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Effective Responses to Aggressive Tax Planning

What Canada Can Learn form Other Juriscictions

Instalment 4: United Kingdom - Disclosure Rules

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With a Contribution from:
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This instalment is the fourth in a series that presents a detailed study on aggressive tax planning. It underpins the issuance of *Tax Paper No. 112* published in July 2009 by the Canadian Tax Foundation (CTF). As mentioned in the preface of the book in order to keep publishing costs reasonable and to avoid delaying its publication, the CTF has given us permission to publish this document in French and English on our Website.

July 2009

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The Mission of the Research Chair in Taxation and Public Finance

The ***Research Chair in Taxation and Public Finance*** (RCTPF) was formed on April 15, 2003 via an unconditional grant from the Québec Government, to whom we are grateful. We are specifically thankfull to the Government for having given us total freedom in selecting topics we thought were important, thus expressing its confidence in the selection of our projects. In Québec, there are few official forums where practitioners, public-sector executives and researchers can discuss new issues in taxation and public finances. In addition, research in these fields generally focuses on a single discipline to the detriment of the multi-disciplinary aspect of relations between the state and its taxpayers. The ***Research Chair in Taxation and Public Finance*** was formed in response to these two realities. Its primary mission is to stimulate interdisciplinary research and training by bringing together professors and researchers interested in the political economy of taxation. For more information on the ***Research Chair in Taxation and Public Finance,*** visit its official Website at: http://www.usherbrooke.ca/adm/recherche/chairefiscalite/.

Gilles Larin holds the RCTPF. Robert Duong[1] was a research professional with the RCTPF when this study was produced. Lyne Latulippe was a consultant with the RCTPF.

We wish to express our gratitude for their observations and suggestions to Gilles Paré and Gaston Bédard, consultants, as well as to other readers who wished to remain anonymous. Of course, the opinions expressed herein are those of the authors who assume full responsibility for the comments and interpretations in this study.

[1] Robert Duong, who is a lawyer, was a research associate with the Research Chair of Taxation and Public Finance at the University of Sherbrooke when this study was done. He is now working with the federal Department of Finance as a policy officer in the area of income tax. The views expressed in this publication are those of the authors and do not in any way represent the position of the Department of Finance of Canada. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

Abstract

Instalment 4: United Kingdom – Disclosure Rules

In 2005, the Research Chair in Taxation and Public Finance initiated studies on aggressive tax planning in light of concerns expressed by tax administrations, the courts, taxpayers and tax advisers (“**stakeholders**”). The project analyzes the tools developed by some of Canada’s major trading partners in response to aggressive tax planning schemes put into effect by taxpayers and tax advisers.

This study aims to spark thinking among the various stakeholders in Canada by taking a comprehensive and pragmatic approach to several issues inherent in aggressive tax planning. In view of the scope of the subject, its complexity and the specific features of the taxation systems of foreign jurisdictions, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all the associated issues. This project was written over a more than a two year period. As the underlying logic was the key element we wished to convey, we wish to emphasise that these documents do not necessarily represent the state of tax legislation or jurisprudence.

As part of this project, the Chair held a symposium in 2006 on the risks inherent in aggressive tax planning for all stakeholders and published a discussion paper detailing the major issues of these schemes.

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal is to assess whether it would be worthwhile for Canada to adopt one or more of these tools to safeguard its tax system. The assessment was carried out taking into consideration the point of view of each stakeholder, according to generally recognized principles of tax administration.

This study consists of ten instalments detailing the study framework that guided our analysis of the tools developed in other countries and our study of each of the selected tools. Our conclusions in relation to all of these tools and possible solutions for Canada were destined to become the 10th instalment. However, it is not published here, because it was recast and augmented to become *Tax Paper No. 112*, published in July 2009 by the Canadian Tax Foundation: *Effective Responses to Aggressive Tax Planning – What Canada Can Learn from Other Jurisdictions*.

We refer the reader to instalment 1, "Study Framework", for an overview of our thinking throughout all instalments.

This instalment deals with the United Kingdom's disclosure rules, which have similarities with Canada's disclosure rules on tax shelters. We begin by describing the context of the disclosure rules. We then identify their general application details as well as the issues of the application for each group of stakeholders. Next, we formulate conclusions on the application of these disclosure rules.

In our view, detection of aggressive planning schemes according to the extent to which they comply with business standards helps to predictably and flexibly define schemes that carry a risk of avoidance. Various groups of stakeholders may hold different views as to the business standards that could usefully be applied in a given situation. The penalty thresholds in case of breach of the rules must not be excessive if the tax administration wishes to encourage filing of information and quickly adopt specific rules to withdraw tax benefits arising from tax avoidance schemes.

However, the lack of parameters in the tax law defining the concept of avoidance implies that all groups of stakeholders, including the courts, will hold differing opinions on the characteristics of these arrangements. Taxpayers and tax advisers then face the possibility of filing information returns regarding arrangements that comply with the objects of the tax law. The proliferation of specific anti-avoidance rules and, in certain cases, the possibility that they apply with retroactive effect have revived the debate in the United Kingdom on the usefulness of a general anti-avoidance rule. In the interests of fairness and predictability in the application of the law, the tax administration must minimize the additional compliance burden imposed by disclosure rules on taxpayers and tax advisers in order to apply them consistently according to the objects of the law.

We believe that the effectiveness of disclosure rules is tied closely to the importance of legal professional privilege in tax matters. In our view, taxpayers may be required to file information on the facts and structure of the arrangement they are aware of and that underlie the tax benefits they claim. Such an obligation is part of a self-assessment system. The courts will have to dispel the uncertainty regarding the obligation of advisers to produce the legal opinions supplied to their clients, more particularly in view of clients' tax purposes in an arrangement.

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1

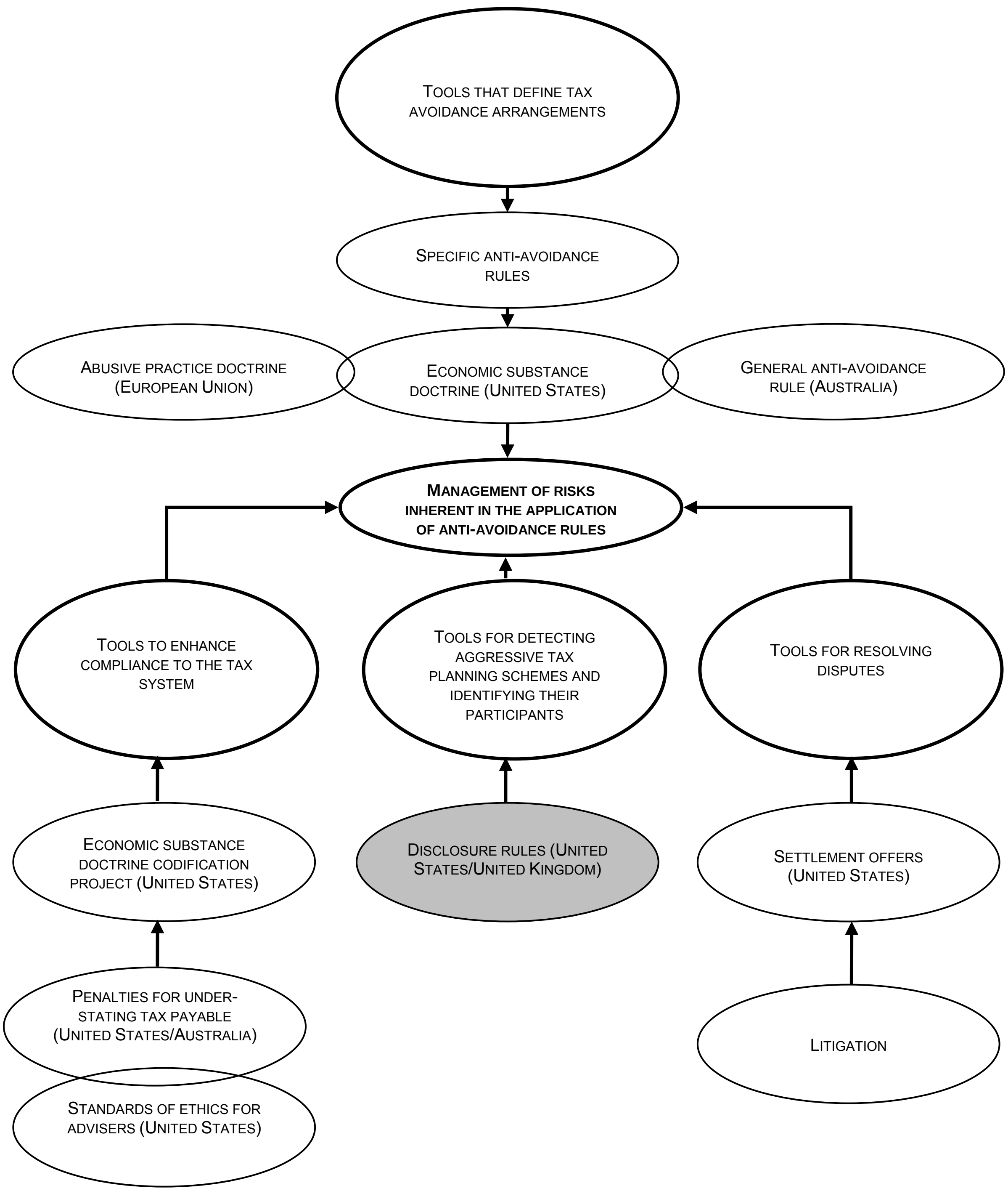
General Context

As discussed in Instalment 1, "Study Framework", of this study, there are a number of tools available to the tax administration to better curb tax avoidance arrangements and increase the risk for aggressive taxpayers and advisers. These tools can be divided into four spheres of intervention of the tax administration:

- Tools that define tax avoidance arrangements.
- Tools that enhance compliance to the tax system.
- Tools designed to detect aggressive tax planning schemes and identify their participants.
- Tools that focus on resolving disputes.

Chart 1.1 on the following page provides a concise illustration of the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted in the appropriate spheres of intervention. The tool considered in this instalment, the disclosure rules in the United Kingdom, is indicated by a grey background to situate its role in the tax administration's management of the risks inherent in aggressive tax planning.

CHART 1.1
SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING: SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS - DISCLOSURE RULES IN THE UNITED KINGDOM



Our Chart.

The United Kingdom's tax administration is seeking to reduce its tax gap. In its simplest form, this is estimated by the tax administration as the difference between the amount of tax that taxpayers should pay under the tax laws and the amount they have actually reported and paid. However, the tax administration cannot provide an accurate measure of this tax gap.[2] Nonetheless, it estimates that it has collected £5.6 billion in revenue during 2006-2007 as a result of the tools adopted since 2002 to protect the tax base – i.e. 0.4% of national revenue.[3]

Aggressive tax planning schemes represent one of the significant sources of this tax gap and the tax administration is seeking to apply various tools to curb them. Briefly, United Kingdom law has specific anti-avoidance rules to block tax planning schemes that are contrary to the objects of the law. The tax administration has estimated that the anti-avoidance rules proposed in the 2005 budget covering, among other things, capital gains, financial instruments, intangible property and cross-border transactions, will enable it to collect £825 million for 2006-2007.[4]

However, specific anti-avoidance rules do not thwart all forms of avoidance schemes. If need be, the tax administration will withdraw the tax benefits claimed by taxpayers arising from such schemes by invoking judicial doctrines. Under these doctrines, the courts apply the tax law according to its objects to the relevant facts of the arrangement in dispute, taking into consideration the non-tax purposes of taxpayers.[5] The courts apply these principles to the facts and circumstances of each arrangement to determine whether a taxpayer can claim the tax benefits. To illustrate these principles, we quote an extract from the decision handed down in 2004 by the House of Lords (Appellate Committee) in *Barclays Mercantile:*

> 35. There have been a number of cases, such as Inland Revenue v Burmah Oil Co Ltd 1982 SC (HL) 114, Furniss v Dawson [1984] AC 474 and Carreras Group Ltd v Stamp Commissioner [2004] STC 1377 in which it has been decided that elements

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2 U.K., National Audit Office, *Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices*, HC 670 Session 2005-2006, London, Her Majesty's Stationery Office, 13 January 2006 [NAO, *Corporation Tax*], page 16. See also the strategy statement of the British tax administration in *Our Vision and Strategy*, London, 15 August 2007 [HMRC, *Vision and Strategy*], online: HMRC Website <http://www.hmrc.gov.uk/avoidance/vision-strategy.htm>.

3 See Table 10.1, "Treasury Estimates of Amounts Raised Through Measures Announced Since Budget 2002 Aimed at Protecting Revenues" in Steve Bond, Malcolm Gammie and John Whiting, "Tax Avoidance" in *The Green Budget 2006*, United Kingdom, Institute for Fiscal Studies, 2006, 172 [Bond et al., "Tax Avoidance"].

4 U.K., HM Treasury, Economic and Fiscal Strategy Report and Financial Statement and Budget Report, *Budget 2005 Investing for our future: Fairness and opportunity for Britain's hard-working families*, London, Her Majesty's Stationery Office, 16 March 2005 [HM Treasury, *Budget 2005*], pages 186-190, more specifically Table A.1, page 186.

5 Bond et al., "Tax Avoidance", supra note 3, page 172.

> which have been inserted into a transaction without any business or commercial purpose did not, as the case might be, prevent the composite transaction from falling within a charge to tax or bring it within an exemption from tax. […]
>
> 36. Cases such as these gave rise to a view that, in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far. It elides the two steps which are necessary in the application of any statutory provision: first, to decide, on a purposive construction, exactly what transaction will answer to the statutory description and secondly, to decide whether the transaction in question does so. As Ribeiro PJ said in Collector of Stamp Revenue v Arrowtown Assets Ltd [2003] HKCFA 46 para 35: *"[T]he driving principle in the Ramsay line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.*[6]*"*
>
> [our extracts and italics]

However, these interpretation principles do not totally remove the uncertainty surrounding the scope of the objects pursued by the law. In a recent decision, the House of Lords rightly pointed to the difficulties of literally expressing the objects of the rules of attribution:

> 65. Hence the new provisions in section 660A were closely modelled on those designed to stop fathers from taking advantage of the fact that their minor children were treated as separate individuals for income tax purposes by settling income-producing property upon them. The aim was to prevent artificial transfers of income from father to child or husband to wife. But, consistently with the policy of exempting outright transfers of property between spouses from capital transfer tax and inheritance tax, an exception was made for outright gifts. The policies are easy to state. But it is not easy to translate them into statutory language which exactly captures the promoters' intent. It is some comfort that the professional judges who have so far decided this case have reached such different conclusions and that we have reached different conclusions from them all.[7]
>
> [our extracts]

Given the abundant and at times contradictory case law, the large volume of complex specific anti-avoidance rules and the sometimes ambiguous nature of the interpretation documents of the tax administration, the latter and professional organizations are increasingly receptive to the idea of a general anti-avoidance rule. In 1998, the tax administration examined whether adopting such a rule would be worthwhile but decided not to because, among other things, of

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6 *Barclays Mercantile Business Finance Limited* v. *Mawson (Her Majesty's Inspector of Taxes)*, [2004] UKHL 51 [*Barclays*]. For an illustration of the difficulties inherent in the application of the concepts formulated by the courts regarding tax avoidance, see David Taylor, "What *Barclays Mercantile* and *Scottish Provident* Mean for You" *International Tax Review* (February 2005) 36 [Taylor, "Barclays"].

7 *Jones* v. *Garnett* (*Her Majesty's Inspector of Taxes*) (25 July 2007), [2007] UKHL 35, paragraph 65.

the uncertainty in the application of this tool and the difficulties it foresaw in implementing an advance rulings' system to make the rule operational.[8]

In October 2007, the tax administration launched public consultations to find ways to protect the integrity of the tax system while simplifying anti-avoidance rules in light of the concerns of taxpayers and advisers.[9] Groups of stakeholders could renew their interest in a general anti-avoidance rule. The British tax administration recently changed the tax rules applicable to arrangements involving sale and repurchase agreements, known as repos, to ensure that the tax law applies on the basis of its objects. In an unusual move, it adopted a preamble that precedes the rules applicable to these arrangements.[10]

Without a general rule, taxpayers and tax advisers must come to terms with the definition of avoidance adopted by the tax administration (HM Revenue & Customs). It is of the view that it is impossible to provide an exhaustive definition of the concept of avoidance.[11] It considers that aggressive tax planning arrangements have a variety of characteristics that, as it sees them, carry a risk of avoidance. The characteristics listed by the tax administration to date include:

- The lack of economic substance in an arrangement.
- The marginal weight of an economic profit compared with the value of the tax benefits obtained.
- A mismatch between the tax and accounting treatment of an arrangement, between the tax treatment of an item in the United Kingdom and in other jurisdictions or between the status of the parties to an arrangement under the tax laws.

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8 On the other hand, in applying the income tax law, the United Kingdom tax administration is considering resorting to the abusive practice doctrine formulated by the Court of Justice of the European Communities in *Halifax* (*E.C.J.* Judgement*, Halifax, plc*, *Leeds Permanent Development Services Ltd*, *County Wide Property Development Ltd* c. *Commissioners of Customs & Excise*, C-255/02, [2006] E.C.R. I-01609, [2006] O.J. C 131/1). In this case, the European Court withdrew the tax benefits that taxable persons claimed regarding value-added tax. According to statements attributable to the head of the United Kingdom's tax administration (HM Revenue & Customs, often abbreviated as HMRC), the British tax administration could apply the abusive practice doctrine regarding income tax: see Chuck Gnaedinger, "Hartnett Reviews U.K. Compliance Initiatives" (2 February 2007), 2007 W.T.D. 23-6. This doctrine has similarities with the general anti-avoidance rule in Canada. For a discussion of the application details of the abusive practice doctrine, we refer the reader to Instalment 2 of Part II of this study.

9 See U.K., HM Treasury, *Tax simplification reviews*, London, Her Majesty's Stationery Office, October 2007, in particular paragraphs 1.4 and 1.24 to 1.28, as well as U.K., HM Treasury and HM Revenue & Customs, *HM Treasury and HMRC tax simplification reviews*, London, Her Majesty's Stationery Office, 9 October 2007, letter in which Edward Troup (Director, Business and Indirect Tax, HM Treasury) and Dave Harnett (Director General (Business) HMRC) invite taxpayers and advisers to express their views on the subject.

10 These changes are considered in subsection 4.12.3 below.

11 See HMRC, *Vision and Strategy*, *supra* note 2 under the heading "What is tax avoidance?"

- The lack of a commercial purpose in an arrangement.
- The presence of a series of complex and artificial transactions.
- A mismatch between the details of an arrangement and those of an arrangement reached on the open market.
- The presence of arrangements designed to sidestep the application of specific anti-avoidance rules.[12]

  [our extracts]

To promptly target avoidance arrangements with specific rules, the tax administration must collect information relating to the affairs of taxpayers in a timely manner. It seeks to do so while minimizing tax compliance costs for taxpayers as a whole. In its report published in 2004 entitled "The Administrative Costs of Tax Compliance", the Treasury Committee of the House of Commons acknowledged that the tax administration must reconcile the objective of tax system simplicity with the protection of the system's integrity and the achievement of social and economic objectives. The committee expressed itself as follows on the reconciliation of these objectives:

> We recognise the conflict between producing a tax system that is simple to understand and operate, and the need for checks and safeguards to bear down on tax avoidance. We also note that the Government has a number of other objectives for the tax system, such as promoting fairness and delivering social or environmental objectives, which can add to the administrative costs of tax compliance. As a result, the Government's objective of reducing compliance costs is only one of a number of objectives for the tax system. We recommend that the Government sets out more clearly the relative priority it attaches to each of these objectives.[13]
>
> [our extracts]

In response, the tax administration noted that its objective is to reduce compliance costs for all taxpayers while enacting tools that are targeted on those that fail to comply with the tax system:

> The Government welcomes the Committee's recognition that there can be several conflicting drivers which affect tax compliance costs. The Government's central aim, as it set out in its evidence to the Committee, is to strike the right balance between these, making compliance easier and less costly for those who want or are trying to comply, with better targeted assurance activity aimed at the non-compliant.

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[12] See U.K., HM Revenue & Customs, *Guidance from Anti-Avoidance Group, Risk assessing: factors which may indicate avoidance*, London, 15 August 2007, online: HMRC Website <http://www.hmrc.gov.uk/avoidance/aag-risk-assessing.htm>.

[13] U.K., H.C. Treasury Committee, *The Administrative Costs of Tax Compliance*, HC 269, Seventh Report of Session 2003-04 (4 June 2004) [H.C., *Administrative Costs of Compliance*], paragraph 10.

> The relative priority to be accorded to different objectives for the tax system will depend on the particular decision which is being considered. The Government remains committed to reducing tax compliance costs where this can be done consistently with its other objectives.[14]
>
> [our extracts]

External auditors mandated by the United Kingdom's tax administration assessed at £5.1 billion, as of 31 May 2005, the cost to British companies of complying with the administrative rules in effect on that date. Companies paid almost half of this amount to external advisers mainly for their expertise in dealing with the complexity of the tax rules. The largest expense item relates to the collection of information by corporations to comply with the tax rules.[15]

Despite seemingly high compliance costs, taxpayers carry out aggressive tax planning arrangements because the value of the tax benefits they claim more than offsets the risk they run.[16] The tax administration incurs a tax gap because of the time lapse between the implementation of such arrangements, their identification and the adoption of specific anti-avoidance rules. It must then commit additional human and financial resources to identify the arrangements and their participants, audit the affairs of the latter and litigate before the courts.

To reconcile the principles of integrity and simplicity, the tax administration is seeking to curb aggressive tax planning arrangements in a targeted fashion, according to their nature and their scope.[17] In recent years, it has adopted various measures to do so while being careful not to prevent taxpayers from carrying out legitimate arrangements. These measures include anti-

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14 U.K., H.C. Treasury Committee, *Government Response to the Committee's Seventh Report: The Administrative Costs of Tax Compliance*, HC 1054, Seventh Special Report of Session 2003-04 (21 September 2004) [H.C., *Government Response on Administrative Costs of Compliance*], paragraph 2.

15 KPMG LLP and HMRC, *Administrative Burden – HMRC Measurement Project*, Volume I (20 March 2006) [KPMG, *Administrative Burden*], in particular pages 4-5 and 36-39.

16 We refer the reader to an earlier paper: "Aggressive Tax Planning and Inherent risks: Would Canada Benefit by Adopting Tools Developed by some of Its Trading Partners? – The Canadian Context", that sets out the reasons why taxpayers implement aggressive tax planning arrangements, their profile and their management of the risks inherent in such arrangements: see <https://acpcol01.usherbrooke.ca/prod/recherche/chairefisc.nsf/alldoc/4CEF322B2F0EC162852572880062A608/$file/Evitement_fiscal_21juin2006.pdf?OpenElement>.

17 U.K., H.C. Treasury Committee, *The 2004 Budget – Volume 1*, HC 479-I, Sixth Report of Session 2003-04 (6 April 2004) [H.C., *2004 Budget*], paragraphs 38-42.

avoidance rules, other rules focusing on indentifying aggressive arrangements[18] and their participants as well as studies on the attitude of aggressive taxpayers.[19]

More specifically, the tax administration passed a law introducing disclosure rules that became effective in 2004. These rules allow a real-time analysis of the features of arrangements with a high risk of avoidance. In light of the information collected, it is better able to judge whether it is worth changing the scope of the tax rules, adopting specific anti-avoidance rules or objecting to the compliance of an arrangement with the tax law.[20]

According to a 2006 tax administration assessment, major professional organizations acknowledge that the disclosure rules generally strike a reasonable balance between their respective duties and privileges.[21] However, groups of stakeholders expressed the following concerns about various aspects, including:

- The broad scope of the parameters describing the arrangements to be disclosed.
- Compliance costs for advisers and taxpayers as a result of the continuous adaptation of disclosure rules.
- Adoption of specific anti-avoidance rules and the possibility that they may be applied retroactively.

Developments relating to the application of disclosure rules in the United Kingdom can be informative for Canadian stakeholders regarding whether it is worth changing similar rules that currently exist in the Canadian tax system – namely the disclosure system relating to tax shelters.[22]

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[18] See U.K., National Audit Office, *HM Revenue & Customs Management of large business Corporation Tax*, HC 614, Session 2006-2007, London, Her Majesty's Stationery Office, 25 July 2007 [NAO, *Management of Business Corporation Tax*].

[19] See U.K., Gareth John, *Large groups' tax departments: factors that influence tax management*, HMRC Research Report 30, London, Her Majesty's Stationery Office, 24 July 2007 [HMRC, *In-house tax departments*].

[20] See NAO, *Management of Business Corporation Tax*, *supra* note 18, paragraph 2.28.

[21] U.K., H.L. Select Committee on Economic Affairs, *The Finance Bill 2004, Volume 1: Report*, HL 109-I, 1st Report of Session 2003-04 (25 June 2004) [H.L., *Finance Bill 2004*].

[22] *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1 and amend., section 237.1.

2

Context of Disclosure Rules

When it comes to aggressive tax planning, the tax administration as well as taxpayers and their advisers are constantly interacting. When the tax administration enacts an anti-avoidance rule to block a given scheme, aggressive taxpayers and their advisers will devise other schemes outside the scope of the rule that has been enacted. To withdraw the tax benefits arising from these innovative arrangements, the tax administration must detect them by auditing the taxpayers' returns. When it does detect them, it will adopt other anti-avoidance rules and will also have to dispute the legitimate nature of the arrangements carried out by the taxpayers. This process can extend over many years.

The tax administration can audit the taxpayers' return effectively and in a timely manner only if they provide sufficiently detailed information to determine their tax payable.[23] In its view, aggressive taxpayers and advisers carry out arrangements with a high risk of avoidance by disclosing these arrangements in an ambiguous way and by availing themselves of confidentiality privileges.[24] Identifying items with a risk of avoidance can prove complex for the tax administration if they are not readily apparent in the returns.[25]

To enhance the detection of aggressive tax planning schemes and their participants, the tax administration (HM Treasury) introduced a disclosure system in 2004 to reduce the time gap between the implementation of arrangements and the filing of information by taxpayers and advisers. This system enables the tax administration to more quickly adopt measures to curb

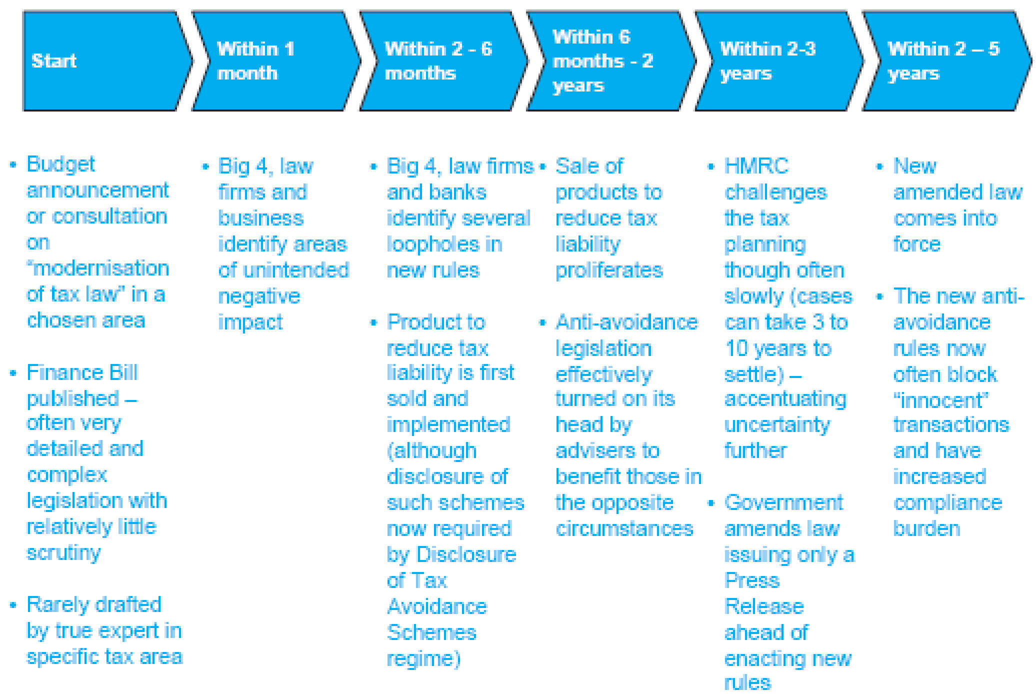
[23] According to the observations of the auditor general, audits on specific items in a tax return are more effective than so-called general audits. See NAO, *Corporation Tax*, *supra* note 2, pages 2, 15 and 16.

[24] U.K., HM Treasury, Economic and Fiscal Strategy Report and Financial Statement and Budget Report, *Budget 2004: Prudence for a purpose: A Britain of stability and strength*, HC 301, London, Her Majesty's Stationery Office, 17 March 2004 [HM Treasury, *Budget 2004*], paragraph 5.84.

[25] U.K., HM Revenue & Customs, Regulatory Impact Assessment, *Tackling Tax Avoidance – Disclosure Requirements* (April 2004) [HMRC, *RIA 2004*], paragraph 4.

schemes that, in its view, are counter to the objects of the law.[26] To manage the uncertainty inherent in an innovative tool, these rules initially targeted arrangements whose tax benefit arose from financial instruments or transactions relating to employee remuneration[27] but, beginning on 1 August 2006, were gradually extended to seven categories of aggressive arrangements.[28] Chart 2.1 illustrates the utility of disclosure rules as part of a perpetual "action-reaction" movement between the tax administration and taxpayers and their advisers.

CHART 2.1
EARLY DETECTION OF AGGRESSIVE TAX PLANNING ARRANGEMENTS THROUGH DISCLOSURE RULES



Source: Figure 24 "Making more tax law – why complexity keeps growing" in Tax Reform Commission, *Tax Matters Reforming the Tax System*, London, The Tax Reform Commission,19 October 2006, page 6.

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26 U.K., HM Revenue & Customs, Regulatory Impact Assessment, *The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 (SI 2006/1543), The Tax Avoidance Schemes (Information) (Amendment) Regulations 2006 (SI 2006/1544)*, (12 June 2006) [HMRC, *RIA 2006*], paragraphs 2-5.

27 The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2004, S.I. 2004/1863 [*Regulations 2004/1863*].

28 HMRC, *RIA 2006*, *supra* note 26, paragraphs 5 and 17.

3

Description

3.1 Hallmarked schemes – arrangements with avoidance risks targeted by the disclosure rules

Reporting tax advisers (promoters)[29] must disclose to the United Kingdom's tax administration information on the arrangements a taxpayer has implemented further to their advice. Advisers must disclose an arrangement if it satisfies the following three levels of criteria (notifiable arrangements):

- The arrangement enables or might be expected to enable a taxpayer to obtain a tax advantage in relation of the tax law in the United Kingdom:
  - An arrangement means any scheme, transaction or series of transactions.[30]
  - A tax advantage is defined as the avoidance or reduction of tax, the obtaining or increase of an amount of tax relief or refund, the deferral of payment of tax or advancement of repayment of tax, or the avoidance of the obligation to deduct or account for tax.[31]
- The tax advantage constitutes or might be expected to constitute the main benefit or one of the main benefits of the arrangement.
- The arrangement is likened to any of the arrangements whose hallmarks have an avoidance risk, as identified by the tax administration (HM Treasury) under its regulatory power (prescribed arrangements, commonly referred to as "hallmarked schemes") [32].

Flow chart 3.1 on page 14 reproduces the one used by the tax administration (Her Majesty's Revenue & Customs, hereafter HMRC) to determine whether an arrangement must be disclosed by advisers or, as the case may be, taxpayers. Table 3.1 on page 15 briefly describes hallmarked schemes.

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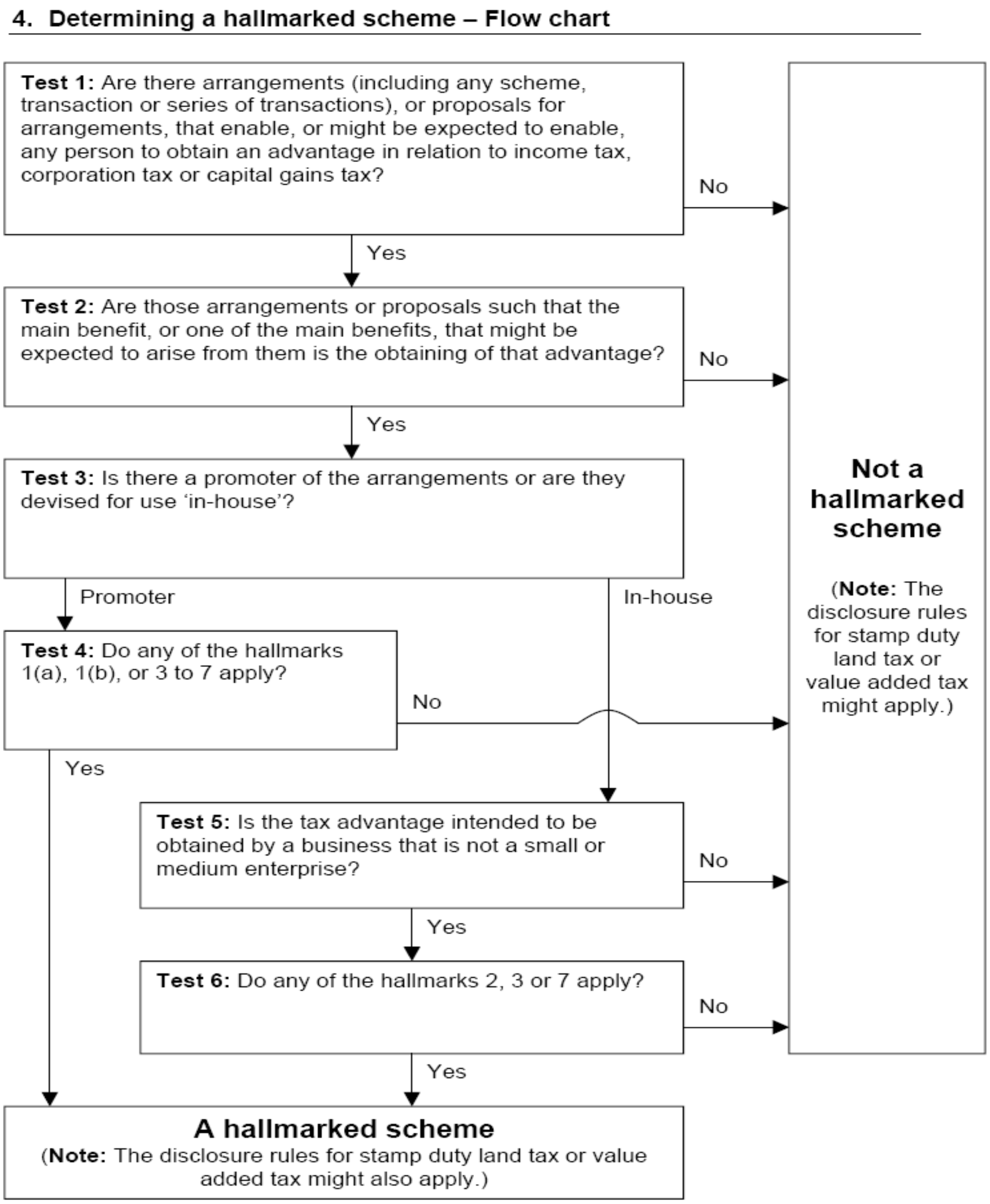
29 Reporting advisers are described in subsection 3.2.1. In some circumstances, taxpayers may be subject to the disclosure rules: see subsection 3.3.1.

30 Section 318 (1) "arrangements" *Finance Act 2004* (U.K.), 2004, c. 12 [*FA 2004*].

31 Section 318 (1) "advantage" *FA 2004.*

32 Section 306(1) *FA 2004.*

FLOW CHART 3.1
DETERMINING A HALLMARKED SCHEME



Source: Taken from the manual published by HM Revenue & Customs entitled Guidance Disclosure of Tax Avoidance Schemes Income Tax, Corporation Tax, Capital Gains Tax and Stamp Duty Land Tax, note 35.

TABLE 3.1
OVERVIEW OF ARRANGEMENTS UNDER THE TAX ADMINISTRATION'S SCRUTINY ON THE BASIS OF HALLMARKS

CATEGORY	DESCRIPTION
CONFIDENTIAL ARRANGEMENT - PROMOTERS ARRANGEMENTS 1A AND 1B	Arrangement for which it is reasonable to expect that the promoter would wish to maintain the elements of the arrangement that gives rise to the tax advantages confidential from other advisers (1A), or keep them confidential from the tax administration (1B) in order to reproduce them for the taxpayer or other taxpayers.
CONFIDENTIAL ARRANGEMENT - TAXPAYERS ARRANGEMENT 2	Arrangement for which it is reasonable to expect that the taxpayer would wish to maintain the elements of the arrangement that gives rise to the tax advantages confidential from the tax administration in order to, among other things, reproduce them for his own use.
ARRANGEMENT WITH A PREMIUM FEE BASED ON THE VALUE OF THE TAX ADVANTAGES ARRANGEMENT 3	Arrangement for which it is reasonable to expect that an adviser would be able to receive from a person experienced in receiving tax advice, a premium fee that is based the value of the tax advantages of the arrangement.
ARRANGEMENT USING INNOVATIVE FINANCIAL PRODUCTS WITH OFF-MARKET TERMS ARRANGEMENT 4	Arrangement where the tax advantage arises, to more than an incidental degree, from the inclusion of a financial instrument in the arrangement, where a promoter or a person connected with the promoter is a party to the financial instrument and if it might be reasonable to expect that the value of the instrument in the open market significantly differs from the value of similar conventional instruments.
STANDARDIZED ARRANGEMENT ARRANGEMENT 5	Arrangement that a promoter can set up for many taxpayers by following steps and using documents that are substantially standardised with no regard to their particular situation, if it would be reasonable for an informed observer with knowledge of the tax law to conclude, based on an objective analysis of the arrangement, that its main purpose is to enable taxpayers to obtain a tax advantage.
ARRANGEMENT ALLOWING INDIVIDUALS TO DECUT BUSINESS OR CAPITAL LOSSES (LOSS SCHEMES) ARRANGEMENT 6	Arrangement where a promoter expects more than one individual to implement the arrangement regarding which it would be reasonable for an informed observer with knowledge of the tax law to conclude that the main benefit arising from the arrangement is to allow each individual to deduct losses in calculating their income.
ARRANGEMENT ALLOWING THE DEDUCTION OF EQUIPMENT LEASING EXPENSES ARRANGEMENT 7	Arrangement involving a lease lasting more than two years of plant or machinery whose cost to the lessor or its market value is at least £10 million and which exhibits any of the following aspects: ▪ An entity is outside the charge to corporate income tax is a contracting party to the lease. ▪ For all practical purposes, the lessor assumes no financial risk if the lessee defaults on its payments. ▪ The arrangement includes a sale and finance leaseback arrangement or a lease and finance leaseback.

Source: Table prepared by the authors based on the disclosure rules and HM Revenue & Customs document entitled *Guidance Disclosure of Tax Avoidance Schemes (Income Tax, Corporation Tax, Capital Gains Tax and Stamp Duty Land Tax)*, note 35.

3.2 Duties of advisers

3.2.1 Reporting advisers (promoters)

Advisers, whether located in the United Kingdom or abroad, are under the obligation to file information returns as "promoters" when, in the course of providing services relating to taxation:

- where they make available a notifiable arrangement ready to be implemented by one or more persons or solicit persons to implement it; or
- where they are responsible to any extent possible for either the design of notifiable arrangements or their organisation or management.[33]

Reporting advisers include lawyers, accountants, banking institutions and securities houses.[34] In the case of a lawyer subject to professional privilege, any other adviser not subject to such privilege or the taxpayer must file the prescribed return.[35]

3.2.2 Information return

A reporting adviser must file the prescribed form with the tax administration[36] which must contain a reasonable explanation of how the notifiable arrangement works as well as the following information (hereunder the "prescribed form"):

- The adviser's contact information.
- A summary of the arrangement and its name, if any.
- Details of the disclosure rules under which the adviser files the form.

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33 Section 307 *FA 2004*.

34 Section 307(2) *FA 2004*.

35 Sections 314, 308(4) and 310 *FA 2004*; U.K., HM Revenue & Customs, *Guidance Disclosure of Tax Avoidance Schemes Income Tax, Corporation Tax, Capital Gains Tax and Stamp Duty Land Tax*, London, HMRC, June 2006 [HMRC, *Disclosure Guidance*], pages 19-20. For the taxpayer, see prescribed form U.K., HM Revenue & Customs, Form AAG3, *Disclosure of Avoidance Scheme (Notification by a scheme user where there is no promoter, or the scheme is promoted by a lawyer who is unable to make full notification)* (HMRC 05/07) [HMRC, *Form AAG3*]. In the tax administration's view, a lawyer may not, however, invoke the legal professional privilege where he markets standardized arrangements, as defined in Table 3.1. The application of the legal professional privilege raises particular issues where a lawyer sends confidential information about his client to an accountant in the course of formulating or implementing an aggressive tax planning arrangement. These issues are dealt with in subsection 4.10.

36 Within HMRC is a specialized tax avoidance group known as the Anti-Avoidance Group (AAG). It receives information returns filed by tax advisers and taxpayers under the disclosure rules. For more detailed information on the role of this group within the tax administration, see the information published on the HMRC Website: <http://www.hmrc.gov.uk/avoidance/about-aag.htm>.

- An explanation of the structure of each aspect of the arrangement giving rise to the advantage that is obtained or will be obtained by a taxpayer.
- The sections of the law in which the tax advantage is grounded.[37]

The adviser or one of the reporting advisers in relation to a notifiable arrangement must file the prescribed form with the tax administration within five days following the day the arrangement was offered to taxpayers or the day he became aware of the execution of any transaction that is part of the notifiable arrangement.[38] If a number of reporting advisers are associated with an arrangement, compliance with the disclosure rules by one of them discharges the others of the requirement to file a form. In some cases, the responsibility for filing the information return lies with taxpayers.

3.2.3 Registration number of the arrangement issued by the tax administration sent to taxpayers

The reporting adviser must send taxpayers the registration number of the notifiable arrangement within 30 days of its being issued by the tax administration.[39]

3.3 Duties of taxpayers

3.3.1 Reporting taxpayers

The taxpayer must file the prescribed form if the reporting adviser is located outside the United Kingdom and does not file it.[40] In the case of a lawyer subject to legal professional privilege, the taxpayer must file the prescribed form if no other adviser not subject to such privilege files it.[41]

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37 U.K., HM Revenue & Customs, Form AAG1, *Disclosure of Avoidance Scheme (Notification by scheme promoter)* (HMRC 05/07). See section 308 *FA 2004* and section 3 *The Tax Avoidance Schemes (Information) Regulations 2004*, S.I. 2004/1864 [*Regulations 2004/1864*].

38 Section 308 *FA 2004*; *Regulations 2004/1864*, *ibid.,* paragraphs 4(1) and (3).

39 Section 312 *FA 2004*.

40 U.K., HM Revenue & Customs, Form AAG2, *Disclosure of Avoidance Scheme (Notification by scheme user where offshore promoter does not notify)* (HMRC 05/07). See section 309 *FA 2004* and *Regulations 2004/1864*, *supra* note 37, paragraph 4(4).

41 See sections 308(4), 310 and 314 *FA 2004*; HMRC, *Disclosure Guidance*, *supra* note 35, pages 19-20. The taxpayer must file HMRC, *Form AAG3*, *supra* note 35.

The taxpayer (in the case of a corporation, its officers) must file the prescribed form when he designs and implements a notifiable arrangement solely for his own use.[42] However, individuals and small or medium-size enterprises are not covered by the disclosure rules.[43]

3.3.2 Prescribed form

The taxpayer who must file the prescribed form in place of a reporting adviser must file it within five days following the day he implements a notifiable arrangement.

The taxpayer who himself devises and implements an arrangement strictly for his own use must file a prescribed return within 30 days following the day the arrangement is implemented.[44]

3.3.3 Filing of the registration number

Taxpayers who have implemented a notifiable arrangement must enter the registration number assigned to the arrangement by the tax administration on each tax return where they claim a tax advantage stemming from it, and indicate the time during any taxation year when they expect to obtain it.[45]

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42 Section 310 *FA 2004*.

43 For the purposes of the disclosure rules, the tax administration has used the definition of a small and medium-size enterprise adopted by the Member States of the European Union: see *The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006*, S.I. 2006/1543 [*Regulations 2006/1543*], sections 2, 4, 7, 8 and 13. Briefly, a small and medium-size enterprise has fewer than 250 employees and annual sales not exceeding €50 million, or an annual balance sheet total not exceeding €43 million. For details on these thresholds, see EC Recommendation, *Commission Recommendation of May 6, 2003 concerning the definition of micro, small and medium-sized enterprises 2003/361/EC*, [2003] O.J. L. 124/36, as well as U.K., HM Revenue & Customs, *R&D tax relief: SME definition: 2003 EC SME Recommendation tests*, CIRD91400, online: HMRC Website <http://www.hmrc.gov.uk/manuals/cirdmanual/CIRD91400.htm>.

44 HMRC, *Form AAG3*, *supra* note 35*.* See section 310 *FA 2004*.

45 Section 313 *FA 2004*.

3.4 Duties and powers of the tax administration

3.4.1 Issuing a scheme reference number

Within 30 days following the day the reporting adviser or taxpayer files the prescribed form, the tax administration will issue a scheme reference number for the disclosed arrangement.[46] Filing of the prescribed form does not in itself prompt the withdrawal by the tax administration of the tax advantages a taxpayer may obtain from the notifiable arrangement.[47] The reporting taxpayer or adviser who does not file the prescribed form incurs monetary penalties.

3.4.2 Power to obtain information from tax advisers

Where auditors have reasonable grounds for believing that advisers subject to the disclosure rules have not filed the prescribed form, they can ask them in writing to provide the following information:

- The reasons why the tax advantages of the arrangement specified by the tax administration in the request do not represent the main advantage of the arrangement.
- The method used to measure the relative importance of the various advantages of the arrangement.
- The reasons why the specified arrangement cannot be seen as a prescribed arrangement.
- The reasons why the adviser is of the view that he is not subject to the disclosure rules.[48]

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46 Section 311 *FA 2004*. The British tax administration will hold consultations to examine ways to use issued registration numbers to identify more taxpayers carrying out commercialized tax arrangements: see U.K., HM Treasury, Press Notices, 2007 PreBudget Report 2007, Press Notice 2 "Protecting Tax Revenues".

47 Section 311 *FA 2004*.

48 See section 108 *Finance Act 2007* (U.K.), 2007, c. 11 [*FA 2007*]. For an explanation of the possibility for the tax administration to obtain an order from the Special Commissioners enjoining advisers to file information returns, see U.K., HM Revenue & Customs, *Disclosure of avoidance schemes: New information powers*, Revenue & Customs Brief 57/07 (14 August 2007), online: HMRC Website <http://www.hmrc.gov.uk/briefs/income-tax/brief5707.htm>.

The tax administration can obtain a court order enjoining an adviser to provide additional documents or information to explain the lack of prescribed forms or to clarify the information contained in a form it previously filed (supplementary filing order).[49] In general, the court must be satisfied that the tax administration has reasonable grounds for believing that these documents and information are covered by the rules or that they will justify or explain the adviser's position.

The tax administration could also obtain a court order regarding an adviser in which the court declares that an arrangement can be seen as a notifiable arrangement. The court must either decide that the tax administration prove that an arrangement must be disclosed by an adviser,[50] or be satisfied that it has reasonable grounds for believing that an adviser must file a prescribed form regarding a notifiable arrangement and that it previously took reasonable means available to determine that the adviser should have done so.[51] Where the court so orders, the adviser must then file the prescribed form under the disclosure rules as if the arrangement specified in the court order were a notifiable arrangement.

Generally speaking, advisers must provide the tax administration with the required information within ten days following the date of the tax administration's request or the court order. In the case of a supplementary filing of information order, 14 days are allowed. In some cases, the tax administration can extend the filing deadline.[52]

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[49] See sections 308A, 313A and 313B *FA 2004,* as well as section 108 *FA 2007*. See also U.K., HM Treasury, Economic and Fiscal Strategy Report and Financial Statement and Budget Report, *Budget 2007 Building Britain's long term future*: *Prosperity and fairness for families*, London, Her Majesty's Stationery Office, March 2007 [Treasury, *Budget 2007*], paragraph 5.137. According to the tax administration estimates, these measures will allow it to collect additional revenues of £15 million in 2007-2008, and £30 million for each of fiscal years 2008-2009 and 2009-2010: see *Table A.1*, page 208 of the budget mentioned above. For the initial announcement of this measure, see U.K., HM Treasury, *Pre-Budget Report 2006*, London, Her Majesty's Stationery Office, 6 December 2006 [Treasury, *Pre-Budget Report 2006*], paragraphs 5.125-126 as well as U.K., HM Revenue & Customs, *Ensuring Compliance with the Tax Avoidance Disclosure Regime*, *Technical Note and Draft Tax Clause* (18 December 2006) [HMRC, *Ensuring Compliance with TAD*].

[50] Section 306A *FA 2004*, *as* added by section 108 *FA 2007*.

[51] Section 314A *FA 2004*, as added by section 108 *FA 2007*.

[52] See sections 308A(6)(b), 313A(4)(b) and 313B(2)(b) *FA 2004*, as well as section a 108 *FA 2007*. See also *The Tax Avoidance Schemes (Information) (Amendment) (No. 2) Regulations 2007*, S.I. 2007/3104, in relation to sections 306A and 314A *FA 2004*, as well as section 108 *FA 2007*.

3.5 Penalties for reporting advisers and taxpayers

A reporting adviser or taxpayer who does not file the prescribed return with the tax administration within the applicable deadline incurs a monetary penalty of £5 000.[53] The penalty must be imposed by an administrative court of Special Commissioners.[54] Where this court imposes the penalty, the tax administration can subsequently impose an additional penalty of £600 per day late until the adviser or the taxpayer corrects the situation. The adviser or taxpayer can appeal to the Special Commissioner the tax administration's decision to impose such additional penalties.

An adviser incurs a daily penalty of up to £5 000 if he fails to comply within the applicable deadline with an order of the Special Commissioner declaring that an arrangement can be seen as a notifiable arrangement in his regard, or with a request from the tax administration enjoining him to file an information return.[55]

Lastly, a taxpayer who does not enter a scheme reference number on his tax return or fails to provide other prescribed information incurs a monetary penalty of £100. This amount rises to £500 for a repeat failure by the taxpayer regarding any other notifiable arrangement within the 30 months preceding such repeat failure, and to £1000 for each subsequent repeat failure within the same period.[56] The taxpayer can appeal the decision of the tax administration to impose a penalty on him to the Special Commissioner.

An adviser or taxpayer can avoid a penalty if he advances reasonable grounds that justify his failure and remedies it within a reasonable time.

The decisions reached by the Special Commissioners regarding the interpretation of the facts cannot be appealed, but the decisions reached on points of law can be appealed to the High

53 Section 315 *FA 2004*; section 98C *Taxes Management Act 1970* (U.K.), 1970, c. 9 [*TMA 1970*].

54 Briefly, a taxpayer can appeal a notice of assessment issued or certain decisions made by the tax administration regarding him to an administrative tribunal consisting of General Commissioners and Special Commissioners. The latter have exclusive jurisdiction over specified cases, including complex avoidance cases. For more information, see Appendix 1.

55 *The Tax Avoidance Schemes (Penalty) Regulations 2007*, S.I. 2007/3104. This regulation comes into force 20 November 2007.

56 Section 315 *FA 2004*; section 98C *TMA 1970*.

Court.[57] Briefly, a point of law implies a misinterpretation or misapplication of the relevant rules, a decision that is completely inconsistent with the evidence or a decision that breaches the rules of natural justice.[58]

57 See DCA, *Special Commissioners*, *supra* note 54 and Appendix 1.
58 Tribunal Services, *Tax Appeals Guide*, *supra* note 54 and Appendix 1.

4

Observations

It will be a few years before the full impact of the disclosure system that came into effect on 1 August 2004 can be measured. The tax administration will need time to complete the analysis of the information collected and audit the affairs of taxpayers who have implemented notifiable arrangements.[59] Until then, some interim observations can be made on the disclosure system since its implementation.

In general, the disclosure rules strike a reasonable balance between the compliance duties of taxpayers and the duties of the tax administration to protect the tax system's integrity. The tax administration has collected a large volume of information that allows it to adopt anti-avoidance rules. It has also noted that taxpayers and tax advisers have systematically altered their tax strategy since the adoption of disclosure rules and variations of these rules.

The disclosure rules provide the tax administration with the advantage of objectively assessing in a timely manner the avoidance risks of certain arrangements. Other stakeholder groups have expressed various concerns on the application of these rules:

- Uncertainty regarding how to identify a tax advantage in an arrangement and how to measure the relative importance of the various advantages arising from it without specific parameters.
- Uncertainty as to the hallmarks of prescribed arrangements.
- Dispute resolution between advisers and taxpayers over the application of disclosure rules in view of the uncertainty raised.
- Differences of opinion over the reasonableness of a disclosure period of five days in view of the reality of professional practice of tax advisers and their dealings with their clients.

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59 HMRC, *RIA 2006*, *supra* note 26, paragraph 12.

- Conflict between disclosure rules and the confidentiality privileges of taxpayers.
- Concerns of advisers over the compliance costs of the disclosure rules, particularly in view of their continual adjustment by the tax administration, which can be seen as a perpetual "action-reaction" movement.
- Concerns of taxpayers and advisers over the scope of specific anti-avoidance rules adopted by the tax administration in light of the information collected under the disclosure rules.

4.1 Generally speaking, these rules strike a balance between the compliance duties of advisers and taxpayers, and the integrity of the tax system

When the disclosure rules were implemented, the Treasury Committee of the UK Parliament acknowledged the importance of the principle of transparency in tax returns to curb aggressive arrangements, without unduly adding to the complexity of the tax system for taxpayers as a whole and the tax administration.

> The Government has a duty to protect the tax revenues and has announced the introduction of a disclosure regime whereby promoters who market tax avoidance schemes and arrangements that meet certain criteria will have to disclose details of them to the tax authorities. We agree with the statement made by one of our expert witnesses working in the tax field that there can be no issue with the concept of full disclosure of tax planning to the tax authorities, and we fully support this proposal in principle. We believe what is required in practice is a scheme that tackles tax avoidance effectively without creating undue compliance burdens for taxpayers and their advisers, or undue administrative burdens for the tax authorities.[60]
>
> [our extracts]

60 H.C., *2004 Budget*, *supra* note 17, paragraph 42.

The tax administration intends to judiciously target aggressive arrangements that carry avoidance risks by targeting only those participating in them:

> The Government welcomes the Committee's support for the principle of disclosure. The proposed rules for direct taxes and VAT are intended to improve transparency in the tax system, allowing early detection of avoidance schemes and more effective targeting of avoiders, reflecting the Government's determination to close down opportunities for tax avoidance. The rules will be carefully targeted at those devising, promoting and using tax avoidance schemes and arrangements.[61]
>
> [our extracts]

According to an assessment of the disclosure regime carried out in 2006 by the tax administration, associations of tax professionals generally acknowledge that the regime strikes a reasonable balance between the duties of each party. When it was introduced, the representatives of these organizations generally acknowledged the principle of greater transparency regarding aggressive tax planning. However, they expressed concerns on the extensive scope of such a regime, its practical application and compliance costs.[62] For the period extending from the date the disclosure regime became effective to June 2006, representatives of legal and accounting organizations, in particular, expressed the view that the disclosure rules set an acceptable demarcation between arrangements with a high risk of avoidance and common business arrangements.[63]

The tax administration is of the view that this tool helps target avoidance schemes without affecting legitimate arrangements, in light of the volume and nature of information disclosed, as well as the limited number of so-called "preventive" disclosures it has received.[64] Table 4.1 on page 25 shows that the tax administration has collected more than eight hundred information returns since the disclosure rules came into force. Informal indicators tend to show that this tool

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61 U.K., H.C. Treasury Committee, *Government Response to the Committee's Sixth Report on the 2004 Budget (HC 479)*, HC 654, Fourth Special Report of Session 2003-04 (17 June 2004) [H.C., *Government Response to 2004 Budget Report*], paragraph 17.

62 H.L., *Finance Bill 2004*, *supra* note 21, paragraphs 18-19. Subsection 4.11 deals more extensively with the concerns about compliance costs.

63 These organizations include: *Institute of Chartered Accountants in England and Wales* (ICAEW), *Association of Chartered Certified Accountants* (ACCA), *Law Society* (LS), *Law Society of Scotland* (LSA). See U.K., H.L. Select Committee on Economic Affairs, *The Finance Bill 2006 Volume 1: Report*, HL 204-I, 6th Report of Session 2005-06 (23 June 2006) [H.L., *Finance Bill 2006*], paragraphs 15-26.

64 U.K., HM Revenue & Customs, Regulatory Impact Assessment, *Tackling Tax Avoidance – Disclosure Requirements* (April 2004) [HMRC, *RIA 2004*], paragraph 4; HMRC, *RIA 2006*, *supra* note 26, paragraph 14.

has contributed to a notable decrease in the number of aggressive tax planning schemes carried out by taxpayers.[65]

Various groups of stakeholders may acknowledge the need to attribute powers to the tax administration to ensure the effectiveness of the disclosure rules. These powers allow it to collect in real time more information on aggressive schemes rather than waiting for taxpayers to file their tax returns before formulating information requests.[66] The main challenge is to enable it to exercise these powers strictly regarding advisers who do not comply with the rules and to obtain only the necessary information.[67]

4.2 The tax administration has collected a large volume of information returns on notifiable arrangements which led to the enacting of anti-avoidance rules

As Table 4.1 on the following page shows, the tax administration has collected almost eight hundred information returns filed by reporting advisers and taxpayers under the disclosure rules.

Under the disclosure rules, the tax administration assesses the compliance of disclosed arrangements with the tax law more quickly and, if need be, can adopt anti-avoidance rules.[68] Since 2004, it has adopted a number of anti-avoidance rules thanks to the disclosure rules.[69] According to data it has published, it has adopted rules to cancel 350 schemes among the 900 identified, i.e. approximately 40% of these arrangements. In particular, it adopted an anti-

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65 HMRC, *RIA 2006*, *ibid*. See also HMRC, *In-house tax departments*, *supra* note 19, pages 21, 39 and 47.

66 See HMRC, *Ensuring Compliance with TAD*, *supra* note 49 in *Appendix A,* paragraphs 10, 15 and 18.

67 See U.K., HM Revenue & Customs, *Summary of Responses: Consultation document ensuring compliance with the tax avoidance disclosure regime*, London, Her Majesty's Stationery Office, 27 March 2007 [HMRC, *Responses on ensuring compliance*], online: HMRC Website <http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_027306>.

68 HMRC, *RIA 2006*, *supra* note 26, paragraph 15.

69 For information relating to the anti-avoidance rules developed by the tax administration in light of information collected under the disclosure rules, see U.K., HM Treasury, *Budget 2007: Budget Notes*, London, Her Majesty's Stationery Office, 21 March 2007 [HM Treasury, *Budget Notes 2007*], BN09, BN12 and BN33; U.K., HM Treasury, *Budget 2006: Budget Notes*, London, Her Majesty's Stationery Office, 22 March 2006 [HM Treasury, *Budget Notes 2006*], BN 18 and BN 27 as well as U.K., HM Treasury, 2005 Pre-Budget Report Press Notices PN03, "Protecting Tax Revenues" (5 December 2005) [HM Treasury, *PN03 2005*]; U.K., Inland Revenue, *Budget 2005: Inland Revenue Budget Notes*, London, Her Majesty's Stationery Office, 16 March 2005 [Inland Revenue, *Budget Notes 2005*], REV 20 and REV 22 and U.K., HM Treasury, 2004 Pre-Budget Report Press Notices PN 3, "Protecting Tax Revenues" (2 December 2004) [HM Treasury, *PN 3 2004*].

avoidance rule three weeks after the disclosure of an arrangement on dividend stripping. According to its estimates, this rule enabled it to collect almost £1 billion in income tax that taxpayers would otherwise have avoided.[70] However, our reading leads us to believe that the tax administration's reaction time is measured in months rather than weeks. The effectiveness of the disclosure regime must then be assessed simultaneously with the effectiveness of anti-avoidance rules. These rules are covered in subsection 4.12.

TABLE 4.1
NUMBER OF INFORMATION RETURNS FILED UNDER THE DISCLOSURE RULES SINCE THE REGIME CAME INTO EFFECT ON 1 AUGUST 2004, UNTIL 30 SEPTEMBER 2007, REGARDING INCOME TAX AND CAPITAL GAINS
PROVISIONAL FIGURES

	TOTAL	REGIME IN FORCE FROM 1 AUGUST 2004 TO 31 JULY 2006		REGIME IN FORCE SINCE 1 AUGUST 2006
		DIRECT TAX (EMPLOYMENT)	DIRECT TAX (FINANCIAL INSTRUMENTS)	DIRECT TAX (TARGETED ARRANGEMENTS)
NUMBER	867	198	463	206
ACCOUNTANTS AND FINANCIAL INSTITUTIONS*	N/A	N/A	381	N/A
LAWYERS AND IN-HOUSE ADVISERS*	N/A	N/A	26	N/A
OTHERS*	N/A	N/A	29	N/A

Source: *: The breakdown of filers is only available to 31 March 2006 and only for the "Direct tax – Financial instruments" category: see Regulatory Impact Assessment, *The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 (SI 2006/1543), The Tax Avoidance Schemes (Information) (Amendment) Regulations 2006 (SI 2006/1544)* (12 June 2006), Annex D. Consequently, the total of the returns filed according to breakdowns by category of advisers is less than the total number of information returns filed for that category of arrangements. Authors' adaptation of the table produced by HM Revenue & Custom, Disclosure Statistics (data gathered by the authors 1 November 2007).

4.3 Taxpayers and their advisers lean towards individualized arrangements tailored to the business structure of taxpayers since the rules came into force

The tax administration has noted a change in the behaviour of taxpayers and advisers regarding aggressive tax planning since the implementation of the disclosure rules. Taxpayers and tax advisers tend towards tax planning arrangements designed specifically for a taxpayer, tailored to his particular situation, compared to standardized arrangements applicable to any taxpayer.[71]

70 See NAO, *Management of Business Corporation Tax*, *supra* note 18, paragraphs 2.28 and 2.29.
71 *Ibid.* at paragraph 2.30.

In addition, corporations are seeking to minimize their tax liability by adjusting their business model (for instance, by establishing a company abroad as a stable establishment rather than a subsidiary) instead of changing their ongoing operations.[72]

4.4 Rules based on the presence and relative importance of a tax advantage in an arrangement resemble a general anti-avoidance rule

By observing the three levels of criteria of the disclosure rules and the administrative guidance, we note that the tax administration advocates an approach similar to a general anti-avoidance rule. The first two levels seek to determine the presence of a tax advantage in an arrangement and if such advantage is its main or one of its main advantages. At the third level, certain prescribed arrangements must be disclosed if their features differ from arrangements carried out according to prevailing business standards on the open market, in light of the economic consequences of the arrangements on the taxpayers' affairs.

We are of the view that under such an approach, the tax administration can identify arrangements with avoidance risks in a flexible manner. A comparison at the third level of an arrangement with others carried out according to business standards on the open market can in principle establish a fair demarcation between legitimate arrangements and avoidance schemes. However, without more specific criteria, groups of stakeholders may have differing opinions on the application of these three levels, as will be shown in subsections 4.5 and 4.6.

We note the disclosure rules lack the criterion of abuse of the objects of the tax law. Measuring the importance of the tax advantage implies in our view a comparison between the taxpayer's arrangement and an arrangement that complies both with applicable business standards and with the objects of the tax law, according to the facts and circumstances. Using the latter criterion would mitigate the compliance burden of taxpayers and advisers who carry out arrangements that do not undermine those objects. However, groups of stakeholders may have difficulty discerning them, which increases differences of opinion on the characteristics of the comparative arrangement.[73] Since the purpose of the disclosure rules is not to withdraw the tax

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[72] See HMRC, *In-house tax departments*, *supra* note 19, pages 19-21.

[73] See Bond et al., "Tax Avoidance", *supra* note 3.

advantages of disclosed arrangements but to collect information in order to withdraw those of avoidance schemes, making use of the criterion of abuse of the tax law runs the risk of adding complexity to the disclosure rules.

4.5 The lack of precise, objective criteria for identifying a tax advantage in an arrangement and measuring the importance of each advantage creates uncertainty

According to the disclosure rules, an arrangement carries an avoidance risk where its terms and conditions differ objectively from those of arrangements that would not have enabled taxpayers to obtain the tax advantage claimed.[74] Identifying a tax advantage and measuring the relative importance of the advantages present in an arrangement therefore imply a comparison of the arrangement with an alternative one.

The disclosure rules describe in general terms how to measure the relative importance of the the taxpayer's purposes in an arrangement. According to HMRC, the relative importance of the tax advantage in an arrangement must be measured objectively by comparing its value with that of any other advantage for the taxpayer in the arrangement. An objective measure of the importance of the tax advantages in an arrangement mitigates differences of opinion among groups of stakeholders as to the application of disclosure rules and increases their effectiveness. However, if they are not sufficiently precise, groups of stakeholders may hold differing views on the importance of the tax advantages in an arrangement compared with that of any other advantage.

However, because of the generality of the criteria used, we are of the view that the importance of the various advantages in an arrangement could, in the taxpayer's view, be determined subjectively according to his intentions. In his view, his arrangements are designed mainly to obtain commercial advantages, the tax advantages being but incidental to the arrangements. He might then be of the view that he need not file information returns under the disclosure rules. The application of these rules then depends on the taxpayer's statements as to the importance he places on the various purposes of an arrangement. We believe that a subjective measure of

74 HMRC, *Disclosure Guidance*, *supra* note 35, pages 19-20.

the importance of the tax advantages according to the taxpayer's intentions limits the effectiveness of the disclosure rules.

One way to make this comparison would be to compare the compliance level of the taxpayer's arrangement with applicable business standards according to the facts and circumstances of the arrangement. Comparing an arrangement with an arrangement that complies with business standards makes it possible to detect the presence of a tax advantage in the arrangement. Despite these parameters, groups of stakeholders will have differing views on the quantitative value of the non-tax advantages for a taxpayer in an arrangement, such as the value of economies of scale for a company in the course of a corporate restructuring. We believe that the tax administration must define more detailed parameters on how to measure the relative value of the various advantages in an arrangement, as for prescribed arrangements as we shall see below in subsection 4.6.

4.6 The simultaneous use of direct and indirect objective indicators helps identify a large number of arrangements regardless of avoidance risks

Groups of stakeholders may have differing views on the status of an arrangement under the disclosure rules because of the lack of clarity of the indicators that define prescribed arrangements. These indicators target aggressive schemes either on the basis of the nature of the relationship between taxpayers and advisers that participate in them (indirect approach), or on the basis of the specific features of these schemes (direct approach).

4.6.1 Indirect approach

The tax administration has taken an indirect approach to identify so-called innovative arrangements given the difficulties in defining them.[75] Arrangements based on confidentiality and on premiums based on the value of the tax benefits depend on the intention of advisers and taxpayers to replicate or implement them. The subjective nature of these criteria makes them difficult to apply. In addition, these criteria can also become obsolete because of the constantly changing business dealings between advisers and taxpayers, in particular regarding the form of

75 HMRC, *RIA 2006*, *supra* note 26, paragraph 27. See the brief description of confidential arrangements and arrangements with a complexity premium shown in Table 3.1 on page 13 above.

advisers' compensation.[76] By examining the advantages and disadvantages of this indirect approach, the tax administration concluded it was appropriate to maintain it — it was able to adopt specific anti-avoidance rules in light of information collected by virtue of these indicators — while making the changes considered necessary.[77] It considered it necessary to complete the indirect approach with a direct one.

4.6.2 Direct approach

The tax administration has adopted objective indicators that more directly define arrangements with an avoidance risk. This risk is determined according to the degree to which the arrangements comply with business standards of arrangements in the open market, considering the economic impact on the participating taxpayers. For an illustration of the approach advocated by the tax administration in this regard, the reader is referred to box 4.1 on page 31.

The business standards criteria lay out a fair and sufficiently predictable distinction between legitimate business arrangements and avoidance schemes. However, their general nature of these criteria allows for a range of interpretations of an arrangement's compliance with them. They may reflect the features of a business arrangement between two parties not exempt from tax and at arm's length, each having a commercial interest in the arrangement and assuming the inherent economic risks. Accordingly, the general nature of these criteria could force advisers and taxpayers to disclose arrangements with only minimal avoidance risks.

Under the prescribed criteria, certain prescribed arrangements must be studied from the standpoint of an informed observer who has knowledge of the tax law. Such persons can reasonably have different views on the application of disclosure rules in the absence of clearer criteria. In the tax administration's view, an informed observer in the tax law is defined as a person with knowledge of the law and who expresses his opinion impartially. It is of the view that such a person need not be a tax adviser, but may be a Special Commissioner. Paradoxically, the Special Commissioners make up the administrative tribunal that handles complex tax questions such as avoidance.[78]

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76 *Ibid*. paragraphs 17-25 and 34-37.
77 *Ibid.*
78 HMRC, *Disclosure Guidance*, *supra* note 35, pages 38 and 40.

Beyond mere knowledge of tax laws, an arrangement's compliance with business standards must be assessed by a person with an appropriate level of expertise in the business or economic field. The box on page 31 illustrates the hallmarks of prescribed arrangements pursuant to which an economic assessment of the terms of an arrangement must be conducted in light of common arm's length business arrangements. Taxpayers and the tax administration may find it difficult to establish the terms of arrangements entered into on the open market. The weight attributable to the claims of taxpayers and of the tax administration as to the compliance of an arrangement with these standards then depends on the context of the arrangement and the expert evidence supporting their claims.[79]

[79] *Weald Leasing Limited and Commissioners for HM Revenue & Customs* (6 February 2007), Decision 20003 (VAT and Duties Tribunal) [*Weald*], especially points 135-136, 148-152 and 171, illustrates the problems for the tax administration in establishing such evidence in tax matters. The decision is available online: Finance and Tax Tribunals Website <http://www.financeandtaxtribunals.gov.uk/aspx/view.aspx?id=3005>. The tax administration has appealed this decision: U.K., HM Revenue & Customs, Revenue & Customs Brief 39/07, "Weald Leasing Limited" (8 May 2007), online: HMRC Website <http://www.hmrc.gov.uk/briefs/vat/brief3907.htm>. The hearing is scheduled for the period from 27 to 30 November 2007. See U.K., HM Revenue & Customs, *VAT Appeals Updates* (update to 27 June 2007), online: HMRC Website <http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_TribunalReports&propertyType=document&columns=1&id=HMCE_PROD1_024644>.

BOX 4.1

RISKS OF TAX AVOIDANCE BASED ON INCONSISTENCIES BETWEEN THE TERMS AND CONDITIONS OF AN ARRANGEMENT AND THOSE OF ARRANGEMENTS ENTERED INTO ON THE OPEN MARKET

As the terms and conditions of certain prescribed arrangements illustrate, the tax administration is of the view that an arrangement carries a tax avoidance risk if its terms and conditions differ from those of an arrangement on the open market, especially where the taxpayer does not bear his share of the risk in the arrangement. The category of arrangements using innovative financial instruments, the category covering arrangements centred on loss deductibility in computing income and the category focusing on the deductibility of equipment leasing expenses illustrate this approach.

In the case of arrangements using innovative financial instruments, the instruments used must be compared with conventional instruments traded on the open market. In the tax administration's view, advisers and taxpayers should disclose an arrangement where the terms of a financial instrument (including its value) that is used differ significantly from those of a similar instrument in the open market.[80] They must then disclose an arrangement where a covered financial instrument alters the relation between the cost of obtaining the tax advantage and the amount of such advantage. They must then disclose an arrangement where a prescribed financial instrument significantly reduces the cost a taxpayer must assume to claim a tax advantage. The taxpayer's use of a conventional loan to acquire property in the course of an arrangement could trigger the application of the disclosure rules if the loan alters the economic assessment of the arrangement as a whole.[81]

In the case of arrangements that allows for the deduction of losses in computing income, the tax administration is of the view that the main advantage in an arrangement resides in deducting such losses where, according to an analysis by an informed observer who knows the tax law, the value of the tax relief exceeds the economic risk the taxpayer bears in the arrangement.[82]

Concerning arrangements bearing on the deductibility of equipment leasing expenses, the parameters specify that the cost must be assessed assuming that an owner of equipment unencumbered of any charge sells the equipment on the open market. In the tax administration's view, the presence of a contracting party who is not within the charge to corporate tax and the lack of financial risk for the lessor if the lessee defaults on its payments could reveal the existence of a tax avoidance scheme.

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[80] HMRC, *Disclosure Guidance*, *supra* note 35, page 34.

[81] *Ibid.* pages 33-34.

[82] *Ibid.* pages 39-40.

4.7 A disclosure period of five days seems unreasonable

In the view of tax advisers, a disclosure period of five days seems unreasonable because of the difficulties in collecting the required information in such a short time. Professional organizations had informed the tax administration that this period is incompatible with the dynamic of business relations between advisers and their clients. Some proposed that the period be not less than 30 days, i.e. the period within which the tax administration must issue a registration number to reporting advisers.[83] However, the tax administration did not agree with this proposal.[84] We feel that five days is unduly short, especially when advisers are allowed 10 or 14 days to comply with an additional information request or a court order. The compliance duties of reporting taxpayers and advisers and the objectives of the disclosure rules could be reconciled in a flexible way by allowing the tax administration to extend the deadline according to circumstances.

Both the tax administration and professional organizations recognize that disclosure by taxpayers of in-house schemes within 30 days rather than at the time of filing their tax return is reasonable and consistent with the objective of the disclosure rules. In light of the returns filed and the observations made by enterprises, large corporations are generally the ones that carry out innovative arrangements covered by the disclosure rules and that have an appropriate knowledge of the arrangements to file a return within that deadline.[85]

Apart from discussions over disclosure deadlines, disagreements can arise as to the day from which the filing deadline runs, either the time when a reporting adviser solicits a taxpayer or the date when a taxpayer implements a notifiable arrangement.

83 H.L., *Finance Bill 2004*, *supra* note 21, paragraphs 38-39.

84 U.K., H.L. Select Committee on Economic Affairs, *The Finance Bill 2005 Volume 1: Report*, HL 13-I, 1st Report of Session 2005-06 (4 July 2005) [HL, *Finance Bill 2005*], paragraphs 1-21 and 58. The House of Lords Committee on Economic Affairs had shown some interest in examining this proposal in greater detail, but did not follow up.

85 HMRC, *RIA 2006*, *supra* note 26, paragraphs 26-27 and 39.

4.8 Penalty thresholds must take into account that the rules might apply to advisers acting in good faith

The risk of incurring a monetary penalty may prompt advisers to comply with the disclosure rules. The penalties appear low compared with the fees of tax advisers or the tax advantages of taxpayers.

The tax administration is of the view that penalties are not the ideal way to resolve differences of opinion on the requirement to disclose an arrangement.[86] High penalty thresholds are undesirable since advisers seeking to comply with the disclosure rules could be subject to them while they would have a minimal deterrent effect on those who do not comply or refuse to comply with them.[87] However, where advisers do not comply with a court order, high penalty thresholds reinforce the disclosure rules in proportion to their objectives.[88]

In principle, the tax administration will not ask for penalties if an adviser or a taxpayer relies on its guidelines or made a reasonable judgment in determining whether they had to disclose an arrangement.[89]

4.9 Judicial review of the tax administration's application of the disclosure rules can prevent abuse

In the tax administration's view, while the majority of tax advisers comply with the disclosure rules, an appreciable number do not. It has identified more than a hundred entities that, in its view, should have filed information returns. Some of these were of the view that the arrangements did not have to be disclosed.[90] Following an audit of a taxpayer's affairs, the tax administration could be of the view that an adviser or the taxpayer should have disclosed a notifiable arrangement.[91]

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86 HMRC, *Ensuring Compliance with TAD*, *supra* note 49, paragraph 3.7.
87 *Ibid.,* paragraph 4.2.
88 We refer the reader to sub-section 3.5 for further details on the structure of the penalties.
89 HMRC, *Disclosure Guidance*, *supra* note 35, pages 73-74.
90 See HMRC, *Ensuring Compliance with TAD*, *supra* note 49 especially paragraphs 3.2 to 3.7, which describe the situation regarding compliance with the disclosure rules by tax advisers.
91 HMRC, *Disclosure Guidance, supra* note 35, page 13.

According to the tax administration (HMRC), advisers who develop fiscally advantageous arrangements fully understand their scope such that the predominance of tax advantages would be obvious to taxpayers who subscribe to them.[92] Advisers and taxpayers may hold different views than the tax administration concerning whether the disclosure rules apply to an arrangement.[93] Advisers may conclude that an arrangement need not be disclosed because, in their view, the rules are ambiguous. Taxpayers are not necessarily in a position to grasp the nuances of their advisers' opinions concerning an arrangement's compliance with the tax law.

The disclosure rules do not provide for a "preventive" reporting mechanism for advisers in cases of uncertainty concerning their application to a given arrangement. The tax administration must check whether aggressive advisers identified via information from other persons have failed to comply with the rules. To prevent any abuse of power by the tax administration, it may seems fair to require it to first use the tools available to it and submit sufficient evidence to a Special Commissioner before an adviser be ordered to file information.[94] However where the court hears a petition with the adviser and the tax administration in attendance, there may be a risk that the latter learns information that goes beyond what is necessary for the purposes of the rules.[95]

4.10 Uncertainty regarding the simultaneous application of disclosure rules and the confidentiality privileges of taxpayers

Taxpayers and the tax administration may engage in litigation over the reconciliation between the disclosure rules and legal professional privilege. According to tax administration figures to March 31, 2007, accountants and financial institutions have filed 381 returns regarding arrangements using financial instruments compared with 26 returns by in-house advisers and lawyers.[96] The tax administration has not extended legal professional privilege regarding disclosure to other categories of advisers. However, taxpayers could raise it where these other advisers work with lawyers to develop and carry out a notifiable arrangement.

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92 *Ibid.* page 20.
93 HMRC, *RIA 2006*, *supra* note 26, paragraphs 21-23.
94 See HMRC, *Responses on ensuring compliance*, *supra* note 67, paragraphs 20-22.
95 *Ibid.* paragraphs 25-28.
96 See Table 4.1, sub-section 4.2.

To reconcile legal professional privilege with the disclosure rules, the tax administration generally imposes the duty of disclosure on the laywer's clients rather than on the lawyers themselves.[97] However, the client could claim legal professional privilege when facing the potential application of the disclosure rules since this privilege belongs to him. He could refuse to file information with the tax administration on the ground that the information contained in his lawyer's tax opinion is protected by this privilege.

It remains to be seen how the courts will reconcile legal professional privilege with the disclosure rules. The parameters developed by the courts in other legal fields could remove the ambiguity of the disclosure rules on the issue of legal professional privilege. In *Three Rivers District Council,*[98] the House of Lords underscored the importance of establishing the context of legal professional privilege in the United Kingdom. Unless the law stipulates an exception, the courts will maintain legal professional privilege under the following principles:

- The privilege arises from a relation of trust between the client and the lawyer.
- The client's privilege in the United Kingdom is absolute. He alone can waive this privilege, unless the law explicitly stipulates an exception to this privilege.
- Unlike in Canada, the courts in the United Kingdom cannot withdraw this privilege in the name of public interest.
- Legal professional privilege is particularly important to allow clients to legitimately organize their affairs confidentially faced with increasingly complex laws and manage their risks with full knowledge of the facts.

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97 The rules as initially proposed did not provide an exception for cases where legal professional privilege could be raised. This compromise was reached further to the representations of the Law Society of England and Wales to the tax administration. According to the Law Society, under legal professional privilege, lawyers should generally not disclose the advice they provide to their clients even though such advise can be seen as prescribed information under the disclosure rules: see Law Society of England and Wales, *Guidance on Tax Avoidance Disclosure Requirements under Part 7 of the Finance Act 2004, (First published on 20 September 2004, amended 5 November 2004)* [Law Society, *Guidance on TAD Disclosure*], pages 3-4.

98 *Three Rivers District Council* v. *Governor and Company of the Bank of England*, [2004] UKHL 48, bearing on the application of legal professional privilege in the course of an investigation into the liability of the Bank of England in its duty of supervision of a bank that declared bankruptcy in the United Kingdom.

The following quotes from Lord Scott's decision in *Three Rivers* succinctly illustrate the importance of this privilege in the United Kingdom:

> 25. […] if a communication or document qualifies for legal professional privilege, the privilege is absolute. It cannot be overridden by some supposedly greater public interest. It can be waived by the person, the client, entitled to it and it can be overridden by statute (c/f R (Morgan Grenfell Ltd) v Special Commissioner of Income Tax [2003] 1 AC 563), but it is otherwise absolute. There is no balancing exercise that has to be carried out (see B v Auckland District Law Society [2003] 2 AC 736 paras.46 to 54). The Supreme Court of Canada has held that legal professional privilege although of great importance is not absolute and can be set aside if a sufficiently compelling public interest for doing so, such as public safety, can be shown (see Jones v Smith [1999] 1 SCR 455). But no other common law jurisdiction has, so far as I am aware, developed the law of privilege in this way. *Certainly in this country legal professional privilege, if it is attracted by a particular communication between lawyer and client or attaches to a particular document, cannot be set aside on the ground that some other higher public interest requires that to be done.*
>
> *26.* […] *legal advice privilege gives the person entitled to it the right to decline to disclose or to allow to be disclosed the confidential communication or document in question.* […]
>
> 28. So I must now come to policy. Why is it that the law has afforded this special privilege to communications between lawyers and their clients that it has denied to all other confidential communications? […] In relation to all these other confidential communications the law requires the public interest in the preservation of confidences and the private interest of the parties in maintaining the confidentiality of their communications to be balanced against the administration of justice reasons for requiring disclosure of the confidential material. There is a strong public interest that in criminal cases the innocent should be acquitted and the guilty convicted, that in civil cases the claimant should succeed if he is entitled to do so and should fail if he is not, that every trial should be a fair trial and that to provide the best chance of these desiderata being achieved all relevant material should be available to be taken into account. These are the administration of justice reasons to be placed in the balance. They will usually prevail. […]
>
> 33. I would refer finally to the justification for legal professional privilege given by Advocate-General Slynn (as he then was) in A M & S Europe Ltd v European Commission [1983] QB 878 at 913, a passage cited by Kirby J in Daniels Corp v ACCC [2002] 192 ALR 561. The Advocate-General said this - "[The privilege] springs essentially from the basic need of a man in a civilised society to be able to turn to his lawyer for advice and help, and if proceedings begin, for representation; it springs no less from the advantages to a society which evolves complex law reaching into all the business affairs of persons, real and legal, that they should be able to know what they can do under the law, what is forbidden, where they must tread circumspectly, where they run risks.
>
> 34. […] in the complex world in which we live there are a multitude of reasons why individuals, whether humble or powerful, or corporations, whether large or small, may need to seek the advice or assistance of lawyers in connection with their affairs; they recognise that the seeking and giving of this advice so that the clients may achieve an orderly arrangement of their affairs is strongly in the public interest; they recognise that in order for the advice to bring about that desirable result it is essential that the full and complete facts are placed before the lawyers who are to

> give it; and they recognise that unless the clients can be assured that what they tell their lawyers will not be disclosed by the lawyers without their (the clients') consent, there will be cases in which the requisite candour will be absent. It is obviously true that in very many cases clients would have no inhibitions in providing their lawyers with all the facts and information the lawyers might need whether or not there were the absolute assurance of non-disclosure that the present law of privilege provides. But the dicta to which I have referred all have in common the idea that it is necessary in our society, *a society in which the restraining and controlling framework is built upon a belief in the rule of law, that communications between clients and lawyers, whereby the clients are hoping for the assistance of the lawyers' legal skills in the management of their (the clients') affairs, should be secure against the possibility of any scrutiny from others, whether the police, the executive, business competitors, inquisitive busy-bodies or anyone else* […]
>
> [our extracts and italics]

According to the general principles developed by the courts regarding legal professional privilege, a taxpayer would seek to invoke it both regarding his adviser's tax opinion and the information contained in his tax return. However, such information must have been provided as part of a relation covered by legal professional privilege. If the information the taxpayer knows of does not stem from discussions covered by this privilege, the tax administration and the courts could conclude that the client must produce the information relating to the facts and structure of the arrangement.[99]

4.11 Concerns about compliance costs associated with disclosure rules, particularly because of their continual adjustment

The likelihood of the tax administration continually adjusting the disclosure rules raises concerns for advisers and taxpayers about tax compliance's costs. These concerns stem chiefly from vague and varied criteria used in the disclosure rules and the continual changes to these rules as the tax administration sees fit.

The tax administration will update the disclosure rules to collect information in real time regarding as many arrangements with tax avoidance risks as possible because it is impossible

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99 For an opinion on the application of the principles to emerge from *Three Rivers* in the context of disclosure rules, see Phillip Baker, "Legal professional privilege & tax avoidance disclosure" *Tax Adviser* (January 2005) 11. See also Sarah Falk and Sean Jeffrey, "Privilege and the Disclosure Regime" *The Tax Journal* (Monday, 8 November 2004) 5, concerning the duties of taxpayers and tax advisers under the disclosure rules.

to define the many forms they take.[100] In principle, it will target only those with higher avoidance risks so as not to add to the compliance burden of taxpayers as a whole. In light of discussions with professional organizations, it recently changed the scope of certain prescribed arrangements in order to target only those with the highest avoidance and minimize administrative requirements for taxpayers.[101]

According to the tax administration, the higher compliance cost for advisers and taxpayers is justified and proportionate to the results obtained to date to fill the tax gap.[102] It will set a reliable measure of the disclosure rules' compliance costs to assess the proportionality between the costs borne by advisers and taxpayers and the objectives of these rules.[103] According to an assessment done by external auditors mandated by the tax administration, the costs that taxpayers bear to satisfy their administrative requirements in taxation are higher for large companies. That may be attributable to the fact that large companies are involved in more arrangements and are more likely to be involved in arrangements covered by the disclosure rules.[104] Nevertheless, advisers and taxpayers who carry out arrangements with low avoidance risk must still comply with the disclosure rules for them to achieve their objective.[105]

The tax administration and professional organizations acknowledge the need to exclude, in general, individuals and small and medium-size enterprises from the disclosure rules. They are not subject to these rules if they formulate and implement an arrangement strictly for their own use. However, the tax administration is of the view that a limited number of small and medium-size enterprises are involved in notifiable arrangements without advisers.[106]

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100 Otherwise, the most aggressive advisers would alter their approach and offer taxpayers an innovative arrangement not subject to the disclosure rules. See HMRC, *RIA 2006*, *supra* note 26, paragraphs 17-22.

101 *Ibid.* paragraph 27.

102 H.L., *Finance Bill 2006*, *supra* note 63, paragraph 24.

103 HMRC, *RIA 2006*, *supra* note 26, paragraphs 58-63.

104 KPMG LLP and HMRC, *Administrative Burden – HMRC Measurement Project*, Volume II-Report by Tax Area (20 March 2006) [KPMG and HMRC, *Administrative Burden*], chapter 25 "Tax Management Provisions", page 10.

105 H.L., *Finance Bill 2006*, *supra* note 63, paragraphs 15-26.

106 HMRC, *RIA 2006*, *supra* note 26, paragraphs 50-52 and 68-70.

4.12 Concerns of taxpayers and advisers about the proliferation and the scope of anti-avoidance rules stemming from disclosure rules

As we pointed out in subsection 4.1, the tax administration assesses in real time the compliance of arrangements disclosed pursuant to the disclosure rules. Through these rules, it can quickly enact anti-avoidance rules and collect additional tax revenues. The efficiency of the disclosure regime must therefore be assessed alongside the efficiency of the anti-avoidance rules.

The tax administration uses these anti-avoidance rules to stymie abusive avoidance arrangements without hampering common business arrangements. The disclosure rules allow the tax administration to change the anti-avoidance rules to more clearly and fairly separate these two categories of arrangements.[107] It can also adjust the anti-avoidance rules to withdraw the tax advantages flowing from new arrangements outside their scope.[108]

An exhaustive analysis of those anti-avoidance rules lies beyond the scope of this study. However, we can make observations on some of them.

Anti-avoidance rules take the form either of a specific rule (hereunder "specific rule") or a targeted rule (hereunder "targeted rule"). Appendices 2 and 3 illustrate the details and limits of a specific rule and a targeted rule respectively. Subject to the differences noted in the following paragraphs, these rules are based on the principle that taxpayers cannot claim tax advantages flowing from arrangements whose main purpose or one of the main purposes is of a tax nature. In the tax administration's view, taxpayers can generally claim the tax advantages flowing from arrangements designed to achieve genuine business purposes and in which they bear a real economic risk.[109]

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[107] See the tax administration's reasons behind the changes made to an anti-avoidance rule in HM Treasury, *Budget Notes 2007*, *supra* note 69 in BN33 *Life insurance Companies: Financing Arrangements*.

[108] See the rule proposed by HM Treasury in HM Treasury, *Budget Notes 2007*, *ibid.* in BN12 *Sale of Lessor Companies Anti-Avoidance* and adopted in *FA 2007*, *supra* note 48, section 31 and in *Schedule 6*, section 2. See also the rule adopted by the tax administration in *Finance Act 2006* (U.K.), 2006, c. 25 [*FA 2006*], section 82 and in *Schedule 10*, section 38.

[109] See section 27 of the *FA 2007*, *supra* note 48 and HM Treasury, *Budget Notes 2007*, *ibid.* in BN30 *Capital Gains Tax: A Targeted Anti-avoidance Rule*. See also U.K., HM Revenue and Customs, *HMRC Guidance-Avoidance through the creation and use of capital losses* (21 March 2007) [HMRC, *Guidance on Avoidance and Capital Losses*] as well as U.K., HM Revenue and Customs, *HMRC Guidance-Avoidance through the creation and use of capital losses* (19 July 2007) [HMRC, *Guidance on Avoidance and Capital Losses (July 2007)*].

4.12.1 Targeted rule

A targeted rule withdraws the tax advantages flowing from arrangements whose tax result would be contrary to one or more objectives of the tax law. The tax administration has enacted targeted rules regarding any arrangement that, in whatever form, hampers the objectives of the tax law regarding capital gains taxation. Essentially, these objectives are:

- A taxpayer may deduct, in calculating his income, amounts on account of capital losses only to the extent that, following a real disposition of an asset, he suffers a genuine financial loss.
- A taxpayer may deduct, in calculating his income, only the capital losses he suffered and only against capital gains he has realized, subject to exceptions explicitly stipulated by the tax law.
- A taxpayer may deduct his capital losses only against his capital gains, and not against income profits.[110]

Targeted rules are designed to withdraw the tax advantages flowing from any arrangements that hamper any of the above objectives. The tax administration has adopted such rules notably to withdraw tax advantages flowing from any type of arrangement creating a so-called artificial capital loss;[111] arrangements enabling companies to acquire capital gains or losses from other companies;[112] or arrangements converting an amount otherwise taxable on income account into a capital gain to enable companies to utilize their capital losses.[113]

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[110] See U.K., HM Revenue & Customs, *HMRC Statement: Avoidance through the creation and use of capital losses by companies* (5 December 2005) [HMRC, *Statement on Avoidance and Capital Losses*], paragraphs 10-11. As part of a study of tax departments of multinational companies in the United Kingdom, it has been noted that the adoption of anti-avoidance rules together with the formulation of the objects of the tax law in the explanatory documents accompanying the rules contributed to reducing the incentive for companies to carry out aggressive tax planning arrangements: see HMRC, *In-house tax departments*, *supra* note 19, page 21.

[111] See HM Treasury, *Budget Notes 2007*, *supra* note 69 in BN30 *Capital Gains Tax: A Targeted Anti-Avoidance Rule* and section 27 *FA 2007*, *supra* note 48.

[112] See HMRC, *Statement on Avoidance and Capital Losses*, *supra* note 110 and section 70 *FA 2006*, *supra* note 108.

[113] HMRC, *Statement on Avoidance and Capital Losses, ibid.*, and section 71 *FA 2006*, *ibid*.

However, these rules apply based on the importance of the taxpayer's purposes rather than according to the objectives of the tax rules. According to the tax administration, a rule formulated this way strikes a balance in a flexible manner between legitimate arrangements and tax avoidance ones, while withdrawing the tax advantages flowing from arrangements unknown to it.[114] In its view, rules that apply based on the weight of the taxpayer's purposes can replace or complete specific rules whose application can be avoided.[115] Still, the tax administration has had to amend certain rules to include arrangements that capitalized on an exception[116] or to extend their application to taxpayers not initially covered by them.[117]

A targeted rule based on relative weight of the purposes of an arrangement carries the risk that the tax administration will withdraw the tax advantages claimed by a taxpayer flow from a common business arrangement, such as the taxpayer's mere shares disposition on the open market to realize a capital loss following a decline in the value of the shares.[118] Because of the vagueness of targeted rules, professional organizations have informed the tax administration of the risks that common business arrangements might be targeted by them.[119]

According to the tax administration, a selective application of targeted rules solely to abusive arrangements minimizes the latter possibility.[120] It intends to apply these rules only if taxpayers

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114 See the statement of HM Revenue & Customs concerning a targeted rule on the deductibility of management expenses in calculating business income in U.K., HM Revenue & Customs, *Guidance on the New Management Expenses Anti-Avoidance Provision*, London, Her Majesty's Stationery Office, 20 July 2007 [HMRC, *Guidance on Avoidance and Management Expenses*].

115 See the opinion expressed by HM Treasury on targeted rules regarding capital gains and losses in HM Treasury, *PN03 2005*, *supra* note 69 under the heading "Corporate Tax Loss", as well as the one expressed by HM Revenue & Customs in HMRC, *Statement on Avoidance and Capital Losses*, *supra* note 110, paragraphs 17-27.

116 The tax administration changed a targeted rule concerning the use of capital losses since taxpayers carried out arrangements to capitalize on an exception stipulated in the rule: see HM Treasury, *Budget Notes 2007*, *supra* note 69 in BN09 *Corporate Capital Loss and Gain Buying*.

117 In 2007, the tax administration extended to all taxpayers subject to capital gains tax, a targeted rule aimed only at business corporations when it was adopted in 2006. See HM Treasury, *Budget Notes 2007*, *ibid.* in BN30 *Capital Gains Tax: A Targeted Anti-Avoidance Rule*, as well as U.K., HM Treasury, 2006 Pre-Budget Report Press Notices PN03, "Ensuring Fairness for All Taxpayers" (6 December 2006) [HM Treasury, *PN03 2006*].

118 See the observations of the *Chartered Institute of Taxation* regarding examples in the guidelines of the tax administration where it expresses the opinion that a targeted rule does not apply, in *Draft TAAR – Comments of the Chartered Institute of Taxation* (9 February 2007), online: CIOT Website <http://www.tax.org.uk/attach.pl/5250/5456/CGTlossesTAAR%20final090207.pdf>. See also HMRC, *Guidance on Avoidance and Capital Losses (July 2007), supra* note 109, paragraphs 38-39.

119 See U.K., HM Revenue & Customs, *Summary of Responses: A Targeted Anti-Avoidance Rule for CGT- draft legislation and guidance issued 6 December 2006* (21 March 2007) [HMRC, *Responses to a TAAR for CGT*].

120 *Ibid.* paragraph 15.

carry out a tax avoidance arrangement deliberately and knowingly.[121] In its view, the publication of guidelines allows taxpayers to make more informed choices.[122] In these guidelines, it uses various indicators that, assessed globally, would lead to the application of a targeted rule. These indicators include:

- the nature of the business purpose of the taxpayer and any other participant in the arrangement;
- the complexity of the arrangement compared with other arrangements that would have enabled the taxpayer to achieve a business purpose more easily and with a smaller tax advantage;
- the details of the arrangement compared with an arrangement between arm's length parties or an arrangement with no tax advantage; as well as
- the economic substance of the arrangements.[123]

In our view, these guidelines do not completely remove uncertainties from targeted rules. In some cases, its interpretation of the rules seems at odds with their terms. The courts could apply targeted rules by assessing taxpayers' purposes both subjectively and objectively, while the tax administration advocates an objective assessment of these purposes. Paradoxically, it could apply targeted rules based on the taxpayer's intentional or deliberate actions to obtain a tax advantage where the tax rules' formulation cannot sustain the advantage.[124]

Taxpayers and tax advisers are of the view that the extended scope of a tax rule should be restricted by an amendment to the law rather than by guidelines formulated by those responsible for its enforcement.[125] For these groups of stakeholders, the extended scope of a targeted rule makes it more unpredictable, especially if the tax administration applies criteria

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121 See HMRC, *Guidance on Avoidance and Capital Losses (July 2007)*, *supra* note 109, paragraph 5.

122 See HMRC, *Responses to a TAAR for CGT, supra* note 119, paragraph 16.

123 See HMRC, *Guidance on Avoidance and Capital Losses (July 2007)*, *supra* note 109, paragraphs 16-20; HMRC, *Guidance on Avoidance and Management Expenses*, *supra* note 114.

124 See the observations of the Chartered Institute of Taxation on a targeted rule in *Draft TAAR – Comments of the Chartered Institute of Taxation* (9 February 2007) [CIOT, *Draft TAAR (9 February 2007)*], online: CIOT Website <http://www.tax.org.uk/attach.pl/5250/5456/CGTlossesTAAR%20final090207.pdf>. See also its observations regarding guidelines published by the tax administration in *Targeted Anti-Avoidance Rule (TAAR) for Capital Losses Comments of the Chartered Institute of Taxation* (1 June 2007), online: CIOT Website <http://www.tax.org.uk/attach.pl/5585/5942/CGTandTAAR%20final010607.pdf>.

125 *Ibid.*

that are not explicitly found in the rule and if the courts apply criteria other than those mentioned in the law or in the guidelines.[126]

The possibility for taxpayers and tax advisers to obtain confirmation from the tax administration that a rule does not apply regarding an arrangement they are contemplating would improve predictability. However, the tax administration does not issue advance rulings regarding arrangements with an avoidance risk. At best, it might issue technical interpretations to clarify the terms of the targeted rules to remove any genuine uncertainty.[127]

In view of the nebulous distinction made by targeted rules between legitimate arrangements and tax avoidance ones, the Chartered Institute of Taxation has proposed that a targeted rule apply if the tax result of an arrangement undermines the objectives of the tax law and if the arrangement is not a genuine business arrangement.[128] This proposal is somewhat similar to the general anti-avoidance rule in Canada.

4.12.2 Specific rule

A specific rule withdraws the tax advantages flowing from an arrangement that, according to the tax administration's, undermines the objects of the tax law and the characteristics of which are clearly identified in the rule.[129] Taxpayers and tax advisers can conceive new arrangements whose features differ from those prescribed by a specific rule. The tax administration must then adopt a specific rule for each new arrangement it identifies. Many years can elapse between the enactment by the tax administration of a specific rule blocking an arrangement and the enactment of additional rules to block each of its variations.[130]

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126 See HMRC, *Guidance on Avoidance and Capital Losses (July 2007)*, *supra* note 109, paragraphs 1-6, 10-17.

127 *Ibid.* at paragraph 25.

128 See CIOT, *Draft TAAR (9 February 2007)*, *supra* note 124, paragraphs 8.1 to 8.3.

129 See the specific anti-avoidance rules proposed by the tax administration each of which applying to separate arrangements and implying various forms of financial instruments in HM Treasury, *Budget Notes 2006*, *supra* note 69 in BN 18 *Protecting Revenues: Financial Products*, and adopted in *FA 2006*, *supra* note 108, section 76 and in *Schedule 6*.

130 For instance, see the changes proposed by the tax administration to various specific rules as announced in U.K., HM Treasury, *Meeting the aspirations of the British People*, 2007 Pre-Budget Report and Comprehensive Spending Review, London, Her Majesty's Stationery Office, October 2007 [HM Treasury, PBR 2007], paragraphs 5.95. For further technical details, see U.K., HM Revenue & Customs, *2007 Pre-Budget Report and Comprehensive Spending Review: Pre-Budget Report Notes*, London, Her Majesty's Stationery Office, 9 October 2007 [HMRC, PBRN 2007], PBRN 06 "Leased Plant and Machinery: Anti-Avoidance" and PBRN 09 "Tackling Avoidance: Corporation Tax: Disguised Interest".

Given the impossible task of specifically defining all types of avoidance, the tax administration could announce that a specific rule will come into force with retroactive effect to the date when it declared its intention to cancel each avoidance arrangement it identifies.[131] The Treasury Committee of the House of Commons has raised uncertainty issues for taxpayers and tax advisers where the tax administration declares that it will withdraw as of the day of such a declaration, the tax advantages of arrangements it knows of at that time, but also of arrangements as yet unknown as well as potential novel arrangements. This type of strategy of the tax administration is counter to the principle of predictability in the application of the tax rules.[132]

The tax administration could adopt a specific rule that inadvertently withdraws the tax advantages flowing from common business transactions. Many years can elapse before the tax administration becomes aware of the unfortunate consequences of a rule on taxpayers carrying out legitimate arrangements. In all fairness, the tax administration must then amend the rule with retroactive effect to allow the tax advantages to any taxpayer who carried out a legitimate arrangement since the rule came into force.[133]

4.12.3 To reconcile simplicity and integrity, the tax administration has changed the tax rules and adopted a preamble so that the rules apply based on the economic substance and accounting treatment of arrangements

In 2007, the UK tax administration changed the rules applicable to sale and repurchase agreements (known as repos) to ensure that the law applies according to their economic substance and accounting treatment. In its view, various tax planning arrangements were able

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131 See HMRC, *Disclosure Guidance*, *supra* note 35, paragraph 2.2. See a declaration by the tax administration on aggressive tax planning arrangements for avoiding payment of tax and national insurance contributions in HM Treasury, *Budget 2005*, *supra* note 4, paragraph 5.99: "The Government is determined to ensure all employers and employees pay the proper amount of tax and national insurance contributions (NICs). Budget 2005 reiterates the Government's intention, announced alongside the 2004 Pre-Budget Report, to close down the ever more complex and contrived attempts at tax and NICs avoidance. Should further arrangements emerge that frustrate this intention, the Government will legislate to close them down where necessary from 2 December 2004."

132 See U.K., H.C. Treasury Committee, *The 2004 Pre-Budget Report*, HC 138, First Report of Session 2004-05 (27 January 2005) [H.C., *2004 PBR*], paragraphs 89-93; H.L., *Finance Bill 2006*, *supra* note 63, paragraphs 27-45.

133 For instance, see the changes contemplated by the tax administration for various specific rules applicable to the sale of equipment leasing companies, as announced in HM Treasury, PBR 2007, *supra* note 130, paragraph 5.83. For further details, see HMRC, PBRN 2007, *supra* note 130 in PBRN 5 "Sale of Lessors: Companies in Partnership"; U.K., HM Revenue & Customs, *Technical Note Sale of Lessors – Companies in Partnership*, London, Her Majesty's Stationery Office, October 2007.

to capitalize abusively on the tax rules over the years. It considered it appropriate to simplify the rules while protecting the tax system's integrity. Below are extracts from tax administration documents concerning these changes:

> The current legislation […] is intended to tax repos in accordance with their economic and accounting substance as financing transactions, but has been exploited in recent years in a number of arrangements involving tax avoidance.
>
> The new rules will introduce a simpler accounts-based regime where profits and losses made by companies from their repo transactions will be taken directly from entries in accounts prepared under generally accepted accounting practice […].[134]

In this regard, the tax administration took the unusual step of adopting a preamble to the rules applicable to these arrangements. According to the explanatory notes to the bill, the preamble states the objects of the tax rules pertaining to repo arrangements. It states that the tax rules apply to the parties to these arrangements in accordance with their economic substance and accounting treatment.

> Paragraph 1 is a relatively unusual provision in a UK tax statute. It sets out the purpose of the Schedule, which is that arrangements involving the sale and subsequent purchase of securities that equate in substance to the lending of money by or to a company (with the securities in substance acting as collateral) are to be taxed in accordance with their economic substance and accounting treatment[135].
>
> [our extracts]

Appendix 4 illustrates the details and limits of this preamble. The preamble is followed by a series of tax rules defining the parameters of repo arrangements as well as the tax rules. The preamble notwithstanding, the tax administration adopted anti-avoidance rules to counter arrangements that would enable taxpayers to earn non-taxable income. Like the tax rules on stock lending mechanisms, the tax administration also extends the scope of the rules relating to repo arrangements to arrangements that are similar to them (quasi-repos).

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[134] U.K., HM Treasury, *Budget 2007: Budget Notes*, London, Her Majesty's Stationery Office, April 2007 [HM Treasury, BN 2007], under BN15 "Sale and Repurchase Agreements ("Repos")", paragraphs 4 and 5.

[135] U.K., HM Treasury, Explanatory Note, *Finance Bill 2007*, London, Her Majesty's Stationery Office [HM Treasury, *Finance Bill 2007 Explanatory Note*] under "Clause 46 and Schedules 13 & 14: Sale and Repurchase of Securities", paragraph 21.

5

Conclusion

Taxpayers, their advisers and the tax administration are generally of the view that the disclosure rules have achieved a reasonable balance between their respective duties and privileges. The rules have a deterrent effect on aggressive advisers and taxpayers while enabling the tax administration to identify tax avoidance schemes in real time. Since the tax administration advocates adopting specific anti-avoidance rules, the disclosure rules allow it to improve its risk management. Nonetheless, we note that the United Kingdom favours a comprehensive approach focusing on general avoidance indicators or on taxation principles to define tax avoidance schemes and subsequently adopt more detailed criteria according to the nature of each of them. Such a strategy is close to that underlying a general anti-avoidance rule.

The three criteria levels of the disclosure rules have the advantage of setting a flexible and predictable distinction between common arrangements and tax avoidance schemes on the basis of an objective comparison of the taxpayer's arrangement with an arrangement that satisfies business standards. However, groups of stakeholder may hold differing views on the application of these levels in the absence of detailed parameters, differences that may become more acute with the continuous adaptation of the rules. Since the tax administration must collect a large volume of information on all arrangements with an avoidance risk, including those that at the end of the day are legitimate arrangements, it must use this tool fairly to avoid undermining its effectiveness in the long run.

In this context, the Chair is of the view that penalty thresholds for non-compliance with the rules should not be excessive. We are also of the view that the courts must ensure that the tax administration does not abusively apply the disclosure rules. Sustained cooperation of the tax administration with professional organizations would help lay out a more precise distinction between legitimate and abusive arrangements and would avoid penalizing tax advisers and taxpayers who comply with the disclosure rules.

The adoption by the tax administration of a variety of anti-avoidance rules illustrates the usefulness of disclosure rules. Besides the number of anti-avoidance rules, their efficiency lies in the tax administration's capacity to set a fair distinction between legitimate and abusive arrangements. It seeks to set it using specific and targeted rules that apply according to the relative weight of the taxpayer's purposes in an arrangement. Such rules create a risk that each group of stakeholders sets out an arbitrary distinction between a tax avoidance scheme and a legitimate arrangement.

To improve their predictability, anti-avoidance rules should be based on objective criteria focusing on the economic substance of arrangements. Like disclosure rules, an objective comparison of the details of the taxpayer's arrangement with those of an arrangement on the open market would attenuate any arbitrary application of the anti-avoidance rules. To foster uniformity, the tax administration should clearly define these criteria in the law rather than leaving the entire burden of overcoming uncertainty to its tax agents through technical interpretations, and the courts through rulings that primarily settle a dispute according to the circumstances of each arrangement.

The use of separate criteria for the purposes of anti-avoidance rules and of disclosure rules makes the tax system more complex. That may be justified because each set of rules has different objectives. On the one hand, using objective criteria for the purposes of disclosure rules allows advisers to know exactly what information they must disclose. On the other, using the relative weight of the taxpayer's purposes in anti-avoidance rules helps maintain the required flexibility in their application according to the specific circumstances specific of each arrangement. Nonetheless, the tax administration should seek to reduce mismatches between disclosure rules and anti-avoidance rules. The tax system could be simplified if the anti-avoidance rules were based on objective criteria focusing on economic substance, as mentioned in the preceding paragraph.

While the tax administration seeks to define arrangements that undermine the objects of the tax law, neither the disclosure rules nor the anti-avoidance rules are based on such criterion. The uncertainty over disclosure rules and the resulting proliferation of anti-avoidance rules, especially in view of the possibility that the latter can apply retroactively, have revived the debate in the United Kingdom over whether it would be worthwhile to adopt a general anti-avoidance rule.[136] A proposal formulated by the Chartered Institute of Taxation eloquently demonstrates the usefulness of a general anti-avoidance rule based on the objects of the tax law in order to reconcile, as much as possible, the principles of simplicity and integrity of the tax system.

Adopting a general rule based on compliance with the objects of the tax law would improve the predictability and uniformity of its enforcement by all stakeholders. The objects of the tax law are not always clear because of the multiplicity of overlapping rules that do not express them consistently over time. While complex, a consistent formulation of taxation principles would alleviate uncertainty over the nature of tax avoidance arrangements. We reproduce quotes from the Green Budget 2006 published by the Institute for Fiscal Studies that express the idea that specific anti-avoidance rules as well as disclosure rules help protect the integrity of the tax system, but make it more complex and undermine the competitiveness of the British tax system in the long run.

> *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. […] 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.*
>
> […]
>
> 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 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* […] However, *a more satisfactory approach to dealing with tax avoidance issues would require a more fundamental overhaul of tax policy* than has been on

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[136] H.L., *Finance Bill 2006*, *supra* note 63, paragraphs 60-65 and 215. See also CIOT, *Draft TAAR (9 February 2007)*, *supra* note 124.

> 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.[137]
>
> [our extracts and italics]

During our study, we have noted that British tax administration's strategy regarding aggressive tax planning tends towards adopting tools in each of its spheres of intervention. In addition to anti-avoidance rules and disclosure rules, it has stated its tax litigation strategy. Furthermore, the tax administration has changed the penalty regime for under-stating tax payable to reconcile the principles of fairness and integrity of the tax system.[138] The risks for taxpayers of being audited and assessed a penalty for under-stating tax payable may dissuade them from carrying out arrangements strictly for tax planning purposes. The law still needs to make a clearer and more permanent distinction between legitimate arrangements and those entered into for tax avoidance.

Beyond the vicissitudes of disclosure rules and anti-avoidance rules, we believe that the British experience shows the usefulness of a general anti-avoidance rule to permanently protect the integrity of the tax system while ensuring predictability, flexibility and consistency. However, in the view of the Tax Reform Commission, adopting such a rule comes after a simplification of British tax rules and implies the implementation of an advance ruling regime.[139] With a general rule and an advance ruling regime already in place, simplification of the tax rules is an initiative that not only the United Kingdom, but also Canada must take to reduce the possibilities of tax avoidance.

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137 Bond et al., "Tax Avoidance", *supra* note 3, pages 176-179.

138 This system frames the power of the tax administration to apply penalties by setting penalty rates that vary with the compliance level with the tax system shown by the taxpayer. See section 97 and *Schedule 24* of *FA 2007*, *supra* note 48; John Whiting and Mark Howard, "Does The Punishment Fit the Crime" *Tax Adviser* (July 2007) 16.

139 Tax Reform Commission, *Tax Matters Reforming the Tax System*, London, The Tax Reform Commission, 19 October 2006, pages 92-93. This commission was set up in the fall of 2005 by the Shadow Chancellor of the Exchequer (the Official Opposition's critic for economic affairs) to identify possible solutions to simplify the tax system, make it fairer and more competitive.

Appendix 1

Role of Special Commissioners in Tax Disputes

Briefly, a taxpayer can appeal a notice of assessment or certain decisions made by the tax administration to an administrative tribunal consisting of General Commissioners and Special Commissioners. In a large number of cases, the Special Commissioners and the General Commissioners can hear taxpayers' appeals. However, the Special Commissioners have exclusive jurisdiction for specified cases.

According to information available on the Website of the Special Commissioners, up to date as at 4 January 2007, 27 Special Commissioners were on active duty (site visited 1 November 2007.) The Special Commissioners are paid officers of the court independent of the tax administration that is charged with enforcing the tax laws (HM Revenue & Customs). According to the General Commissioners' Website, up to date as of 15 December 2005 (site visited 1 November 2007), the Special Commissioners have exclusive jurisdiction mainly in cases involving complex tax issues such as:

- Estimating the value of shares or British securities not quoted on an exchange for the purposes of calculating capital gains tax.
- Transfer of property offshore.
- Attribution to a company resident in the United Kingdom of income from affiliated foreign companies.
- Assessing the value of transactions involving oil companies and, in particular, tax avoidance issues in arrangements involving securities.[140]

[140] For more details on the role and operation of this administrative tribunal, see U.K., Tribunal Services, *Tax Appeals: A guide to appealing against decisions of Her Majesty's Revenue and Customs on income tax and other direct tax matters*, London, DCA Corporate Communications, July 2004 [Tribunal Services, *Tax Appeals Guide*]; U.K., Department for Constitutional Affairs, *Special Commissioners: Appeals and Other Proceedings Before the Special Commissioners*, Explanatory Leaflet, issued by the Presiding Special Commissioner, 3rd Edition, London, Department for Constitutional Affairs, 2003 [DCA, *Special Commissioners*]; U.K., Department for Constitutional Affairs, *Transforming Public Services Complaints, Redress & Tribunals: White Paper presented to Parliament by the Secretary of State for Constitutional Affairs and Lord Chancellor*, London, Her Majesty's Stationery Office, July 2004, pages 46-47.

On 19 July 2007, the United Kingdom enacted a law to simplify the administration of its judicial system and improve access to it for all citizens.[141] Briefly, most existing courts will be brought within a system consisting of a First-tier Tribunal and an Upper Tribunal that will operate impartially under a procedure code. In general, the First-tier Tribunal is the trial court and the Upper Tribunal, the appeal court. The Special Commissioners are on the list of courts whose functions may be transferred to either of these levels. Each level may consist of specialized chambers according to the field of expertise of the existing tribunals. It is likely that the functions of the Special Commissioners will be transferred to either of these levels and may form a specialized chamber. The transfer is to take place by April 2009.[142]

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141 *Tribunals, Courts and Enforcement Act 2007* (U.K.), 2007, c. 15. This statute will be fully operational once all its sections enter into force successively.

142 The Ministry of Justice will hold consultations in the Fall of 2007 to hear the views of stakeholders on the advisability of creating and structuring specialized chambers. See U.K., Ministry of Justice, *Tribunal, Courts and Enforcement Bill Detailed Policy Statement on Delegated Powers*, London, Her Majesty's Stationery Office, May 2007, page 6, as well as U.K., HM Revenue & Customs, *HM Revenue & Customs and the Taxpayer: Tax Appeals against decisions made by HMRC*, *Consultation Document*, London, Her Majesty's Stationery Office, October 2007, paragraphs 1.4-1.6, 3.6-3.7 and 6.1.

Appendix 2

Illustration of the Terms and Conditions and Limits of Specific Anti-Avoidance Rules: Stock Lending Arrangements

A specific rule withdraws the tax advantages gained by a taxpayer if one of his main purposes is to obtain these advantages and if the arrangements satisfy prescribed characteristics. A rule determines the terms and conditions of payments made or deemed made by the parties to an arrangement, the nature of the property traded, the amount that must be included or that taxpayers can deduct in calculating their income as well as the timing of such inclusion or deduction. However, aggressive tax planning has taken various forms over the years to sidestep each specific rule adopted by the tax administration.

To illustrate, the British tax administration has adopted many specific rules since 1991, including sections 736B, 736C and 736D of the *Income and Corporation Taxes Act 1988,*[143] to withdraw tax advantages flowing from various forms of avoidance arrangements using a stock lending mechanism. We are of the view that these rules provide a good illustration of the limits of specific anti-avoidance rules. However, an exhaustive analysis of these rules lies beyond the scope of this study, in view of their complexity and the fact that they form part of a personal and corporate tax system that is constantly changing in the United Kingdom. At best, this appendix seeks to highlight some of their major features strictly for the purpose of this instalment, based on the laws adopted by the British tax administration and the interpretation documents it has published.

As part of a stock lending arrangement, the borrower undertakes to deliver to a person on a given date and for a specified price, a quantity of securities that it does not own. To fulfil its obligation to such person, the borrower will supply him with securities that he has borrowed from a lender. The borrower provides the lender with collateral consisting of other securities (or other property, including a sum of money) which value is at least equal to that of the borrowed

143 *Income and Corporation Taxes Act 1988* (U.K.), 1988, c. 1 [*ICTA 1988*].

securities. The borrower then acquires securities identical to those borrowed in order to remit them to the lender when the loan matures.

The borrower uses such a mechanism, in particular, as part of a short sale. The borrower expects the price of the securities to decline between the short sale's date and the loan's maturing date. If that's the case, he earns a profit corresponding to the difference between the price of the short sale and the cost of the securities acquired to satisfy his obligation to the lender. During the loan:

- The issuer of the securities will pay the borrower the interest and dividends paid on them, and the latter must in turn remit them to the lender as compensation.
- As a corollary, the lender will receive the interest and dividends paid on the securities provided as collateral, but he must remit them to the borrower as compensation.

Section 736A *ICTA 1988* sets the main rules applicable to the amounts paid and received by the borrower and the lender.[144] These rules apply both to the loan of securities between the borrower and the lender and to the securities provided as collateral by the borrower to the lender – this latter transaction itself being a stock lending mechanism.

Briefly, the borrower must:

- Include in calculating his income:
    - The dividends and interest paid on the borrowed securities.[145]
    - The compensatory payments made by the lender corresponding to the amount paid on the securities provided as collateral, on account of dividends or interest depending on the nature of the amount thus paid.[146]

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144 For an overview of the tax consequences for the borrower and the lender, see U.K., Inland Revenue, *Manufactured Dividends on UK Equities*, Guidance Notes, London, Her Majesty's Stationery Office, April 2001, pages 13-14, as well as U.K., Inland Revenue, *Manufactured Interest on UK Equities*, Guidance Notes, London, Her Majesty's Stationery Office, April 2001, pages 12-13, in addition to the HMRC tax manuals, online: HMRC Website<http://www.hmrc.gov.uk/manuals/index.htm>.

145 Briefly, individuals and companies must include these amounts under the general tax rules concerning interest and dividends of the *Income Tax (Trading and Other Income) Act 2005* (U.K.), c. 5 [*ITTOI 2005*] or the *ICTA 1988*. Section 84 *Finance Act 1996* (U.K.), 1996, c. 8 [*FA 1996*] and subparagraph 15(4A) *Schedule 9* of that Act specify that a company that borrows securities must include the interest paid on such securities during the loan in the calculation of its profits: see U.K., HM Treasury, *Finance Bill 2002 Amendments and New Clauses*, London, Her Majesty's Stationery Office, 2007, online: HM Treasury Website <http://www.hm-treasury.gov.uk/consultations_and_legislation/finance_bill_2002/ consult_finance_amend144.cfm>.

146 For the compensatory payments on account of interest paid by companies, see sections 84 and 97 *FA 1996* as well as subparagraph 15(4A) *Schedule 9* of that Act. For payments made on account of dividends, see sections 208 and 736A *ICTA 1988* and subparagraphs 2(1) and (2) *Schedule 23A* of that Act: a company that lends

 − The capital gain he makes from the sale of the loaned securities.[147].

- Deduct in calculating his income, the compensatory payment he makes to the lender in compensation for dividends and interest paid on the borrowed securities.[148]

The lender must:

- Include in calculating his income:
  - The dividends and interest paid on the securities provided by the borrower as collateral.
  - The compensatory payments made by the borrower corresponding to the amount paid by the issuer of the loaned securities on account of dividends or interest, depending on the nature of the amount thus paid.
- Deduct in calculating his income, the compensatory payment he makes to the borrower in compensation for dividends and interest paid on the securities provided as collateral.

Taxpayers have taken advantage of the stock lending rules to carry out tax avoidance schemes. Over the years, the tax administration has adopted a series of specific rules to block them one at a time, including sections 736B, 736C and 736D *ICTA 1988*.

In the arrangement targeted by section 736B *ICTA 1988,*[149] neither the borrower nor the lender previously had to include dividend or interest income in calculating their income contrary to the usual terms and conditions of a loan mechanism. The borrower borrowed securities from the lender and provided other securities as collateral, without having to pay the lender the interest or dividends paid on the borrowed securities. The lender did not have to pay the borrower the interest or dividends from the securities provided as collateral. The tax administration adopted this rule in 1997, and changed it in 2000, to have the compensatory payments included

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shares of a company to another company does not have to pay tax on the latter's payment to it as compensation for dividends paid on the loaned shares, if each of the companies resides in the United Kingdom.

147 See sections 1, 2, 8 and 263B *Taxation of Chargeable Gains Act 1992* (U.K.), 1992, c. 12 [*TCGA 1992*] and U.K., HM Revenue & Customs, *CRM17085 – Stock Loans: Capital gains – disposal of borrowed shares*, Corporate Finance Manual, London, Her Majesty's Stationery Office, 2007, online: HMRC Website <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM17085.htm>.

148 Briefly, individuals can deduct a compensatory payment up to the portion of the payment they include in calculating their income: see sections 574 and 579 *Income Tax Act 2007* (U.K.), 2007, c. 3 [*ITA 2007*], as well as section 736A *ICTA 1988* and paragraphs 2A and 3 *Schedule 23A* of the latter Act. Companies can deduct a compensatory payment made on account of interest against any amount included in their loan relationships account: see sections 83, 84 and 97 *FA 1996* as well as section 736A *ICTA 1988* and paragraph 3 *Schedule 23A* of the latter Act. However, they cannot deduct a compensatory payment on account of dividends paid on shares of British companies: see sections 337A and 736A *ICTA 1988* as well as subparagraph 2(2) *Schedule 23A* of that Act.

149 For individuals, see section 596 *ITA 2007*.

respectively in the calculation of the income of the lender or the borrower resident in the United Kingdom:

- The borrower must include in calculating his income an amount deemed paid by the lender equal to the interest and dividends that would have been paid on the securities provided as collateral.
- The lender must include in calculating his income an amount deemed paid by the borrower corresponding to the interest and dividends that would have been paid on the borrowed securities were it not for the arrangement.
- Neither the lender nor the borrower may deduct the amount deemed paid in calculating their income.

However, this rule does not apply to an arrangement where the borrower provides the lender with a sum of money as collateral. In this arrangement, a borrower resident in the United Kingdom acquires, from a foreign lender, securities of a company resident in the United Kingdom and provides a sum of money as collateral. However, neither party need compensate the other during the loan for the return obtained on the securities or on the money provided as collateral. The amount of the dividend is calculated such that the borrower obtains a return similar to that obtained on a commercial interest-bearing deposit. Prior to 2006, the tax consequences of such a mechanism were as follows:

- The borrower was deemed to make a compensatory payment to the lender corresponding to the return obtained on the securities during the loan.
- Since the lender was a non-resident, no tax was payable to the United Kingdom on such amount deemed paid by the borrower.
- The borrower received non-taxable dividends on the securities.[150]
- The borrower did not have to include, in calculating his income, an amount on account of interest deemed paid on the amount provided as collateral.

Here is a practical illustration of this arrangement taken from the explanatory notes of the British tax administration:

> If a company has £100m cash to invest for 6 months, it could put the money on deposit and earn, say, £2.5m interest on which corporation tax at 30% would be £0.75m. Instead, the company decides to enter into a 6 month stock lending arrangement with a non-resident counterparty under which it borrows a basket of

[150] Article 208 *ICTA 1988*.

> UK equities to the value of £100m, and provides cash collateral of £100m. The UK equities have been selected so that they will pay dividends of £2.5m during the term of the arrangement, and there is no provision for the borrower to pay manufactured dividends to the lender or for the lender to pay interest on the £100m cash collateral to the borrower.
>
> At the end of the 6 months, the borrower returns the UK equities to the lender, who repays the £100m cash to the borrower. The economic effect is that the borrower has received interest on its £100m cash but in the form of UK dividends and it claims that those dividends are tax exempt (by virtue of section 208 ICTA 1988). Effectively, the borrower has "swapped" interest for an equivalent amount of UK dividends.
>
> Section 736B ICTA 1988 will apply to deem the borrower to pay £2.5m manufactured dividends to the lender, but that will have no effect because the lender is not UK resident (and no relief for the deemed payment is available to the borrower). But that section does not apply to deem interest on cash collateral to be paid to the borrower.[151]
>
> [our extracts]

Through the disclosure rules, the tax administration has identified mechanisms that have been designed to take advantage of this possibility. To block that sort of scheme, it adopted section 736C *ICTA 1988*[152] in 2006. This rule describes the terms and conditions of the arrangement, prescribes the tax consequences arising from the application of the rule and sets out the calculation of interest income the borrower must include in his income. Under this rule:

- The borrower must include in calculating his income an amount on account of interest income deemed paid by the lender on the amount of money provided as collateral.
- This amount is calculated using a reasonable interest rate comparable to a rate paid by financial institutions on deposits during the life of the mechanism.
- The lender cannot deduct this amount of interest deemed paid in calculating his income.

To define any arrangement that undermines the objects of these rules, regardless of form, the tax administration also adopted section 736D *ICTA 1988.*[153] This rule seeks to outline any arrangement structured to avoid the application of the rules mentioned above. Accordingly, the

[151] U.K., HM Revenue & Customs, Statements and Notices, *Financial Avoidance Using Stock Lending Arrangements* (5 December 2005), online: HMRC Website < http://www.hmrc.gov.uk/pbr2005/stock-lending.pdf>.

[152] For taxpayers other than corporations, see sections 597, 598 and 599 *ITA 2007*.

[153] For taxpayers other than corporations, see section 600 *ITA 2007*.

latter apply regarding any type of collateral offered by the borrower of the securities or any arrangement that can be seen as a stock lending arrangement.[154]

To illustrate the terms and conditions and limits of specific rules, we reproduce extracts from sections 736C and 736D *ICTA 1988* adopted by the tax administration in 2006 in light of information obtained through the disclosure rules.

[154] See U.K., HM Treasury, *Explanatory Notes Finance (No. 2) Bill 2006*, London, Her Majesty's Stationery Office, April 2006 [HM Treasury, *FA 2006 Explanatory* Notes], under *Clause 76 and Schedule 6,* paragraph 44.

736C Deemed interest: cash collateral under stock lending arrangements

(1) This section applies where—
- (a) the borrower under a stock lending arrangement is treated under section 736B(2) as paying under that arrangement an amount representative of interest on any securities ("the relevant securities"),
- (b) an amount of money ("cash collateral") is payable to or for the benefit of the lender for the purpose of securing the discharge of the requirement to transfer the relevant securities back to the lender,
- (c) the stock lending arrangement is designed to produce a return to the borrower which equates, in substance, to the return on an investment of money at interest, and
- (d) the main purpose, or one of the main purposes, of the stock lending arrangement is the obtaining of a tax advantage.

(2) Where this section applies—
- (a) the Tax Acts are to apply as if the borrower receives an amount of interest payable in respect of the cash collateral, and
- (b) the amount of the interest is calculated in accordance with the following provisions of this section (see, in particular, subsections (3) to (7)).

(3) The interest is treated for the purposes of the Tax Acts as if it were received on the date ("the return date") on which the borrower transfers the relevant securities back to the lender.

(4) The interest is treated for the purposes of the Tax Acts as if it were payable in respect of the period ("the interest period")—
- (a) beginning with the date on which the lender transfers the relevant securities to the borrower, and
- (b) ending with the return date.

(5) The rate of interest payable in respect of the cash collateral is a rate that is reasonably comparable to the rate that the borrower could obtain by placing the cash collateral on deposit for the interest period.

(6) For the purposes of this section, the amount of the cash collateral on which the interest is payable is taken to be—
- (a) in any case where the amount of the cash collateral varies at any time on or before the return date, the highest amount of the cash collateral at any time on or before the return date, and
- (b) in any other case, the amount of the cash collateral as at the return date.

(7) The amount of the interest which the borrower is treated as receiving in respect of the cash collateral for the interest period is reduced (but not below nil) by any interest which the borrower actually receives in respect of that collateral for that period.

[…]

(10) The fact that the borrower is treated as receiving an amount of interest is not to be taken as implying that the interest is payable by the lender or any other person.

[…]

(13) For the purposes of this section it does not matter—
- (a) whether the cash collateral is payable by the borrower or by any other person,
- (b) whether the cash collateral is payable under the stock lending arrangement or under any other arrangement,
- (c) whether collateral in another form is also provided in connection with the stock lending arrangement."

Source: Section 3 *Schedule 6 FA 2006*.

736D Quasi-stock lending arrangements and quasi-cash collateral

(1) In this section “quasi-stock lending arrangement” means so much of any arrangements between two or more persons as are not stock lending arrangements, but are arrangements under which—

(a) a person (“the lender”) transfers securities to another person (“the borrower”), and

(b) a requirement is imposed on a person to transfer any or all of the securities, or any other property, back to the lender or any other person, and it does not matter whether the person on whom that requirement is imposed is the borrower or any other person.

(2) In this section “quasi-cash collateral”, in relation to any stock lending arrangement or quasi-stock lending arrangement, means—

(a) any money which is payable for a relevant purpose, plus

(b) any other property which is transferable for a relevant purpose.

(3) Money or other property is payable or transferable for a relevant purpose if it is payable or transferable to or for the benefit of—

(a) the lender under the stock lending arrangement or quasistock lending arrangement, or

(b) a person connected with that lender, for the purpose of securing the discharge of the requirement to transfer any or all of the securities, or any other property, back to that lender or any other person.

(4) For the purposes of sections 736B and 736C, a quasi-stock lending arrangement is treated as if it were a stock lending arrangement.

(5) For the purposes of section 736C, in relation to any stock lending arrangement or quasi-stock lending arrangement,—

(a) quasi-cash collateral is treated as if it were cash collateral, and

(b) the amount of the quasi-cash collateral in relation to the stock lending arrangement or quasi-stock lending arrangement is taken to be the amount of the cash collateral.

(6) If any property other than money is transferable for a relevant purpose, the amount of the quasi-cash collateral so far as relating to that property is determined by reference to its market value.

(7) In any case where—

(a) section 736C applies in relation to a quasi-stock lending arrangement, and

(b) the person for whom the tax advantage was designed to be obtained is a person (“the other person”) other than the borrower under that arrangement, that section has effect as if the other person were the person who receives the amount of interest mentioned in that section.

(8) In any case where section 736C applies in relation to a quasi-stock lending arrangement—

(a) any reference in that section to cash collateral being payable to or for the benefit of the lender includes its being payable to or for the benefit of a person connected with the lender,

(b) the reference in subsection (1)(c) of that section to a return to the borrower includes a return to any other person, and

(c) any reference in that section to the transfer back of the relevant securities by the borrower to the lender includes the transfer back of any or all of the securities, or any other property, by any person to the lender or any other person.

(9) Section 839 (connected persons) applies for the purposes of this section.

(10) In this section—
“money” includes money expressed in a currency other than sterling,
“property” means property in any form,
“stock lending arrangement” and “securities” have the same meaning as in section 263B of the 1992 Act,
“transfer” means a transfer otherwise than by way of sale.”

Source: Section 3 *Schedule 6 FA 2006*.

Appendix 3

Illustration of the Terms and Limits of a Targeted Anti-Avoidance Rule

This appendix illustrates the specific features of targeted anti-avoidance rules. A targeted rule usually seeks to withdraw the tax advantages of arrangements one of the main purposes of it is to obtain these advantages. Unlike a specific rule, it does not describe any particular form of arrangement. Therefore, it is more flexible because it applies based on the circumstances of each arrangement. It is also timeless compared with a specific rule since it applies to any arrangement regardless of the form it takes over the years. As we pointed out in subsection 4.12.1, the tax administration must not unduly restrict the scope of a rule by applying it only to one category of taxpayers. It must also formulate the rule in such a way as to avoid a situation where an exception itself becomes the source of avoidance arrangements.

Sections 8 and 16A *TCGA 1992* represent targeted rules designed to withdraw a capital loss from taxpayers (corporations and individuals) arising from an arrangement whose main purpose or one of the main purposes is to obtain a tax advantage. The tax administration first amended section 8 *TCGA* to withdraw capital losses claimed by corporations flowing from such an arrangement. It then subsequently adopted section 16A*TCGA 1992* so that this rule applies equally to corporations and individuals – in so doing, this rule replaced the amendments made in 2006 to section 8 *TCGA 1992*.

The following extracts illustrate the main terms and conditions of these rules.

8 Company's total profits to include chargeable gains

(1) Subject to the provisions of this section and section 400 of the Taxes Act, the amount to be included in respect of chargeable gains in a company's total profits for any accounting period shall be the total amount of chargeable gains accruing to the company in the accounting period after deducting—

(a) any allowable losses accruing to the company in the period, and
(b) so far as they have not been allowed as a deduction from chargeable gains accruing in any previous accounting period, any allowable losses previously accruing to the company while it has been within the charge to corporation tax.

(2) For the purposes of corporation tax in respect of chargeable gains, "allowable loss" does not include –

(a) a loss accruing to a company in such circumstances that if a gain accrued the company would be exempt from corporation tax in respect of it, or
(b) a loss accruing to a company in disqualifying circumstances (see subsection (2A)).

(2A) For the purposes of subsection (2)(b), a loss accrues to a company in disqualifying circumstances if—

(a) it accrues to the company directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and
(b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.

(2B) For the purposes of subsection (2A)—

"arrangements" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable), and

"tax advantage" has the meaning given by section 184D.

(2C) For the purposes of subsection (2A) it does not matter—

(a) whether the loss accrues at a time when there are no chargeable gains from which it could otherwise have been deducted, or
(b) whether the tax advantage is secured for the company or for any other company.

Source: 8 *TCGA 1992* as amended by 69 *FA 2006*.

16A Restrictions on allowable losses

(1) For the purposes of this Act, “allowable loss” does not include a loss accruing to a person if—

(a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and

(b) the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.

(2) For the purposes of subsection (1) —

“arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable), and

“tax advantage” means—

(a) relief or increased relief from tax,
(b) repayment or increased repayment of tax,
(c) the avoidance or reduction of a charge to tax or an assessment to tax, or
(d) the avoidance of a possible assessment to tax,
and for the purposes of this definition “tax” means capital gains tax, corporation tax or income tax.

(3) For the purposes of subsection (1) it does not matter—

(a) whether the loss accrues at a time when there are no chargeable gains from which it could otherwise have been deducted, or

(b) whether the tax advantage is secured for the person to whom the loss accrues or for any other person.”

[…]

(6) The amendments made by this section have effect in relation to losses accruing on disposals made on or after 6th December 2006.

Source: Section 27 *FA 2007*.

Appendix 4

Illustration of the Terms and Limits of a Preamble

In subsection 4.12.3, we pointed out that the British tax administration has changed the rules applicable to sale and repurchase agreement (repo) arrangements to ensure that the law applies to these arrangements according to their economic substance and their accounting treatment. The tax administration considered it was appropriate to simplify these rules while being sure to protect the integrity of the tax system, since taxpayers took advantage of the law to claim tax advantages considered abusive.

In this regard, the tax administration adopted a preamble that states the object underlying the tax rules that apply to repo arrangements. As stated in subsection 4.12.3, the tax administration seems to be of the view that this preamble will make it clear that these tax rules apply according to the economic substance of the arrangements and in accordance with their accounting treatment.

This preamble is followed by a series of tax rules defining the parameters of repo arrangements as well as their tax treatment. In addition to the preamble, the tax administration adopted anti-avoidance rules to counter arrangements that would enable taxpayers to earn non-taxable income. Like the tax rules that cover stock lending arrangements discussed in Appendix 2 above, the tax administration is also extending the scope of the rules relating to repo arrangements to similar arrangements (quasi-repos).

We reproduce below the preamble to the rules for repo arrangements, as well as the main sections following the preamble, with their respective titles and numbering only.

Schedule 13

Sale and repurchase of securities

Purpose of Schedule

1. (1) The purpose of this Schedule is to secure that in the case of an arrangement -

(a) which involves the sale of securities and the subsequent purchase of securities, and

(b) which equates, in substance, to a transaction for the lending of money at interest from or to a company (when the securities which were sold as collateral for the loan),

the charge to corporation tax in that case reflects the fact that the arrangement equates, in substance, to such a transaction. […]

Meaning of debtor repo

2. […]

Meaning of debtor quasi-repo

3. […]

Ignoring effect on borrower of sale of securities: debtor repos, debtor quasi-repos and other arrangements

4. […]

Relief for borrower for finance charges in respect of the advance: debtor repos and debtor quasi-repos

5. […]

Ignoring sale and subsequent purchase for purposes of chargeable gains: debtor repos

6. […]

Meaning of creditor repo

7. […]

Meaning of creditor quasi-repo

8. […]

Ignoring effect on lender of sale of securities: creditor repos and creditor quasi-repos

9. […]

Charge on lender for finance return in respect of the advance: creditor repos and creditor quasi-repos

10. […]

Ignoring purchase and subsequent sale for purposes of chargeable gains: creditor repos

11. […]

Repo under arrangement designed to produce quasi-interest: anti-avoidance

12. […]

Requirements to deduct tax from manufactured payments: creditor repos and debtor repos

13. […]

Interpretation

14. […]

Source: Section 47 and Schedule 13 *FA 2007*.

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