Unacceptable Discretion: Countering Tax Avoidance and Preserving the Rights of the Individual

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The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise the taxpayer is put more or less in the hands of the tax gatherer.

Adam Smith, The Wealth of Nations.

The need to raise taxes is central to the organisation of any civilised state. It is something of a paradox that to do so requires the forcible extraction of cash from individual citizens — an action which breaches another attribute of a free society: the protection of private property. This article examines the practical and legal problems raised by this tension between the need to prevent loss of tax revenues through avoidance and the rights of the private citizen not to have his property taken from him arbitrarily.

This question is not an abstract one concerned only with the rights of the individual. The legitimate desire of the state to protect its revenues from the ravages of the marauding tax planner — particularly those advising businesses — can easily lead to the introduction of legislative and administrative measures which interfere with commercial activity.

The temptation to deal with difficult points of legal definition by conferring an administrative discretion on Revenue authorities may be hard for a government to resist. To give in to the temptation can result in those authorities

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being given, in effect, the discretionary power to tax without any workable restraints being imposed on the exercise of that discretion.

This article considers some ways in which this problem has manifested itself in the United Kingdom in recent years; it examines the remedies open to the taxpayer aggrieved by the arbitrary exercise of administrative discretion and tries to draw some conclusions on how government should approach this problem in the future.

I. HISTORY

To understand the difficulties facing the tax raisers in the 1990s, it is necessary to go back and look at the history of taxpaying in this country and the problems and solutions that have arisen over the last 75 years or so.

As a preliminary point, it should be emphasised that this article is concerned with the problems of tax avoidance — the legitimate use of rules to mitigate tax liability — rather than tax evasion — the illegal non-payment of tax rightfully due.

The existence of the concept of tax avoidance in the UK is itself indicative of the approach to tax collecting here. The implication of the word ‘avoidance’ is that there is something to avoid — in this case an intention of the law to catch the taxpayer which has failed. While such an intent undoubtedly exists behind every taxing statute, its existence is studiously ignored by the Courts. This apparently curious result has grown out of the approach of the UK Courts to the interpretation of tax law.

Judges have been quite categorical that the collection of tax must be by the clear words of the taxing statute regardless of any purpose or mischief which may lie behind it. The stated rationale for this approach was the need for certainty — a taxpayer must be clear as to what his liability to tax is. In one very well-worn phrase, ‘There is no room for any intendment; there is no equity about a tax: there is no presumption as to a tax; you read nothing in; you imply nothing, but you look fairly at what is said and at what is said clearly and that is the tax’. This approach — although perhaps slightly modified in recent years — has formed the basis for all tax avoidance arrangements and has, no doubt, led to the frustration of legislators and administrators.

It has also led to the somewhat complicated games of avoidance schemes and countering legislation which has characterised the development of so much tax legislation this century. These games are played in somewhat slow time — not least because of the speed (or lack of it) of the legislative process, but also because of the slow reaction of the legislature to countering specific avoidance

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1 The Cape Brandy Syndicate v CIR (1921) 12 TC 366 per Rowlatt J.
schemes which reflected the seriousness with which tax raising used to be approached.

There is no doubt that the slow response of the legislators to avoidance schemes meant that for many years the boot tended to be firmly on the taxpayer’s foot. This can be seen particularly in relation to certain tax avoidance schemes between the wars.

1. Between the Wars

The history of surtax avoidance in the 1920s and 1930s is an extraordinary chronicle of mismanagement by the authorities\(^2\) — devices designed to allow surtax payers to divest themselves of income proliferated. The failure of the Inland Revenue to take the right cases through the Courts followed by its subsequent failure to procure suitable anti-avoidance legislation for nearly 10 years left large loopholes for well-advised taxpayers to gallop through. It appears that only the promotion of some of the more blatant schemes in the popular press spurred the Revenue into some sort of action.

What is interesting about this period is that the subject of tax avoidance was regarded as being sufficiently serious to merit a Cabinet Committee devoted to it, and despite initial failings at both the political and administrative levels, the legislation eventually enacted had been carefully considered by both the Revenue and by Ministers before becoming law.

2. Post-1945

After (and indeed during) the war the process continued much as before — the loopholes in legislation were progressively stopped by a series of specific and detailed measures; nowhere more so than in the area of dividend stripping and bond washing.

The problems in this area stem from the differing tax treatment of income from shares and the capital gains arising on sale. A series of detailed measures were introduced from the 1930s to the 1950s designed to prevent individuals from divesting themselves of income from shares by various devices of sales and repurchases. The success of ingenious advisers in circumventing each new set of anti-avoidance measures resulted in the enactment of s.28 FA 1960 (now s.703 Taxes Act 1988) which introduced a wide-ranging anti-avoidance measure aimed at ‘transactions in securities’ generally.\(^3\)

The difficulty with specific anti-avoidance devices is that if they are not to catch the innocent party they must be tightly drawn; but if they are too tightly

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\(^2\) For an excellent article on this subject, see Dr David Stopforth, ‘1922–36: halcyon days for the tax avoider’, *British Tax Review*, 1992, no. 2, pp. 88–105.

\(^3\) For a discussion of the history of these provisions see *Whiteman on Income Tax*, third edition, 1988, pp. 1055 et seq.
drawn they may fail to catch the situation at which they are aimed. The 1960 legislation was widely drawn but aimed at transactions which the Revenue had found itself powerless to counter with existing legislation. Precisely because the legislation was so widely drawn, it was introduced with a ‘bona fide commercial’ let-out — so that a taxpayer who was inadvertently caught by the wide reach of the provisions could avoid their application if he could show that he had a good commercial reason for effecting the transactions in question and was not motivated by tax avoidance. This in turn led to the introduction of a clearance procedure — the earliest such procedure still on the statute book. This allows a taxpayer to apply to the Revenue in advance of any transaction for a binding view as to whether the provisions will or will not apply to him. The inclusion of such a procedure was an acknowledgement that the introduction of a bona fide test introduced a degree of subjectivity and hence uncertainty into the taxing statutes which was unacceptable without some means for a taxpayer to determine his position in advance.

The 1960 legislation, containing, as it did, potentially draconian powers to prevent tax avoidance, was the subject of vigorous debate in Parliament both at the time and as later amendments were brought through. It was criticised on the ground that it gave the executive a discretionary power to levy tax on a transaction not expressly made taxable by Parliament. Assurances were given in Parliament that the provisions would only be applied to the specific circumstances at which they were aimed. Despite such assurances, the Revenue subsequently sought to apply the provisions to situations never contemplated at the time of their introduction. When, in due course, this approach was challenged in the Courts, one judge’s reaction was: ‘having provided reasonable safeguards for the bona fide or ordinary transactions I do not think that the legislature has given any indication of intending to use kid gloves in these cases’.

The provisions of s.703 which emanated in the 1960s continue to dog tax advisers in the 1990s and the need to obtain advance clearance for commercial transactions which incidentally obtain a tax advantage for the parties is a considerable drag on a number of transactions. In addition, the tension between these provisions and other provisions of the legislation conferring tax reliefs is not always clear cut — the Revenue has been known to use s.703 to deny the benefit of other explicit relieving provisions of the legislation based solely on its view of what those provisions were intended to catch. The absence of any effective appeal procedure against a refusal of the Revenue to give clearance in such a case means that the Revenue holds an effective discretion to block such transactions.

4 IRC v Brown (1971) 47 TC 217 per Megarry J.
5 Most recently to prevent utilisation of advance corporation tax within groups in certain circumstances.
3. Post-1960

In 1960 the draftsman of s.703 acknowledged the width of the scope of the provisions by providing for the ‘bona fide commercial’ let-out. It is unfortunate that this approach has only been followed in one subsequent set of anti-avoidance provisions — those relating to exchanges of shares. Since then the trend has been to draft for the specific wider than necessary and to deal with any cases caught unintentionally by concession. A few examples will make this trend clear:

(1) In recent years the increased amount of cross-border activity has increased the opportunities that exist for tax mitigation between jurisdictions. One fertile area for the tax planner has lain in the field of treaty shopping — the use of the UK’s extensive network of double tax treaties to move interest and other financial flows out of the UK and around the world free of withholding taxes. Treaties generally provide for a reduced or zero rate of tax on interest flows between the treaty parties. The Revenue’s (legitimate) concern is that a treaty with one country should not be used as a means for residents of third countries to re-route their interest flows to escape withholding which would otherwise apply (although it is a nice question in the 1990s whether effective taxation of the return on capital is ever possible).

It is a difficult question how effective restriction of the abuse of treaties should be achieved. Detailed discussion of this is beyond the scope of this article but, in broad terms, the choice lies between a purely formalistic approach where the benefit of the treaty is given or denied on the basis of a set of rules which take no account of the motive of the taxpayer but look only to the circumstances — such as ownership, source of funds etc. — and a motive test where the question of whether the transaction is bona fide or motivated by tax avoidance determines the application of the relevant treaty provisions. The trend seems to be for the Revenue to adopt a formalistic approach following the lead of the United States but without the let-out for bona fide commercial transactions. Recent provisions have been widely drawn, without any regard to the taxpayer’s motive. An innocently affected party has no legal redress but will have to seek discretionary relief from the Revenue.

(2) Concern over the perceived abuse of the reliefs afforded to groups of companies has led to ever-increasing amounts of complex legislation attempting to define when a group does or does not exist. The problem was regarded as sufficiently serious to justify several dense pages of legislation

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6 See Article 28 of the United States/Germany Double Tax Treaty.
7 See for instance the amendments to the United Kingdom/Denmark Treaty introduced by Double Taxation Relief (Taxes on Income) Denmark Order 1991.
in 1992.8 While the legislation was going through Parliament, the Revenue and Ministers acknowledged that the drafting is deficient, so an extra-statutory concession has had to be published at the same time as the legislation.9 It is of considerable concern that legislation can be subjected to parliamentary scrutiny at the same time as the executive exercises a discretion not to apply the legislation as enacted.

(3) The final example also comes from the Finance (No. 2) Act 1992. Late in the course of preparation of the Finance Bill, the Revenue lost a case before the Appeal Commissioners on so-called ‘equity notes’. These were perpetual debt instruments issued by UK companies to US parent companies which had the characteristics of debt in the UK (so giving a tax deduction for interest paid) but were treated under US rules as being equity instruments. As a result of this treatment, the return was treated as dividends for US tax purposes rather than interest — this having significant US tax benefits. It is debatable whether it is the UK or the US exchequer which loses from such arrangements, but the Revenue took the view that it was the UK and that action had to be taken immediately.

Legislation was drafted and brought forward with extreme haste and is now on the statute book.10 Although the statute goes further than was intended and it has therefore been left to the discretion of the Revenue authorities to apply it in a more restricted way, there is no reference to tax advantage or any indication as to the mischief to which the provisions are aimed. There is no bona fide let-out and as a result if the Revenue ever seeks to apply the provisions more widely in the future, the taxpayer will be left with no effective right of appeal. What is more, because there is no formal clearance mechanism, taxpayers concerned about the possible application of the provisions — and this will include many foreign investors setting up UK subsidiaries — will need to obtain express confirmation from the Revenue that the provisions will not apply to their particular situation or will have to structure their affairs so as to avoid the application of the new rules.

What seems to have happened in this case is that a legitimate desire to protect the revenue has overridden any concern for the fairness of the provisions. The reluctance of the Revenue and, apparently, of Ministers to subject themselves to the public scrutiny of parliamentary procedure is evidenced by a statement by the Financial Secretary to the Treasury which acknowledges that the provisions have been deliberately drafted in a

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10 Finance (No. 2) Act 1992 s.31.
‘flexible’ way so that Parliament need not be troubled with having to consider further legislation on this topic in future years!11

These examples (all of which reflect law still on the statute book) disclose an interesting trend: the legalistic approach between the wars was supplemented by the introduction of a ‘bona fide commercial’ test in 1960 which acknowledged that the legislation went further than necessary and which contained a clear statement of the ‘tax advantages’ that were to be countered. Subsequently legislation has continued to be wide-ranging but has been tempered, not by a statutory test of bona fide commerciality but by largely non-reviewable Revenue discretion and subject, apparently, to possible extension in future years by Ministers or the Inland Revenue.

II. RIGHTS OF APPEAL

Most taxing provisions carry with them some right of appeal and it is worth looking briefly at what these are and how effective they can be in dealing with any abuse of these provisions.

Any assessment to tax carries with it a right to appeal; the appeal mechanism is straightforward and well understood. Appeals proceed through a private hearing of the Appeal Commissioners to the High Court, the Court of Appeal and ultimately the House of Lords. An appeal has to be based on a wrong understanding of the facts by the Revenue or on a wrong interpretation of the law — a taxpayer might appeal against an assessment under s.703 on the ground that the transactions were in fact bona fide commercial (a question of fact) or against the denial of benefit of treaty relief on the basis that the Revenue had wrongly interpreted the provisions of the Treaty. On the face of it, the appeal mechanism would appear to be sufficient to protect the taxpayer from any concern of abuse of powers by the Revenue.

The problems with the appeal procedure are twofold — it does not always apply and it involves significant cost and delay. Taking a complex commercial case through the Appeal Commissioners can cost upwards of 250,000, and to take such a matter through to the House of Lords can cost two or three times that. This factor alone is a major disincentive to taking any matter to appeal and often enables settlement of tax liability to be achieved by the Inland Revenue simply because the taxpayer considers the cost of appeal higher than the amount of tax for which he is being asked to settle.

In addition to the basic right of appeal against an assessment, there are provisions whereby the decision of tax authorities can be reviewed (a so-called ‘judicial review’). It is well established that judicial review proceedings cannot be brought unless the other appeal mechanisms have been exhausted or are not

11 Hansard, 30 June 1992, col. 446.
appropriate. Judicial review therefore applies to such matters as the failure of the Inland Revenue to apply published statements, a refusal to rely on an agreement previously made and similar matters involving unfairness and abuse of power. The tendency to use the judicial review procedures has increased in recent years and it has now become established that the Revenue not only has a duty to act fairly and consistently but that it can be held, in certain circumstances, to the wording of any statement or commitment which it gives even if this is not necessarily consistent with the strict letter of the statutory provisions.

Despite the developments of recent years, the circumstances in which the Revenue’s behaviour can be reviewed are still considerably limited and the Courts will, as a first principle, respect the fact that the Revenue’s primary obligation is to collect those taxes which are due under the statutes. What the Courts cannot do is to review the content of the legislation and determine whether it does what Parliament intended or whether it goes further than necessary. Nor can they determine the purpose for which the legislation was introduced and relieve the taxpayer from its application because his circumstances do not meet that purpose if in fact he fits within the clear words of the section. In such cases the taxpayer has to rely on the discretion of the Revenue not to apply the provisions to him, and if it chooses not to do so, he has no recourse to the Courts.¹²

III. PRACTICAL PROBLEMS

So far this article may appear to be a somewhat theoretical treatise on the rights of the taxpayer rather than pointing up problems in the real world. But those problems exist.

The corporate taxpayer undertaking a complex reorganisation of its structure motivated for purely commercial reasons will need to be satisfied that the anti-avoidance provisions of s.703 will not apply to it — here a statutory clearance procedure and a bona fide commercial test exist in the legislation and the additional cost involved in obtaining the necessary clearances will probably be regarded as a justifiable expense in the course of the overall transaction.

When one turns to the problems of the multinational group investing in the UK, the problems take on a somewhat different complexion. To pick only two areas: the unwritten rules on thin capitalisation and the written but uncertain rules on equity notes make it very difficult for the investor to set up and finance his UK subsidiary without some comfort from the Revenue as to whether the debt finance of his subsidiary will be at an acceptable level and not fall foul of the equity note provisions. No doubt that comfort will be given but to what extent can it be relied on — does he want to risk the uncertainties of judicial review should the Revenue change its mind? Even if he does, the availability of

¹² As a footnote to this, note the progress of Pepper v Hart (1990) STC 786.
judicial review is dependent on the Revenue having been provided with all the material facts — is he satisfied that he has done this?

These are real points and real problems and ones which the professional tax adviser has to face every day. But in many cases they stem from one single point of difference between the taxpayer and the Revenue — is what is proposed a legitimate commercial aim or unacceptable tax planning?

While it may have been very clear in the 1930s what surtax was intended to catch and how the tax avoidance schemes avoided it, it is considerably less certain in the 1990s what the tax bill of a multinational company ‘ought’ to be. There is no clear intention or mischief to the legislation — just a complex web of taxing and relieving provisions interacting with each other and with other jurisdictions to produce a liability to tax.

IV. DEFINING LEGITIMATE TAX PLANNING

The debate about the boundaries of legitimate tax planning has ranged far and wide and there will always be differences of view. What can be agreed is that this question can never be definitively answered. The boundaries move with public sentiment, with developing financial techniques and with the introduction of new statutory reliefs. Tax law will always have to address this question and to determine where the line will be drawn.

There is no doubt that the Revenue, for all its size and the high quality of its personnel, suffers from a major failing: it is trying to track techniques and transactions devised by others and it does not have the financial resources of the private sector at its command.

The Revenue’s view of the private sector and those who work in it on tax advice is well illustrated by a comment made by the Financial Secretary to the Treasury in the debate on equity notes referred to above. One has to believe that this comment, if not drafted by his Revenue advisers, at least reflects their views in the matter (this comment follows on from a justification of a particular form of drafting on the basis that it is required in order to prevent the provisions being circumvented): ‘That serves to reinforce the fact that we are dealing with people of almost infinite ingenuity, and that our task is to try to keep ahead of them’.13

The problem is a real one for Ministers — according to Revenue figures, the amount of tax at stake in relation to equity notes was likely to exceed 150 million. The pressure to accept the legislation as drafted without too much concern as to whether the drafting goes further than strictly necessary or whether adequate protection for other taxpayers is contained in the provisions must be acute. There are inevitably few commercial lobby groups pressing for more fairly drafted anti-avoidance legislation. The growth in legislation dependent on administrative discretion for its proper operation which results from this attitude

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is worrying and the time has undoubtedly come when a more thorough review of both the method of tax law making and the specific means needed to counter tax avoidance is needed.

V. CONCLUSIONS

The problem that emerges from this can be summarised as follows: the purely legalistic approach of the early years of anti-avoidance legislation was not adequate. Wide-ranging legislation was necessary in certain areas. Initially that legislation was drafted with care and with adequate safeguards for the actions of the Revenue to be reviewed by the Courts. Under the pressure of time and the increased pace of commercial activities, the wide-ranging approach has been retained but less and less regard has been paid to the safeguards for the taxpayer. To protect the exchequer, it has proved necessary (or at least expedient) to increase the administrative and discretionary power given to the Inland Revenue. While protection of the exchequer is necessary, the Revenue, as administrators and collectors of taxes, is not the right body to be the ultimate arbiter as to what constitutes legitimate tax avoidance. If Parliament is not willing or able to tackle the task itself, it must be left to the judiciary and not to the executive. In the words of one judge, a taxpayer should be ‘taxed by law and not untaxed by concession’.14

VI. SOLUTIONS

(1) To start to resolve these issues, it would help if there were a generally accepted definition of unacceptable tax avoidance. While this might seem impossible (and certainly beyond the scope of this article), any effective attempt by the Revenue to provide a definition has been singularly lacking in recent years. It does not seem to have been accepted by the Revenue that it should be given, at least in part, to the Courts to review and modify as time passes. The Government and the Revenue appear to be failing to recognise that provisions which take away the rights and property of private citizens must be properly hedged about by the checks and balances of review by the Courts. The time has perhaps come to consider a general anti-avoidance provision coupled with a ‘bona fide commercial’ let-out to be applied in those areas where the drafting of specific anti-avoidance measures has become too complex.

(2) In devising means to stop tax leakage, Parliament has failed to take into account the effect that anti-avoidance provisions have on the many businesses and individuals who are not seeking to take advantage of the particular loophole that is being addressed. Failure to target legislation

14 Vestey v IRC (1977) 54 TC 503 per Walton J.
tightly and taking the easy (and admittedly effective) scattergun approach may achieve the immediate aim, but it increases the administrative burden of tax compliance for a large number of other taxpayers and creates an atmosphere of uncertainty about the UK system which deters UK and overseas investors from investing here. The legislators must have more regard to the clarity of legislation. The process by which legislation is drafted and amended should be thoroughly reviewed.

Where a loophole is discovered, the intention to legislate can be announced (provided that that intention is clearly stated) but there should then be adequate consultation and a real determination to target any provisions with certainty and with clarity. Where necessary, a discretion can be given to the Revenue as to the application of the provisions but that discretion must be properly hedged about with an adequate appeal procedure.

The Revenue is known to be unhappy with its decisions being taken to appeal but if this is based on a fear of being found wrong it cannot be justified; if on a concern that the Appeal Commissioners tend to find for the taxpayers then it reflects either poorly drafted legislation or a good reason for allowing the right of appeal in the first place.

(3) Although more careful drafting of legislation and making its application more subject to review are essential, they can never deal with the infinite variety and rapid pace of change of commercial activities (despite the Government’s attempts this year to legislate next year’s anti-avoidance provisions before they are needed!).

Serious consideration should be given to a more formal method of obtaining binding rulings from the Revenue on particular points. This would enable the taxpayer whose activities genuinely go beyond what is contemplated by the legislation of the day to seek a binding view from the Revenue on his own particular circumstances. There are admittedly a number of practical problems to be addressed before such a system can be introduced in the UK but these largely come down to two issues: the reviewability of the rulings and the administrative cost to the Revenue.

The first of these has already been addressed — where the Revenue gives a view then it should be subject to review by the Courts — it is not acceptable in a free society for the tax collector also to be the ultimate arbiter of the amounts due.15 The second point is a practical one — where are the resources, both manpower and financial, for any review system to come from? The simple answer to this is that where the question on which a ruling is sought involves business taxation (as an overwhelming majority of difficult tax questions do), there is no reason why the Revenue should not

15 'Nemo debet esse jude in propria causa'.
charge for its services. Businesses are prepared to pay for tax advice — why should advice which by its very nature will be authoritative not also be paid for? There is a clear precedent for this — the fee charged by the OFT for the use of the Merger Control process.

These are some practical suggestions but ultimately the question comes down to one of balancing the protection of the revenue with fairness and certainty for the taxpayer. In the UK we occupy what I believe to be an enviable position on the world tax stage — we lie between the over-regulated over-formalistic systems of North America and the rather curious systems of some of the European countries operating under the uncertainties inherent in a civil tax code.

The openness of the UK system combined with the respect which it gives (or at least used to give!) for the sanctity of an individual’s private property is something of which we should be proud. We should not be proud of the complications which have been generated, particularly in the corporate tax regime, in recent years without real regard to practical problems for the taxpayer and without sufficient concern for certainty and fairness.