

fund had in fact been a non-distributing fund during that time. This will be of particular benefit to fund managers that promote retail Luxembourg FCPs or French FCTs.

#### *Non-UK domiciled investors*

Non-UK domiciled remittance basis users<sup>49</sup> investing in non-reporting funds will not be taxed on any dividends or gains unless these are remitted to the UK.<sup>50</sup> The regulations do not spell out exactly how such investors will be treated vis-à-vis investments in reporting funds, although one would expect dividends, gains and reported income not to be taxable unless remitted to the UK.

#### *Conclusion and further developments*

The regulations broadly follow the Government's original intentions set out in the HM Treasury Consultation Papers and HMRC Budget Notes, with some minor gaps. The most notable gap concerns the treatment of distributions from non-reporting funds holding mainly equities, and in particular whether they will be taxed in the same way as distributions from reporting funds or according to the FA 2009 changes from April 22, 2009. Similarly, the treatment of non-UK domiciled remittance basis investors in reporting funds needs to be clarified, although it may be possible to determine the treatment by reference to the relevant provisions of the Income Tax Act 2007 together with the new offshore funds regulations.<sup>51</sup>

Drafting gaps aside, the ability under the new regime to become a reporting fund is, on balance, likely to be a highly tax-efficient option for UK resident investors in directly held offshore funds, and more commercially attractive for accumulation funds. The use of certain transparent funds may also provide planning opportunities, provided that the planning does not inadvertently run into traps that could trigger income tax charges for investors.

To prepare for the upcoming changes and to minimise the risk of inadvertent non-compliance, fund managers should seek advice on the specific requirements and duties of a reporting fund before applying for reporting fund status. This will not only make them aware of the fund's obligations, but should also give them time to develop suitable models for calculating reportable income and set up their reporting systems appropriately.<sup>LT</sup>

SARAH GABBAI\* and TONY STITT\*\*

### **HMRC's discussion document on "unallowable purpose" tests**

In the 2007 Pre-Budget Report the Chancellor announced a review of anti-avoidance legislation with a view to simplifying it.<sup>1</sup> The resulting Anti-Avoidance Simplification

<sup>49</sup> It is assumed for these purposes that the individual has applied to HMRC for non-domiciled status and paid the £30,000 charge.

<sup>50</sup> See the new offshore funds regulations, above fn.1, reg.19.

<sup>51</sup> ITA s.809A.

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<sup>LT</sup> Capital gains tax; Income tax; Offshore funds

<sup>1</sup> HM Treasury, *Meeting the aspirations of the British people* (London, 2007) at [4.52], available at [www.hm-treasury.gov.uk/d/pbr\\_csr07\\_chapter4\\_241.pdf](http://www.hm-treasury.gov.uk/d/pbr_csr07_chapter4_241.pdf) [Accessed December 6, 2009].

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Review (the Review) has had a number of manifestations so far, including various workshops (including one in mid-September 2009) and one-to-one discussion groups with members of the tax professions, some changes in the Finance Act 2009<sup>2</sup> and several discussion documents and consultation documents. This note considers the discussion document *Simplifying Unallowable Purpose Tests*, published on July 31, 2009 and the response date of which was October 30, 2009 (the Discussion Document).<sup>3</sup> The Discussion Document comprises a proposed framework for unallowable purpose tests and draft detailed guidance as to how these tests are to be applied.<sup>4</sup> The responses to the Discussion Document were published on December 9, 2009 (the Response Document).<sup>5</sup> The writer will review the framework, the draft guidance and the Response Document in turn, after some introductory thoughts.

### *Introductory*

#### Objectives

The Review was set up “to consider how anti-avoidance legislation can best meet the twin aims of simplicity and revenue protection.”<sup>6</sup> The Discussion Document was intended “to see whether there is scope for simplification of unallowable purpose tests in relation to direct taxes.”<sup>7</sup>

#### The role of a discussion document

Over the last 10 years or so we have become used to a succession of consultation documents from HMRC covering various areas and aspects of the tax code. In most cases these ask about concrete proposals by HMRC to improve the tax code in various ways. The proposals are usually fairly limited in scope and have been fairly well worked-up including, in many cases, draft legislation and draft guidance about the intended operation of the draft legislation. In general, responses are invited to specific questions posed in those consultation documents and there is limited scope for commentators to suggest alternative proposals. A good example of this would be the recent consultation document on revised legislation for transactions in securities, also published on July 31, 2009.<sup>8</sup>

<sup>2</sup> Specifically, TCGA 1992 s.171A amended by FA 2009 s.31 and Sch.12.

<sup>3</sup> HMRC, *Simplifying Unallowable Purpose Tests*, available at [http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?\\_nfpb=true&\\_pageLabel=pageVAT\\_ShowContent&propertyType=document&columns=1&id=HMCE\\_PROD1\\_029748](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&propertyType=document&columns=1&id=HMCE_PROD1_029748) [Accessed January 13, 2010].

<sup>4</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3. The discussion of the framework occupies 11 short chapters in the Discussion Document and the draft guidance is at Annex B.

<sup>5</sup> HMRC, *Summary of Responses: Simplifying Unallowable Purpose Tests*, available at [http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?\\_nfpb=true&\\_pageLabel=pageLibrary\\_ConsultationDocuments&propertyType=document&columns=1&id=HMCE\\_PROD1\\_030013](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_030013) [Accessed March 30, 2010].

<sup>6</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.2.

<sup>7</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.2.

<sup>8</sup> HMRC, *Simplifying Transactions in Securities Legislation*, available for download via [http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?\\_nfpb=true&\\_pageLabel=pageVAT\\_ShowContent&propertyType=document&columns=1&id=HMCE\\_PROD1\\_029739](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&propertyType=document&columns=1&id=HMCE_PROD1_029739) [Accessed January 13, 2010].

A discussion document is a very different animal from a consultation document. The discussion ranges far more widely and the proposals tend to be formulated at a higher level with increased scope for discussion by respondents, including scope for discussion of matters not necessarily covered within the scope of the discussion document itself. The intention appears to be to stimulate debate on the relevant topic in the round, rather than restricting the responses to specific, well worked-up proposals.

One of the results of this is that some of the suggestions posed in a discussion document might, on analysis, turn out to be unwelcome to taxpayers or advisers: they might be unworkable or, simply, be bad ideas. However, this is not a criticism of HMRC and the ideas emanating from the policy teams. Far from it: the discussion documents are an opportunity for all interested parties to debate “blue-sky” ideas with a view to coming up with proposals and new legislation or practices which are intended to be beneficial for the operation of the UK tax code as a whole. From that perspective, HMRC are to be commended for their openness in their discussions, both on paper and face-to-face, over a number of complex and difficult areas.

Previous experience of discussion documents (for example, the discussion document on the taxation of foreign profits a few years ago) demonstrates that HMRC are willing to listen to constructive criticism from tax professionals and to shape the proposals and revised legislation accordingly. It is, therefore, important that all tax professionals read these discussion documents and respond to them, either directly or through an appropriate representative body, in order that future tax legislation is shaped by the widest possible range of views.

#### The nature of an unallowable purpose test

The Discussion Document states that “the Government’s policy is that the tax system should not disrupt or distort normal commercial activities”, and that the tax system “should apply fairly and consistently to these activities.”<sup>9</sup> The Discussion Document also notes that some transactions are carried out for tax avoidance purposes “which go beyond normal commercial behaviour.”<sup>10</sup> So an unallowable purpose test might be defined as a test of whether a transaction is carried out with sufficient of a tax avoidance purpose as to “go beyond normal commercial behaviour”.

An unallowable purpose test is therefore generally a test of the object sought to be achieved by a transaction, which, in effect, says that if somebody enters into a transaction or arrangements for the purposes of avoiding tax, the benefit of arranging matters in that particular fashion should not be available to the taxpayers concerned.<sup>11</sup> In essence, this goes to the heart of whether the transactions have gone “beyond normal commercial behaviour” and have become tax avoidance behaviour. Conversely, if the transactions have, when considered in the round, been carried out for commercial purposes and tax avoidance is not a major part of the object sought to be achieved by a transaction, or of carrying it out in that particular way, the appropriate tax consequences should remain available to the taxpayer.

<sup>9</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.4.

<sup>10</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3.

<sup>11</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3. In para.10040 of the draft guidance, HMRC draw a distinction between “purpose” and “motive”. In the writer’s view, the distinction drawn is not helpful and is possibly too subtle for the purposes of an unallowable purpose test.

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The difficulty with this concept is that it can sometimes be difficult to determine when the level of tax planning exceeds normal commercial purposes and becomes distortive tax avoidance behaviour. Of course, this also highlights the fact that the tax system does “disrupt or distort normal commercial activities”, in the words of the Discussion Document, simply by making it necessary for taxpayers to consider whether a particular tax treatment applies, or should apply, to a commercial activity or whether they need to restructure or plan the activity in order to get the desired tax result.

It is this area in which the uncertainty for taxpayers lies, an uncertainty that is highlighted by the fact that we are told in the Discussion Document that there are in excess of 200 purpose tests in UK direct tax legislation.<sup>12</sup> Indeed, at the workshop held in September 2009 it was suggested that there may be as many as 300 such tests throughout the legislation!

### The need for unallowable purpose tests

A question that has been raised in workshops hosted by HMRC, and which has also no doubt been highlighted in some of the more intimate meetings that HMRC have arranged over the past two years or so, is whether, and to what extent, the UK’s tax code should depend on the intention of the taxpayers. The alternative school of thought, posed publicly by, amongst others, Andrew Hubbard, currently President of the Chartered Institute of Taxation, is that the same transaction should be taxed in the same way for all taxpayers. Referring again to the words of the Discussion Document, a test of intention would allow the tax code to apply fairly to normal commercial activities, whereas taxation without regard to intent would allow the tax code to be applied consistently to those activities. There is, therefore, perhaps a tension between the fair application and the consistent application of the tax code to any given transactions. An increasing number of tax professionals, though not all, now appear to accept, however, that transactions should not be entered into purely to avoid tax and with no commercial “drivers” or only very limited ones.

The longest-serving unallowable purpose test (with which most readers will be familiar) is that in the transactions in securities legislation, first introduced by the Finance Act 1960.<sup>13</sup> This was a wide provision of wide scope intended to counteract tax advantages from entire classes of transactions involving shares or other securities which were seen as being designed to avoid tax, usually by turning taxable income into capital receipts (which were, in 1960, non-taxable). The provision itself was introduced in response to the ingenuity of tax advisers throughout the previous 15 years or so and the fact that specifically targeted anti-avoidance provisions in successive Finance Acts had only served to divert the tax avoidance activities into different transactions which were not caught by the targeted provisions.

During the extensive debates on these provisions during the passage of the Finance Bill 1960 it was clear that Members of Parliament had taken on board the concerns expressed by many tax professionals as to whether the provisions would therefore operate to prevent normal commercial transactions or to create uncertainty as to the tax consequences of those transactions. It was clear from the Government responses at the time that this was

<sup>12</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.4.

<sup>13</sup> FA 1960 s.28, subsequently ICTA 1970 s.460ff, later ICTA s.703ff, and (from April 1, 2010) CTA 2010 s.731ff, which applies only to taxpayers liable to corporation tax. The legislation (so far as it applies to taxpayers liable to income tax) has now been re-written to ITA s.682ff.

not the intention and, as a result, a number of safeguards were put in place. First, the provisions were not to apply so long as they were carried out for bona fide commercial reasons, or in the ordinary course of making or managing investments (the escape clauses), so long as the arrangements did not have a main object of avoiding tax.<sup>14</sup> Secondly, in order to reduce uncertainty, a facility was enacted allowing a clearance to be obtained in advance from specialist officers of HMRC that the Board of HMRC were satisfied on the facts supplied in relation to a given transaction that the anti-avoidance provision would not apply.<sup>15</sup> This pre-transaction clearance facility has become something of a touchstone for tax advisers for the last 50 years.

Similar unallowable purposes tests have, however, proliferated over the ensuing half century, which is why we now have between 200 and 300 such tests in various parts of the UK direct tax code. The problem this has caused is two-fold: first, many of the unallowable purpose tests that have been enacted over the last 25 years or so have not had any pre-transaction clearance facility (for example, the unallowable purpose test for loan relationships at section 441 of the Corporation Tax Act 2009 (CTA)) and, secondly, with so many unallowable purpose tests spread throughout the UK direct tax legislation, it is not possible for HMRC to resource a clearance facility that would be responsible for all of these tests. So a relatively straightforward test which was originally intended to apply to a very limited area of the tax code has multiplied to generate considerable uncertainty throughout the UK's tax code.

It may be that the more recent non-statutory clearance facility for business customers was intended to help with the uncertainty generated in part by the large number of unallowable purpose tests to be negotiated in planning any transactions. Nevertheless, in the writer's experience (and from anecdotal evidence), this facility has not been used a great deal and therefore does not appear to have materially reduced the overall uncertainties to taxpayers.

So where does this leave us? It seems obvious that the need for unallowable purpose tests should be debated as a preliminary to any discussion as to how such tests should be formulated in general. But it would appear that the Government has decided, without debate, that such tests are necessary. That said, is it fair to blame policy makers for taking this approach? For every new regime within the tax code that is introduced, some tax professionals have thought up increasingly novel ways of achieving a result that may not have been intended by Parliament. At the risk of being contentious, therefore, it might be suggested that some sectors of the tax professions may have brought the current situation upon themselves and the rest of us.

### *The framework*

The Discussion Document proposes a framework for unallowable purpose tests suggesting that they should generally contain the following seven components:

- (1) the area of the tax code to which the purpose test relates;
- (2) filters which refine and reduce the need to consider the test;
- (3) the entity, person or construct (a concept, such as an arrangement or a loan relationship) to which the test will apply;

<sup>14</sup> See ICTA s.703(1) (CTA 2010 s.734 from April 1, 2010) and ITA s.685.

<sup>15</sup> See ICTA s.707 (CTA 2010 ss.748 and 749 from April 1, 2010) and ITA s.701.

- (4) the purpose to be tested;
- (5) a definition of what is an unallowable purpose;
- (6) the threshold of that purpose; and
- (7) the tax consequences triggered by the test.<sup>16</sup>

We are told that the framework “is not prescriptive and deviations from it may be appropriate for policy reasons”.<sup>17</sup> However, we are also told that any deviations from the basic framework should be explained in relation to terms of why those deviations from the basic framework are required.

The writer has reviewed a number of unallowable purpose tests with which he is most familiar, and has found himself asking whether these framework components actually add anything to the terms of current legislation. Most unallowable purpose tests already contain all of these components, whether those tests are framed in a lengthy and explicit way, such as in the transactions in securities legislation<sup>18</sup>, or more succinctly, such as in the loan relationships unallowable purpose test.<sup>19</sup> So while formulating the framework might be intellectually helpful, the writer does not consider that it adds anything new to the way in which unallowable purpose tests are formulated. The framework merely expresses what already exists rather than providing something novel to work with. Nevertheless, the writer will examine below each of the components of the framework in turn.

Another difficulty is that the new framework for unallowable purpose tests is designed only to inform *future* tests to be included in the tax code. The inference is that there is no intention to re-visit, review or revise any of the existing unallowable purpose tests, unless they are being revised in any case, like the transactions in securities test. As a result, if the new formulations of the unallowable purpose tests make any material difference to the operation of these tests, there will be a two-tier system, with old-style and new-style tests, for a long time to come.

#### The components of the proposed framework

*Which area of the tax code?* The first component of the proposed framework is to determine to which provisions the particular test is to be applied. HMRC suggest that this might be to a single provision, multiple provisions, a single regime or multiple regimes.<sup>20</sup> For example, the tests in section 137(1) of the Taxation of Chargeable Gains Act, 1992 (TCGA), for the application of the deemed reorganisation provisions in section 135 TCGA, apply to a single provision, if section 135 is considered alone, or to multiple provisions if it is accepted that section 136 TCGA also gives rise to a deemed reorganisation. Conversely, the unallowable purpose test for intangible fixed assets in section 864 of the CTA applies to the whole of Part 8 of the CTA, i.e. to a whole tax regime.

The Discussion Document recognises that the wider the scope of a purpose test, the greater the potential for uncertainty or as the paper puts it “the more difficult it may be for the structure of the test to interact satisfactorily with the differing legal and commercial concepts relevant to each particular regime.”<sup>21</sup> Conversely, if the scope of the test is too

<sup>16</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6.

<sup>17</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6.

<sup>18</sup> ICTA s.703ff (CTA 2010, s.731ff from April 1, 2010) and ITA s.682ff.

<sup>19</sup> CTA s.441.

<sup>20</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6 Pt (i).

<sup>21</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6 Pt (i).

narrow, it will be too easy to get around the test. As an example, the very restricted scope of the test at paragraph 5 of Schedule 7AC TCGA, relating to the substantial shareholdings exemption, means that it is almost never in point.

*Filters.* The Discussion Document refers to both positive and negative filters, the former being filters which ensure that a purpose test only applies when certain factors are present and the latter being filters which ensure that the test does not apply when certain other factors are present.<sup>22</sup> The transactions in securities legislation, for example, specifically brings the provisions into play only if one of four specific Circumstances is present (a positive filter), but disapplies those provisions where there is a bona fide commercial reason (a negative filter) so long as there is no tax avoidance motive (another positive filter).

The Discussion Document explains that filters are intended to ensure that the test “is properly targeted at the areas of highest risk” and is only targeted “at arrangements where avoidance is likely to be in point.” However, the filters have to be properly targeted so that positive filters are not too easily evaded and negative filters are not too easily engaged. Nevertheless, the proper use of appropriate filters should increase certainty for all parties and “significantly reduce the compliance cost for those undertaking commercial transactions.”<sup>23</sup>

*The entity, person or construct targeted.* The Discussion Document suggests that the tests will normally apply to a legal person, such as an individual or a company or some other taxable entity. However, it may be necessary to apply the test to a construct, such as an arrangement, a transaction or a legal relationship.<sup>24</sup>

The application of a test to a legal person should not generally give rise to too many difficulties. However, the application of a test to a construct is a more difficult concept and one which will require careful drafting in each case. If the definition is drafted too widely, the scope of the unallowable purpose test will merely create greater uncertainty. But if it is targeted too narrowly, it will be too easy to avoid the test completely. The Discussion Document recognises both these issues but does not suggest how the targeting will be achieved. This is another instance of the Discussion Document not adding any improvements to the formulation of unallowable purpose tests.

*The purpose to be tested.* The Discussion Document proposes that the legislation may test the purpose of a person who is party to or “concerned with” an arrangement, transaction or legal relationship, which seems quite straightforward. However, it also proposes that an arrangement, transaction or legal relationship itself might have a purpose. While some of the unallowable purpose tests in the legislation do have this kind of wording, the Discussion Document recognises that the purpose to be looked at is, at source, the purpose of a person or persons, as arrangements, transactions, or legal relationships are, of course, inanimate (and, indeed, intangible). So the taxpayer is necessarily thrown back to the discussions in decided tax cases about whose purpose needs to be looked at. A similar problem arises when we try to analyse the purpose of any legal person that is not an individual. Companies or trusts are legal persons but are also both inanimate and

<sup>22</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6 Pt (ii).

<sup>23</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.7.

<sup>24</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3.

intangible and cannot themselves prima facie have a purpose. So this apparently complex test always comes back to the purpose of the individual or individuals designing the arrangements, transactions or legal relationships.

Decided cases (such as *Brebner v IRC (Brebner)*,<sup>25</sup> *Addy v IRC (Addy)*<sup>26</sup> and *IRC v Marwood Homes (No.3) (Marwood Homes)*<sup>27</sup>) tell us that the purpose to be looked at will be the purpose of the individuals involved in the transactions, either on their own account or as shareholders or directors of a company, being the individuals who direct the operations of the company in the area to which the transactions relate. This might equally apply to either the trustees or beneficiaries of a trust, too. There is some suggestion (particularly in *Addy*<sup>28</sup> and *Marwood Homes*<sup>29</sup>) that the purpose to be looked at might include the purpose of relevant advisers, too, although this is a dangerous proposition: for the advisers to be the individuals who direct the operations of a company they would in effect be shadow directors and their authority may not extend to that.

The Discussion Document also notes that there may be more than one set of purposes in point when looking at a particular situation. For example, transactions carried out between members of groups of companies might have an overall tax benefit to the group while being beneficial to one company but in some ways less beneficial (for tax or commercial purposes) to other group companies. Again, this potential ambiguity is largely resolved by looking at the purposes of the individuals behind the decision making process.

An obvious point made in several places in the Discussion Document is that any unallowable purpose test has to be properly targeted in these circumstances. The tax liabilities resulting from the application of most of the unallowable purpose tests fall within the self assessment regime (the transactions in securities legislation being a notable exception) and HMRC recognise the difficulties where there are multiple parties to arrangements and some parties to the arrangements might not be aware that an unallowable purpose test is potentially in point for the purposes of self-assessing the tax liabilities of, for example, the company of which they are directors.<sup>30</sup> This is similar to another point made in the Discussion Document, regarding the position where a test is applicable to parties “concerned with” arrangements. The scoping issue here is whether, for example, the director of a group company is necessarily “concerned with” arrangements which might impact that group company but which were carried out wholly by other companies within the group.

*The definition of an unallowable purpose.* The Discussion Document starts off by suggesting that unallowable purposes could include obtaining a tax advantage, benefiting from a specified relief outside the original policy objectives of that relief, or the facilitation of activities outside the charge to tax or of non-commercial activities. These are probably familiar concepts to many who have looked at the various unallowable purpose tests in the past.

Possibly the most difficult area is the concept of obtaining a relief outside the original policy objectives of that relief. There is long standing jurisprudence, arising from the

<sup>25</sup> *IRC v Brebner* (1967) 43 TC 705 (HL).

<sup>26</sup> *Addy v IRC* [1975] STC 601 (HC) at 610d and 611b.

<sup>27</sup> *IRC v Marwood Homes (No.3)* [1999] STC (ScD) 44 (Section 703 Tribunal).

<sup>28</sup> *Addy* [1975] STC 601 (HC), above fn.26, at 610d and 611b.

<sup>29</sup> *Marwood Homes* [1999] STC (ScD) 44, above fn.27.

<sup>30</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.9, “The ‘purpose of a person’ or ‘the purpose of arrangements’”, “Whose purpose and which relationships?”.

comments of Lord Templeman in *Reed v Nova Securities Ltd*, that “the Revenue cannot complain that the taxpayer has secured a fiscal advantage by the method prescribed by [the legislation itself]”.<sup>31</sup> This principle has been recently restated, in *New Angel Court Ltd v Adam*.<sup>32</sup> So the real difficulty is understanding what the policy intention behind the legislative opportunity actually was and whether structuring transactions so as to fall within those reliefs is offensive. This is particularly difficult when one considers the rate of evolution of commercial transactions. A relief as enacted for a particular purpose might not apply to a novel commercial transaction, even though an analysis of the policy intention of that relief might suggest that it should apply to that transaction.

The Discussion Document goes on to discuss the definition of “tax advantage” to be used and notes that this might be very narrow and specific, such as whether a particular credit or debit on an intangible fixed asset should be recognised for tax purposes, or much more broadly defined, such as an “income tax advantage” in the context of the transactions in securities legislation.<sup>33</sup> Once again, focus is fundamental, as an insufficiently focused definition might create excessive uncertainty, but too narrow a scope might render the purpose test useless.

And the “elephant in the room” in this context is, of course, what comparison is to be made in determining whether there is a tax advantage. In other words, what tax charge should have arisen, as a matter of policy against which the reduced charge or increased relief can be measured? In the consultation document on transactions in securities, the proposal is to make this much more explicit, taxpayers being required to determine the tax that would have arisen on a distribution to them of the relevant distributable reserves as compared to the tax charge instead arising on the capital receipt.<sup>34</sup> The Discussion Document also suggests that it might be appropriate to look at the transactions that might have occurred absent the potential tax advantage.<sup>35</sup>

*The threshold of purpose.* The options proposed in the Discussion Document are whether a test should apply where tax avoidance is a purpose, a main purpose or one of the main purposes, a dominant purpose or a sole purpose.<sup>36</sup> The threshold most familiar to most readers will be that of “the main purpose, or one of the main purposes”, as found in, for example, section 137(1) of the TCGA.

The Discussion Document also suggests the alternative test of what “it is reasonable to assume”. It suggests that this would allow purpose to be “assessed objectively”.<sup>37</sup> However, surely this depends on whom one asks for the reasonable assumption? A cynical inspector at HMRC might, in his view, reasonably assume that a transaction was entered into to avoid tax. A more commercially-minded adviser or tax director might reasonably

<sup>31</sup> *Reed (Inspector of Taxes) v Nova Securities Ltd* [1985] STC 124, HL, per Lord Templeman at 131j. Lord Templeman’s comments were paraphrased by Jonathan Parker L.J. in *New Angel Court Ltd v Adam* [2004] EWCA Civ 242; [2004] STC 779 at [87] as “. . . the Revenue cannot complain that a taxpayer has obtained a tax advantage by availing itself of the opportunity which the legislation itself offers”.

<sup>32</sup> *New Angel Court Ltd v Adam (Inspector of Taxes)* [2004] EWCA Civ 242; [2004] STC 779.

<sup>33</sup> ITA s.685.

<sup>34</sup> HMRC, *Simplifying Transactions in Securities Legislation*, above fn.8, at [7.4]–[7.5].

<sup>35</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.11.

<sup>36</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6 Pt (iv), *The purpose to be tested*.

<sup>37</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.10 “The threshold of purpose”.

assume that effecting the transaction was a sensible way to achieve certain commercial objectives, while incidentally minimising the tax bill, perhaps by falling into the scope of a relief or exemption, thus “availing itself of the opportunity which the legislation itself offers” (Lord Templeman, see text at *The definition of an unallowable purpose*, above). Once again, we come back to the fuzzy area between acceptable mitigation or planning and unacceptable avoidance and, once again, we are back to subjectivity, not objectivity, as to what it is “reasonable to assume”.

More helpfully, the Discussion Document notes that sole purpose tests are likely to be of very limited application and that a dominant purpose test is likely to be more appropriate in most cases, allowing some degree of measurement of the overall commercial and non-tax driven purposes against the tax-focused purposes of a transaction or arrangements.<sup>38</sup>

*The tax consequences triggered by the test.* The Discussion Document proposes a wide range of possibilities. It notes that merely ignoring the transactions or arrangements will rarely be the right approach, although this is the approach taken in, for example, the legislation on intangible fixed assets (section 864 CTA: “any tax avoidance arrangements are ignored”). Instead, the Discussion Document suggests that there be a deemed result, negating the transactions or arrangements, the imputation of an alternative result, a restriction on the permissible treatment of losses or debits or a restriction on the amount of losses or debits. The quantum of the adjustment could be the whole of an amount, that part attributable to the unallowable purpose, or an amount equivalent to the tax advantage sought or actually obtained.<sup>39</sup>

Which of these tax consequences, and the quantum, that should be applied is noted to be a matter to be determined by the policy and technical considerations relevant to the appropriate area of the tax code. Each of the possibilities is discussed in some detail, although the discussion does not, in the writer’s view, add anything particularly new to the debate about the application of unallowable purpose tests. It is of some concern to note that policy makers are told that they may consider “whether policy objectives mean that a disallowance in excess of the tax advantage enjoyed would be appropriate.” This is an issue that would clearly concern taxpayers and advisers, although one might see it as in line with comments made by HMRC officials and Government Ministers over the last few years, that they intend to ensure that tax avoidance will no longer be commercially acceptable.

The Discussion Document goes on to consider who should be the subject of the tax consequences. In particular, should this be restricted to the person who entered into tax planning arrangements or to anyone else who is “concerned with” those arrangements? Should it be targeted solely at those parties who obtain a tax advantage? Or should the test be directed more generally?<sup>40</sup>

The Discussion Document does not address the difficulties of a test directed only at, say, a group company that obtains a tax advantage, so that there is no remedy for another group company that suffers a tax disadvantage that is not impacted by the operation of the unallowable test. As a result, the group as a whole might be worse off than if it had not carried out the transactions at all. The general purpose of an unallowable purpose test is to prevent tax benefits accruing where they should not: the tests are not intended

<sup>38</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.10 “The threshold of purpose”.

<sup>39</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.11.

<sup>40</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.11.

to be penal, to leave taxpayers in a worse position than had they not carried out any tax planning. So it seems logical to suggest that the effect of unallowable purpose tests should apply to all the relevant parties in such cases.

### *The draft guidance*

The “Overview” section of the Discussion Document refers to improvements in the comprehension and clarity of the unallowable purpose tests.<sup>41</sup> The larger part of this document (36 out of 57 pages) is a detailed set of draft guidance notes on various aspects of the unallowable purpose tests. Hitherto, HMRC have been reluctant to publish any guidance on the application of such tests, as demonstrated by the paucity of published material on the application of the transactions in securities legislation. So the publication of such extensive guidance is a new approach which will be, potentially, of great use to taxpayers and their advisers, as well as to inspectors. Indeed, this part of the Discussion Document is the part that is likely to be of most practical use to all tax professionals and HMRC are to be strongly commended for this change of approach.

### General comments

At this stage, as noted, the guidance is in draft form. To that extent, it definitely needs some improvement but the first draft is an extremely helpful start. The difficulty is that the concepts being discussed are complex and are largely based on comments made in decided tax cases, most of which related to the transactions in securities legislation, rather than being based on legislation. What this means is that there are a number of strands of anti-avoidance jurisprudence that have been developed, in particular over the last 50 years, by judges looking at different transactions in different economic and commercial environments. Those readers who have tried to turn the multiplicity of judicial comments into a coherent anti-avoidance code, and to find the bright lines between acceptable planning or mitigation and unacceptable tax avoidance, will appreciate the difficulties inherent in turning 50 years of jurisprudence into a coherent set of guidance notes of general applicability that is accessible to all tax professionals on both sides of the fence. The writer would therefore emphasise that any comments on the draft guidance are not intended as a criticism of the work that HMRC have put into the draft.

The current draft of the guidance is not always particularly clear or comprehensible. In many areas there are detailed discussions of what has been said in various cases without there being a clear conclusion as to HMRC’s view on that particular element of the unallowable purpose test generally. It would be more helpful if each part of the guidance started with a brief summary of HMRC’s view of, or approach to, the particular element of the unallowable purpose tests, with the discussion following that summary explaining how HMRC have reached their view and making it clear which *rationes decidendi* or *obiter dicta* in the decided cases are considered by HMRC to be most apposite in reaching those conclusions.

For example, paragraph 10135 of the draft guidance tries to distinguish between tax mitigation and tax avoidance.<sup>42</sup> However, this part of the draft guidance does not reach

<sup>41</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.1 at 1.1.

<sup>42</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Annex B.

any specific conclusions. While this part of the draft guidance makes very interesting reading, it does not really add anything in terms of clarity or comprehension as to where HMRC consider that the line should be drawn. Arguably, HMRC might be reluctant to draw a single bright line between mitigation and avoidance. But to be of any use, which is presumably one of the (main) objects of the whole exercise, the draft guidance needs to provide some practical advice to taxpayers.

Similarly, paragraph 10230 of the draft guidance has an interesting discussion about whether the purpose of a subsidiary is the same as the purpose of its parent company and whether one can contemplate the idea of a purpose of the group as a whole.<sup>43</sup> But it does not draw any specific conclusions or offer any practical advice that taxpayers might use in determining their self assessment position. Most taxpayers will be reading the guidance not for the academic discussion but for some practical assistance as to the application of the unallowable purpose tests in the area in which they are transacting.

### The test of purpose

This part of the draft guidance discusses whose purpose or what purposes should be considered, an issue which is discussed in more detail above.<sup>44</sup> Once again, the guidance makes interesting reading but actually fails to come to the ultimate conclusion that, in every single case, the purpose boils down to that of one or more human beings guiding the activities of a business. This area of the guidance needs to be expanded to encompass the fundamental issues discussed earlier in this article, and made clearer and more practically useful.

### Commercial purpose test

The draft guidance does not seem to cover in any detail the concept of the commercial purpose of a transaction *per se* or why this is important. Almost all the discussion in this area is actually looking at whether the commercial purpose is tainted by an unallowable purpose, rather than focusing on the commercial elements.<sup>45</sup>

This also leads to a more fundamental question: whether a test of commercial purpose is really required. This is not covered in the draft guidance, although an answer is arguably implicit in the fact that many of the unallowable purpose tests in recent legislation focus do not contain any reference to a commercial motive (for example, the disqualifying purpose tests for allowable losses in section 16A TCGA 1992). So recent legislation seeks to counteract transactions that are carried out with a view to avoiding tax (that being the ultimate unallowable purpose), without regard to whether the transaction itself is carried out with a commercial purpose.

That said, the strength of the commercial purpose for carrying out a transaction is often important in determining whether any tax advantage is merely an ancillary benefit or amounts to another main purpose. So, for example, in *Brebner*,<sup>46</sup> had there been no commercial purpose behind the transactions it might have been decided that the

<sup>43</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Annex B.

<sup>44</sup> See text under subheading *The framework*: The components of the proposed framework and HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Annex B at [10400]—[10440].

<sup>45</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3.

<sup>46</sup> *Brebner* (1967) 43 TC 705 (HL), above fn.25.

transactions could only have been carried out in order to obtain the tax advantage. Instead, the decision of the courts was that the commercial purpose was so overriding that the tax benefit that arose was merely ancillary. This case, and many others, demonstrates that the measure of the commercial benefit of the transaction can be vital in determining whether an unallowable purpose test might be applicable. It would therefore be more helpful if the guidance were to include some practical guidance about how to “measure” the strength of their commercial purposes against the quantum of any tax benefit that might be achieved.

As an aside, paragraph 10430 refers to a tax advantage being “deemed not to be a commercial purpose.”<sup>47</sup> In the writer’s view this would be an incorrect proposition. There is no proposition in law that tax is not a commercial purpose.<sup>48</sup>

### Main purpose

Paragraph 10140 discusses the difference between a main or ancillary purpose. Once again, the discussion fails to come to any form of conclusion that would be of practical assistance to taxpayers in trying to determine whether a tax advantage arises through a merely incidental or ancillary purpose to a transaction or whether its scale amounts to a main purpose.

As an illustration, there are many situations where the economic objective can be achieved in two fairly straightforward ways, neither materially more complex than the other, but one has a lower tax charge than the other. On the one hand, the principle established by the *Duke of Westminster’s* case<sup>49</sup> would appear to be that taxpayers are entitled to take the path of least taxation. On the other hand, the specific decision to take the path that leads to the lowest taxation is, as a matter of logic, a purely tax-driven decision and would, therefore, appear to fall foul of a logical unallowable purpose test. Clearly, this is not HMRC’s view, nor has it ever been that of the courts. But the discussion on whole or main purpose does not throw any further light on where the boundaries lie and is therefore, once again, of little practical assistance.

### What are schemes or arrangements?

This is an area that is not thoroughly discussed by the draft guidance. Paragraph 10210 discusses the concept that arrangements can have a purpose (and is rather confused as to whether it can), and has a long quote about what arrangements are, from a Special Commissioners’ decision (*Barclays Bank Plc v HMRC*<sup>50</sup>). But there is no discussion about what schemes or arrangements are for the wider purposes of unallowable purpose tests that are specifically directed at these.

Once again, for the purposes of comprehensibility and clarity, it would be of more practical assistance to the tax community if the draft guidance looked at the meaning of words such as “scheme” or “arrangements”, perhaps taking as a starting point the very helpful discussion in the *Snell* case.<sup>51</sup>

<sup>47</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Annex B at [10440].

<sup>48</sup> See text under *Introductory*: the nature of an unallowable purpose test, above and HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Annex B at [10040].

<sup>49</sup> *Duke of Westminster v Commissioners of Inland Revenue* (1935) 19 TC 490 (HL).

<sup>50</sup> *Barclays Bank Plc v HMRC* [2005] UKSPC SPC00520; [2006] STC (SpC) 520.

<sup>51</sup> *Snell v HMRC* [2006] EWHC 3350 (Ch); [2007] STC 1279 (HC).

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### *The Response Document*

A summary of responses, with some further comment by HMRC (the Response Document) was published on December 9, 2009.<sup>52</sup> There were 12 formal responses (six from advisory firms, three from representative bodies and three from companies) and the Response Document also referred to the discussion *fora* that HMRC had hosted. Broadly, respondents welcomed the opportunity to discuss the unallowable purpose tests, their impact on HMRC's customers and the proposals to target the tests more specifically. But there was also concern that the tests were increasingly being used as "an alternative to effective and well-written legislation". One comment was that the fact that there are 28 additional unallowable purpose tests in the Finance Act 2009 suggests "that they are becoming a crutch for the draftsmen and policy makers".<sup>53</sup>

The writer was unsurprised to see that several respondents agreed that subjective purpose tests are a barrier to simplification of tax legislation and that there was also a strong view that unallowable purpose tests are "inherently undesirable" and that the treatment of a transaction for tax purposes should not depend on the purposes of the parties involved.<sup>54</sup>

HMRC's immediate response is to agree that the framework can be improved and that where the benefits of an unallowable purpose test are uncertain or unidentifiable, or outweigh the costs to taxpayers, there should not be one.

In practical terms, HMRC noted that the resource required to have a clearance facility for all unallowable purpose tests would be huge and such a facility will not be offered. However, HMRC also understand the preference for certainty and will work with their customers to "find ways of offering increased certainty."<sup>55</sup>

There is no intention to review all existing tests, given the number of such tests and the cost of such an exercise. However, it was noted that some tests might be improved, for example by the introduction of filters, which Ministers might consider in future Finance Bills as a simplification. Indeed, the concept of filters in unallowable purpose tests was strongly supported by respondents.

There was general agreement that the guidance did not actually guide either HMRC or taxpayers and that the text discussed without giving answers. In view of these criticisms, HMRC will redraft the guidance. The writer was considerably surprised to see that the draft guidance was not, in fact, widely welcomed and that a significant number of respondents were concerned that HMRC were intending to use the guidance as a substitute for statute.

The writer is concerned to note that HMRC do not appear to be contemplating a further consultation document. Under *Next steps*, the Response Document says that HMRC will "share the redrafted framework and guidance with key stakeholders" to help decide whether the framework and guidance should be adopted.<sup>56</sup> It is not clear who those key stakeholders would be, although one hopes that they will include non-HMRC and non-Treasury people. The writer would prefer to see a proper consultation document,

<sup>52</sup> HMRC, *Summary of Responses*, above fn.5.

<sup>53</sup> See HMRC, *Summary of Responses*: above fn.5, Ch.3, Use of Purpose Tests.

<sup>54</sup> See HMRC, *Summary of Responses*: above fn.5, Ch.3, Use of Purpose Tests.

<sup>55</sup> See HMRC, *Summary of Responses*, above fn.5, Ch.3, Other Comments.

<sup>56</sup> HMRC, *Summary of Responses*, above fn.5, Ch.1.

giving everyone a further chance to enter the debate, even if this means delaying HMRC's preferred adoption date of summer 2010.

### *Conclusions*

As previously noted, the Review was set up with the objective of considering “how anti-avoidance legislation can best meet the twin aims of simplicity and revenue protection” and it is asserted that “the tax system should not disrupt or distort normal commercial activities” and that it “should apply fairly and consistently to these activities.”<sup>57</sup> Furthermore, the specific framework for unallowable purpose tests is intended to “improve comprehension, clarity and consistency”.<sup>58</sup> Does the Discussion Document achieve any of these objectives?

#### Simplicity versus revenue protection

The suggestions put forward in the Discussion Document are more likely to meet the aim of revenue protection than simplicity for taxpayers, which is perhaps not surprising since the Discussion Document was prepared by HMRC and Treasury policy makers.<sup>59</sup> While simplicity may be an admirable objective, it is hard to see how such a complex area, in which tests are dependent on the intentions of individual human beings, can ever be made either objective or simple, a view shared by many respondents. And, given that the purpose test is only one of the elements of the framework, each of which has many sub-elements, the writer reluctantly concludes that the whole area of unallowable purpose tests must remain complex.

#### Fairness versus consistency

As noted above, the twin aims of fairness and consistency just do not appear to be compatible, particularly, again, in the context of tests where the application of the tax code depends on the intentions of the individuals behind the transactions or arrangements concerned. While the definition of what is fair might be open to debate, the Discussion Document may lead to increased fairness in the tax system, but may well do so at the expense of consistency. That said, if there are already between 200 and 300 unallowable purpose tests in the legislation, there are already between 200 and 300 areas where the tax code is not applied consistently, so how much difference will the proposed framework make?<sup>60</sup>

This is particularly so, as the Discussion Document is designed to inform future tests to be included in the tax code, not comprehensively to review or revise any of the existing 200—300 or so unallowable purpose tests.

#### Comprehension, clarity and consistency of unallowable purpose tests

The Discussion Document is still very useful in two main areas. While none of the concepts discussed in the context of the various elements is in any way particularly novel,

<sup>57</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.4.

<sup>58</sup> HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.1 at 1.1.

<sup>59</sup> The proposed framework has also been discussed with Parliamentary Counsel - HMRC, *Simplifying Unallowable Purpose Tests*, above fn.3, Ch.6.

<sup>60</sup> The framework is discussed in detail under the appropriate subheading above.

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this paper is a comprehensive review of unallowable purpose tests as they currently fit into the UK's direct tax legislation. For those practitioners who have not had to consider the tests in detail before, the Discussion Document is interesting, informative and in many ways helpful in explaining some of HMRC's views in this area. Indeed, the writer considers the Discussion Document to have considerable educational value.

And if the standard of the draft guidance is anything to go by, the final guidance, informed by comment from the whole of the tax community, is likely to become the document of choice to be read by all tax practitioners who need to understand the body of case law in the context of unallowable purpose tests. So the Discussion Document "works" on the level of increasing comprehension and clarity of unallowable purpose tests.

Overall, the writer is not convinced that there is much value in the exercise of codifying a framework for unallowable purpose tests. But the proposed guidance is potentially of great practical use and reading it and thinking about it has been intellectually stimulating. For all of those reasons the writer commends and thanks HMRC for it.<sup>LT</sup>

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<sup>LT</sup> Discussion documents; Intention; Tax avoidance; Tax simplification; Unallowable purpose