MACFARLANES

THE GAAR: AN ANTI-AVOIDANCE RULE IN ALL BUT NAME

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The GAAR recommended by the Aaronson Study Group was restricted to highly artificial and abusive avoidance schemes. The actual GAAR is capable of being read as a wider general anti-avoidance rule because its crucial filter is based on reasonableness, not artificiality. As a result, it risks introducing considerable uncertainty into normal tax planning and adversely affecting the attractiveness of the UK as a destination for inward investment. The Guidance is a valiant attempt to reduce that uncertainty but, because avoidance is treated by HMRC as inherently unreasonable, it ultimately fails in that objective.

Barring any last minute changes to the Finance Bill clauses, we now know the precise shape and nature of the UK's first ever GAAR and, in the draft Guidance, we now have our first valuable insight into how HMRC sees the GAAR operating in practice.

TAXES COVERED

There has been no change since the June 2012 Consultation Document in the scope of the taxes covered by the GAAR. Furthermore, despite representations, it will apply to tax advantages arising from, but conflicting with the purpose of, a double tax treaty.

THE FIRST FILTER: "TAX ARRANGEMENTS"

The GAAR will apply to arrangements which pass through two filters. The first takes the form of a definition of "tax arrangements" but is effectively a general anti-avoidance rule. Arrangements will pass through this filter if their main purpose, or one of their main purposes, is obtaining a tax advantage. "Tax advantage" includes a tax relief and, crucially, tax avoidance (and, indeed, deferral). Whether the parties to an arrangement have a main purpose of tax avoidance is to be tested objectively, rather than (as is more usual in TAARs) subjectively.

There are two strands to the approach taken by the courts in defining what amounts to "tax avoidance". The first can be found in the cases concerning transactions in securities, in which transactions have been characterised as involving tax avoidance if they "improve the taxpayer's position vis-à-vis the Revenue" (*IRC v Trustees of the Sema Group Pension Scheme* [2003] STC 95). It is irrelevant that the actual transaction carried out by the taxpayer (which is more tax advantageous than the hypothetical comparator transaction) may itself be wholly commercial and fully accord with the evident purpose of the legislation. All that matters is that the improvement in the taxpayer's position vis-à-vis the Revenue is a main purpose of the transaction, rather than mere "icing on the cake". There was no suggestion in *Sema* that the carrying out by the pension scheme of a transaction giving rise to repayable tax credits conflicted with or defeated the evident intention of Parliament or that Parliament would have restricted the availability of repayable tax credits to pension schemes and charities if it had thought about it.

The second strand to the approach taken by the courts to "tax avoidance" is one which distinguishes between tax planning and tax avoidance (a distinction not properly addressed in *Sema*). According to Lord Templeman in *CIR v Challenge Corpn Ltd* [1986] STC 548 and Lord Nolan in *IRC v Willoughby* [1997] STC 995, tax planning involves the taxpayer taking a course of action to improve his tax position (generally by reducing his taxable income or increasing his allowable expenditure) which accords with the evident purpose and the spirit of the legislation. This may be in response to a fiscally attractive option expressly made available by the legislation (e.g. taking out an ISA) or it may involve a course of action implicitly envisaged by the legislation (e.g. two spouses taking advantage of the principle of independent taxation by equalising their savings). By contrast, tax avoidance involves the taxpayer taking a course of action "designed to conflict with or defeat the evident intention of Parliament". The scheme in *Ramsay* was clearly designed to conflict with the statutory intention (namely, that CGT losses should have a commercial reality) and, therefore, involved tax avoidance.

A course of action designed to defeat the will of Parliament must include one which, though it does not conflict with the evident intention of the legislation, does conflict with its spirit. For instance, the transactions in *Mayes v HMRC* [2011] STC 1269 clearly involved tax avoidance but did not conflict with the strict letter of the legislation. (The legislation was highly mechanistic and evinced no purpose of taxing life assurance policies on a commercial or economic basis.) However, the transactions in that case did contravene the spirit of the life assurance legislation, because Parliament would clearly have negated the scheme if, at the time of enactment, it had been made aware of the shortcomings in the legislation exploited by the scheme. Testing whether a course of action is inconsistent with the spirit of the legislation will generally involve consideration of the policy underlying it. Despite the policy anchor, it is the uncertainty generated by the concept of "what Parliament would have done" that in the past has caused business such fear of a general anti-avoidance rule.

THE SECOND FILTER: THE “REASONABLENESS” TEST

So, only arrangements which are designed to conflict with the evident purpose of the legislation or its spirit (or both) pass through the first “avoidance purpose” filter. They then move to the second filter which, it is claimed, will confine the GAAR to artificial and abusive schemes. The GAAR will only apply to arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action, having regard (in particular) to the consistency of the substantive results of the arrangements with the principles and policy underlying the relevant tax provisions, the use of contrived and abnormal steps to achieve those results and whether the arrangements exploit any shortcomings in those provisions. One indication that an arrangement might not be reasonable is that it results in profits or losses which diverge from economic reality and that result cannot reasonably have been intended when the tax provisions were enacted.

In our view, it will be very difficult to persuade the Advisory Panel or the tribunal on an appeal that an arrangement which is designed to defeat the will of Parliament is nevertheless a reasonable course of action. One example might be a piece of bad law which HMRC (whether lawfully or not) has consistently refrained from enforcing over several years but has not taken steps to repeal or reform. Indeed, this is now recognised in the GAAR by a provision that the fact that tax arrangements accord with established practice which has been accepted by HMRC might indicate that the arrangement is reasonable. But, in such a case, the reasonableness filter does not add much to the taxpayer’s existing right to enforce by judicial review his legitimate expectation that HMRC’s practice will be applied equally to him.

The central weakness in the reasonableness filter is that the main considerations to be taken into account are the legislation, its policy and its shortcomings. These are all decisive considerations already taken into account at the first filter. The reasonableness test does not add anything, unless it is reasonable to design arrangements to defeat the will of Parliament. What would really make the second filter a genuine safe harbour for responsible tax planning and confine the GAAR to artificial and abusive schemes would be an express requirement that the arrangement must comprise elements which are artificial or contrived. Representations to that effect were made in response to the June 2012 consultation document but all that has been conceded is a provision that the presence of contrived steps in the arrangement is a relevant consideration. However, a *requirement* of artificiality features in GAARs in other countries and is a key requirement of the GAAR which the European Commission has recently recommended be adopted by all EU member states.

COUNTERACTION OF TAX ADVANTAGES

Tax advantages caught by the GAAR will be counteracted on a just and reasonable basis.

In practice, this is likely to mean that:

- an arrangement which is wholly self-cancelling will be taxed as if it had not been entered into, generally with the result that a loss will be disallowed;
- a party to a commercial transaction on to which an avoidance scheme has been grafted will be taxed as if he had carried out the transaction that he was most likely to have carried out but for his tax avoidance purpose; and
- in any other case (including where it is not possible to determine what the corresponding transaction would have been), a bespoke just and reasonable approach will be required.

Although the concept of counteraction implies an action initiated by HMRC, the GAAR will in fact operate under self-assessment. Representations on this point went unheeded. This is counter-intuitive. No taxpayer will self-assess the operation of the GAAR. Indeed, it is debatable whether the GAAR requires him to do this. The GAAR does not seem to make the tax arrangement ineffective from the outset (which *would* require self-assessment) but merely provides for an apparently effective tax advantage to be counteracted by adjustment. We expect to see renewed representations on this point.

COMMENCEMENT

The decision to apply the GAAR only to arrangements entered into after Royal Assent is welcome. It seems representations that it would be unsatisfactory if the GAAR applied to arrangements at a time when the Advisory Panel and the Guidance which it approves had no statutory mandate have been heeded. Parties to pre-commencement tax arrangements which they wish to vary will need to consider whether the variation gives rise to a new post-commencement arrangement.

THE ADVISORY PANEL

The key function of the Advisory Panel will be to provide opinions on the potential application of the GAAR as a kind of reality check. In particular, it will provide evidence of the reasonableness of the taxpayer’s actions in the relevant commercial context. Quite how this will differ from the judicial function of giving a first-tier decision remains to be seen.

The procedure for making representations to the Panel and providing responses imposes strict time limits on taxpayers but none on HMRC. This seems unfair and not necessarily conducive to producing the "quick and cost effective" means of establishing the limits of the GAAR promised by the Consultation Document.

It is most disappointing that representations that the Panel should publish its opinions in full (if necessary, in an anonymised form) fell on deaf ears. It is grossly unfair that HMRC, being a party to every dispute, will have access to every opinion of the Panel, whilst taxpayers generally will be denied such access. An annual digest of key principles is no substitute for the detailed reasoning in individual cases.

Following strong representations on the potential for unfairness and conflicts of interest if HMRC was represented on the Panel, HMRC recently announced that it was relinquishing such a role. Furthermore, the Chair of the Panel will be independent of HMRC and have sole control of the membership of the Panel.

THE GUIDANCE

Representations that the Guidance should be totally independent went unheeded. The drafting and revising of the Guidance will be initiated by HMRC, though it has to be approved by the Panel. This gives the Panel an important, but nevertheless passive, role.

The draft Guidance just published confirms our worst fears that the GAAR will be a general anti-*avoidance* rule in all but name.

Part A contains a fair explanation of tax arrangements and the double reasonableness test. However, it does not add much to the draft clauses. Interestingly, HMRC recognises that taxpayers are legally entitled to minimise their taxes (quoting from Lord Tomlin in the *Duke of Westminster* case) but points out that that does not make all tax avoidance reasonable. It also points out that the view that tax is legalised theft, such that all avoidance is reasonable, is an extreme view and not, therefore, one which can reasonably be held!

Our fears derive from Part B. This Part founds on the assumption that the question whether an arrangement is reasonable depends wholly on whether it is consistent with the principles and policy underlying the relevant tax provisions or whether it is designed to defeat those principles and that policy, for instance by exploiting loopholes. But, in the draft clauses, these are merely circumstances to be taken into account. They are not decisive. More importantly, as we have pointed out above, these questions are an integral part of the test in the first filter. If an arrangement is consistent with the principles and policy underlying the relevant tax provisions, it does not involve avoidance, as properly defined, and does not pass through the first filter. Conversely, if every arrangement which conflicts with the principles and policy underlying the legislation, and therefore passes through the first filter, is *necessarily* an unreasonable course of action, then the second filter achieves nothing and the GAAR is a general anti-*avoidance* rule.

All of the examples in Part B to which the GAAR is said to apply are highly egregious schemes which either have no commercial purpose or involve bolting a highly artificial avoidance scheme on to a commercial transaction. They produce results which defy economic reality and many involve transactions other than at arm's length. With one possible exception, they clearly break both the evident purpose and the spirit of the legislation. The one exception is the IHT reservation of benefit example. It cannot be said with complete confidence that Parliament would have blocked this scheme if it had been aware of it, given that it is precisely the sort of scheme taken into account when the law was changed after Lady Ingram's case. Most of these egregious schemes would be defeated by technical arguments or by the *Ramsay* principle. They tell us nothing about what forms of responsible tax planning are excluded from the GAAR.

In our view, none of the examples in Part B to which the GAAR is said not to apply would pass through the first filter, because they are innocuous transactions which do not involve avoidance, as properly defined. Each one is said to be consistent with the principles and policy underlying the legislation and is, therefore, *necessarily* reasonable. But that is irrelevant. Because they do not pass through the first filter, their reasonableness is never tested. These examples tell us nothing about what forms of tax planning pass through the first filter but nevertheless fall outside the scope of the GAAR because they are reasonable.

It is interesting that HMRC regard the late paid interest example as consistent with the principles and policy underlying the legislation. On balance, we feel that this example does not pass through the first filter on the grounds that taking steps to avoid a tax relief becoming stranded (a tax result which is worse than the economic result) is not avoidance, as properly defined.

One final point on the Guidance. It is clear that, at least in borderline cases, taxpayers and HMRC are likely to differ on what constitutes a contrived step. For instance, in the agricultural property example, we suspect few taxpayers would regard buying a farm with an IHT saving in mind, letting it for 7 years and then transferring it into trust as being contrived steps. They are the genuine purchase and subsequent gift of a tax efficient asset (like an ISA).

CONCLUSION

Neither the revised GAAR legislation nor the Guidance provide any comfort that the GAAR will not operate as a general anti-*avoidance* rule or that it will reduce the uncertainty surrounding the scope and application of any such rule. It will not, therefore, give taxpayers confidence that, without an informal clearance from their CRM (if they have one), they can safely proceed with commercial transactions which they structure tax efficiently. What is in truth a general anti-avoidance rule is being missold as a general anti-abuse rule.

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