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What will the proposed new general anti-avoidance rule mean for British business?

Graham Aaronson QC, appointed by the Government to investigate a general anti tax-avoidance rule ("GAAR"), released his report today. He recommends a narrow anti-abuse rule targeted at artificial schemes and designed not to affect "responsible tax planning".

We look at the details of the Aaronson Report and answer the key questions for British business: will this impact on ordinary commercial transactions and so add to the cost and complexity of doing business in the UK? Or are its authors right that only extreme cases will be affected?

1. Comment

Designing a GAAR is a very difficult task. Distinguishing legitimate tax planning from egregious avoidance is inevitably not easy. It is made more complex by the background of competing pressures.

Businesses are keen to operate in the UK and individuals want to live here, but both are constantly being blandished by other jurisdictions with tax breaks of one kind or another. The UK has rightly responded by introducing incentives to make the UK a competitive place to live and do business. The risk is that any GAAR, however carefully crafted, will undermine the UK's attractiveness.

On the other side of the debate are those who are offended by distasteful tax planning. The pressure from this camp is for a widely drafted GAAR. The pressure is increased by the ill-informed or politically motivated who fail to understand the disaster that would follow from an uncompetitive tax system. There are also those who think that there is some morally "right" amount of tax that should be paid that is distinct from the amount legally required to be paid – this, however, is a fundamental misunderstanding of the rule of law.

Until there is a body of case law and practice, the impact of the GAAR, if introduced, is impossible to judge. The risk is that the GAAR satisfies none of the interested parties. It will create cost and uncertainty for business and potentially encourage businesses and

individuals to set up elsewhere. It may well not satisfy those offended by some current tax planning. We think Graham Aaronson QC and his study group have made a decent fist of their task, but only time will tell whether it leads to an improvement in the tax system or merely an increase in complexity.

2. What are the Aaronson Report's main conclusions?

The Report strongly recommends the introduction of a narrow GAAR targeted at "highly abusive, contrived, artificial and egregious schemes" but designed not to affect "responsible tax planning". The group proposes draft legislation creating what they believe is a narrowly focused GAAR with a high bar on its use.

3. Why now?

Tax avoidance has been rising up the political agenda for some time. A GAAR has been considered several times before and rejected as costly and complex. The Liberal Democrats' manifesto commitment to introduce a GAAR was included in the coalition agreement with the Conservatives, and the Government subsequently appointed Graham Aaronson QC to investigate.

4. How will the proposed GAAR work?

The test is whether there is an "abnormal arrangement" which achieves an "abusive tax result"? An abnormal arrangement is one that objectively either has no significant purpose other than achieving an abusive tax result, or has features included mainly to achieve an abusive tax result. An "abusive tax result" is an advantageous tax result, that is a reduction or deferral of receipts, an increase or acceleration of deductions or a reduction in tax rate.

There are four safeguards.

First, there is a defence for arrangements which are "reasonable tax planning" - a reasonable exercise of choices of conduct afforded by tax legislation. This safeguard applies even if a judge's own view is that an arrangement involves unreasonable choices of conduct – the question is whether the contrary view could reasonably be held.

Second, there is a defence if the taxpayer can show the arrangement was neither designed nor carried out with the intention of achieving an advantageous tax result.

Third, the burden of proof in the application of the GAAR is on HMRC, not the taxpayer

Fourth, the GAAR can only be applied to an arrangement if a senior HMRC officer refers it to an advisory panel (with a majority of independent members). HMRC and the taxpayer will then make representations to the advisory panel, and the panel will advise the officer whether in its opinion it is reasonable to apply the GAAR to counteract the arrangement. That opinion will be subsequently admissible in evidence if HMRC proceed to litigation. The advisory

panel's opinion is not binding, but the Aaronson Report assumes a court would take it into account.

5. What happens if you enter into an arrangement caught by the GAAR?

Where the GAAR is held to apply, the Court (not HMRC) have the power to counteract the arrangement to produce a result which is "reasonable and just". In circular transactions it may be reasonable and just to treat the transaction as if it did not take place at all.

Where the arrangement does achieve some purpose the counteraction will take the form of the Court making an assessment of tax on a hypothetical equivalent transaction without the abusive tax result. In some other jurisdictions this type of test has been hard to apply. Where it is not possible to find a hypothetical equivalent, there will be a "reasonable and just" counteraction.

Unlike other jurisdictions, there are no proposals to include any provisions for applying special rates of interest or penalties to tax recovered by use of the GAAR.

6. Which taxes will be covered by the GAAR?

Initially it is intended that the GAAR will apply to national insurance and to the main direct taxes: income tax, capital gains tax, corporation tax and petroleum revenue tax (so not, for example, the bank levy, inheritance tax or stamp duties). That stamp duty land tax ("SDLT") is omitted is surprising since we understand the group was influenced in recommending a GAAR by views that highly abusive SDLT avoidance was taking place. At a later stage, when the GAAR is seen to operate fairly and effectively, consideration will be given to including other taxes such as SDLT. It has been recommended that the GAAR not apply to value added tax, as this tax has its own anti-abuse principles derived from EU law.

7. Will there be a clearance system?

Most previous GAAR proposals have included a clearance system – indeed the original Liberal Democrat manifesto proposal suggested that HMRC would charge a commercial fee for clearances.

The Aaronson Report takes the approach that the focus of the GAAR upon egregious avoidance cases means that clearances for normal tax planning will not be necessary. In their view, an extensive clearance system would create an impediment for transactions and business and become an unreasonable burden for HMRC. A clearance system could also give HMRC too much discretionary power.

However, where the tax legislation already has an existing clearance procedure (for example for company reorganisations), the application could include a request for a GAAR clearance.

8. What kind of transactions does the Aaronson Report expect to be caught by the GAAR?

It would have been helpful if the Report had given examples of arrangements that would be caught by the GAAR. Unfortunately it does not do so.

This may be because most aggressive tax planning has failed in the courts in recent years. Even where taxpayers have been able to steer a course through the maze of anti-avoidance legislation, the courts have taken purposive approaches which deny the intended tax benefits - even when, on a literal reading of the relevant legislation, the tax planning would succeed.

A good recent example of this was scheme in the *Tower MCashback* case. £143m was invested in a circular transaction to no net economic effect, but – on a strict application of the rules – the taxpayers would obtain income tax relief. The Supreme Court viewed the arrangement as having no meaningful substance, and relief was therefore unavailable. Other recent cases such as *Prizedome* and DCC Holdings are examples of the courts taking (some might say stretching) a purposive approach to construction of legislation to deny results that the taxpayer hoped for.

There is only one recent example of an aggressive scheme of this kind having succeeded in the courts. This is the "SHIPS 2" scheme in *HMRC v Mayes*. The Court of Appeal held the scheme to be effective, despite its highly artificial and contrived nature. However they did so with considerable reluctance, concluding that it was for Parliament to tackle such avoidance.

The Report refers to SHIPS 2, and it is reasonable to conclude this is a case where the Aaronson Report would see the GAAR applying – indeed its authors may see themselves as responding to what amounted to a plea by the Court of Appeal for legislative aid. However the loophole in SHIPS 2 has long been closed without need for a GAAR. It is very difficult to think of examples of schemes that would succeed under current law, yet would generally be regarded as egregious and abusive.

9. Will the GAAR result in increased tax revenues?

The Aaronson Report has designed the GAAR as more of a deterrent than a revenue-raising measure. Given the intended limited scope, this strikes us as a realistic aim – certainly those who were hoping for billions of additional tax revenue are likely to be disappointed.

Whether it will act as an effective deterrent is not clear. One problem is that those who are engaged in the most aggressive tax planning may also be prepared to take very bullish interpretations of the GAAR. Under the proposed GAAR, the question would come down to whether certain kinds of tax planning were reasonable. The obvious scope for argument surrounding questions of reasonableness means that the deterrent value may be limited.

This can currently be seen in the area of SDLT planning (an area that will not be affected by the GAAR). The SDLT rules already have their own specific GAAR. But this does not seem to deter those who aggressively market schemes for avoiding SDLT when buying residential property. Because of the specific SDLT GAAR it is highly questionable whether these schemes work, but the schemes are marketed and implemented regardless.

10. Will the GAAR create cost and uncertainty for business?

If the GAAR remains in the limited form proposed by the Aaronson Report, in our view it would be unlikely to affect ordinary business transactions. In that respect, we believe the Report has succeeded in its aim.

However we fear "mission creep", as do the Report's authors themselves. One risk is that Parliament may "refine" the GAAR to catch wider classes of transaction. Even if that does not happen, there are elements of the proposed GAAR that make it susceptible to expansion by subsequent caselaw, for example by interpreting the definition of "arrangements" to refer to individual elements of a large transaction (and this is the kind of approach that led to the scope of the Australian GAAR expanding over time). We can also see HMRC using this kind of argument as a stick to frighten taxpayers out of tax planning that is objectively reasonable.

The Aaronson Report's proposed GAAR is designed to minimise this risk, even to the (unprecedented) extent of proposing that their guidelines be given statutory force. But the subjective nature of the reasonable tax planning safeguard means that we would expect the scope of the GAAR to become highly controversial.

The problem is that the question of what is acceptable tax planning and what is avoidance is as political and philosophical as much as it is legal. There are some who still hold to the traditional view that a taxpayer has the absolute right to arrange his or her affairs to minimise tax. There are others who believe that we all have a duty to contribute to society by paying the "right" amount of tax (whatever that is).

The application of the safeguards will therefore be contested. Many well known companies pay a low effective rate of corporation tax on profits because of the application of tax reliefs and exemptions (such as capital allowances, designed to encourage investment, and the exemption from tax on sale of subsidiaries, designed to encourage the UK as an attractive location for multinational holding companies). Objectively such companies are simply arranging their affairs to rely on reliefs and exemptions for their intended purpose; however it is clear a number of journalists, activists and politicians do not regard such companies as paying the "right" amount of tax. It is easy to see how political pressure could be brought on HMRC to apply the GAAR to such arrangements, even if that was not its authors' intent.

The temptation may therefore be to apply the GAAR more widely, or to amend it into something that can be applied more widely. That would create significant cost and uncertainty for business.

11. Is the proposal liable to abuse by HMRC?

Even in its current form we think there is going to be risk of abuse in relation to the application of the GAAR despite Aaronson Report's attempts to give taxpayer safeguards. We fear that some in HMRC may be tempted to apply the GAAR in wider circumstances that the Report intends, and that will damage British business. The proposal is laced with comforting language for taxpayers (what upright citizen would be worried that they were going to enter "abnormal arrangements" or achieve an "abusive tax result"). But behind these comforting words are tests that are much less comforting and which rely on ultimately the subjective judgment of HMRC and the Courts.

The complexity of the tax code means that it is not uncommon for an ordinary commercial transaction to potentially create an anomalous tax result, particularly where the surrounding facts and circumstances are complex. Parties will often put arrangements in place to avoid that anomalous result. These arrangements may have no other purpose than to avoid tax – however the tax result they are trying to avoid is one that Parliament likely did not intend. How, then, would the GAAR apply to such a scenario?

A good example is in the context of a corporate restructuring. In recent years there have been a number of high profile cases of companies getting into financial difficulty, in circumstances where the amounts they owe to their banks are significantly in excess of their assets. To continue trading, the company will often seek to reach an accommodation with its bankers under which some of the debt is written off. Yet the standard UK tax treatment of a write-off is that the company becomes taxable. There is an exemption for debt-write offs where the lender receives equity in exchange for the debt, but this is often something lenders are unwilling to do (e.g. because of accounting consolidation issues). This puts businesses in an impossible position – if they do nothing they will become insolvent, and the business (and the jobs which depend upon it) will be lost. Yet writing off the debt – necessary to save the business – will trigger tax that the company will not be able to afford to pay, rendering the company insolvent. In practice, many businesses have squared this circle through various forms of tax planning.

Would such arrangements be caught by the GAAR? It seems to us that it should not - and the Aaronson Report would appear to agree that taking steps to avoid an inappropriate tax disadvantage in a commercial transaction is reasonable tax planning. But the taxpayer would have to rely on HMRC or the Courts agreeing that this was a reasonable exercise of choices of conduct under tax legislation. It is a brave chief executive who can be confident that the

GAAR will not adversely affect how much tax his or her company is required to pay, or at least how much management time and professional fees has to be spent in seeing off HMRC enquiries.

12. Would the GAAR benefit taxpayers?

The Aaronson Report sees two key benefits.

First, that in some cases (such as perhaps *Tower MCashback*, *Prizedome* and *DCC Holdings*) the Courts have gone too far in applying a purposive interpretation. This calls into question the integrity of tax law and makes it more difficult to advise on likely outcomes. The Report's authors believe it preferable for Parliament to enact an explicit rule in a GAAR, and that this will result in greater certainty for taxpayers.

Second, that if there were a GAAR, the Government would no longer have to rely on introducing targeted anti-avoidance rules with each piece of new tax legislation. Future tax legislation would therefore be simplified. They also anticipate that, in time, existing anti-avoidance rules could be repealed.

The latter objective, in particular, is optimistic. We suspect HMRC would fear that removing targeted anti-avoidance rules would invite abuse and we will end up with a system that has both the GAAR and targeted anti-avoidance rules.

13. When is any GAAR likely to be enacted?

The Aaronson Report's proposed GAAR is stated to be merely illustrative, and there will be a further period of consultation. Ultimately the decision whether to proceed with the GAAR will be one for the Government. The earliest any GAAR could be enacted is, in principle, Finance Act 2012 although this is very unlikely. Finance Act 2013 is more plausible.

14. If the GAAR is so limited, won't everybody be happy to accept it?

The limited scope of the proposed GAAR means that the Aaronson Report may be criticised on two fronts.

First, by those seeking a GAAR targeting a much wider range of transactions. The likes of UK Uncut view many ordinary business transactions as tax avoidance, and are likely to be disappointed by much of the content of the Report. It is, however, clear that the Report's authors view a widely targeted GAAR as detrimental to British business.

Second, by those who ask whether the limited benefits of the proposed GAAR justify its costs. As we note above, the Report does not give any examples of cases where the GAAR would apply. So if the GAAR's scope is so modest, and the arrangements it targets so unusual, will its greatest effect be to further complicate the UK tax code and create uncertainty for business?

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