Humpty Dumpty tax

HMRC's guidance on TCGA 1992, s 16A is misleading and dangerous to taxpayers and their advisers, says SIMON MCKIE.

'WHEN I USE a word', Humpty Dumpty said in a rather scornful tone, 'it means just what I choose it to mean – neither more nor less'.

Finance Act 2007, s 27 inserted a new s 16A into TCGA 1992 providing that a person's loss is not an allowable loss if:

'(a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements and,
(b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.'

'Arrangements' is widely defined as including 'any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)'. The definition of a 'tax advantage', which is based on that in TA 1988, s 709(1), is also very wide.

It will be noticed that the securing of a tax advantage does not have to be the main purpose of the arrangements but only a main purpose.

All references in this article are to TCGA 1992 unless otherwise stated.

Widespread criticism

The legislation was first published in a draft on 6 December 2006 and it has been criticised by all of the major taxation bodies as denying loss relief to many ordinary tax planning transactions. HMRC have consistently denied that this is the case, issuing successive drafts of 'guidance' on the legislation (issued in a final form on 19 July 2007) which were themselves criticised as misleading and inaccurate.

On 9 February 2007, in a paper supported by STEP, The Law Society and the ICAEW's Tax Faculty, the CIOT

> **KEY POINTS**
> - TCGA 1992, s 16A is likely to catch many ordinary tax planning transactions.
> - HMRC's relevant guidance is inaccurate.
> - The legislation should be amended to restrict it to artificial transactions.
> - Advisers cannot rely on the guidance.
> - Use of white space in tax return to disclose a loss that is not allowable under the relevant legislation.

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endorsed the Government's declared policy of ensuring that those who deliberately and knowingly create capital losses by means of complex or convoluted schemes of transactions should not be enabled to claim relief but concluded:

'… we have some serious reservations about the way in which the policy is being enacted. In our view it will affect a much wider range of transactions than is suggested in the guidance notes, and … taxpayers … undertaking what they consider to be "standard" end of year tax planning will be caught.'

The paper went on:

'… [the] guidance does not reflect or explain the legislation. Indeed … in some places the guidance contradicts the legislation … New rules must be implemented by legislation and not by extra-statutory concession or guidance notes … While guidance notes are helpful, they are not a substitute for proper legislation.'

The paper concluded:

'In its unamended form, the legislation is likely to catch a range of transactions that most taxpayers would consider to be "normal tax planning" rather than tax avoidance. We do not think it is acceptable that taxpayers must rely simply on HMRC guidance to say that they are not caught …'

When the Finance Bill was published with the legislation unchanged, the professional bodies made similar representations; and substantial criticisms were made by both main opposition parties in the Finance Bill committee debates. In spite of the overwhelming weight of informed opinion, the Government has enacted the provisions published in December 2006 without any change whatsoever.

Inaccurate examples

The guidance contains 18 examples of how the legislation applies to various situations. Its analysis reaches the correct conclusion for the correct reasons in only five of those examples. In four, it reaches the correct conclusion for the wrong reasons and in nine its conclusions are simply wrong. In those nine, the guidance asserts that the legislation does not apply to circumstances where it does. Why is the guidance so consistently wrong? On 1 June 2007, the CIOT commenting on the final draft of the guidance, said:

'In our view clause 27 of the Finance Bill (in its present form) is perfectly clear. Our difficulties are not with the meaning of the legislation, but with its width … this is a clear case where the proposed guidance is likely to be ineffective because we believe that it is (improperly) attempting to concede by concession relief from losses which clause 27 has not granted.'

The paper identified the source of the guidance's errors:

'You appear to be of the view that "main purpose" here is an objective test rather than a subjective one. You also appear to be of the view that, if the transaction is carried out in a straightforward way and/or has a genuine economic outcome, then the transaction cannot be said to have gaining a tax advantage as one of its main purposes.

'We think that this view is fundamentally wrong.'

The main purpose test

The guidance nowhere says that the 'main purpose test' is 'objective' but the CIOT is certainly correct as to the paper's methodology.

The Guidance says (at para 11):

'The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements.'

Here, the guidance is almost but not quite correct. In *Snell v CRC* [2006] EWHC 3350, which concerned the purposes of arrangements under TCGA 1992, s 137, the High Court accepted that the purposes of the taxpayer who planned and undertook arrangements were the 'relevant' information from which to determine the purposes of these arrangements. In the leading case on the purposes of trading expenditure, *Mallalieu v Drummond* [1981] STC 391, Lord Brightman stated that:

'The [relevant statutory tests did] not refer to "the purposes" of the taxpayer … They refer to "the purposes" of the business which is a different concept, although the "purposes" (i.e. the intentions or objects) of the taxpayer are fundamental to the application of the paragraph … To ascertain whether the money was expended to serve the purposes of the taxpayer's business it is necessary to discover the taxpayer's "object" in making the expenditure … As the taxpayer's "object" in making expenditure has to be found, it inevitably follows that … the Commissioners need to look into the taxpayer's mind at the moment when the expenditure is made.'

Thus in determining the purposes of a transaction one looks at the objects of the person or persons who undertook that transaction and that involves determining the state of that person's mind at the relevant time. It is thus a purely subjective test. See *John Pimblett & Sons Ltd v CCE* [1988] STC 358, *Vodafone Cellular Limited v Shaw* [1997] STC 734, *Coffee Republic plc v Commissioners for HMRC* [2007] LON/2006/0756.

At paragraph 12 the guidance goes on to say:

'There is no one factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All the circumstances in which the arrangements were entered into need to be taken into consideration. The circumstances might include:

- 'the overall economic objective: this should be considered not only from the perspective of individual participants in the arrangements, but also from any wider perspective, such as that of the settlor or beneficiaries of a settlement whose trustees were participants; for these purposes an economic objective does **not** include tax motivated reasons;
- 'whether this objective is one which the parties involved might ordinarily be expected to have, and which is genuinely being sought;
- 'whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional, complex or costly steps would have taken place were it not for the tax advantage that could be obtained.'

Determining the purposes of arrangements from the objects of the participants in entering into the arrangements involves determining the state of the participants' minds at a particular time. That is an enquiry of fact to be determined upon evidence. The factors listed in paragraph 12 should be no more than examples of evidence which may be relevant to determining the state of the participants' minds at the relevant time. They are clearly not the only evidence which one might consider and in many cases one will have more direct and more relevant evidence. For example, one might have correspondence between a taxpayer and his advisers setting out why particular transactions or actions were to be adopted, as was the case in *Snell*.

Nonetheless, if the factors set out in paragraph 12 are merely examples of the sort of evidence which HMRC will consider in determining participants' objects in entering into the arrangements, then they are unobjectionable.

In fact, in the guidance, the factors appear to be alternative or further tests in addition to, or in substitution for, the statutory purpose test.

The example in ***Boxes 1*** and ***2*** reproduce Examples 4 and 15 in the guidance although the analysis is mine rather than HMRC's. In relation to the example in ***Box 1*** the guidance says:

'It is … necessary to consider whether securing a tax advantage was a main purpose of those arrangements, and to do so it is necessary to take account of all the circumstances in which the arrangements were entered into, including the participants' overall economic objective, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. Mrs H's decision to acquire shares in S plc was unconnected with Mr H's disposal of similar shares, and Mr H has simply taken advantage of the statutory relief for capital losses in s 2(2) in a straightforward way. Moreover, Mr H has incurred a real economic loss on a genuine disposal to a third party. Mrs H has made a genuine purchase on arm's length terms. These factors suggest there was no main purpose of obtaining a tax advantage, so these transactions do not fall foul of the TAAR.'

It is not necessary to have regard to whether the participant's economic objective 'has been fulfilled in a straightforward way, or whether additional complex or costly steps have been inserted' in this example because we are told as a fact that Mr H 'sells shares in a company … in order to crystallise a loss which can be set against his chargeable gains arising in a year'. His object in the transaction is to obtain a tax advantage. Whether that is done in a straightforward or complex way is simply not part of the statutory test.

Commenting in a paper dated 9 February 2007, on a similar example in a previous draft (which omitted the irrelevant information in relation to the wife's transactions) the CIOT said:

'We cannot see why the new legislation, as drafted, does not apply here. Are there arrangements? Yes. There is a "transaction" (the sale of the shares in [S] … plc). Is there a "tax advantage"? Yes, [Mr H] obtains relief from tax. Is securing that relief one of the main purposes of the transaction? Yes, [Mr H] would not have sold the shares in [S] plc were it not for the ability to offset the loss.'

Similarly, in relation to the example in ***Box 2***, the guidance says:

'To decide what J's main purpose was in entering into these arrangements, it is necessary to consider the overall economic objective of the arrangements, and whether that objective is being fulfilled in a straightforward way, or whether additional, complex or costly steps have been inserted. J has made a real disposal of a capital asset in a straightforward way, and has incurred a genuine economic loss. There have been no additional, costly or complex steps inserted into the transactions. The fact that the disposal has been made with a view to using the proceeds to invest in shares which fall within the enterprise investment scheme tax regime does not mean that the arrangements have been entered into with a main purpose of securing a tax advantage, because the straightforward use of a statutory relief does not of itself bring arrangements within the TAAR. Hence the TAAR does not apply.'

In this example, we are told as a fact that J makes his investment 'with a view to securing income tax relief'. That is plainly, therefore, a main purpose of the transaction and one does not need to look for further evidence as to the transaction's purpose. The fact that the investment is straightforward does not mean that J has not made it with the object of obtaining income tax relief.

In commenting on the example when it first appeared in an earlier draft, the CIOT agreed with the analysis I have given and said in a paper dated 2 April 2007:

'While we agree that it is right the legislation should not apply in these circumstances, again we cannot follow the logic …

'The conclusion that the transaction is not caught does not appear consistent with the explanation of when the legislation applies, given in paragraphs 7 to 14 of the revised guidance.

'We would stress that we agree with the conclusion reached in Example 10 of the revised guidance that the loss should, as a matter of principle, be allowable, but on the basis of the actual legislation suggest it is not …'

If HMRC had wanted the evidential categories in paragraph 12 of the guidance to be part of the statutory test, the Government could have enacted the legislation in that form. Indeed, in Committee the Opposition put forward various amendments to restrict the scope of the section including amendments designed to restrict it to artificial or complex transactions which the Government rejected. It is clear that the Government has intentionally made a provision which will apply to much standard tax planning in order to ensure that it will catch all of the transactions which it considers objectionable. In the words of the CIOT, the taxpayer is to be 'taxed by law' but 'untaxed by concession'.

The Government refuses to acknowledge this. The Economic Secretary to the Treasury, Ed Balls, asserted in Committee that 'the guidance is not concessionary, as alleged by the CIOT', but the CIOT has stuck to its guns.

Box 1: Sale of shares to realise a capital loss

The facts

Mr H sells shares in a company, S plc, in order to crystallise a loss which can be set against his chargeable gains arising in the year. Unbeknown to Mr H, his wife Mrs H, buys shares of the same class in S plc a few days later, at the same price as Mr H sold the original holding.

The correct analysis

Mr H has obtained a tax advantage because he has obtained a relief from tax. His disposal of the shares constitutes arrangements because 'arrangements' include 'any … transaction'. The obtaining of the tax advantage is a main purpose of the arrangements because we are told that they were undertaken 'in order to crystallise a loss'. The loss resulting from the disposal falls within the new s 16A(1)(a) because it accrues to Mr H 'directly … in consequence of … [the] … arrangements'.

Section 16A applies and Mr H's loss is therefore not an allowable loss.

His wife's transactions would only be of any relevance to the matter if they provided evidence as to the purpose of the arrangements. As Mr H is ignorant of his wife's transactions they do not do so.

What should advisers do?

What are taxpayers and their advisers to do where the Government deliberately publishes false guidance on the law? Can they rely on the guidance? Unfortunately, it would be unsafe to do so. There are a number of reasons for that.

First, the guidance is rarely expressed with sufficient precision for a taxpayer to clearly show that he falls within its terms.

Secondly, the guidance is hedged around with caveats. For example, paragraph 26 explains that the examples:

'… are not designed as templates for deciding whether a loss is or is not caught by the TAAR in any particular case. That can be determined only in the light of all the actual facts and circumstances.'

So it would appear that even if a taxpayer's situation exactly matches an example it would be possible for HMRC to reach a different conclusion on the application of s 16A.

Thirdly, as the CIOT has pointed out, it is inevitable that the examples will leave gaps allowing the legislation to be applied differently to cases involving facts differing only slightly from those in an example.

Fourthly, even if the taxpayer were able to show that his circumstances were exactly covered by the guidance, he is unlikely to be able to rely on it. The guidance is not binding on the Special Commissioners or the courts (see *Gaines-Cooper v CRC* [2007] STC (SCD) 23) and it is unlikely that the remedy of judicial review would be available. It is clear that HMRC do have the power to make extra statutory concessions but they have refused to acknowledge that that is what the guidance does. What is more, the power to make such concessions extends only to:

'… the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of parliamentary time.' *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2006] STC 270. See also *Fayed & Others v Advocate General for Scotland and CIR* [2004] STC 1703.

It is the opinion of the professional bodies that s 27 is a provision of the widest possible application and that the guidance purports to restrict its application radically. Even if the court were to agree that HMRC had held themselves out as applying a concessionary treatment, it is likely to find that concessionary treatment to be ultra vires.

Fifthly, even if it were possible for the taxpayer to enforce the application of the guidance through judicial review, that remedy is discretionary, highly uncertain, expensive and subject to onerous time limits.

Regarding the matter pragmatically, in completing their self assessment returns, can taxpayers safely take advantage of losses which are disallowable in law under s 16A but which they suspect, on the basis of the guidance, HMRC may be willing to allow? It would be foolhardy to do so. *Jones v Garnett* [2007] All ER(D) 390 showed that HMRC are happy to reverse the practice of years in an attempt to establish a strained and artificial construction of taxation legislation where there is substantial tax at stake. How much more likely are they to reverse an over-generous interpretation of this legislation?

One approach might be for the taxpayer to use the white space to disclose that he has taken advantage of a loss which is not allowable under the relevant tax legislation on the basis that it seems to be in accordance with HMRC's published views in the guidance. That might be an example of a rare occasion where a taxpayer's disclosure fulfils the criteria set out in the case of *Veltema v Langham* [2004] STC 544 providing protection against the imposition of penalties under TMA 1970, s 95.

In its submission of 1 June 2007 the CIOT said:

'… we ought also to put on record that we are considering whether the proposed guidance might be challenged by judicial review. We are at an early stage of our thinking on this front, but our initial thinking is that it may be appropriate to bring early judicial review proceedings to clarify the status and effectiveness of the guidance.'

Although that would put the CIOT in the uncomfortable position of asking the courts to restrain HMRC from applying concessionary practices favouring the taxpayer, the application should proceed. The present situation leaves taxpayers and their advisers in an unacceptable position of uncertainty.

In any event, tax advisers will require the independent guidance of their own professional bodies as to how they should deal with the contradictions between the actual content of s 16A and the view of it taken in HMRC's guidance.

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Box 2: Investment in EIS shares

The facts

An individual, J, invests in shares under the enterprise investment scheme with a view to securing income tax relief. in order to fund the purchase of the shares J sells the capital assets which are standing at a loss to a third party.

The correct analysis

The sale of the shares and the purchase of the EIS shares are clearly arrangements because they are a series of transactions planned and undertaken by reference to each other. We are told as a fact that the purpose of J's investment in the EIS shares was to secure income tax relief. A main purpose of the arrangements is therefore to secure a tax advantage. What would otherwise be an allowable capital loss accrues to J 'directly … in consequence of … [the] … arrangements'. Section 16A therefore prevents J's capital loss from being an allowable loss.