility that that could be done. The fact that the promoter might discover from a published source what is currently a secret from him is irrelevant.

Professor Redston objects that 'it would be pure fantasy for an adviser to wish that a well-known piece of tax planning was known only to him and not to anyone else' and as a separate point that 'it would not be *reasonable* for a third party to expect the adviser to be harbouring this secret, unfulfillable desire'. As to the first point, the condition is satisfied where any promoter would wish the technique to be kept confidential from 'any other' promoter. The condition is not that it is not known 'to anyone else'. As I have said, it is quite possible for a fact to be kept secret from one person which is known to many others.

As to the second point, the test is whether a person would reasonably expect a promoter to wish the technique to be kept confidential, not whether that wish is reasonable. It may be reasonable to consider that a person will wish for the unattainable even if the wish itself is unreasonable. Professor Redston's objection fails to pay attention to the hallmark's actual wording.

Put at the lowest, it is impossible to conclude that the strategy does not fall within the 'confidentiality from promoters' test. For the reasons I have given, it is probable that it does.

> *It is not a requirement of the condition that the hypothetical promoter who knows of the technique keeps it secret, but that he wishes it to be kept secret.* ”

If a piece of planning falls within any of the hallmarks, it is disclosable. It is probable that the first limb of the First Hallmark will catch most routine tax planning, but I shall go on to consider Professor Redston's further criticisms.

Confidentiality from HMRC

Arrangements will fall within the Second Limb of the First Hallmark if:

> 'the promoter would, but for the requirements of these Regulations, wish to keep the way in which that element secures that advantage confidential from HMRC ... and a reason for doing so is to facilitate repeated or continued use of the same element, or substantially the same element, in the future.'

In my original article I commented:

> 'The element in the arrangements ... which gives rise to the tax advantage is that a gift to a life interest trust will qualify for hold-over relief whereas an outright gift to an individual will not. It is pretty clear that any adviser recommending a tax strategy to a number of clients is likely to wish, if it were possible, that the way in which the tax planning works would not become known to HMRC for a period of time. That is because that would reduce the risk that HMRC would sponsor a change in the law to nullify the advantage before the adviser's clients had been able to implement the necessary steps ...'

On this, Professor Redston comments:

> 'Of course, if a scheme is innovative, the adviser will wish that he didn't have to disclose it: this is why the test exists in the first place. But is it true of schemes with which HMRC are already familiar? Why would an adviser have such a wish when HMRC already know about the scheme?'

The simple answer to this is that we have to ask ourselves under the Second Limb of the First Hallmark whether the promoter, but for the requirements of these regulations, would wish to keep confidential from HMRC the way in which the element secures the tax advantage.

As we have seen, to be kept confidential is simply to be kept a secret from. It is implicit in the hypothetical question posed by the Second Limb of the First Hallmark that one is to assume that it is possible for the matter to be kept confidential. What is to be kept confidential is not the specific arrangements themselves or even the element of them which secures a tax advantage, but the 'way in which that element secures that advantage'. So one has to consider whether the promoter would wish the tax planning technique which is used in the arrangements to be kept secret from HMRC.

HMRC often allow tax planning techniques to continue for many years and then sponsor blocking legislation to close them down.

Professor Redston goes on:

> 'It seems bizarre for the promoter to wish that HMRC didn't know about the scheme, so *he can continue to use it* – when he has been applying the methodology for many years with HMRC's full knowledge.'

But that is not bizarre at all. HMRC often allow tax planning techniques to continue for many years and then sponsor blocking legislation to close them down. The 'Home Loan Scheme' was in use in the late eighties, but it was one of the main targets of the pre-owned assets charge enacted in 2004. If it had been possible for that strategy to be kept secret from HMRC every adviser who advised on it would have been in a stronger position. Professor Redston's error is in thinking that the Second Limb of the First Hallmark requires one to consider whether the promoter would wish the particular transactions which he has recommended to be kept confidential from HMRC rather than 'the way that element secures that [tax advantage]'; that is the generic technique which is used.

The Third Hallmark

The Third Hallmark, the premium fee test, applies where the arrangements are such that:

> '… it might reasonably be expected that a promoter or a person connected with a promoter of arrangements that are the same as, or substantially similar to, the arrangements in question, would, but for the requirements to disclose information under these Regulations, be able to obtain a premium fee from a person experienced in receiving services of the type being provided.'

A premium fee for this purpose is:

> 'A fee chargeable by virtue of any element of the arrangements (including the way in which they are structured) from which the tax advantage expected to be obtained arises, and which is:
>
> (a) to a significant extent attributable to that tax advantage; or
> (b) to any extent contingent upon the obtaining of that tax advantage.'

My article argued that tax advisers are engaged to provide tax advice and that clients expect that tax advice to be useful. Tax advice is normally only useful if the client pays less tax than he would have done had he not taken the advice. The higher the perceived quality of the taxation advice offered, the higher the price. That being the case, virtually all fees charged for taxation advice will be attributable to a significant extent to the tax advantage arising from the advice.

Professor Redston comments on this that:

> 'A premium fee is one which a promoter could reasonably be expected to receive "but for the requirements to disclose information under the regulations"'.

Actually, this is incorrect. The phrase 'but for the requirements to disclose information under the regulations' does not, as the reader can see, appear in the definition of a premium fee, but in the conditions of the Premium Fee Hallmark.

That hallmark can be read in two ways; first, that one simply ignores the adviser's duty of disclosure in deciding whether a premium fee may be obtained or not (the 'First Interpretation') or, secondly, that the hallmark is only satisfied if one could obtain a premium fee ignoring the duty of disclosure, but one could not obtain a premium fee taking account of it (the 'Second Interpretation').

The Second Interpretation is certainly interesting and it may be that Professor Redston has inadvertently discovered a major loophole in the test. If one were to accept the Second Interpretation, it is highly unlikely that the test would ever be satisfied. The hypothetical client will not be worried about the adviser's duty to make a disclosure because he will have implemented his transactions before HMRC will have had a chance to sponsor a change in the law. So the fact that an adviser will have to make disclosure of a transaction will, in almost all circumstances, have no effect on the fee which a client is willing to pay for the adviser's advice. What it may do, of course, is make it uneconomic for the adviser to develop the concept and to offer the advice at all.

Now this is no doubt an interesting technical argument but an adviser, deciding whether or not to make disclosure, is unlikely to take the risk that a court will prefer a construction which empties the Third Hallmark of effect over one which does not.

The Fifth Hallmark

Professor Redston admits that 'over time … this hallmark [standardised tax products] may become more problematic', but:

> 'There is an exception from the hallmark's application, for arrangements which are of the same, or substantially the same, description as arrangements which were first made available for implementation before 1 August 2006. This means that the Cordelia structure, and other commonplace tax planning, falls outside the disclosures rules providing they were known about before 1 August 2006.'

The test for the exclusion, however, is not whether the tax planning technique was 'known about' before 1 August 2006, but whether they are 'of the same, or substantially the same description as arrangements which *were first made available* [emphasis added] for implementation before 1 August 2006'. The example makes clear that the technique which it describes relies upon the changes made by FA 2006 which received Royal Assent on 19 July 2006. The relevant provisions of that Act were changed regularly during its passage through Parliament. Only a foolhardy adviser would have allowed his client to undertake transactions designed by relation to its provisions before the Act was passed. In the example it is stated that:

> 'Following the passing of FA 2006, Old Reliable & Co had their standard trust precedents and pro forma hold-over elections for the purposes of s 260 updated and settled by counsel.'

That is not a process which can take place in twelve days. It is therefore implicit in the example that it is highly unlikely that any adviser will have made such arrangements available for implementation before 1 August 2006.

A Nelsonian eye?

So as I said, it is clear that ORC would be prudent to disclose their advice under the disclosure rules because it is probable that it falls under both limbs of the First Hallmark, the Third Hallmark and the Fifth Hallmark. ORC's purely routine tax planning advice provides a valid example of why most tax planning advice in relation to the prescribed taxes will now be disclosable.

The disclosure rules are clearly not 'proportionate and workable'.

There is no virtue in turning a Nelsonian eye to legislation which imposes a wide duty of disclosure on the profession whilst HMRC's misinformation encourages non-compliance with that duty. HMRC's guidance is so imprecise, either deliberately or inadvertently, that if in the future they decide to impose the full rigour of the penalty regime, the guidance will give little protection to advisers. The 'significant consultation' on these regulations does not seem to have been very beneficial. The purpose of making representations on draft legislation, primary or secondary, is to identify and criticise unworkable and arbitrary legislation of this sort. Without that robust criticism the process of consultation is simply an exercise in public relations. ■

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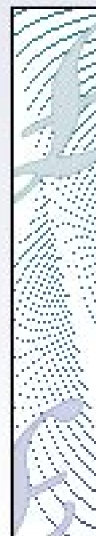

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