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Tax Avoidance—A U.K. Perspective

BY MARK SIMPSON

"The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."[1]

Governments face a dilemma: They will always want to maximize tax revenues (never more so than in testing economic times) but at the same time don't want to be seen to discourage businesses from investing in their jurisdictions by increasing the tax burden. On the other hand, taxpayers are always keen to keep their tax liabilities as low as possible.

Against this background, we have seen an increasing focus on tax avoidance (actual and perceived). This article focuses on some of the actions that have been taken in the U.K. that will be of interest to U.S. and international companies.

A Question of Morals

The following extract from the "Autumn Statement" issued by Chancellor of the Exchequer George Osborne Dec. 5, 2013, exemplifies the current approach to tax avoidance taken by the U.K. government:

> Since 2010 the Government has been relentless in its crackdown on tax avoidance and aggressive tax planning, and there are strong signs that its approach is working. But a minority of taxpayers continue to seek out unacceptable ways to reduce the amount of tax that they pay. This increases the tax burden on the rest of society, and creates an unfair playing field for businesses and employers. The Government will therefore continue to take further steps to close down avenues for both tax avoidance and evasion.[2]

There is, of course, a key distinction between tax avoidance and tax evasion. Both involve taking steps to minimize the incidence of tax on assets or income. But evasion is unlawful and has always been "wrong" and punished accordingly (think of smuggling or fraudulent nondisclosure of revenues). On the other hand, tax avoidance is lawful. It involves taking advantage of gaps and opportunities in the tax code, staying within the law.

While tax avoidance hasn't been made unlawful, Chancellor Osborne's words continue a trend of using language to create the impression that avoidance in fact comes very close to evasion. At the very least, tax avoidance is presented as an activity of dubious morality so that what was accepted only a few years ago as a typical and lawful tax minimization strategy is now branded as unacceptable, even anti-social, behavior. The focus has shifted to paying the "right" or "fair" amount of tax.[3]

Quite where the dividing line between avoidance and tax planning lies in the new semantics isn't clear.

Despite this shift in language, it is still (generally) accepted that arranging one's affairs to minimize tax can be entirely legitimate and above criticism. However, because avoidance is now a pejorative term, this behavior tends to be called "acceptable tax planning," distinguishing it from "aggressive" tax planning that, as noted in the Autumn Statement, appears to be almost indistinguishable from tax avoidance.

Quite where the dividing line between avoidance and tax planning lies in the new semantics isn't clear—something which clearly suits Her Majesty's Revenue and Customs as it looks at ways to discourage taxpayers who seek to pay anything less than the "right" amount of tax (whatever that may be).

Base Erosion and Profit Shifting

Another aspect of tax policy has recently been added to the mix. As businesses operate on an increasingly global basis, they naturally look to manage the overall

[1] "L'art de l'imposition consiste à plumer l'oie pour obtenir le plus possible de plumes avec le moins possible de cris." Jean Baptiste Colbert (1619-1683), minister of finance under King Louis XIV of France.

[2] Autumn Statement 2013, page 6 Executive Summary.

[3] Starbucks responded to a vociferous campaign that it wasn't paying enough tax on profits in the U.K. by volunteering to pay more—the legal basis for Her Majesty's Revenue and Customs accepting such a payment is unclear.

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global tax cost they incur. Governments face the loss of tax revenues as businesses find ways to generate profits from trading with residents of a country without incurring a tax liability in that country—so-called base erosion and profit shifting (BEPS).

These concerns aren't new and, through unilateral action and the network of bilateral tax treaties, countries have tried to address them over the years, for example by using transfer pricing rules to reallocate profits for tax purposes where transactions between associated companies haven't taken place on arm's-length terms.

The existing rules have been challenged by globalization and, in particular, the development of electronic commerce. The U.K. aims to be at the forefront of collective global action to review and update the current rules, including the work being done under the auspices of the Organization for Economic Cooperation and Development.

As part of the high profile debate on BEPS, the U.K. government has sometimes criticized multinationals for seeking to minimize their exposure to U.K. tax by taking advantage of favorable non-U.K. tax regimes.

As businesses operate on an increasingly global basis, they naturally look to manage the overall global tax cost they incur.

This is dangerous territory as the government also has set itself the objective for the U.K. to have the most competitive tax system in the developed world. Steps have been taken to achieve this—lowering rates of corporate tax on profits, overhauling the controlled foreign company rules to make them more business-friendly and introducing the new patent box regime. Some of these changes have already been criticized, both within and from outside the U.K., for encouraging unfair tax avoidance, proving again that what is sauce for the goose is also sauce for the gander.

Judicial Approach

Some 80 years ago, the judicial approach to tax avoidance in the U.K. could be summed up in these much quoted words:

> Every man is entitled if he can to order his affairs so that the tax attracted under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[4]

The courts were on the side of the taxpayer.

Attitudes changed in the second half of the 20th century as judges became more willing to find ways to prevent taxpayers from successfully avoiding tax liabilities. Inevitably this was a hit-and-miss process, dependent as it is on the cases that come before the courts. From the mid-1980s, a succession of decisions appeared to be developing into a judge-made anti-avoidance doctrine based on looking at the substance of a transaction rather than its legal form.[5]

At the beginning of the 21st century, the House of Lords (then the highest U.K. court) decisively rejected this view, holding that the courts had no constitutional authority to impose such an overriding doctrine on to tax legislation.[6]

The role of the courts is to apply established rules of statutory interpretation to determine whether a transaction or series of transactions is taxable under the relevant legislation. However, the courts will apply a purposive construction that considers the underlying purpose of the legislation. This can allow the courts to ignore elements of a composite transaction or series of transactions that have no commercial purpose.

Later court decisions have clarified how the ''new'' approach is intended to be applied. One effect was perhaps immediately apparent to HMRC—it couldn't rely on the courts alone to strike down tax avoidance schemes. HMRC has therefore turned to other techniques to block tax avoidance.

It would be an overstatement to say that there has been a coordinated and consistent approach—much is opportunistic, driven by schemes and taxpayer behavior that comes to light. However, it is possible to identify two broad themes:

- the use of legislation to make avoidance of tax difficult; and
- the use of publicity to shine a light on ''unacceptable'' behavior.

Targeted Legislation

The U.K. tax code has gained substantial weight over the years. A significant part of the legislation issued each year now addresses tax avoidance. On rare occasions a new tax is introduced to replace a previous regime that had become, in the government's eyes, too easy to avoid.

For example, in 2003 stamp duty land tax (SDLT) replaced stamp duty on U.K. land transactions. One of the stated aims of SDLT was to stop widespread avoidance of stamp duty. In the same year, and for the same reason, the rules governing the tax treatment of shares acquired through employment were overhauled. The success (or otherwise) of these attempts to close down widespread unacceptable avoidance can be seen in the almost constant flow of amendments to the rules to counter ongoing ''unacceptable'' taxpayer behavior.

More commonly, existing tax rules are supplemented by new provisions that are designed specifically to stop tax planning that has become too prevalent or too costly. This approach has a long history—early anti-

[4] Lord Tomlin in *Duke of Westminster v. Comm'r of Inland Revenue*, [1936] AC 1. At around the same time, the U.S. courts adopted a similar approach—compare the much repeated words of Judge Learned Hand in *Helvering v. Gregory*, 69 F. 2d 809, 810-11 (2d Cir. 1934): ''Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.''

[5] The doctrine of substance over form is, of course, well-established in the U.S.

[6] *MacNiven (HMIT) v. Westmoreland Invs. Ltd.*,[2001] UKHL 6.

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avoidance rules appeared in the 1960s when income tax rates were very high and capital gains were tax free (an obvious ''loophole'' to be exploited).

Targeted rules can restrict the availability of reliefs where there is a tax avoidance motive or bring particular arrangements within the charge to tax. These targeted anti-avoidance rules (TAARs) now litter the tax code, adding considerably to its length and complexity—it has been estimated that there are more than 300 TAARs.

The Ultimate Deterrent?

Despite the proliferation of TAARs, tax advisers have continued to find ways around tax legislation. So, in March 2012, the government announced that a statutory anti-avoidance rule would be introduced into U.K. law.

Under the U.K.'s GAAR, a ''double reasonableness test'' determines whether arrangements entered into to secure a tax advantage will be treated as ''abusive.''

As might be imagined, the concept wasn't enthusiastically embraced by many taxpayers or their advisers. There was a certain inevitability about the process: The government had already taken advice from a study group of tax experts[7] whose conclusion was that a statutory anti-avoidance rule could be made to work in the U.K. (as it has, with varying degrees of success, in other countries around the world).

Some of the rougher edges were knocked off the proposal during the consultation period but the direction of travel was fairly clear. Draft legislation was published in December 2012 and, with relatively little amendment, was included in the Finance Act 2013, becoming law in July 2013. During the course of this process, the provision gained a new name—the general anti-abuse rule (GAAR)—apparently to better reflect its purpose.

The GAAR applies to most U.K. taxes, a key exception being value-added tax, which is governed (ultimately) by European Union law and principles. These already allow for the civil law concept of ''abuse of law'' under which a person who relies on the literal meaning of a law to claim a right that runs counter to its purpose is considered not to deserve to have that right upheld. This principle has been applied to U.K. taxpayers in relation to VAT.[8] So, the GAAR was either not needed in relation to VAT or not appropriate, depending on your point of view.

However, you can see the influence of ''abuse of law'' in the way the GAAR is drafted. It introduces a new concept to U.K. tax law: Taxpayers now have to consider whether what they are doing ''cannot reasonably be regarded as a reasonable course of action.''[9]This ''double reasonableness test'' determines whether arrangements entered into to secure a tax advantage will be treated as ''abusive.'' It is claimed that this will limit the application of the GAAR only to egregious tax planning, although it is far from clear at this stage where the boundaries lie.

There is more to the GAAR than the legislation itself. A permanent advisory panel has been established with two functions:

- to advise HMRC whether the GAAR is applicable to a particular taxpayer's affairs (advice that HMRC can ignore); and

- to issue general public guidance on the types of situation where the GAAR could apply.

In order to provide some initial guidance, HMRC has published its own thoughts. These usefully confirm that some plain vanilla planning isn't within HMRC's sights, while also highlighting some well-publicized schemes as falling clearly on the wrong side of the line. There is a large gray area in between these two extremes. It is to be hoped that the panel will, over time, reduce the areas of uncertainty.

HMRC has enthusiastically embraced the GAAR, describing it as a game-changer and showing every indication of wanting to make use of it.[10] The agency acknowledges that existing TAARs and case law principles already allow it to block much planning, so the GAAR operates as an additional deterrent.

The introduction of the GAAR has unfortunately not stopped the creation of new TAARs—further examples are included in the draft Finance Bill published in early December.

Schemes entered into before July 2013 are outside the scope of the GAAR so it will take some time before we start to see how HMRC uses the GAAR in practice. In the meantime, it operates as a further discouragement to taxpayers who may have considered entering into tax planning arrangements.

Compulsory Disclosure of Tax Schemes

While TAARs and, now, the GAAR may be effective to change taxpayer behavior and limit the opportunities for inappropriate tax avoidance, there can often be a long gap between a taxpayer implementing tax planning and HMRC finding out what has gone on. To address this issue, a new regime was introduced in 2004 to accelerate the collection of information on new tax planning techniques.[11]

DOTAS (disclosure of tax avoidance schemes) requires tax advisers and other ''promoters'' of schemes to inform HMRC about them in advance of their first use. The regime now covers most taxes.

Where a scheme is disclosed to HMRC, it is given a reference number that the promoter must give to clients who use the scheme. The client is then required to include the reference number on its tax return. In this way, HMRC gets to know about schemes at a much earlier stage and also finds out how many times that pro-

[7] The study group, under Chairman Graham Aaronson QC, published its report in November 2011.

[8] *Halifax plc v. C&E Comm'rs*, CJEC Case C-255/02, [2006] STC 919.

[9] Section 207(2) Finance Act 2013.

[10] See, for example, paras B2.3 and B2.4 of HMRC's GAAR Guidance.

[11] The U.K. isn't alone in adopting this approach—see, for example, the reportable transactions rules in the U.S.

moter's scheme has been used. Promoters are also required to provide details of clients who use their schemes to HMRC.

The DOTAS rules are now being tightened up and, in addition, ''high risk promoters'' will in the future be publicly named and required to inform their clients of their status. Some may see this as a badge of pride but, since users of schemes backed by high risk promoters will be subject to a greatly extended period during which their tax affairs can be scrutinized by HMRC, the intention is clear—to put promoters of aggressive schemes out of business.

To date the government hasn't taken forward suggestions to require tax advisers to register with HMRC. The treatment of high risk promoters is perhaps a first step toward such a system of regulation.

Bash the Bankers (and Others)

Public exposure of tax avoiders seems to be the flavor of the month. In 2009, banks operating in the U.K. were invited by the government to sign up to a voluntary code of practice on tax. This was expressly part of the general strategy to counter tax avoidance.

Since many tax schemes have directly or indirectly relied on bank finance, it may become increasingly difficult to implement tax planning, whether aggressive or not.

The code requires banks to follow the spirit as well as the letter of the law, both in relation to their own tax affairs but also when financing customers. This has had the desired effect as banks are noticeably less willing to fund tax planning arrangements.

The code is now being strengthened in a number of respects. Banks were invited to adopt or re-adopt the code before the Autumn Statement in December and more than 250 did so. Legislation will now be introduced to put the code on a statutory basis, allowing HMRC to name and shame banks that fail to live up to the standards set for them.

These changes can only reinforce a cautious approach to tax avoidance and, since many tax schemes have directly or indirectly relied on bank finance, it may become increasingly difficult to implement tax planning, whether aggressive or not.

In a similar vein, businesses bidding for large government contracts must now confirm that their tax affairs are in order and that they haven't participated in schemes that have been successfully challenged.[12] Past misdeeds could disqualify a bidder from winning the contract. Local authorities have been encouraged to adopt similar high standards as part of their procurement procedures.

HMRC is generally required to keep taxpayers' affairs confidential so, except where the law allows, cannot name and shame in other circumstances. There are, of course, plenty of others who feel less constrained, particularly as government ministers continue to promote the idea that tax avoidance is a moral issue.

This has given the green light to public exposure and trial by media of taxpayers caught trying to avoid tax. The modern day equivalent of a day in the stocks is for your tax affairs to be discussed in the tabloid press (as U.K. comedian Jimmy Carr discovered to his cost) or scrutinized in Parliament (where the Public Accounts Committee has poured scorn on multinationals and HMRC alike).

Even those involved in implementing the GAAR aren't safe: One member has already resigned having been secretly recorded at a conference explaining some straightforward tax planning.

Conclusion

Much has changed since the 1930s when the courts supported taxpayers in doing whatever they (legally) could to minimize their tax liabilities. We now live in a very different world where tax avoidance is much less acceptable.

Over the years, HMRC has built up a fearsome armory of tools to close down tax avoidance, culminating this year in a range of new weapons, including the GAAR. Time will tell what impact the GAAR has in practice but, with rules in the pipeline to name and shame tax advisers and their clients, as well as banks who participate in ''unacceptable'' tax planning, it seems clear that life will only get tougher.

On the other hand, the U.K. needs to stay open for business and the crackdown on avoidance can sit uncomfortably with the government's objective of a competitive tax system to attract inward investment. HMRC stands accused of being ''soft'' on big business, particularly multinationals who are adept at taking advantage of favorable tax regimes in the U.K. and elsewhere.

There is a fine line to be drawn between a business-friendly tax approach and stopping unacceptable avoidance. Precisely where this line lies will perhaps never be entirely clear, which, from the writer's perspective, at least ensures that tax advisers will never be out of a job.

[12] Action Note 06/13—Procurement Policy Note: Measures to Promote Tax Compliance, published by the Cabinet Office July 25, 2013.

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