The Philosopher's Stone or the Emperor's New Clothes—An Old Conundrum[1]

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General anti-avoidance rule; Tax avoidance

The Government has announced that it plans to enact a general anti-avoidance rule (GAAR) based on proposals by Graham Aaronson. In this article the proposed GAAR is tested against two examples of very ordinary tax planning and is found to be the very sort of "broad spectrum" provision which Mr Aaronson admits would not be beneficial to the UK tax system.

The proposal that the United Kingdom should enact a general anti-avoidance rule (GAAR) has recurred regularly during the author's career in taxation.[2] Until now, such proposals have not proceeded.

HMRC find a GAAR tempting as a significant new weapon in maximising tax revenues because the uncertainty of its application would confer on them a de facto power of discretionary taxation. That very uncertainty, however, is the reason why business and the professions have opposed it. Until now, they have 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 tax revenues so that it has been accepted that the only way of reducing that uncertainty is to introduce a comprehensive pre-transaction clearance system which would be expensive and time consuming for HMRC.[3] However tempting HMRC 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 arises from the difficulty of defining 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 the Government regularly provides incentives by giving tax reliefs for particular forms of behaviour. Such forms of behaviour are normally ones which taxpayers would not undertake if the relief were not given. If it were otherwise, the incentive would be unnecessary. Any attempt, therefore, to define the dividing line between acceptable and unacceptable tax planning by reference to a fiscal purpose risks the GAAR applying to the very categories of transactions which the Government wishes to promote.[4]

[1] This article is based on a longer article which first appeared in the *Rudge Revenue Review* entitled "The Philosopher's Stone or the Emperor's New Clothes".

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

[3] 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.

[4] See para.5.14. All references, unless otherwise stated, are to Mr Aaronson's Report of the November 11, 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?

After a year's work in response to the Government's invitation, Graham Aaronson QC produced his report on a GAAR with draft legislation in November 2011.

He concluded that "a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system".[5] Instead he strongly recommended that a "specifically targeted anti-abuse rule" should be enacted because it would confer benefits which "are substantial and valuable".[6] He concluded that "it should be possible to draft such a rule so that it would operate effectively and fairly"[7] and he appended to his Report draft legislation.

He asserted that because:

> "… an anti-abuse rule which is targeted at contrived and artificial schemes will not apply to the centre ground of responsible tax planning … there will be no need for a comprehensive system of clearances …".[8]

Does his proposed GAAR meet his terms of reference by ensuring "that sufficient certainty about the tax treatment of transactions could be provided without undue compliance costs for businesses and individuals"[9] and "that the rules will not erode the UK tax regime's attractiveness to business"?[10]

A final test?

It seems clear that, if one of our leading revenue law QCs, assisted by a distinguished committee,[11] cannot, after a year's work, draft a GAAR which provides reasonable certainty of application, it cannot be done. So in this article, the author examines the draft legislation and tests it against two sets of transactions[12] which would not, normally be classified as contrived and artificial schemes of tax avoidance and which, if the draft legislation fulfils its purpose, should not fall within the ambit of its provisions.

One of the disappointments of Mr Aaronson's Report is that he nowhere attempts to define the targets of his legislation. He provides only one example of the type of scheme to which a GAAR should apply; the scheme considered in the case of *Mayes v Revenue and Customs Commissioners*[13] 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 author's two examples seem 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"[14] it may be that the response of Mr Aaronson and some readers will simply be that the GAAR should apply to the transactions in my examples. If that were so, it would amply demonstrate the difficulty of predicting what any individual will consider to be reasonable tax planning.

[5] Paragraph 1.5.
[6] Paragraph 1.8.
[7] Paragraph 1.11.
[8] Paragraph 1.7(vi).
[9] Paragraph 2.2(iv).
[10] Paragraph 2.2(iii).
[11] Graham Aaronson QC was assisted by an advisory Committee comprising Mr John Bartlett, Professor Judith Freedman, Sir Launcelot Henderson, The Rt. Hon. Lord Hoffmann, Judge Howard Nowlan, and Professor John Tiley QC.
[12] See the boxed examples at the end of this article.
[13] *Mayes v Revenue and Customs Commissioners* [2011] EWCA Civ 407; [2011] S.T.C. 1269.
[14] Paragraph 1.5.

Example 1

David Domus purchased a house in the country on April 1, 2002 for £2 million which he occupied as his main residence. It is now worth £4 million. On April 30, 2009 he purchased a flat in London for £500,000 which he let. By Spring 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 CGT, 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 established that it was a residence for the purposes of the Taxation of Chargeable Gains Act 1992 (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 April 30, 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 2[15]

Bob Aedificator had been a self-employed builder for many years. He regularly made profits of £35,000 out of which, after paying income tax and national insurance contributions (NIC) 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 NIC purposes and distributing the remainder of the money he required for his living expenses by way of dividend, he could reduce his tax and NIC for the year from £8,643.95 to £5,095.00. He duly acquired a new company on April 1, 2002 and transferred his trade to it. 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[16] and was abolished with effect from the financial year 2006.[17]

The application of the draft legislation to the above examples

Section 8—the charge to tax

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.[18]

Abnormal arrangements

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

[15] To help us test the concept of reasonableness, Mr Aedificator's transactions 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.

[16] FA 2004 s.28.

[17] FA 2006 s.26.

[18] There seems to be a contradiction between s.8 and the summary of it which is given in s.2. Section 2 says that s.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 and [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.

"(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:

> "[w]hich 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."[19]

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. One presumes that 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 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 tax and NIC charged directly and indirectly on his trading profits. Again if that is an abusive tax result then his arrangements are abnormal arrangements.

Abusive tax result—section 3

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

An advantageous tax result

An advantageous tax result is defined in s.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."

[19] Appendix I s.7(1).

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 does not seem to fall within s.15(2)(b) and (c) and it is not clear that it falls within s.15(2)(a) either. Relief under TCGA 1992 s.223 operates by providing that a gain which would otherwise be chargeable to CGT 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. Such a construction, however, would clearly represent a major loophole in the provisions in respect of a wide range of other transactions so a court 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 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.

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 ss.4 and 5 from being treated as achieving an abusive tax result we must complete our examination of s.3 by looking at s.3(2).

Section 3(2) provides:

> "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 s.3(2) because in doing so one is not exploiting their application. What is clear is that this is a further uncertainty in the legislation.

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 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 s.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 s.3(2) is to be construed in this way.[20]

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 s.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 tax liabilities.

[20] Paragraph 6.3(i), Appendix II, para.20.

Reasonable tax planning—section 4

Are they arrangements which are "reasonable tax planning within s.4"?
Section 4(1) provides:

> "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."

"... 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 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 technical effects. On the other hand, if we do not posit an ordinary man whom do we posit? Often clients who implement tax planning will themselves rely on their advisers to understand the details. Yet surely the standard of reasonableness cannot be the opinion of an hypothetical reasonable tax adviser? Nor surely can it be that of an hypothetical 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[21] 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 TCGA 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.

Application of section 4 to Mr Domus

So if we apply s.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 TCGA 1992 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).

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

Exploiting main residence relief achieved a certain notoriety during the revelations concerning MPs' expenses claims. Journalists and many members of the general public 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 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:

> "[b]elieves 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. The author would not regard that as unreasonable but then, nor would he regard Mr David Mayes' decision to enter into the transactions which gave rise to the allowable income tax loss which was the subject of that case 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 business so as to take advantage of the nil starting rate of corporation tax. Whether a court would find such a 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."[22] 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.[23]

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

[22] Appendix I s.8(2) and (5).
[23] Appendix I s.8(3).

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

So, not only is there 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.

Readers at this point may simply say "surely HMRC aren'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 have no discretion in the matter. They will be under a duty to collect tax on the basis of the law; in these circumstances, on the basis that the GAAR applies.

The safeguards

Mr Aaronson acknowledges 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 s.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 of his 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 s.8.

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 are given no discretion, beyond their 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 s.8 is mandatory. That being so, if 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 it. The court may consider any published guidance or determinations of the Advisory Panel[24] but it need not do so.

[24] Section 10(3)(b).

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 without specialist tax expertise would be foolhardy to make such representations himself. Making a representation, therefore, will mean incurring further professional fees. The 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 wish 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 to force additional tax revenue from taxpayers with modest amounts of tax at stake is likely to be irresistible.

A costly failure

The fundamental problem with the draft legislation 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 s.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 the 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 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.