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Should Humpty Dumpty be your Guide?

Capital gains tax; Capital losses; Tax avoidance

"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." HMRC's "guidance" on Taxation of Chargeable Gains Act 1992 s.16A is misleading and dangerous to taxpayers and their advisers.

Finance Act 2007 s.27 inserted a new s.16A into Taxation of Chargeable Gains Act 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".[1]

"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 Income and Corporation Taxes Act 1988 s.709(1) - now in Income Tax Act 2007 s.683(1), as "income tax advantage" - , 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.

This legislation will deny loss relief to much ordinary tax planning.

Widespread criticism

The legislation was first published in a draft on December 6, 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

[1] Taxation of Chargeable Gains Act 1992 s.16A(1): all references in this article are to the Taxation of Chargeable Gains Act 1992 unless otherwise stated.

the case, issuing successive drafts of ‘‘guidance’’ on the legislation (issued in a final form on July 19, 2007) which has itself been criticised as misleading and inaccurate.

On February 9, 2007, in a paper supported by STEP, the Law Society and the ICAEW’s Tax Faculty, the CIOT 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 to say that 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 out of those 18 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 will not apply to circumstances where it does. Why is the Guidance so consistently wrong? On June 1, 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 Guidance's treatment of the main purpose test

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

The Guidance says:

> "The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements."[2]

Here, the Guidance is almost but not quite correct. In *Snell v Revenue & Customs Commissioners*,[3] which concerned the purposes of arrangements under Taxation of Chargeable Gains Act 1992 s.137, the 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 (Inspector of Taxes)*,[4] 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

[2] HMRC Guidance, para.11.
[3] [2006] EWHC 3350 (Ch). See the Case Note article by Nicholas Harries *"When Does Deferral Become "Avoidance Altogether"?"* in [2007] P.C.B. 255.
[4] [1983] S.T.C 665, HL.

> 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 also *John Pimblett & Sons Ltd v Customs & Excise Commissioners*,[5] *Vodafone Cellular Ltd v Shaw*[6] and *Coffee Republic v Commissioners of HMRC*[7]).

The Guidance goes on:

> ''If any participant who has entered into the arrangements has done so with a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.''[8]

This is an important error. As we have seen, one determines the purposes of arrangements from the objects of the participants. Because one participant has an object of avoiding taxation that does not, of itself, result in that being a main purpose of the arrangements if the participant's involvement in the arrangements is peripheral. What is required is to determine whether a purpose of the arrangements is a main purpose, not whether an object of a participant is one of his main objects.

What is clear is that s.16A can apply where the tax avoidance purpose is that of a third party. In their February paper the CIOT gave the following example:

> ''A (who is UK domiciled and resident) sells a non-UK situs asset at a loss to an unconnected person, B (who is UK resident but not domiciled). B—who could have purchased a similar UK situs asset instead—has a main purpose of enabling future gains to be taxed on a remittance basis. This purpose may be unknown to A.''

Here, were it not for s.16A, an allowable loss would have accrued to A. The sale is an arrangement within the statutory definition because it is a transaction. In considering the purpose of that arrangement one considers the objects of the

[5] [1988] S.T.C. 358.
[6] [1997] S.T.C. 734.
[7] [2007] LON/2006/0756.
[8] HMRC Guidance, para.11.

persons who entered into it. B's object in entering into the transaction must be of equal weight to A's. Therefore B's object of avoiding tax on future gains is a main purpose of the arrangement. One of the main purposes of the arrangements, therefore, is to secure a tax advantage. The result is that A does not realise an allowable loss.

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."[9]

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 inquiry of fact to be determined upon evidence. The factors listed in para.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 v HMRC*.[10] Nonetheless, if the factors set out in para.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, they appear to be alternative or further tests in addition to, or in substitution for, the statutory purpose test.

[9] HMRC Guidance, para.12.
[10] [2006] Sp.C. 532.

The example in Boxes 1 and 2 on pages 425 and 426 below reproduce Examples 4 and 15 in the Guidance although with the author's analysis 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 section 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 on a similar example in a previous draft (which omitted the irrelevant information in relation to the wife's transactions) the CIOT commented[11]:

> "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

[11] In a paper dated February 9, 2007 at para.6.2.

> 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 EIS 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 this author has given and said[12]:

> ''Whilst 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 para.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. The Government rejected the amendments on the basis that they would allow some tax avoidance which they wished to be caught to escape the ambit of the section. 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, said in committee that ''The

[12] In a paper dated April 2, 2007 at paras 24–26.

Guidance is not concessionary, as alleged by the CIOT''. As we have seen, the CIOT stuck to its guns saying on June 1, 2007:

> ''in our view 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.''

What should advisers do?

In the author's view, it would not be safe for taxpayers and their advisers to rely on the Guidance for a number of reasons.

First, the Guidance is rarely expressed with sufficient precision for a taxpayer to clearly show that he falls within its terms. For example it says[13]:

> ''In particular it is unlikely that individuals with a normal portfolio of investments who make disposals in the ordinary course of managing their portfolio would be affected by these new rules . . .''

It does not define what is meant by a ''normal portfolio'' or ''disposals in the ordinary course of managing'' that portfolio.

Secondly, the Guidance is hedged around with caveats. For example, it explains that:

> ''Examples of how the legislation will apply in particular circumstances are set out below. These examples are intended to show how different factors will be taken into consideration in deciding whether or not the TAAR applies in a given set of circumstances. They 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.''[14]

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.

[13] HMRC Guidance, para.3
[14] HMRC Guidance, para.26.

Even if the taxpayer were able to show that his circumstances were exactly covered by the Guidance, would HMRC be bound by it? The Guidance is not binding on the Special Commissioners or the Courts (see *Gaines-Cooper v HMRC*[15]).

It is unlikely that the remedy of judicial review will be available. It is clear that HRMC do have the power to make extra statutory concessions but only in

> "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".[16]

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 itself out as applying a concessionary treatment it is likely to find that concessionary treatment to be ultra vires.

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.

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*[17] 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 overgenerous 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 HRMC'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*[18] providing protection against a discovery assessment under Taxes Management Act 1970 s.29.

[15] [2007] S.T.C. (SCD) 23.
[16] *R. (on the application of Wilkinson) v Inland Revenue Commissioners* [2005] UKHL 30.
[17] [2007] All E.R. (D) 390.
[18] *Veltema v Langham* [2004] S.T.C. 544, CA.

In its submission on June 1, 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.

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 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 Mr H's purpose in making his disposal. As Mr H is ignorant of his wife's transactions they do not do so.

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 Enterprise Investment Scheme 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.