

## PAPER 1

### TAX AVOIDANCE

#### *Oxford University Centre for Business Taxation*

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*In summer 2012 the National Audit Office (NAO) commissioned the Oxford University Centre for Business Taxation (OUCBT) to draw up an academic review of the Disclosure of Tax Avoidance Schemes regime (DOTAS) and the tax avoidance landscape. The academic review formed part of the evidence base behind the NAO's report: "Tax avoidance: tackling marketed avoidance schemes" (November 2012). The NAO's report "examines the effectiveness of the DOTAS regime and HMRC's response to marketed tax avoidance schemes, particularly those used by large numbers of individuals and smaller businesses."*

*The review produced by the OUCBT consisted of three papers on tax avoidance generally, DOTAS and the Tax Gap. They are being made available here as a matter of public record.<sup>1</sup>*

*The OUCBT is an independent academic organisation that has no collective view. The academic review represents the view of the individual authors only: Professor Michael P. Devereux, Professor Judith Freedman and Dr. John Vella.<sup>2</sup> Nothing stated here should be taken to represent the views of the NAO. Details of the independent status of the OUCBT and its various sources of sponsorship can be found at <http://www.sbs.ox.ac.uk/centres/tax/about/Pages/Funding.aspx>*

#### **1. PAPER OBJECTIVE**

Concern about "tax avoidance" is nothing new.<sup>3</sup> Over the years, tax avoidance has been the frequent subject of parliamentary and media attention, although this ebbs and flows. In recent years, it has once again come under the political and public spotlight.<sup>4</sup> As in the past, wealthy individuals and large companies have been accused of these practices, as have popular public figures, politicians and public sector employees. Whilst these revelations have always attracted attention, they cause understandable outrage at a time

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<sup>1</sup> Minor amendments and additions to the papers have been made since their submission to the NAO. In particular the papers have not been updated to reflect the new information released in the NAO report itself.

<sup>2</sup> The authors are grateful to Francis Ng for valuable research assistance.

<sup>3</sup> For an account of evidence given to the Royal Commission on the Income Tax in 1920 see Martin Daunton, *Just Taxes The Politics of Taxation in Britain, 1914-1979* (CUP 2002) p. 110. In *The History of Tax Avoidance* (Wisedene Ltd 1989) journalist Nigel Tutt told the story of the Tucker and Rosminster schemes, which he stated had attracted John Lennon, Roger Moore and Englebert Humperdinck.

<sup>4</sup> This can be seen in the media interest in avoidance as well as the creation of pressure groups campaigning against avoidance. See the series of articles by The Times on tax avoidance <<http://www.thetimes.co.uk/tto/money/tax/article3449509.ece>>and by The Guardian on the tax gap <<http://www.guardian.co.uk/business/series/tax-gap>>. See also for example, the website of UK Uncut. <http://www.ukuncut.org.uk/>

of tight public finances, far-reaching austerity measures and a struggling economy. The question is how to tackle the problems. This requires a clear analysis of their cause and differentiation between different causes. Labelling a whole range of quite different behaviours as “avoidance” without further differentiation is unhelpful.

This paper aims to inform the important debate on tax avoidance by exploring the language used and setting this in context. Tax avoidance is something that needs to be tackled with vigour and public confidence that the tax system treats people equitably is vital. Yet the actors concerned - taxpayers, advisers and revenue authorities - operate within a complex domestic and international tax environment. Many of the complexities and flaws in the system can only be tackled by radical structural changes, which will require fundamental policy thinking and change and international co-operation. Oversimplifying the debate and searching for individual or corporate villains will not assist in remedying the underlying problems. Even if public naming and shaming influences a few taxpayers in the public eye to impose their own voluntary constraints, it will not necessarily affect the worst avoiders, and may even encourage some non-compliance from those who feel that “everyone is at it”. Only understanding the flaws in the tax system and working on serious changes can give long-term results.

The use of one label of “avoidance” to describe a whole range of activities is questionable, and, as this paper will show, appealing to fairness or morality to counter them may not be particularly helpful in reaching a practical solution. The arguments put forward in this paper on these points should not, however, be equated with a view that all activities which reduce taxation legally are unproblematic. Some of the activities discussed in the avoidance debate represent deeply unsatisfactory aspects of the current tax system from a policy point of view. In some cases what is needed is enforcement of the law, whilst in others, changes in policy, the international tax system and/or domestic law may be needed. Differentiation of the problems is needed to find appropriate answers.

We do not suggest that nothing can be done under the current system. There could be improvements in enforcement and also to legislation which could curtail some forms of activity. But some of the activities that are described as avoidance in press reports and parliamentary discussions,<sup>5</sup> whilst raising questions about how states raise and target taxation, could not be curtailed or prevented without more fundamental change. In those cases the solution lies ultimately with the political process. There is a need for discussion about what is popularly considered “fair”, but this should be used alongside other considerations to inform the policy process and then to be embodied in the law through proper parliamentary processes.

The paper is divided into 4 sections. Section 2 looks briefly at different meanings of the term “tax avoidance”. As these words have no fixed or obvious meaning, the very term is a source of much confusion. It is used to cover a broad spectrum of activities, often without adequate differentiation or sensitivity to the term’s limitations. Section 3 attempts to elaborate on some points made in section 2 and discusses some fundamental concepts such as “parliamentary intention” and the “spirit of the law”, in more detail. Section 4 briefly outlines the various tools available to deal with avoidance of different types. Section 5 concludes.

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<sup>5</sup> See, for example, The Guardian, “A roll call of corporate rogues who are milking the country”, 30 October 2012; The Sunday Times, “Apple avoids up to £570 m in British Tax”, 14 October 2012 and The Times, “Cameron ‘unhappy’ over multinationals’ tax avoidance”, 25 October 2012.

## 2. WHAT IS “TAX AVOIDANCE”?

In order to have a coherent discussion of the issues, we need to differentiate various forms of activity that are often grouped together as avoidance. “Tax avoidance” has no fixed legal meaning, although courts have sought to elucidate it in some cases and, for example, to distinguish tax avoidance from tax planning or tax mitigation.<sup>6</sup> Matters are often complicated but not usually clarified by the addition of adjectives such as “aggressive”, “abusive” or “unacceptable” to the term.<sup>7</sup> All categorisation in this area is problematic but since it is clear from recent debates that the terms mean different things to different people, we need to start by examining what they might mean by the term. The framework that follows is simply designed to provide a basis for the discussion in this paper and is not intended to be a comprehensive and definitive categorisation. Indeed, at the borders it can be very difficult to say a priori which of these categories any given transaction falls into, because much can depend on the interpretation of the courts and all the surrounding facts. So reasonable people can take different views of which category certain transactions fall into and only the highest court can give a definitive answer. In truth there are not separate categories but a continuum from transactions that would not be effective to save tax under the law as it stands at present to tax planning that would be accepted by revenue authorities and courts without question. In fact, certain of these categories are not strictly forms of ‘avoidance’ at all, as we shall explain, but as they all have been referred to as such in recent debates, they will be discussed further.

### I Distinguishing Evasion

Practically every media report on avoidance now starts with the statement that the activities it is discussing are legal but still amount to avoidance. It is well understood that there is a difference between evasion, which involves non-disclosure or concealment, be it fraudulent or not<sup>8</sup> and which is illegal; and avoidance, which is ‘legal’. Evasion needs to be tackled by strong enforcement of the existing law. This is an important topic, highly relevant to the Tax Gap figures, but is not the topic of this paper, which deals only with avoidance as discussed below.

### II Avoidance

#### A. Ineffective Avoidance

By saying that avoidance is legal, we mean that it involves no criminal activity, and no failure to make a required disclosure. This does not, however, make it effective to achieve

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<sup>6</sup> E.g. *CIR v Challenge Corp Ltd* [1986] S.T.C. 548; *IRC v Willoughby* [1997] 1 W.L.R. 1071, HL, [1997] S.T.C. 995. See James Kessler, “Tax Avoidance Purpose and Section 741 of the Taxes Act” [2004] *British Tax Review* 375.

<sup>7</sup> See Lord Hoffmann’s comment in *MacNiven v Westmoreland Investments* [2001] UKHL 6, [2001] S.T.C. 237 at p. 257: “...when the statutory provisions do not contain words like ‘avoidance’ or ‘mitigation’, I do not think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not.”

<sup>8</sup> For further discussion see Judith Freedman, “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle” [2004] *British Tax Review* 332, pp.347-350.

its objective of reducing tax liability. In some cases (provided the activity is discovered and action is taken) the legislation enacted and treaties agreed as construed by the courts will be effective to prevent the avoidance scheme from saving tax and so ultimately there will be no successful avoidance.<sup>9</sup> For the purposes of this paper, we shall call this ‘**ineffective avoidance**’.

Clearly this form of avoidance needs to be countered by adequate disclosure provisions<sup>10</sup> and a properly resourced revenue authority. Counteraction may also require international co-operation and exchange of information. The attitude of the courts is important to the effectiveness of legislation. The approach of the courts can vary over time, as discussed below, but in cases under this head the legislation will apply to defeat a scheme, possibly with the assistance of purposive interpretation to achieve this result. It is not correct to assume that UK courts can only apply a literal interpretation of legislation.

The aim of the courts is to construe legislation in a way that gives effect to “parliamentary intention”. Parliamentary intention in this context is a term of art, extensively debated in legal literature and should be distinguished from a colloquial usage. Lord Nicholls has explained: “...the ‘intention of Parliament’ is an objective concept, not subjective. The phrase is a shorthand reference to the intention which the court reasonably imputes to Parliament in respect of the language used. It is not the subjective intention of the minister or other persons who promoted the legislation. Nor is it the subjective intention of the draftsman, or of individual members or even of a majority of individual members of either House.”<sup>11</sup> In other words the political and authoritative process of Parliament passing legislation produces the text of legislation, the intention of which is found by the courts looking at the wording of that legislation.<sup>12</sup>

Over the years the UK courts have developed what is called ‘purposive interpretation’ to help them ascertain parliamentary intention, and therefore no longer apply a strict letter of the law approach. The courts are, however, governed by the rules of legal interpretation, which, in the UK quite unusually, do not permit the use of extraneous material in interpreting the legislation. Nevertheless the UK courts are able to look at the

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<sup>9</sup> HMRC has recently won a number of cases against the taxpayers in avoidance schemes, although the law is unclear in this area and other cases have been lost. In some cases courts at different levels come to very different conclusions. The law is not sufficiently certain at present to be able to predict the outcome of some of these borderline cases with confidence and this is problematic. E.g. HMRC was successful in *Tower MCashback LLP 1 v Revenue & Customs Commissioners* [2011] 2 A.C. 457, *Eclipse Film Partners No 35 LLP v HMRC* [2012] UKFTT 270 (TC); [2012] STI 1607 and *Howard Peter Schofield v The Commissioners for Her Majesty's Revenue and Customs* [2012] EWCA Civ 927 but was unsuccessful in *Mayes v Revenue & Customs Commissioners* [2011] S.T.C. 1269 and (in important respects) in *UBS AG v HMRC* [2012] UKUT 320

<sup>10</sup> This is one of the purposes of the Disclosure of Tax Avoidance Schemes (DOTAS) regime. This regime is discussed in some detail in an accompanying paper (Paper 2).

<sup>11</sup> *R v Secretary of State for Environment, Transport and the Regions ex parte Spath Holme Ltd* [2001] 2 AC 349.

<sup>12</sup> See also Lord Reid in *Black-Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG* [1975] A.C. 591, at 613: “In seeking for the intention of Parliament we are seeking not what Parliament meant but the true meaning of what they said”. On Parliamentary intention see also Judith Freedman, “Interpreting tax statutes: tax avoidance and the intention of Parliament”, *Law Quarterly Review* 2007, 53 at 72 et seq. especially the literature referred to there.

context of the particular provision in terms of the purpose of the statute as a whole.<sup>13</sup> Parliamentary intention in this special, narrow sense can be made clearer through specific anti-avoidance legislation, but such legislation, if it becomes too complex, may become counter-productive. Very detailed anti-avoidance legislation can actually create avoidance opportunities by creating loopholes.<sup>14</sup>

Another legislative approach is to widen the terms of the initial legislation (*principles-based legislation*) so that it can be more broadly interpreted and to have a *General Anti-avoidance Rule (GAAR)*, which should provide an overriding principle that can go beyond normal rules of statutory interpretation. Here the danger is that if the terms used are too wide, ordinary taxpayers going about their normal activities will suffer from uncertainty. Moreover, the courts might cut down the provisions in order to give them a narrow meaning to ensure that they comply with the rule of law.<sup>15</sup>

We discuss *Parliamentary intention, purposive interpretation, principles-based legislation* and *GAARs* further below.

## **B. Effective Avoidance**

Effective avoidance may arise due to a defect in the legislation or other failure in the way the legislation is written that cannot be corrected by purposive interpretation. This is not necessarily a policy failure as such, but there may be a difficulty in applying purposive interpretation, particularly where the policy behind the legislation is not discernible, as is too often the case with technical tax legislation.

Where there is a pure drafting defect in the legislation, this can often be dealt with by the courts construing the legislation purposively.<sup>16</sup> In other words the court finds that it was parliamentary intention in the narrow sense described above to cover that point. Sometimes that is not possible under the rules of interpretation, which only allow the courts to look at the material within the statute itself. In a case where the statute taken as a whole is not adequate to cover, or allow a reading that can cover an omission or gap or unfortunate interaction with another piece of legislation, this can mean that the courts cannot strike down a tax scheme and so it is effective to save tax.

Increasingly, purposive interpretation prevents this failure of legislation from happening, but there have been recent decided cases where a scheme has worked despite the

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<sup>13</sup> As discussed further below in section 3. This is subject to the so-called rule in *Pepper v. Hart* [1993] A.C. 593 which permits the courts to look at Ministerial statements in very limited circumstances and which has only rarely been of assistance.

<sup>14</sup> In what some would describe as a cat and mouse game, with HMRC always behind the taxpayer. The activity of taxpayers exploiting this has been described as 'creative compliance' - Doreen McBarnet and Chris J. Whelan "The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control" (1991) *Modern Law Review*, 54, 848.

<sup>15</sup> This has been the experience in other jurisdictions, e.g. Australia, in relation to their previous GAAR.

<sup>16</sup> An examples of such defects can be found when the legislature omits to provide for transitional provisions on a change of the law, for example- see *Commissioners of Inland Revenue v. Scottish Provident Institution* [2004] UKHL 52, [2005] S.T.C. 15. In this case the courts read the legislation as dealing with the point - and so we can say that it was parliamentary intention to cover it. Some gaps, however, are too wide for the courts to fill in this way.

availability of purposive interpretation under these rules, even though applying a test that would look at the legislation as a whole and the background materials it is possible to argue that no reasonable legislature could have intended that to be the outcome of the legislation they enacted.

This last test is a wider view of Parliamentary intention than is available to the courts under current law and so the only current answer open to policy makers is to legislate to put a stop to this behaviour, if the Government and ultimately Parliament decide that this should be done.

Some would say that where a scheme is effective because it is not contrary to parliamentary intention defined narrowly, it is not tax avoidance at all. Strictly speaking this is the case - if it succeeds, by definition it is not avoidance because it is within the law.<sup>17</sup> It may still be described as avoidance by others, however, because in their view it reduces the tax otherwise payable and is contrary to the wider view of parliamentary intention described above, sometimes also called the “spirit of the law”.

Some anti-avoidance legislation enables the courts to look at the purpose of the transactions, which may assist them to counteract some activities that would otherwise fall into this category, and move them to category A above.

Once a GAAR has been introduced, as the Government has announced it proposes to do, this would also move some, at least, of the category B transactions into A without the need for specific legislation. It would have the timing advantage of being in place already, so that the Government would not always be playing catch up. GAARs have different ways of defining which cases should be moved to category A. Many GAARs use tests that look at the characteristics of the transaction in question. The proposal in the UK is to use a concept of abusive transactions and to allow some background material not currently admissible to be presented to the courts as evidence. In this way it would move closer towards applying a test that would look at the legislation as a whole together with the background materials, so that it could evaluate what a reasonable legislature could have intended to be the outcome of the legislation they enacted. This would be a move towards the wider view of Parliamentary intention described above. This would catch at least some, and hopefully most, of the transactions that are currently effective under this B category.

### ***C. Using legislation or the international tax system to one's advantage***

Sometimes domestic legislation and/or double taxation treaties together with the norms of international taxation result in taxpayers being able to take advantage of opportunities to reduce their taxation. It may be that the outcome could be a very low tax bill for those

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<sup>17</sup> So Lord Hoffmann has stated extra-judicially: “tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by a statute which means that such a tax is to be imposed. If that is what Parliament means, the courts should be trusted to give effect to its intention. Any other approach will lead us into dangerous and unpredictable territory.” Leonard Hoffmann, ‘Tax Avoidance’ (2005) *British Tax Review*, 2, 197, p.206.

taxpayers. This does not mean they are engaged in avoidance under categories A or B above. Nevertheless, some have called this avoidance because they do not consider those taxpayers to be paying their “fair share” of tax.

So, for example, this could include some companies that have a high turnover in the UK but pay little or no tax here because they make payments for interest, licenses and royalties to other jurisdictions. In the current debate, concern has been expressed about such taxpayers and their activity has been described by some as avoidance and immoral.<sup>18</sup> In some of these cases about which concern is currently being expressed, there may be avoidance under category A above. Alternatively they might fall under category B. Although we have attempted to divide these categories as a tool for thinking about appropriate actions, as we have said there is in reality a continuum and much depends on the facts of each case and the way in which the courts interpret the legislation, which brings in the question of Parliamentary intention in the technical sense described above. In either case there is a need for investigations to see whether the existing law is being properly applied and enforced. If current law cannot stop the behaviour in question, there may be a need for legislative change as discussed below, but note that a GAAR is not designed to catch transactions which fall squarely under category C and not B.

The fact that there is little or no tax payable is not, however, conclusive evidence that there is avoidance under either head A or B above. In some of these cases, these companies are simply operating in accordance with incentives created by the international tax system and by domestic governments trying to attract economic activity into their jurisdictions. This the governments may do for non-tax reasons, or because this activity gives rise to forms of taxes other than those which are not being collected. HMRC has recently confirmed that it accepts this to be the position in its briefing entitled ‘Taxing the Profits of Multinational Businesses’.<sup>19</sup> The tools at the disposal of the international community to ensure that tax is not escaped include, for example, the transfer pricing and controlled foreign company (CFC) rules. We may well question whether the transfer pricing rules are adequate, or CFC rules are sufficient or appropriate,<sup>20</sup> but these are considerations relating to tax policy reform and not to tax avoidance. They are not issues that can be remedied by pressure on a particular taxpayer to act in a different way. Even if that were to have an effect on one taxpayer it would not tackle the underlying issues.

There are various ways to try to reform the taxation of business, especially international business. One route would be to reform existing rules, including those on transfer pricing, royalties, interest deductibility and the CFC rules. There are, however, constraints on a country’s ability to undertake these international changes unilaterally. The desire to maintain or improve the country’s competitive position is one powerful constraint. European Law is another. For example, it prohibits most withholding taxes on interest and royalties<sup>21</sup> between associated companies in Member States and restricts the scope of CFC rules.<sup>22</sup> Further it may be difficult, though not impossible, to change established

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<sup>18</sup> See Andrew Godall, “MPs urged to probe international tax avoidance”, *The Tax Journal*, 26 October 2012. The Guardian, “Starbucks ‘pays £8.6m tax on £3bn sales’”, 15 October 2012.

<sup>19</sup> HMRC, “Taxing the profits of multinational businesses” Issue Briefing, October 2012. This is available at: <<http://www.hmrc.gov.uk/about/briefings/profits-multinationals.pdf>>

<sup>21</sup> Article 1(1) of the European Interest and Royalties Directive prohibits withholding taxes on intra-group royalty payments within the EU.

<sup>22</sup> *Cadbury Schweppes plc v IRC* (C-196/04) [2006] E.C.R. I-1995 (ECJ Grand Chamber).

international norms on such matters as transfer pricing even though these norms were developed in a former era and are not always suitable for current economic and technological conditions.

For this reason some would argue that tinkering with such rules can never produce a satisfactory result – a more radical change is required. We could move away from a corporate level tax on profits altogether and tax business activity on a different basis instead. This would raise other issues. Another popular radical solution would be to keep a corporate profits tax but to adopt a unitary system of taxation. Under this system multinational companies would be treated as a single entity for tax purposes. Their profits would be determined on a world-wide basis and then allocated to different jurisdictions in accordance with a pre-established formula based on factors such as assets, labour and sales. Whilst clearly providing a number of benefits, it is equally clear that this system raises a number of problems, including difficulties surrounding the design of the all-important formula that will suit all the relevant jurisdictions and not be open to manipulation by taxpayers.

One of the authors of this report has proposed a different radical solution: a destination based cash flow tax.<sup>23</sup> This solution has many desirable properties; however further work is required to turn it into a workable proposal.

This is not to say that radical change is not possible. However there is unlikely to be a system which effortlessly solves all current difficulties without creating others. Claiming that there is a simple alternative to the current system as a silver bullet is unhelpful to real progress. A good deal of hard work, international co-operation and serious dialogue will be necessary to find the best practical way forward.

### **III Consequences of categorisation**

Although these categories have been defined in a relatively simple way above, the complexity and uncertainty surrounding some aspects of tax law mean that it is not always clear into which of these categories a transaction might fall, as mentioned in the discussion under category C. Even after investigation, there may be a degree of judgment involved in deciding on which side of the line a transaction falls. There may also be issues of fact to be decided, such as valuation or pricing, or if the legislation refers to the purpose of the transaction. Ultimately this can only be decided by the courts, although in many cases the issue does not come to the courts because it is impractical to litigate every case. This is one reason why cases may quite legitimately be settled within a range – in some circumstances the question is not susceptible to a binary yes or no answer.

Sometimes, as discussed below, the problem will be that policy makers are not clear about their objectives when drafting legislation. It is then hard to discern parliamentary intention from the legislation at any level, or there may be disagreement as to what it is. At other times the taxpayer may argue that the legislation applied to him and in accordance with its background purpose as he sees it, others would say that the transaction in question is only being undertaken for tax advantage and so should not benefit from the particular relief or incentive relied upon. The film financing schemes would be an

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<sup>23</sup> Michael P. Devereux, “Issues in the Design of Taxes on Corporate Profit”, 65 *National Tax Journal* 709-30 (September 2012).



example. There are reliefs to encourage film financing but some investors engage in them only for tax purposes. The courts are clear that having a tax avoidance motive alone is not enough to prevent a taxpayer from relying on a statute, so what more is needed to prevent a taxpayer from relying on a film financing relief which appears to operate in a very beneficial way for him?

Whether this falls into category A, B or C will depend on the decision of the court and can be something upon which even the courts can disagree.<sup>24</sup>

### 3. AVOIDANCE CONCEPTS- FURTHER DISCUSSION

#### **I Law as the necessary starting point.**

Whilst concepts of fairness and morality play an important role in any political debate about taxation levels and distribution, in order to ascertain what tax is actually due in a way that is practical and enforceable by society it is necessary to have a *legal* definition of what is to be taxed (tax base) and at what rate. The answer to those questions must ultimately depend on the law. There is no other way of determining the tax due.

Let us take a simple example of a UK corporation, Red plc. Suppose Red plc made accounting profits shown in its financial statement of £100 million this year. Let us suppose that this company bought machinery for £5 million, invested £10 million in research and development, had tax losses of £10 million brought forward from previous years and made £50m of its profits from sales through branches located in overseas jurisdictions. How should these facts affect the tax to be paid?

If the law said that corporation tax should be paid as a percentage of the accounting profits of a company, then this might be a simple matter. However, the accounting profits are not the tax base for corporation tax in the UK. UK corporation tax allows accelerated depreciation for the purchase of the machinery; grants reliefs for research and development expenditure that may amount to more than 100%; allows many tax losses to be brought forward and set against profits in the current year and exempts much income from foreign branches. The tax due may therefore be considerably lower than the headline rate of tax applied to the accounting profits would suggest. If that is so, then the case of Red plc may be entirely within category C above and therefore not engaged in avoidance at all.

Someone looking only at the headline rate of tax and the commercial accounts might consider this was “unfair” if they wished for a policy that charged every company a percentage tax on the profits stated in their financial accounts. But there is no ‘fair’ or reasonable basis for this judgment, because deliberate policy decisions on the part of the government and the international tax community are designed to give a different result.

Red plc’s behaviour can only be judged on the basis of the applicable law and not on some abstract notion of fairness. If Red plc has engaged in sales at over-value, or has set up a branch or subsidiary, or complex web of such entities, which have no genuine economic

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<sup>24</sup> See, for example, *Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes)* [1992] STC 226 and *Eclipse Film Partners No 35 LLP v HMRC* [2012] UKFTT 270 (TC); [2012] STI 1607 on this long standing problem.

activity, then, under current UK and international law, it will be appropriate to challenge its figures, but only if that is shown to be the case. If that is the case then the Red plc may fit under category A above, or possibly B if the law is not adequate to enable adjustments to be made to its behaviour.

Similarly we can take some of the recent examples of companies discussed in the media, Starbucks<sup>25</sup> and Facebook.<sup>26</sup> They have been criticized for not paying tax where they are making sales, but sales are not the basis for the corporation tax, so this alone is no cause for criticism of the companies concerned. We could argue that the tax base should change, but unless and until that occurs, the fact that there is a high turnover but no taxable profit is not in itself an indicator that the taxpayer is behaving in an unreasonable way.

Relying on the lack of “morality” of particular taxpayers to argue that a “fair share” of tax is not being paid is not helpful, for the simple reason that abstract concepts such as “fairness” cannot be used to determine a taxpayers’ tax liability. This is not to say that morality is unimportant or irrelevant to how an individual behaves or a business operates, but simply that it cannot answer the question of how much tax is payable. As a distinguished legal philosopher (Tony Honoré) has written:

“According to most people’s moral outlook members of a community should make a contribution to the expense of meeting collective needs. ...So members of a community have in principle a moral obligation to pay taxes. But this obligation is incomplete or, if one prefers inchoate, apart from law. It has no real content until the amount or rate of tax is fixed by an institutional decision, by law. What amounts to a reasonable contribution is not otherwise determinable, since what is required is a co-ordinated scheme which can be defended as fair not merely in the aggregate amount it raises but in its distribution. Taxpayers cannot settle it for themselves, as people can within limits settle for themselves, say, the proper way of showing respect for the feelings of others. Apart from law no one has a moral obligation to pay any particular amount of tax. An obligation to pay an indeterminate amount is not an effective obligation; it requires only a disposition, not an action. So, apart from law no one has an effective obligation to pay tax.”<sup>27</sup>

Morality *is* relevant to what society decides its tax laws should be, and a healthy and informed discussion of this is important, but this then needs to be given content by an institutional decision, by law, as Honoré suggests.

There are other reasons why we must necessarily turn to the law to determine the tax due by a taxpayer. Subject to some exceptions, the rule of law requires that taxpayers are able to determine the tax consequences of their actions in advance. This can only be done through legislation and not vague notions of fairness. Also, under the British constitutional

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<sup>25</sup> See Tom Bengin (Reuters), “Special Report: How Starbucks avoids UK Tax”, 15 October 2012. For comments on the story see, for example, BBC, “Starbucks 'paid just £8.6m UK tax in 14 years'”, 16 October 2012 and The Guardian, “Starbucks 'pays £8.6m tax on £3bn sales'” 15 October 2012..

<sup>26</sup> See, for example, The Independent, “Facebook: The antisocial network branded 'disingenuous and immoral'”, October 11, 2012; The Guardian, “Facebook accused of taking UK for a ride over taxes” 10 October 2012 and The Guardian, “A roll call of corporate rogues who are milking the country”, 30 October 2012.

<sup>27</sup> Tony Honoré “The Dependence of Morality on Law” in *Oxford Journal of Legal Studies* vol 13, no 1 (1993), p. 5,

set up, the imposition of tax on citizens is the monopoly of Parliament.<sup>28</sup> Tax in the UK must be imposed by Parliament through legislation.

If Red plc's actions fall under category A above, what is needed is enforcement. If they fall under category B above some small scale adjustment to the law may suffice, or the introduction of a new tool such as a GAAR to shrink category B should assist. If the behaviour falls within C, but is considered to be undesirable by the government as advised by HMRC, political groups or others, then the answer lies in policy change and political action, but not criticism of the taxpayers concerned who will have complied with the law.

It may be responded that morality is relevant when deciding whether to enter into a transaction that falls within category A or B, above. There are certainly some practical reasons not to do so, since where avoidance eventually turns out to be ineffective it can turn out to be both expensive and to carry reputational risks. Even if it is effective and within the narrow sense of the intention of Parliament there could be reputational damage including with HMRC. Some individuals and companies may indeed decide not to enter into some of those types of transaction for these reasons, but where the courts cannot find a clear parliamentary intention in the legislation it is hard to argue that a taxpayer should do so and it seems unfair to subject such a taxpayer to moral or reputational arguments where the law decides that what they did was within the intention of parliament in so far as that can be ascertained from the legislation. We therefore turn to discuss in more detail how the intention of parliament is to be ascertained for these purposes.

## **II Purposive Interpretation, Parliamentary Intention and the Spirit of the Law.**

### *A. General rules of statutory interpretation and the meaning of Parliamentary intention.*

In applying the law to a tax transaction, the courts follow an accepted method of statutory interpretation. Over the years, the accepted method of interpretation has varied considerably. There were periods when the predominant form of interpretation was literalist, but this is no longer the case.<sup>29</sup> UK courts now interpret, or, at least, are meant to interpret, statutes purposively:

“[t]he pendulum has swung towards purposive methods of construction ... nowadays the shift towards purposive interpretation is not in doubt.”<sup>30</sup>

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<sup>28</sup> Article 4 of the Bill of Rights 1688 provides: “That levying Money for or to the Use of the Crowne by pretence of Prerogative without Grant of Parlyament for longer time or in other manner than the same is or shall be granted is illegal.” 1 Will. And Mar. Sess. 2, c.2. Art. 4. See also *MacNiven v. Westmoreland* [2001] UKHL 6, [2001] S.T.C. 237, at [29] *per* Lord Hoffmann and *The Collector of Stamp Revenue v. Arrowtown Assets Limited* [2003] HKFCA 46 at [105] *per* Lord Millett.

<sup>29</sup> Lord Cairns expressed the old literalist attitude in *Partington v. Attorney General* (1869) L.R. 4 H.L. 100, 122: “If the person sought to be taxed comes within the letter or the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.”

<sup>30</sup> *Regina (Quintavalle) v. Secretary of State for Health* [2003] UKHL 13, [2003] 2 A.C. 687, at [21] *per* Lord Steyn. See also, for example, *Carter v. Bradbeer* [1975] 3 All E.R. 158, 161 *g per* Lord Diplock;

Using this purposive approach to interpretation, a court interprets the statute in a manner that furthers its purpose even if that sometimes necessitates a stretched interpretation of the language.<sup>31</sup> Courts in the UK, therefore, will not, or should not, allow a transaction to stand if it merely follows the letter of the law but not its intention, although this intention is to be derived from the objectives of the legislature as revealed by the wording of the legislation.<sup>32</sup> For this reason there should not be any gap between the way the law is actually interpreted and Parliamentary intention in the narrow sense of the phrase as defined above.

There might still, however, be a gap between giving effect to parliamentary intention in the narrow sense or even the wider legal sense discussed above that could result from introducing a GAAR and the much wider colloquial sense discussed. This has to be the rule in order to give us practical and reasonably certain law. In the words of Lord Simon:

“... in a society living under the rule of law citizens are entitled to regulate their conduct according to what a statute has said, rather than by what it was meant to say or by what it would have otherwise said if a newly considered situation had been envisaged”.<sup>33</sup>

Although parliamentary intention and ‘spirit of the law’ are sometimes used in a wider colloquial sense in debate given that this involves some guesswork about what Parliament would have intended, it can only be used to argue for a change in the law and not for interpretation of the law.

### *B Applying the general principles of interpretation to taxation*

There have been times when the interpretation of tax law lagged behind that of other statutes and the judges took a very literal view of tax law. The much cited *Duke of Westminster* case stems from such a time. This case contains the famous principle that:

“[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts 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.”<sup>34</sup>

This has never been overruled, but only means that taxpayers are within their rights to arrange their affairs in any way which complies with the law interpreted in the manner mandated by courts. Since the approach of the courts has changed over time, this force of this principle has been tempered, especially since the *Ramsay* case in 1981.

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*Pepper v. Hart* [1993] A.C. 593, 617 E per Lord Griffiths; *Attorney General's Reference (No 5 of 2002)* [2004] UKHL 40, [2005] 1 A.C. 167, at [31] per Lord Steyn.

<sup>31</sup> See Francis Bennion, *Statutory Interpretation*, 5<sup>th</sup> ed., (Butterworths 2007), pp. 955-959 and cases cited therein, for example, *Cutter v. Eagle Star Insurance Co Ltd* [1988] 4 All ER 417 at 425.

<sup>32</sup> Michael Zander, *The Law-Making Process*, 6<sup>th</sup> ed., (CUP 2004), p. 194. See also footnote 10 and text thereto.

<sup>33</sup> *Stock v Frank Jones (Tipton) Ltd* [1978] 1 W.L.R. 231.

<sup>34</sup> *IRC v. The Duke of Westminster* [1936] A.C. 1, at pp. 19-20.

It is now established that purposive interpretation applies in the case of tax law as to every other area.<sup>35</sup> As the Aaronson report on the GAAR<sup>36</sup> notes, the courts are prepared to stretch the meaning of legislation in tax cases in order to give them a purposive interpretation, but, as seen above, limits will apply to this.<sup>37</sup>

In addition the line of judicial reasoning which the courts have developed since the *Ramsay* case, (sometimes known as the Ramsay principle)<sup>38</sup> has now reached the stage where it is said that “the ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.”<sup>39</sup>

Unfortunately the case law over the past few years is far from clear as to exactly what this means and how far this permits the courts to go, as we can see from the varying decisions in the cases now coming through the courts.<sup>40</sup> HMRC has achieved some recent successes relying on this principle of statutory interpretation, but other cases have been lost.<sup>41</sup>

The problem is that even without the complications of the *Ramsay* line of cases, applying a purposive approach to the interpretation of statutes is not straightforward. As a rule of thumb, the more detailed and complex the statute the more difficult it is to interpret purposively.<sup>42</sup> Whilst not unique in this respect,<sup>43</sup> tax legislation is known to be particularly detailed and complex.<sup>44</sup> The courts will, however, still try to “ascertain the purpose of the legislation as a whole and to extract some rational and coherent scheme

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<sup>35</sup> See, for example, *IRC v. McGuckian* [1997] S.T.C. 908; *MacNiven v. Westmoreland* [2001] UKHL 6, [2001] S.T.C. 237 and *Barclays Mercantile Business Finance Limited v. Mawson* [2004] UKHL 5, [2005] S.T.C. 1.

<sup>36</sup> Graham Aaronson QC, “GAAR Study: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system”, 11 November 2011. This is available at <[http://www.hm-treasury.gov.uk/d/gaar\\_final\\_report\\_111111.pdf](http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf)>

<sup>37</sup> For example, Aaronson noted that in *HMRC v DCC Holdings* [2010] UKSC 58, Lord Walker, delivering the judgment of the Court, at paragraph 25 noted – “argument has focused, in particular, on whether and how far the words in section 84(1) [FA 1996]...can be stretched (or need to be stretched) in order to avoid the absurd result of...”. Graham Aaronson QC, “GAAR Study: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system”, p. 18.

<sup>38</sup> *WT Ramsay Ltd v. IRC* [1981] S.T.C. 174.

<sup>39</sup> *The Collector of Stamp Revenue v. Arrowtown Assets Limited* [2003] HKFCA 46 at [35] per Ribeiro PJ cited in *Barclays Mercantile Business Finance Limited v. Mawson* [2004] UKHL 5, [2005] S.T.C. 1. at [ 36].

<sup>40</sup> See cases cited in footnote 7 above. See also Judith Freedman, “Interpreting tax statutes: tax avoidance and the intention of Parliament”, *Law Quarterly Review* 2007, 53 and John Vella, “Eclipse Film Partners No 35 LLP v HMRC: a different approach to tax avoidance from MCashback?” 2012 *British Tax Review*, p. 252.

<sup>41</sup> See, for example, *Tower MCashback LLP 1 v Revenue & Customs Commissioners* [2011] 2 A.C. 457 and *UBS AG, DB Group Services (UK) Limited v The Commissioners for Her Majesty's Revenue and Customs* [2012] UKUT 320 (TCC).

<sup>42</sup> See Lord Denning’s comments on the difference in interpreting a legal instrument emanating from the EU and a UK statute in *H.P. Bulmer Ltd. v. J. Bollinger S.A.* [1974] Ch. 401, 425 (CA). See also Kenneth Diplock, ‘The Courts as Legislators’ in B. W. Harvey (ed.), *The Lawyer and Justice* (Sweet & Maxwell 1978), p. 273.

<sup>43</sup> John Vinelott, ‘Interpretation of Fiscal Statutes’ (1982) *Statute Law Review*, 3, 78, p. 80 and Renton Committee, *The Preparation of Legislation*, (1975) Cmnd 6053 (HMSO), pp. 27-30.

<sup>44</sup> See generally Renton Committee, *The Preparation of Legislation*, (1975) Cmnd 6053 (HMSO), pp. 110-120.

from it.”<sup>45</sup> At times, however, the task becomes impossible. In one case, Staughton LJ concluded:

“[i]n reaching these conclusions I have not attempted any purposive construction of the detailed provisions of the Act, since I am not sure what their purpose is.”<sup>46</sup>

Even if there is a reasonably clear purpose to the legislation there is a limit to how far the language of a statute can be stretched to bring it in line with its purpose, and a concern amongst the judges about the line between permissible purposive interpretation and impermissible judicial law-making.<sup>47</sup>

In a recent case, *Mayes v HMRC*,<sup>48</sup> members of the Court of Appeal expressed their frustration in being unable to stretch the language of the statute to produce a result which was consonant with its purpose. After agreeing with Mummery LJ in finding in favour of the taxpayer Thomas LJ continued:

“However ... my concurrence is reluctant. The higher rate taxpayers with large earnings or significant investment income who have taken advantage of the scheme have received benefits that cannot possibly have been intended and which must be paid for by other taxpayers. It must be for Parliament to consider the wider implications of the decision as it relates to the way in which revenue legislation is structured and drafted.”

Toulson LJ also found in favour of the taxpayers but thought the result instinctively seemed wrong:

“... because it bears no relation to commercial reality and results in a windfall which Parliament cannot have foreseen or intended. ... The particular consequences in the present case were obviously not foreseen or intended by the legislature; but legislation, especially legislation which is highly engineered, can have unintended consequences.”

In this case the judges are using the term ‘Parliamentary intention’ in its wider sense of what Parliament would have intended had it been able to foresee a particular outcome, yet they felt bound by the narrower concept of parliamentary intention - that which could be found within the words of the statute itself.

In cases such as this, when HMRC are unsuccessful in challenging transactions before courts because these schemes comply with the law interpreted purposively, they fall within category B above, of effective avoidance.

The lack of clarity in the *Ramsay* case law and the limitations on statutory interpretation is one reason why the Aaronson Study proposed a GAAR which would, as one aspect, allow

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<sup>45</sup> John Vinelott, ‘Interpretation of Fiscal Statutes’ (1982) *Statute Law Review*, 3, 78, p. 80.

<sup>46</sup> *BP Oil Development Ltd. v. IRC* 64 TC 498, 532B-D per Staughton L.J.

<sup>47</sup> Johan Steyn, ‘Dynamic Interpretation Amidst an Orgy of Statutes’ (2004) *European Human Rights Law Review*, 3, 245. Note also Lord Millett’s remark: “Of course, we are all purposive constructionists now; but there are limits to what even purposive construction can achieve” - Peter Millett ‘Construing Statutes’ (1999), *Statute Law Review*, 20, 107, p. 108. See also Leonard Hoffmann ‘Tax Avoidance’ (2005) *British Tax Review*, 2, 197, p. 205.

<sup>48</sup> [2011] EWCA Civ 407.

the introduction of background material as evidence, and which would also allow the use of various indicia of abuse so that this method of interpretation need not be relied upon exclusively to defeat behaviour that currently may fall into category B above, but which Aaronson suggests should fall into category A.

### *C The spirit of the law*

What about transactions which are effective under statutes construed in accordance with parliamentary intention in the narrow sense used above, but not in some colloquial sense of parliamentary intention? Such transactions are sometimes said to be those where the “spirit of the law” differs from the law itself, but as we have explained, it is neither consistent with the rule of law nor practical, nor indeed “fair” to allow HMRC simply to apply the law as it should have been, rather than as it is. And if the law cannot be construed in a particular way, even adopting the most modern methods of purposive interpretation (and once it is introduced this will include applying the GAAR), it is not reasonable to expect taxpayers to follow the law as it should have been rather than as it is.

The duty of HMRC, or any tax authority, can only be to collect the tax due under the law interpreted in accordance with the accepted canons of interpretation. Steps taken to induce behaviour which requires taxpayers to go further than this would be of questionable constitutionality. Whilst HMRC might reasonably adopt an interpretation of the law which is different to that which a court might eventually reach, they cannot require that the taxpayer should refrain from engaging in an activity which might eventually be upheld by the courts, nor should the taxpayer be punished for such behaviour.

This gives a potential problem with certain HMRC statements. For example, in its Guidance on the *Code of Practice on Taxation for Banks* HMRC states that:

“The Government expects that banking groups, their subsidiaries, and their branches operating in the UK, will comply with the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament ...

In arriving at a view as to whether the transaction is contrary to the intentions of Parliament, the bank should *not only consider a purposive construction* of the legislation but should also consider whether Parliament can realistically have intended to give the proposed result in circumstances that are very different from those that existed at the time (e.g. are loopholes being used to arrive at an unexpected result). The question of whether the tax results are contrary to the intentions of Parliament can be answered in practice by asking whether the tax consequences of a proposed transaction are too good to be true. The Government has a track record of acting to close avoidance opportunities of which it becomes aware.”<sup>49</sup>

This warns banks not only to follow the law but to go further than the law. HMRC is in effect encouraging the taxpayer to adopt a different method of interpretation to that mandated by the courts: purposive interpretation. It seems fair enough to warn banks, and indeed other taxpayers, that if they engage in avoidance under category B in our

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<sup>49</sup> HMRC, *A Code of Practice on Taxation for banks - Supplementary Guidance Note*, 9 December 2009. This is available at: <<http://www.hmrc.gov.uk/thelibrary/tax-banks-sup.pdf>>

classifications above, those routes will be closed in future. It is certainly reasonable to make the point that the full force of the law will be used to try to make sure those actions fall within category A above. The use of such threats to inhibit the actions of the taxpayer who relies on the law as it stands,<sup>50</sup> or as an attempted justification for retrospective legislation,<sup>51</sup> is however, more problematic constitutionally. A GAAR, by contrast, though it should have a similar result in some cases, would do so constitutionally by changing the way legislation applied and this it would do prospectively.

A similar issue arises at an international level under the OECD Guidelines for Multinational Enterprises, chapter XI of which deals with taxation.<sup>52</sup> The requirement to follow the spirit of the law in these guidelines explicitly states that it is not a requirement to go beyond what is legally due.

“It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature. It does not require an enterprise to make payment in excess of the amount legally required pursuant to such an interpretation.”

The official OECD commentary goes further and states that:

“Corporate citizenship in the area of taxation implies that enterprises should comply with both the letter and the spirit of the tax laws and regulations in all countries in which they operate, co-operate with authorities and make information that is relevant or required by law available to them. An enterprise complies with the spirit of the tax laws and regulations if it takes reasonable steps to determine the intention of the legislature and interprets those tax rules consistent with that intention in light of the statutory language and relevant, contemporaneous legislative history. Transactions should not be structured in a way that will have tax results that are inconsistent with the underlying economic consequences of the transaction unless there exists specific legislation designed to give that result. In this case, the enterprise should reasonably believe that the transaction is structured in a way that gives a tax result for the enterprise which is not contrary to the intentions of the legislature.”

In some jurisdictions the description of how tax rules are to be interpreted is consistent with that used by the courts. In the UK the commentary, but not the text, goes further than the current

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<sup>50</sup> Financial Markets Law Committee, *Response to the June 2009 HM Revenue & Customs Consultation Document on a Code of Practice for Banks*, Issue 146, October 2009, available at: <http://www.fmlc.org/papers/Issue146Oct09.pdf>.

<sup>51</sup> Similar issues arise in respect of risk rating of large companies generally. See Judith Freedman, Geoffrey Loomer and John Vella, “*Corporate Tax Risk and Tax Avoidance: New Approaches*”, (2009) *British Tax Review*, 74 and Judith Freedman, “Responsive Regulation, Risk and Rules: Applying the Theory to Tax Practice” (2011) 44 *UBC Law Review*. This code was used as a justification for retrospective legislation; see HM Treasury, “Government action halts banking tax avoidance schemes”, 27 February 2012. This is available at: < [http://www.hm-treasury.gov.uk/press\\_15\\_02.htm](http://www.hm-treasury.gov.uk/press_15_02.htm)>

<sup>52</sup> OECD, “*OECD Guidelines for Multinational Enterprises*”, (2011 edition). This is available at:<<http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/48004323.pdf>>



approach to ascertaining the intention of parliament used in the courts. The UK position may be brought closer to the position elsewhere by changing the rules of evidence in some cases, as is currently proposed to do with the GAAR.

Some similar issues arise in relation to the Tax Gap papers and statistics issued by HMRC in the UK. Here HMRC states that:

“The tax gap is defined as the difference between tax collected and the tax that should be collected (the theoretical liability). The theoretical tax liability represents the tax that would be paid if all individuals and companies complied with both the letter of the law and *HMRC’s interpretation of the intention of Parliament in setting law (referred to as the spirit of the law)*.”<sup>53</sup>

This measure aggregates many different types of behaviour. In particular, by using HMRC’s interpretation of the intention of parliament rather than that of the courts, it includes behaviour that is not tax avoidance at all, but that is fully compliant. There are valid reasons why HMRC might want to measure the amount it expected to receive under its own interpretation, but it is misleading to call this a measure of avoidance, as discussed further in our Tax Gap paper.

#### **4. DIFFERENT APPROACHES TO DEAL WITH TAX AVOIDANCE**

There are at least three different routes through which the authorities can address tax avoidance: (i) challenge/litigation, (ii) legislation and (iii) administrative action.<sup>54</sup> A further addition to HMRC’s anti-avoidance armoury has been the Disclosure of Tax Avoidance Schemes (DOTAS) regime. This regime, which is discussed at some length in an accompanying paper, is primarily designed to support these different approaches, although it can also have a deterrent effect.<sup>55</sup>

The DOTAS regime<sup>56</sup> and challenge and litigation will address category A avoidance and may also be employed to try to move some aspects of category B into A by encouraging the courts to take a fully purposive approach through persuasive and well considered and funded litigation. Category B may also need to be dealt with by rectifying legislation if the government so desires and Parliament agrees and should be reduced by the introduction of a GAAR. Transactions falling under category C and with no elements that falls within A or B can only be dealt with more fundamental change through legislation based on policy change and international action.

##### **i. Challenge/Litigation**

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<sup>53</sup> HMRC (2012) “Measuring Tax Gaps 2012”, p.3. This is considered at some length in Paper 3 accompanying this one.

<sup>54</sup> For more detail see Institute for Fiscal Studies (2009), *Countering Tax Avoidance in the UK: which way forward*, TLRC Discussion Paper No. 7.

<sup>55</sup> Further new developments in other jurisdictions which justify more study include: promoter penalties, especially penalties linked to disclosure rules; additional financial reporting requirements; the co-operative compliance programme; and the use of questionnaires.

<sup>56</sup> Considered at length in Paper 2 accompanying this one.

Litigation plays an important role in defining the limits of tax law. As a means of tackling avoidance, however, it is expensive, time-consuming and uncertain in its outcome especially in the light of some of the case law on tax avoidance discussed above. Closing avoidance opportunities prospectively through legislation might appear to be a more attractive option, in some cases although there are also downsides in pursuing this route.

## **ii. Legislation**

Legislative intervention can take various forms, each with its particular strengths and weaknesses.

### *a. Specific Detailed legislation*

Detailed legislation and specific amending legislation has the advantage of making sure that particular loopholes are closed and is of unquestionable legitimacy. On the other hand, it increases the length and complexity of the legislation and so adds to compliance costs for complaint taxpayers. Precisely because it is so detailed, it removes from the courts the flexibility to construe it purposively<sup>57</sup> and it can have unintended consequences, including the creation of fresh avoidance opportunities.

A major problem is that prospective legislation does not affect existing transactions and could even imply that transactions targeting similar legislative provisions which have yet to be changed are valid at law. Most importantly, this approach leads to an interminable cat and mouse game. As an avoidance opportunity is closed down through legislation, another is found, which also needs to be closed down. The authorities can only play catch up and the process never ends.

These considerations have led to the use of innovative types of legislation.

### *b. Targeted Anti-Avoidance Rules (TAARs)*

A considerable number of TAARs have been introduced in the UK over the years. They are in many ways similar to GAARs, but are called “targeted” because they only apply in a specific area of tax law. They target transactions with particular characteristics, and in particular allow the courts to look at the purpose of the arrangements in question. TAARs have given rise to concerns about uncertainty.

The TAARs often appear to be unworkable without extensive guidance from HMRC, since they are so widely drawn that they appear at times to go further than their target. Some argue that it is unsatisfactory to produce legislation so wide that it requires such guidance.<sup>58</sup>

### *c. General Anti-Avoidance (or anti-abuse) Rule (GAAR)*

The Aaronson Study resulted in proposals for a GAAR, and the Government is proposing to introduce provisions along the lines suggested, to counter abusive tax arrangements as

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<sup>57</sup> Leonard Hoffmann, ‘Tax Avoidance’ (2005) *British Tax Review*, 2, 197.

<sup>58</sup> Judith Freedman and John Vella, ‘HMRC’s Management of the U.K. Tax System: The Boundaries of Legitimate Discretion’ in Judith Freedman, Chris Evans and Rick Krever (eds), *The Delicate Balance: Revenue Authority Discretions and the Rule of Law* (IBFD 2011).

defined in draft legislation.<sup>59</sup> This proposed GAAR would be an overriding principle. It would mean that the courts would not be limited by normal principles of statutory interpretation where they were satisfied that obtaining a tax advantage was a main purpose, or one of the main purposes of the arrangements and where the arrangements were abusive. The draft legislation contains non-binding and non exhaustive indications of what might make an arrangement abusive. Importantly, the legislation would relax the normal rules about the evidence that can be taken into account in considering the way in which this legislation should be applied. Were this to be introduced it would be a very important step in reducing avoidance and changing attitudes to avoidance in the UK. It would also apply to some cross border arrangements.

Critics have attacked the Government's proposals as being too wide.<sup>60</sup> They have also been attacked as too narrow.<sup>61</sup> This paper cannot cover this debate in detail, but what is clear is that the proposals are an attempt to balance the needs of the rule of law with the desire to combat aspects of tax avoidance, that is cases currently falling under category B above, which are currently effective only because the courts cannot look at parliamentary intention in its wider sense. What a GAAR cannot ever do, whether it is called a general anti-avoidance principle<sup>62</sup> or a general anti-abuse rule, is deal with any wish to change the outcome of cases under category C, where no element of categories A or B are involved.

#### *d. Principles-Based Legislation (PBL)*<sup>63</sup>

In addition to introducing a GAAR another possibility would be to change the way we legislate about tax and to use a broader, less detailed style, which would lend itself better to purposive interpretation and less well to "creative compliance". This has been experimented with in the UK and in Australia, but has so far met with limited success, in part because of our legal culture and in part perhaps because of poor implementation.<sup>64</sup>

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<sup>59</sup> Graham Aaronson QC, "GAAR Study: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system", 11 November 2011. This is available at [http://www.hm-treasury.gov.uk/d/gaar\\_final\\_report\\_111111.pdf](http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf) Judith Freedman, one of the authors of this report, was part of the Aaronson Study Group. The Government has now appointed Graham Aaronson as interim head of a Panel to take forward the work on the GAAR [http://www.hm-treasury.gov.uk/press\\_108\\_12.htm](http://www.hm-treasury.gov.uk/press_108_12.htm)

<sup>60</sup> See, for example, CBI, "CBI Comments on the General Anti-Abuse Rules (GAAR) Consultation", 13 September 2012 [this is available at: <[http://www.cbi.org.uk/media/1750561/cbi\\_response\\_to\\_gaar\\_-\\_sept\\_2012.pdf](http://www.cbi.org.uk/media/1750561/cbi_response_to_gaar_-_sept_2012.pdf)>] and ICAEW, "Comments submitted on 14 September 2012 by ICAEW Tax Faculty in response to HM Revenue & Customs consultation document *A General Anti-Abuse Rule* published on 12 June 2012" [available at <<http://www.icaew.com/~media/Files/Technical/Tax/Tax-faculty/TAXREPs/2012/taxrep-45-12-gaar-icaew-tax-faculty-response-14-9-12.pdf>>]

<sup>61</sup> Andrew Godall, "Draft GAAR is 'disappointingly narrow', says Labour", *The Tax Journal*, 14 September 2012. The progress of the General Anti Tax-Avoidance Principle Bill 2012-13 sponsored by Mr Michael Meacher MP can be followed here: <<http://services.parliament.uk/bills/2012-13/generalantitaxavoidanceprinciple.html>>

<sup>62</sup> As originally suggested by Judith Freedman, Judith Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] *British Tax Review* 332.

<sup>63</sup> See Judith Freedman, "Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited" (2010), *British Tax Review*, Issue 6, 717.

<sup>64</sup> Rick Krever, "Plain English Drafting, Purposive Drafting, Principles-based Drafting: Does Any of it Matter?" in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (OUCBT, 2008) and Judith Freedman, "Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited" (2010), *British Tax Review*, Issue 6, 717.

### **iii. Administrative Action**

In recent years, HMRC have pursued a variety of administrative initiatives to address avoidance. There has been a concerted effort to bring the issue of tax onto the agenda of boards of directors of large companies; banks have been encouraged to sign the Code of Practice on Taxation discussed above and a risk rating approach has been developed which provides large companies with incentives to reduce their avoidance activities.

These initiatives recognize that the impact of a company's tax planning activity goes beyond the amount of tax paid. It also has reputational effects and influences relations with revenue authorities. There is value in emphasizing the point. Given that HMRC's interpretation of the law is not necessarily correct, however, encouragement to taxpayers to refrain from transactions which are perfectly compliant with the law can raise issues about how far it is reasonable to rely on these administrative measures.

## **5. CONCLUSION**

It is neither possible nor helpful to attempt to define avoidance with one general definition. The range of different types of activity referred to technically and popularly as "avoidance" must be disaggregated in order to find the different ways necessary to limit behaviour that society as a whole considers undesirable. This needs to be done without unreasonably deterring investment or creating conditions in which compliant taxpayers feel they cannot go about their business with any assurance of certainty. In the end, this can only be achieved by legislation passed through Parliament having arisen from a proper political process, including debate involving all sections of society from protest groups and NGOs through to experts and policy advisers. The media has a role to play in facilitating this debate, and many journalists have done an important task in bringing forward information, although some allegations have been based on misunderstandings of the system (albeit sometimes understandable misunderstandings or gaps in knowledge in the light of tax complexity).

Some of the types of behaviours complained of could be dealt with by enforcing existing law, strengthening that law in technical ways or introducing a GAAR along the lines explained above, which is something currently being explored by the Government. Other issues relate to questions of fundamental policy and established international taxation norms and agreements between states including EU treaties. So, for example, the fact that companies incorporate subsidiaries or headquarter companies wherever in the world they wish to, taking into account the tax rate, provided they satisfy all the surrounding rules about doing that and comply with any transfer pricing and CFC rules in place is not something HMRC can counteract. The authors of this paper are on record as calling for fundamental reform of the tax system. In assessing the work being done by HMRC, or the way taxpayers currently behave, however, this type of problem must be dealt with differently from the types of activity which fall under categories A and B described above.

