10. Tax avoidance

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Summary

- The government's efforts to tackle tax avoidance have become more high-profile in recent years. Measures to 'protect revenues' announced since the 2002 Budget alone are estimated to be raising about £4½ billion this year.
- The traditional distinction between illegal tax evasion and legal tax avoidance (or planning) has been complicated by the efforts of the authorities to have some forms of avoidance seen as unacceptable even if they satisfy the letter of the law. In some areas, the government is now threatening to use retrospective legislation to ensure that taxpayers contribute what ministers regard as their 'fair share'.
- The Tax Avoidance Disclosure regime is the most important recent legislative development in tackling avoidance. It appears to have been successful from the government's point of view, judging by the volume of disclosures made and the blocking measures deployed to halt arrangements it sees as unacceptable.
- The authorities are also highlighting to senior executives the risk to their reputation of being found to engage in unacceptable tax avoidance, while leaving it unclear exactly what is unacceptable. This may help to raise revenue in the short run, but is also likely to make the UK a less attractive location for internationally mobile companies and individuals.

10.1 Introduction

Recent years have seen the government step up its efforts to reduce the amount of tax revenue that it perceives to be lost as a result of various forms of tax avoidance. Its responses include the development of the Tax Avoidance Disclosure rules, under which certain tax planning schemes have to be notified to the tax authorities shortly after they are marketed or implemented, and the 'Tax in the Boardroom' agenda, under which the authorities are highlighting to large companies and their senior management the risk to their reputation of engaging in more esoteric forms of tax planning.

Tax avoidance is not a new phenomenon. But it has received much more attention in recent years, both internationally (for example, through the establishment of the four-country Joint International Tax Shelter Intelligence Committee) and in the UK. As shown in Table 10.1, measures described as 'protecting revenues' or 'protecting tax revenues' introduced since Budget 2002 alone are estimated to raise around £4½ billion in 2005–06.[1] Some revenue-

[1] This estimate is based on figures from various Budgets and Pre-Budget Reports. Nominal figures are uprated to 2005–06 terms using the Treasury's latest estimates of money GDP. Where Treasury estimates for later years are not published, the revenue raised from earlier measures is assumed to remain constant as a share of national income.

raising anti-avoidance measures are always likely to be required just to prevent a widening in the existing ‘tax gap’ (between what the authorities collect in revenue and what they think they should be collecting) as new avoidance schemes are developed. But the government clearly wants to do more than just run to stand still, and would like reduce the tax gap over time – especially as it has repeatedly overestimated revenues in recent years, making its fiscal rules harder to meet.

Table 10.1. Treasury estimates of amounts raised through measures announced since Budget 2002 aimed at ‘protecting revenues’ (£ billion, 2005–06 terms)

Announcement	2003–04	2004–05	2005–06	2006–07	2008–09
Since Budget 2005	n/a	n/a	0.2	0.5	0.7
Budget 2005	n/a	n/a	0.7	1.0	1.0
Between Budget 2004 and Budget 2005	n/a	0.0	1.0	1.2	1.1
Budget 2004	n/a	0.3	0.8	0.9	0.9
Between Budget 2003 and Budget 2004	0.0	0.2	0.4	0.6	0.6
Budget 2003	0.5	0.5	0.5	0.5	0.5
Between Budget 2002 and Budget 2003	1.0	0.8	0.9	0.9	0.9
Total	**1.4**	**1.9**	**4.5**	**5.6**	**5.7**
% of national income	*0.1*	*0.2*	*0.4*	*0.4*	*0.4*

Sources: Various Budgets and Pre-Budget Reports. Only measures scored under ‘protecting revenues’ or ‘protecting tax revenues’ included. Nominal figures uprated to 2005–06 terms using the Treasury’s latest estimates of money GDP. Where Treasury estimates not published, the revenue raised is assumed to remain constant as a share of national income.

This chapter takes stock of what has happened of late, puts it into context and reviews the direction of these developments.

10.2 What is acceptable tax avoidance?

Defining relevant terms used to be straightforward. Tax evasion was, and still is, the use of illegal means to reduce tax liabilities – for example, making false statements on tax returns. In contrast, tax avoidance – or planning, or mitigation – was legal, and the only question was whether an action worked technically or not. This could require a court case to decide, but the distinction between evasion and avoidance was clear in principle.

These days, the terminology is more complex, including what is widely seen as an attempt by the tax authorities to blur the distinction between avoidance and evasion and to tar avoidance with a certain amount of the disapproval that normally attaches to evasion.

In the eyes of the authorities, all actions that are taken to reduce a tax bill appear to be viewed as suspect in some way, unless they are very clearly just taking advantage of a tax relief in the manner that was intended. That, though, raises its own difficulties: what did Parliament intend by the legislation in question?

Of course, if the judges decide that the particular arrangements entered into by the taxpayer did not work, and did not achieve the tax saving that he or she had in mind, then there is no avoidance. But, equally, there will have been no avoidance if the judges decide that Parliament misfired, so that the arrangements fall within the letter of the law – however much it may appear that Parliament may not have intended its language to cover the particular arrangements entered into by the taxpayer. As a matter of law, that is what Parliament has prescribed and a taxpayer does not avoid tax by limiting his or her liability to what the law prescribes.

Tax avoidance is thus encouraged by the complexity of tax legislation. Complexity leaves room for dispute about the intention of the law as written, and for creative attempts to find arrangements that fall within the letter of the law, if not its spirit. Thus it is not surprising that tax avoidance attracts considerable attention in areas such as the taxation of international companies, where the UK tax system must interact with foreign tax systems and complexity is perhaps inevitable. Another area is the taxation of financial companies, where financial innovation (such as the use of derivative instruments) has allowed transactions to be constructed in ways that attract a more favourable tax treatment, while having essentially the same economic substance as simpler transactions that would be taxed less favourably.

Quite apart from the fact that Parliament does not always say what it probably meant to say – or overlooks the possibilities for avoidance that its language offers taxpayers – the judges themselves do not always agree on their approach to arrangements designed to reduce tax liabilities. In a number of his judgments, Lord Templeman sought to build a distinction between actions that are acceptable and those that are not. Any illegal arrangements are clearly unacceptable, but so too are some legal ones. Lord Templeman's brand of judicial activism would have struck down unacceptable arrangements, even if they fell within the letter of the law. They would not then have their intended tax-reducing effect, under a form of judicial general anti-avoidance doctrine.

Lord Templeman's approach has not, however, survived his retirement. The current House of Lords has rejected the idea of some form of overriding judicial general anti-avoidance doctrine in favour of a purposive approach to the construction of tax legislation (one in which the court seeks to discern the particular legislative purpose of the provisions and then to interpret them to give effect to that purpose), coupled with an unblinkered approach to the taxpayer's arrangements, i.e. focusing on what they really amounted to or achieved.

This appears from the recent House of Lords cases of *Barclays Mercantile Business Finance Limited v Mawson (2004 UK HL 51)* and *IRC v Scottish Provident Institution (2004 UK HL 52)*. These cases suggest that the more contrived and artificial the taxpayer's arrangements, and the less explicable they are by his or her everyday business or personal circumstances, the more likely the judges are to rule them unacceptable. Barclays Mercantile won but Scottish Provident lost, probably because the transactions in question could be seen as part of Barclays Mercantile's normal business activities, while for Scottish Provident they fell outside its everyday business and were undertaken solely to exploit particular tax provisions and generate a tax loss.

The attempt to draw a dividing line between tax planning and unacceptable avoidance received an extra twist with the statement on Finance Bill measures by the Paymaster General, which accompanied the 2004 Pre-Budget Report.[2] This referred to avoidance on rewards from employment, particularly in relation to bonus payments. It stated that 'this Government is determined to ensure that all employers and employees pay the proper amount of tax and NICs on the rewards of employment, however those rewards are delivered' and that 'everyone ... should pay ... their fair share'. Importantly, the statement made clear that not only would legislative action be taken to stop avoidance devices, but also such action would be retrospective to the date of the statement where the arrangements in question '… emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment'.

This statement underlines how difficult it is to draw the line between acceptable and unacceptable avoidance. The traditional game is for Parliament to legislate the boundaries of taxation and lay a minefield designed to keep taxpayers on the 'right' side of the line. Taxpayers and their advisers then chart a path through the legislative minefield and Parliament returns to the task of laying mines and building higher fences. Now Parliament also reserves the right to move the boundary, so that even if you chart a path through the minefield, you may still end up on the 'wrong' side of the fence.

10.3 Underlying issues

As this last point illustrates, there are fundamental constitutional objections to the threat and use of retrospective legislation. The context within which the Paymaster General's statement was made, however, illustrates both the importance of tax avoidance and the issues that underlie much of the problem of avoidance.

A starting point is perhaps to ask why taxpayers want to undertake tax planning. The answer should be obvious. As Lord Clyde so vividly put it in 1929, 'No man in this country is under the least obligation, moral or otherwise, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his store' (*Ayrshire Pullman Motor Services & Ritchie v CIR, 1929, 14 TC 754*). Even the great American tax avoidance judge, Learned Hand, said that there was no morality to the payment of taxes and to say otherwise was 'mere cant' (*Commissioner vs. Newman, 195F.2D 848, 850-51, CA2 1947*).

Few people 'enjoy' paying tax even though many recognise the necessity to pay some tax as the price of achieving and maintaining a civilised society. From a business's perspective, tax planning is largely about managing or reducing costs. Therein lies the crux of the issue: tax planning is not all about reducing a tax bill beyond what the authorities might argue is a 'proper' amount; much tax planning is concerned with ascertaining likely outcomes and managing them. Business, as much as anything, wants so far as possible to operate in an environment of certainty.

[2] http://www.hm-treasury.gov.uk/media/938/F0/pbr04_PMGstatement.pdf.

The definitions and arguments in these areas have evolved over the years. What was once planning might now be tarred as avoidance and even unacceptable avoidance. The attempts to mitigate National Insurance contributions (NICs) on employee rewards are an example of this evolution. Whatever one's view of some of the schemes attempted in recent years, their origin can be traced to the lifting of the upper earnings limit from employers' NICs in 1985, which significantly increased the amount of contributions at stake.

Some forms of planning are still clearly acceptable: salary sacrifice schemes, for example, can work to mitigate NIC bills. But a very artificial construct aimed purely at mitigating NIC charges is likely to be viewed as unacceptable and possibly even a target for retrospective action (as per the Paymaster General's statement in 2004).

Three aspects mark this out as an interesting case. First, the scope for avoidance was obvious, having removed the upper limit on employers' contributions. Second, it is clearly divisive and unacceptable that the majority of employers should be paying NICs in respect of their employees, while others should avoid their obligations with increasingly artificial schemes. This undermines the integrity of the tax system as a whole. Third, the arrangements usually represented a 'shot to nothing': if an employer entered into an arrangement to avoid the tax which failed, the only penalty was having to pay the tax that would have been paid in the absence of the arrangement.

Ultimately, different people will reach different views on where the blame lies in these situations. Is it with government and its revenue departments, for failing to appreciate the likely responses to its decisions, and for piecemeal initial attempts to counter them that were largely ineffective? Or with taxpayers, for entering into arrangements that may only have a remote chance of success, on the basis that they will still be ahead of the game if they fail either by deferring payment of tax or by settling with the Revenue for less than they would otherwise have paid absent any arrangements? At least in this field – the payment of employee salaries and bonuses – it is possible to say with reasonable certainty that the use of artificial arrangements to pay such salaries and bonuses will no longer be tolerated and will be countered, if necessary, retrospectively.

This is not to condone the threat or use of retrospective legislation, but to illustrate the point that employee earnings are a relatively straightforward tax base. All tax avoidance is ultimately a function of the tax base, namely how easy it is to define what the government wants to tax in legislative language. So a statement such as that made by the Paymaster General is easier to make in the field of employee earnings than it is in relation to, say, finance leasing, as illustrated by the Barclays Mercantile case. As the recent decision of the Canadian Supreme Court in Canada Trust Co also illustrates, finance leasing transactions are difficult to categorise as avoidance, even under a statutory general anti-avoidance measure. This is because the tax base in question – business profits – is inherently difficult to define. The Courts will not be able to provide a coherent answer if the underlying legislation is not coherent, and legislation is least likely to be coherent when there is no clear underlying economic principle to define what is sought to be taxed.

10.4 Tax Avoidance Disclosure

The major recent development on the legislative front in the UK as far as tax avoidance is concerned has undoubtedly been the advent of Tax Avoidance Disclosure (TAD) rules. Introduced by Finance Act 2004 and a variety of Statutory Instruments, this is a framework for early disclosure to the tax authorities of planning that falls under certain headings.

The catalyst for the introduction of the TAD regime was probably schemes such as Gilt Strips, which sought to eliminate tax and NICs on big bonus payments. The prevalence of this and other planning convinced the tax authorities and the government in the UK that they were losing the battle against tax avoidance, with significant revenues at stake.

The essence of the TAD regime, which became fully effective in the latter part of 2004, is:

- Promoters (professional firms and financial institutions in the main) have to disclose marketed schemes within five days of making them available.
- Similarly, tax planning that falls under certain categories has to be disclosed within five days of starting to implement it.
- The taxes covered initially were income tax, capital gains tax and corporation tax.
- Disclosure is only required if an ‘employment product’ or ‘financial product’ is involved.
- There are various ‘filters’ designed to screen out disclosure of routine material, a key one being the use of a ‘premium fee’ test, i.e. would the idea or advice in question command a premium fee in the market place?
- In-house planning would normally only be disclosed when the tax return was submitted.

In parallel to these rules for direct taxes, disclosure for VAT planning was also introduced but took a slightly different route. The obligation to disclose is on the registered trader and what has to be disclosed falls into two camps:

- designated schemes, such as payment handling services or value shifting;
- planning with one or more ‘hallmarks’ such as confidentiality agreements or a sharing of VAT saved.

Disclosure has to be made within 30 days of submitting the VAT return.

These disclosure regimes have produced a considerable volume of disclosures – informal HMRC statistics suggest some 500–600 direct tax disclosures and about 750 indirect tax disclosures by Autumn 2005. They also led to a raft of blocking measures in each of the 2004 and 2005 Pre-Budget Reports and the 2005 Budget. This is a clear indication that the system is working – that the authorities are getting the information they need to take action.

The aim of the disclosure regime is to get at innovative ideas – new schemes. However, it is important to note that disclosure is not restricted to marketed schemes, as was expected when the regime was first announced. There is a requirement to disclose planning that arises from bespoke everyday advice under certain circumstances. It is this that has caused much difficulty. Another source of difficulty is the interaction with legal professional privilege, with lawyers at one stage arguing that they could not be required to disclose. Amendments to the regulations have sidestepped this problem to a degree, without completely solving it.

In the mean time, disclosure for stamp duty land tax has been added from August 2005 (and has already attracted more than 200 disclosures, fuelled at least in part by a lack of filters within the system apart from a monetary limit of £5 million). Then, in late 2005, legislation was laid before Parliament to bring NICs into the regime from sometime in 2006.

The December 2005 Pre-Budget Report announced that this regime would be strengthened in three ways:

- it would be extended to all of income tax, capital gains tax and corporation tax (i.e. not restricted to employment and financial products);
- the filters would be reviewed and redefined and potentially strengthened;
- the requirement for in-house planning notifications would be changed such that disclosure would be required in 30 days.

10.5 'Tax in the Boardroom'

Another important development is the recent attempt by HM Revenue & Customs to raise awareness among senior management of large companies of the potential risks of being caught on the wrong side of what the authorities consider to be unacceptable tax avoidance.

In Autumn 2005, HMRC officials wrote directly to the chairmen of the UK's largest 500 companies, seeking to establish a dialogue over the management of tax issues and tax risk. There are certainly positive aspects to greater communication between tax collectors and taxpayers, which should lead to greater understanding of the other side's position. The attempt to raise the profile of tax at the Board level in many ways chimes with views in the investment community and some leading tax advisers.

However, there is also a perception in some quarters that the newly merged revenue authority is seeking to exert pressure on companies by raising questions about their tax strategies at boardroom level. Combined with the increase in anti-avoidance legislation described above, this development reinforces the signal from the authorities that they are taking a tougher line on various forms of avoidance.

Indeed, the emphasis on 'tax risk' could also be perceived as an attempt to increase uncertainty among taxpayers about the border between acceptable and unacceptable forms of tax planning, and to foster increased nervousness about the reputational risk of being seen to fall on the wrong side of the divide. Promoting opacity and unpredictability may seem a clever way to raise revenue in the short run, but transparency and certainty have long been seen as hallmarks of a fair and efficient tax system. It is hard to know if and when such an approach will turn out to be a significant deterrent to international companies and globally mobile individuals deciding whether to locate or remain in the UK, but if and when the evidence becomes clear, the damage may be hard to undo. The government should remember that it is not just companies that need to worry about reputational risk.

10.6 Conclusion

Although it has moved to extend tax avoidance disclosure and strengthen the filters for non-reportable arrangements, the government undoubtedly regards the disclosure regime as successful. Success, however, comes at the cost of an outpouring of specific or 'targeted' tax avoidance rules that, on top of all the other legislative activity in the tax field in recent years, threatens to clog the system. It may be correct that many of the anti-avoidance provisions are of 'limited' application – consigning schemes to the history books or ensuring that they never get off the ground – but there remains a cost to taxpayers, and business in particular, in ensuring that their ordinary commercial and personal arrangements do not fall foul of particular provisions and in avoiding their unintended effects.

It is important for the integrity of the tax system that people should contribute their 'fair share' of tax revenues and that there should not be undue scope for particular individuals to reduce their share of those revenues. This is the basis of the Paymaster General's statement on employment liabilities. This principle is less easily applied to business taxation because the nature of the tax base – 'profits' – is more difficult to state and in today's conditions is global in nature. It is an inherently difficult tax base both to define and to identify with the UK. In this respect, it is difficult to achieve a coherent policy that, on the one hand, demands that businesses pay their 'fair share' of taxation without undue avoidance and, on the other, aims for a globally competitive tax system. Ongoing targeted anti-avoidance provisions may contribute to the former objective while undermining the latter by clogging the arteries of a competitive tax system.

The current approach may serve to meet the government's immediate revenue needs and in some areas may contribute to a perception of greater fairness. Its long-term effects in other areas of the tax system may be less beneficial. However, a more satisfactory approach to dealing with tax avoidance issues would require a more fundamental overhaul of tax policy than has been on the agenda in the UK for many years. In the short term, we can be confident that the 2006 Budget will bring a further round of anti-avoidance measures.