# The acid test

*Simon McKie* reviews the illustrative draft legislation which is the outcome of the Aaronson review into a general anti-avoidance rule

After a year's work Graham Aaronson QC produced his report on a general anti-avoidance rule (a 'GAAR') and illustrative draft legislation in November of last year.

He concluded that 'a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system.' Instead he recommended that a 'specifically targeted anti-abuse rule' should be enacted and concluded that 'it should be possible to draft such a rule so that it would operate effectively and fairly'.

He claimed that because his GAAR:

> '... will not apply to the centre ground of responsible tax planning ... there will be no need for a comprehensive system of clearances ...'

Does his proposed GAAR meet his terms of reference that it should ensure 'that sufficient certainty about the tax treatment of transactions could be provided without undue compliance costs for businesses and individuals' and 'that the rules will not erode the UK tax regime's attractiveness to business'?

## A final test?

Certainly, one would say that if a Revenue QC of Mr Aaronson's standing advised by such a distinguished committee cannot, after a year's work, draft a GAAR which provides reasonable certainty of application, then it cannot practically be done.

In this article, I examine the draft legislation and test it against two sets of transactions (***See Examples 1 and 2***) which would not normally be classified as contrived and artificial schemes of tax avoidance and which, if the draft legislation fulfils its purpose, should surely not fall within the ambit of its provisions.

## The charge to tax

***Section 8***

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.

## Abnormal arrangements

Section 6 provides:

> '(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 'which in the context of the particular arrangement may be regarded as abnormal features, and which ... may be taken into account in determining whether that arrangement [was] an abnormal arrangement'. Neither the fact, however, 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 (See ***Example 1***) abnormal? 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

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## KEY POINTS

- The proposal for a targeted anti-abuse rule is the outcome of the study by Graham Aaronson over the past year
- The proposed legislation is not intended to apply to the centre ground of tax planning advice, but to abusive transactions
- This article challenges that assurance and suggests problems in even basic tax-motivated behaviour

of its main purposes, achieving an abusive tax result'.

Similarly, Mr Aedificator (see ***Example 2***) incorporates his trade in order to reduce the direct tax and NICs charged directly and indirectly on his trading profits. Again, if that is an abusive tax result then it is clear that his arrangements are abnormal arrangements.

### Abusive tax result – section 3

An abusive tax result is an advantageous tax result which will be 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.'

It is not clear whether the result of Mr Domus' arrangements is an advantageous tax result. It doesn't seem to fall within (b) or (c) of section 15(2) and it is not clear that it falls within section 15(2)(a) (ibid). TCGA 1992 s 223 operates by providing that a gain which would otherwise be chargeable to capital gains tax is not so chargeable (either wholly or partly). That does not seem to be aptly described as a significant reduction in receipts or an increase in deductions. There is no deduction involved in the relief. The gain is not reduced, it is merely wholly or partly not chargeable. Nonetheless, such a construction would clearly represent a major loophole in the ambit of the GAAR. A court allowing itself a wide latitude in 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' for this purpose.

Mr Aedificator's incorporation of his trade, is clearly contrived to achieve an advantageous tax result because it achieves a significant reduction in the overall rate of tax chargeable. The fact that the profits which would otherwise be charged to Income Tax are charged partly to Corporation Tax and partly to Income Tax does not affect the matter.

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

#### *Section 3(2)*

Section 3(2) provides that:

'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 ss 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

## EXAMPLE 1 – MR DOMUS

David Domus purchased a house in the country on 1 April 2002 for £2m which he occupied as his main residence. It is now worth £4m. On the 30 April 2009 he purchased a flat in London for £500,000 which he let. By the spring of 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 capital gains tax, 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 was just enough to establish that it was a residence in respect of him for the purposes of 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 the 30 April 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.

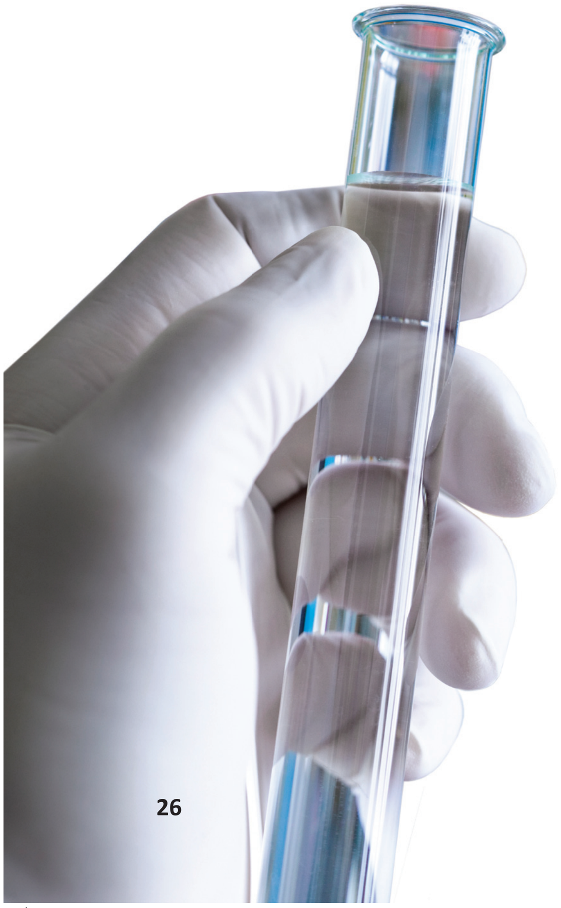
(b) exploiting the application of particular provisions of the Acts, or

(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 context 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 sub-s (2) because in doing so one is not exploiting their application. What is clear is that there is a further significant uncertainty in the legislation here.

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 section 1 ibid. If 'exploit', however, includes the sense of improperly taking advantage of the legislation it would require another difficult act of judgment, akin to the test required by section 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 section 3(2) is to be construed in this way. (Paragraph 6.3(i), Appendix II, para 20.)



## EXAMPLE 2 – MR AEDIFICATOR

Bob Aedificator had been a self-employed builder for many years. He regularly made profits of £35,000 out of which, after paying his income tax and 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 income tax and NICs for the year from £8,643.95 to £5,095.00. He duly acquired a new company on 1 April 2002 and transferred his trade to it on that date. 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 (FA 2004 s 28) and was abolished with effect from the financial year 2006 (FA 2006 s 26).

## No tax intent – section 5

Section 5 provides, loosely, that arrangements entered into without tax intent are not to be treated as achieving an abusive tax result. 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 their tax liabilities and therefore are not relieved by section 5.

## Reasonable tax planning – section 4

Are they arrangements which are 'reasonable tax planning within section 4'?

Section 4 provides:

'(1) 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.

(2) Accordingly, section 8 (counteraction) shall not apply to such arrangements.

(3) Such arrangements are in this Part referred to as "reasonable tax planning".'

***'… reasonably be regarded as a reasonable exercise…'***

We are given no standard by which to judge reasonableness. Normally, reasonableness criteria in the law are judged by reference to the ordinary, reasonable man. Such a test would present great 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 don't posit an ordinary man who 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 ordinary reasonable tax adviser? Nor, surely, can it be that of a hypothetical ordinary 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 and the intellectual capacity to understand its application to transactions of all levels of complexity. (One doubts whether a man who has acquired such knowledge for no purpose could properly be described as reasonable.) 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 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 section 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).

Exploiting the main residence exemption achieved a certain notoriety during the revelations concerning MP's expenses claims. Journalists and many members of the general public plainly 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 for businessmen to choose that form of organisation rather than the other. Nonetheless, in its Discussion Paper on 'Small Companies, the Self Employed and the Tax System' issued in December 2004 the Government said that it believed:

> '… that the choice of legal form that a small business takes should reflect commercial rather than tax considerations … 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 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 an artificial transaction to be a reasonable exercise of the choices of conduct afforded by the provisions of the Acts remains uncertain.

## Significant uncertainty

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 under the GAAR.

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 special discretion in the matter. It will be under a duty to collect tax on the basis of the law.

## The safeguards

Mr Aaronson does acknowledge 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 section 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 he wishes to make 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 section 8.

The designated officer has a duty to consider the opinion of the addvisory panel but need not adopt its opinion. The court may consider any published guidance or determinations of the Advisory Panel (s 10(3)(b)) but it need not do so.

If Mr Domus or Mr Aedificator is issued by HMRC with notices where HMRC consider that the GAAR applies to them they will be faced with a choice as to whether to make representations. A taxpayer in that position would be foolhardy to make the representations themselves. So making a representation would mean incurring further professional fees. Our 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 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 issue is likely to be irresistible.

## A costly failure

The fundamental problem with the draft legislation is that its application depends primarily upon a judgment 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 section 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 judgment of reasonableness which, in practice, must be highly subjective. 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 many 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 very 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.

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