DISCLOSURE OF TAX AVOIDANCE SCHEMES AND INHERITANCE TAX

THE BACKGROUND TO THE EXTENSION OF THE DISCLOSURE RULES TO INHERITANCE TAX

PART ONE

SIMON McKIE

The extension

The *Disclosure of Tax Avoidance Schemes* (DOTAS) regime (disclosure rules) requiring disclosure of tax planning transactions, imposed by the *Finance Act 2004* part VII[1], has been extended, with effect from 6 April 2011, to certain classes of arrangement under which an advantage is obtained in relation to an inheritance tax (IHT) charge. There will be many advisors, to whom the disclosure rules did not apply, who will now have to consider whether they have a duty to make a return under those rules. In particular, large numbers of solicitors and financial advisors who give advice on what may seem very routine IHT planning should now carefully consider whether they have a duty to make a disclosure to HMRC under these rules.

When the disclosure rules were introduced in 2004, they only covered arrangements that were either connected to employment or involved financial products[2], and that enabled a person to obtain an advantage in respect of income tax, corporation tax or capital gains tax. A separate but similar regime governs value added tax[3].

At the time, the government made much of the fact that the rules would only affect a restricted range of advisors because they were closely targeted on those areas most likely to be the subject of avoidance. This restraint was soon abandoned so, even before the rules were extended to IHT, they had been extended to stamp duty land tax[4] and national insurance contributions[5] and were no longer restricted to particular categories of transactions[6].

The extension of the disclosure rules to IHT is restricted to certain classes of transactions involving trusts[7], but the history of the rules suggests that it will not be long before they are extended to IHT generally.

AN ILL-CONSIDERED DEVELOPMENT

When the disclosure rules were introduced in 2004, I commented that:

- the regulatory impact assessment (RIA) made no attempt to quantify the cost to the taxpayer of the rules
- the RIA contained no estimates of the tax that the rules would raise
- there was no evidence of a substantial problem of non-disclosure as HMRC alleged, and

'Any firm or individual advising on IHT planning, which includes property becoming relevant property, will have to review their advice to see whether or not it must be disclosed'

- the measures would give a competitive advantage to the small minority of dishonest advisors over the honest majority[8].

IGNORING EXPERT OPINION

Similarly, the extension of the rules to IHT lacked any proper assessment and quantification of its advantages and disadvantages. A consultation document proposing the extension was issued on 27 July 2010[9]. It referred to 'some informal discussions [which] were held with representative bodies and other interested parties in January 2010' and asserted that the principle of extending the DOTAS regime 'was generally accepted, though there were concerns about how this might be implemented'[10].

In the Chartered Institute of Taxation's response to the consultation document, however, it made the following comments, which it described as 'fundamental reservations':

'*1.2 We suggest that a review of the overall policy of inheritance tax (IHT) and what it is trying to achieve would be a better way of dealing with perceived tax avoidance than imposing yet another layer of anti-avoidance legislation in the form of these disclosure requirements. Indeed, in the current financial climate, we would suggest that introducing a disclosure regime based on transfers into trust rather than avoidance of IHT per se is not a sensible use of HMRC's resources...*

'2.1 Misguided legislation *We have yet to be convinced that there is widespread avoidance of the IHT charge that arises when property is transferred into trust or, if there is, that it is in truth avoidance. The gift into trust provisions should be subjected to a policy review before the imposition of DOTAS system can be justified. In any event, correcting the gift with reservation provisions might be a more appropriate response to the perceived problem. The cost assumptions provided in the impact assessment lack credibility.'*

In a similar vein, STEP responded:

'*We would suggest that DOTAS represents a fundamentally flawed response to the real issue that arose out of a misconceived inheritance tax policy introduced in 2006. There is no logical policy reason why lifetime transfers into trust should be taxed more severely than outright transfers to individuals.*

'*...If this misconceived policy was reversed then we suggest that much of the impetus for the sort of schemes the DOTAS aims to catch would fall away anyway...*

'*We are concerned that, given the breadth of the draft regulation, much time and effort will be expended by... practitioners [not greatly concerned with sophisticated tax planning] (giving rise to increased costs to their clients) establishing whether or not the strategy they are advising needs to be reported or not.*'

HMRC published a summary of the responses to the consultation on 6 December 2010 in which these fundamental criticisms by two professional bodies, which between them represent the combined expertise of over 30,000 taxation and trust practitioners, were dismissed as, 'two respondents [who] felt that the proposed legislation is "misguided" and a "fundamentally flawed" response to what they perceive as misconceived policy changes in 2006'. The document went on to ignore these criticisms on the basis that they were '...beyond the scope of this consultation' there being 'no plans for such a reform of IHT at this stage'.

A FAILURE TO ACCURATELY ASSESS ITS FINANCIAL IMPACT

An impact assessment of the proposals was published on 22 July 2010[11].

The impact assessment estimated the administrative burden on 'promoters' at GBP90,000 per year. This was based on a cost of each notification of GBP3,700 per scheme on the assumption that 25 schemes will be notified to HMRC in each year. The impact assessment said:

'*Many promoters are likely to be familiar with the DOTAS regime already as it applies to other taxes. Those likely to promote IHT schemes will also be familiar with the IHT regime and have processes in place to comply with the new rules. However, [sic] there may be a few promoters who have no experience of the DOTAS regime. They would have to familiarise themselves with the regime and draft guidance for their staff*[12].'

As we shall see, the use of the word 'promoter' is misleading. It is a term used in the legislation where it is given a special meaning[13], very different from the meaning it bears in ordinary English use. It is clear that any firm or individual advising on IHT planning, which includes property becoming relevant property, may be a promoter under the disclosure rules and will have to review their advice to see whether or not it must be disclosed. Many solicitors and financial advisors will have to consider the disclosure rules for the first time. Indeed, in its summary of responses to the consultation document, HMRC admitted as much, saying: '...in relation to IHT, there is likely to be a higher proportion of lawyers among tax practitioners than may be the case for many other

taxes. These practitioners may not have had to deal with DOTAS previously.'

It is clear from the operation of the disclosure rules in relation to other taxes that large numbers of arrangements are not disclosed that fall within the letter of the rules. No doubt it will be the same with IHT. Nonetheless, prudent firms will institute a general procedure of reviewing all of their advice, and that will impose costs on clients hugely in excess of GBP90,000 per annum. What is more, the impact assessment made no attempt to quantify the likely savings from the disclosure regime. Finally, the impact assessment revealed that only two options were considered: first, the proposed extension of the disclosure regime and, second, doing nothing.

When the regulations were laid before the House of Commons, they were accompanied by a tax information and impact note (TIAN) that revealed the introduction of the scheme was not forecast to have any effect on government revenues and yet which stated that 'the change is expected to reduce the future use of IHT avoidance schemes [sic], which currently present a risk to the Exchequer'. So either the use of such arrangements does not reduce overall government revenues or the effects of the disclosure rules are either so minor or so unpredictable that they cannot be taken into account in government forecasting.

The TIAN does show signs of having taken some account of the professional bodies' criticisms. It says, for example:

'On the basis of representative body estimates that up to 10,000 practitioners will need three hours training, [initial costs] will be in the region of GBP3 million[14]. Although not directly chargeable on individuals, these initial costs will ultimately influence fee charging policies[15].'

Having acknowledged that this new burden will be imposed by the change, the TIAN makes no attempt to make any use of this assessment in its quantification of the cost of the compliance regime. In making that quantification, it maintains the method of the impact assessment, assuming that 25 schemes will be notified in a year, increases the estimated cost of each notification from GBP3,700 to GBP4,400 without explaining how that figure is calculated, and thus arrives at an annual cost of GBP110,000. It seems to place great weight on the fact that HMRC '…is developing a list of existing schemes and arrangements that do not have to be reported which should reduce the number of unnecessary disclosures'.

As we shall see, the list produced by HMRC is confused, imprecise, inaccurate and heavily caveated and is unlikely to be of any material use to a practitioner in deciding whether or not a disclosure should be made.

It is clear that the major cost for practitioners will not be that of making returns required under the disclosure rules but of reviewing advice to determine whether or not a disclosure is required. If we assume, for example, that the 10,000 practitioners to which the TIAN refers give on average of ten pieces of advice per year[16] and spend one hour reviewing each piece of advice[17], and if we adopt the Revenue's assumption that the average charge-out rate is GBP100 per hour, that would give an annual cost, which will ultimately be borne by the clients of the advisor, i.e. taxpayers, of GBP10 million. So a relief, the benefits of which are so unpredictable that they have no effect on the government's forecasts of its income, is likely to impose an annual cost on this body of taxpayers of GBP10 million. That is small beer in comparison with the total burdens imposed on taxpayers but not, surely, a burden that should be imposed without some commensurate quantification of its benefits.

So the extension of the disclosure rules to IHT cannot be justified on financial grounds. As STEP's representations made clear, the increase in tax-motivated transactions, if indeed there was such an increase, to which the new rules are claimed to be a response, was merely a symptom of a more fundamental problem. That more fundamental problem is the conceptual incoherence of the rules governing the IHT of trusts, which resulted from the changes made in the *Finance Act 2006*.

THE FORM OF THE LEGISLATION

The legislation governing the disclosure rules is one example of the many worst features of modern tax legislation. The primary legislation provides only a framework for the disclosure rules and a series of powers for the Treasury to make secondary legislation by way of statutory instrument, ensuring that the disclosure rules are not subject to proper parliamentary scrutiny. The bulk of the legislation is, therefore, found in regulations, and these regulations have been amended piecemeal and now require consolidation.

The government has allowed HMRC to sponsor poor legislation, the faults of which they have attempted to correct through inaccurate and inadequate guidance[18]. The practitioner is, therefore, placed in the position of having to decide to what extent they can rely on HMRC's statements as to the effect of the law where many of those

'The guidance is often so imprecise that the practitioner will not know whether or not they fall within its terms'

statements are inaccurate and, where they are not, present what is only one tenable view among many as if it were the only possible view. The guidance is often so imprecise that the practitioner will not know whether or not they fall within its terms. Even if they do fall within the terms of the guidance, where the guidance conflicts with the law they will only be able to rely on it to the extent that they can anticipate establishing, in judicial review proceedings, that they have a legitimate expectation that the guidance will be applied.

THE CONTENT OF THE IHT DISCLOSURE RULES

I now turn to the IHT disclosure rules themselves. Because they are an extension of the existing rules, they fit within an extensive compliance system, which has been developed since 2004. I do not examine that system in this article but instead concentrate on the elements that are new and relate to IHT but, to do so, I first examine those provisions of part VII into which the new regulations fit.

NOTIFIABLE PROPOSALS

Sections 308-310 impose a duty of disclosure on promoters of notifiable proposals, which are subsequently implemented, and on persons entering into transactions forming part of notifiable arrangements. We shall see that the term 'promoter' is very widely defined and will include most providers of taxation advice[19] in respect of notifiable proposals. A notifiable proposal is defined as: '...a proposal for arrangements which, if entered into, would be notifiable arrangements (whether the proposal relates to a particular person or to any person who may seek to take advantage of it)[20].'

NOTIFIABLE ARRANGEMENTS

Notifiable arrangements are defined in s306(1) as:

'...any arrangements which...
(a) fall within any description prescribed by the Treasury by regulations
(b) enable, or might be expected to enable, any person to obtain an advantage in relation to any tax that is so prescribed in relation to arrangements of that description, and
(c) are such that the main benefit, or one of the main benefits, that might be expected to arise from the arrangements is the obtaining of that advantage.'

Before looking at those elements of this definition, which are prescribed by regulation, we shall look at the meaning of 'arrangements', 'advantage' and 'main benefit'.

ARRANGEMENTS

Section 318(1) provides that the meaning of 'arrangements' for this purpose 'includes any scheme, transaction or series of transactions'. It will be noticed that the definition is inclusive rather than exhaustive. In the context of the definition of a settlement for the income tax provisions[21], the term 'arrangement' has been held to be a wide one[22]. It is likely that the courts will take a similarly wide view of the meaning of 'arrangements' in the disclosure rules. Certainly, it is clear from s318(1) that 'arrangements' can include a single transaction. As we shall see, HMRC seems to assume erroneously that a single transaction cannot be within the meaning of 'arrangements' for this purpose.

TAX ADVANTAGE

An 'advantage' in relation to any tax is defined in s318(1) as:
'(a) relief or increased relief from, or repayment or increased repayment of, that tax, or the avoidance or reduction of a charge to that tax or an assessment to that tax or the avoidance of a possible assessment to that tax
(b) the deferral of any payment of tax or the advancement of any repayment of tax, or
(c) the avoidance of any obligation to deduct or account for any tax.'

The definition is based on the one in the *Transactions in Securities* legislation[23], which has been considered by the courts in a number of cases. Although the exact meaning of that definition is uncertain, its scope is certainly extremely broad. In the guidance, HMRC says: 'Where the scheme is expected to result in tax being avoided or reduced then the long-standing judgment of Lord Wilberforce in *CIR* v *Parker* [1966] AC 141 applies and the existence of a tax advantage is tested on a comparative basis[24].'

CIR v *Parker* concerned the *Transactions in Securities* provisions. It is perhaps a reasonable assumption that the courts will have regard to the case law on the meaning of 'tax advantage' in that legislation in construing the phrase in the disclosure regime.

In the case of *Emery* v *CIR*[26], it was held that a tax advantage is obtained where a person receives something in a non-taxable form, which, if received in another way, would have been taxable even though it might also have been received in a third way that was non-taxable. By extension, one may take the view that a tax advantage arises where a result might have been obtained by a route that results in a tax charge but is actually obtained by another route that results in no, or a lesser, tax charge.

What is more, in respect of the *Transactions in Securities* rules, the courts have applied a wide latitude in identifying a hypothetical receipt to which to compare the actual receipt. In *Cleary* v *IRC*[27], a company repurchased its own shares. In determining whether there was a tax advantage, a comparison was made with the situation that would have ruled had the company paid a cash dividend equal to the purchase consideration. Of course, a shareholder who sells shares suffers a diminution in their rights over the company, whereas one who receives a dividend does not. In spite of that, the court was able to regard the receipt of sale proceeds as being the same receipt for the purpose of the comparison as a hypothetical receipt of a dividend.

There is a great difference between the sort of transactions that are subject to the *Transactions in Securities* rules and those that are undertaken for IHT planning purposes. Where a transfer into trust is made, the transfer will not be a benefit to the transferor except in an intangible manner by satisfying their wish to provide for those whom they love and for whom they feel responsibility. If we look at all of the parties concerned, the settlor and the beneficiaries, there will not be any net change in their wealth.

How will the courts decide which hypothetical transactions they are to regard as comparable to the actual transactions taking place in the arrangements? If the end result of two alternative sets of transactions is exactly the same, and the actual and hypothetical transactions are only differentiated by the inclusion of intermediate steps in the actual transaction, it is likely that the courts will find the two sets of transactions, actual and hypothetical, to be equivalent.

For example, if a father who wishes to make a discretionary settlement for his daughters instead gives money to his wife in the hope and expectation that she will settle the money on discretionary trusts on identical terms to those on which he would have settled it, it would be easy for the court to decide that the hypothetical arrangements to which the actual arrangements are to be compared is the direct settlement. Even here, however, the effects of the two are not exactly the same. For example, if the wife was to become insolvent within two years of the settlement being made, it could be set aside, whereas, in such circumstances, a settlement made directly by the husband could not[28].

What, however, if the wife is subject to gift and succession taxes in another state and, by reference to the taxation laws in another state, makes a significantly different settlement from the one which the husband would have made? Will the courts then still see the actual and hypothetical transactions as equivalent? If they were to follow the wider approach adopted in the *Transactions in Securities* cases no doubt they would, but would they do so in relation to the very different provisions relating to the disclosure of IHT arrangements?

So it will often be difficult to determine what hypothetical transaction should be the comparator with which the taxpayer's actual transaction is to be compared.

Consider this situation: I am contemplating settling shares in an investment company on discretionary trusts for my daughters. Because the shares are worth more than my unused nil rate band, I decide first to reorganise the share capital of the company so as to create preference shares with a market value equal to my unused nil rate band, and ordinary shares whose value is equal to the value of the whole company in excess of that amount. I then settle the preference shares on discretionary trusts and make an outright gift of the ordinary shares. In determining whether a main benefit of the arrangements consisting of the reorganisation, gift and settlement is the obtaining of a benefit in relation to a relevant property entry charge, do I compare my actual transactions with a simple settlement of the original shares on discretionary trusts? The effect of my actual transactions will be very different from that of the transactions that I originally contemplated, which might be taken to be the comparator of the hypothetical arrangements.

HMRC's guidance provides no useful commentary at all on these difficult issues.

The expression 'main benefit' which is used in s306(1)(c) raises the difficult question of when the obtaining of such an advantage as is mentioned in s306(1)(b), which might be expected to arise from the arrangements under consideration in any particular case, is not just 'a benefit' of the arrangements, but 'the main benefit' (or one of the main benefits) that might be expected to arise from the arrangements. The Oxford English Dictionary defines 'main' as 'principal, chief, pre-eminent' and specifically in relation to 'a quality, condition, action, etc' as meaning 'very great in degree, value, etc; highly remarkable for a specified quality, very great or considerable of its kind'.

It should be clear from this definition that there can only be more than one main benefit of a thing where those main benefits may all be fairly described as chief or as very great in degree or highly remarkable, etc. Where one benefit is of greatly more importance than all the others, the absolute

'In deciding whether the benefit consisting of the advantage is a main benefit, you are making a comparison with the other benefits expected to arise'

pre-eminence of one benefit precludes any other benefit from being a main benefit[29].

It should also be noted that in contrast to s306(1)(b), s306(1)(c) looks at the expected benefits of the actual arrangements concerned. So in deciding whether the benefit consisting of the advantage is a main benefit, you are making a comparison with the other benefits expected to arise under the actual arrangements rather than arising from another set of hypothetical arrangements.

The guidance gives no help in understanding the ambit of condition (c). It makes the point that the test is objective rather than subjective, which is only partially true: as we have seen, although condition (c) does not look at an actual person's expectation, it is still concerned with expectation – that of a hypothetical person. Apart from that all it says is:

'In our experience, those who plan tax arrangements fully understand the tax advantage such schemes are intended to achieve. Therefore, we expect it will be obvious (with or without detailed explanation) to any potential client what the relationship is between the tax advantage and any other benefits of the product they are buying[30]...'.

It will be noticed that in sub-sections (b) and (c), the definition is not concerned with actual benefits but rather with benefits that might be expected to arise. The use of the conditional 'might' implies a hypothetical person whose likely expectations are to be considered. You would presume that is a hypothetical, reasonable man. The question of whether the condition in s306(1)(c) applies, therefore, must depend upon whether a reasonable man would consider one of the main benefits of the arrangements to be the obtaining of a tax advantage. It will often be the case that the 'promoter' of the scheme asserts that the strategy will work, whereas HMRC, when it becomes aware of it, asserts that it will not. In considering whether s306(1)(c) is satisfied, however, it is the probable expectations of the reasonable man that matter and they may share the opinion of either the 'promoter' or of HMRC.

The second part of this article, which looks at the detail of the provisions and guidance, will feature in the next TQR *supplement*

Simon McKie TEP is Chairman and a designated member of McKie & Co (Advisory Services) LLP

[1]All further statutory references in this article are to the *Finance Act 2004* unless otherwise stated
[2]*Tax Avoidance Schemes (Information) Regulations 2004 SI 2004/1863*
[3]*VATA 1994*, s58A and s58B and Sch 11A
[4]The *Stamp Duty Land Tax Avoidance Schemes (Prescribed Description of Arrangements) Regulations 2005* (SI 2005/1868)
[5]*The National Insurance Contributions* (application of part 7 of the *Finance Act 2004*) *Regulations 2007* (SI 2007/785)
[6]The *Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006* (SI 2006/1543)
[7]See below
[8]*Taxation* magazine 20 May 2004 'Big Brother Forces a Confidence – II'
[9]Referred to in the remainder of this article as the 'consultation document'
[10]Consultation document para 3.3
[11]Referred to in the remainder of this article as the 'impact assessment'
[12]Page 5 of impact assessment
[13]Section 307
[14]This implies an average charge-out rate of GBP100. As the individuals being trained will need to fully understand the relevant IHT provisions and have the capacity to understand the complex disclosure rules that is unrealistically low
[15]TIAN, 'Impact on individuals and households'
[16]Surely a very modest estimate
[17]Considering the complexity of the issues, this is a very low estimate of the time involved
[18]The guidance on the disclosure rules is referred to in this article as the 'guidance'
[19]And indeed other forms of advice
[20]s306(2)
[21] Now found in the *Income Tax (Trading and Other Income) Act 2005*, Pt 5 Ch 5
[22] For example *Burston* v *CIR (Number 1)*; *Halperin* v *CIR KB* [1945] 2 All ER 61; *CIR* v *Prince-Smith KB* [1943] 1 All ER 434; *Young* v *Pearce*: *Young* v *Scrutton* ChD [1996] STC 743; *CIR* v *Pay* ChD [1955] 36 TC 109; *Crossland* v *Hawkins*, CA [1961] 2 All ER 812; *Vandervell* v *CIR* HL [1967] 2 AC 291; *CIR* v *Wachtel* ChD [1971] 1 All ER 296
[23]Now found, in a further modified form, in the *Income Tax Act* 2007 part 13 chapter I
[24]Guidance para 9B4.1
[25]*CIR* v *Parker (and related appeals)* HL [1966] 1 All ER 399
[26]*Emery* v *CIR* ChD [1981] STC 150
[27]*Cleary* v *IRC* HL (1967) 44 TC 399
[28]*Insolvency Act 1986* s339
[29]You may, however, be cautious in the light of the Special Commissioner's decision in *PA and Mrs M Snell* v *HMRC* SpC [2008] SSCD 1094, which concerned the meaning of 'main benefit' in the transfer of assets abroad legislation. The Special Commissioner found that, although a sale was undertaken for a bona fide, commercial purpose, it also had another main purpose of conferring a tax advantage: despite the tax benefit of the transaction being just 7 per cent of the total transaction value
[30]Guidance para 9B:5