Analysis

Comparing US and UK anti-avoidance approaches

SPEED READ The US recently codified a judicial doctrine requiring taxpayers to satisfy an 'economic substance' standard in order to obtain the desired tax treatment of a transaction. The UK Government has also announced consideration of a general anti-abuse rule. Comparing the US and UK judicial approaches to tax-avoidance transactions may be useful in understanding these new rules. While UK courts have generally shied away from asserting a substance over form doctrine, instead relying on statutory construction principles to adjudicate tax effects, the US courts have been fairly liberal in developing various judicial doctrines to attack perceived tax abuse. Variants of some of these judicial doctrines appear in both countries.

Donald Korb is former Chief Counsel for the US Internal Revenue Service. He joined Sullivan & Cromwell as a Partner and the Head of the firm's tax controversy practice in January 2009. A practising attorney for over 35 years, he played a prominent role in increasing the effectiveness of the IRS during his time there. Email: korbd@sullcrom.com; tel: +1 202 956 7675.

Aditi Banerjee has a broad-based practice at Sullivan & Cromwell, involving general tax planning as well as transactional tax advice. She has been active in structuring and restructuring acquisitions, financial restructuring, and private equity and partnership work. She also has experience in tax controversy work. Email: banerjeea@sullcrom.com; tel: 020 7959 8437.

The US Congress recently codified what has been historically a judicially developed doctrine requiring a taxpayer to satisfy an 'economic substance' standard when determining whether the taxpayer is entitled to tax benefits from a particular transaction. The UK Government has also announced a proposed consultation on the possibility of introducing a statutory general anti-abuse rule for taxes. These two events are a striking development; traditionally, both countries have relied on the courts to appropriately interpret the statutory tax law in order to adjudicate the appropriate tax result. In light of these developments, a brief comparative exploration of the US and UK judicial approaches to tax-avoidance transactions may be useful, and the US experience with codification of the economic substance doctrine may be of particular interest to UK readers.

Prior to the enactment of new s 7701(*o*) … no unified definition of the economic substance test existed

The UK and the US: distinctive anti-avoidance doctrines

Westminster v Gregory: substance v form

The development of the UK and US anti-avoidance doctrines are rooted in two cases, one in 1935 in the US and the other in 1936 in the UK, which yielded diametrically opposite holdings and led to divergent judicial approaches to tax-avoidance transactions.

On the UK side, the House of Lords upheld in the *IRC v Duke of Westminster* [1936] AC 1 case, a scheme whereby the taxpayer covenanted to pay his employee £1 and 18 shillings per week for a period of seven years (regardless of whether he continued to be in the taxpayer's employ); the employee was legally entitled to a wage of £3 a week but was told that in practice he would only be expected to claim the balance of £1 and 2 shillings; and the taxpayer took the deduction for the payment under the covenant in computing his income for surtax. The House of Lords upheld the legal form of the transaction, notwithstanding the economic reality of the arrangement.

Thus, the seminal *Duke of Westminster* decision stood for the proposition that the form of a transaction that a taxpayer chose must be respected, and a court cannot look behind it for some underlying substance, so long as the taxpayer had successfully satisfied the legal requirements of the chosen form. The *Duke of Westminster* approach has come to be seen as taking a more literal approach to the applicable statutory language, rather than a 'purposive' approach focusing on the legislative intent behind the statute. This focus on formalism permeated UK case law until the landmark *Ramsay* decision decades later (discussed below), which took a 'composite transaction' approach. However, the underlying rationale of *Duke of Westminster* – that the legal rights and obligations incurred by a taxpayer must be respected – is still a core principle in UK tax law.

The judicial trajectory in the US has been quite different. The US judicial narrative on tax-avoidance transactions began with a seminal 1935 case: *Gregory v Helvering* (1935) 293 US 465. In that case, the taxpayer formed a new corporation and effected a corporate reorganization to transform what otherwise would have been a sale of stock followed by a dividend to a tax-free reorganisation followed by a sale of stock at the preferred capital gains rate. The court disregarded the corporate reorganisation and imposed the tax that would have otherwise applied.

The key holding from this decision is the following (293 US 465 at p 470): 'In these circumstances, the facts speak for themselves…The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.'

Several judicial doctrines aimed at cracking down on tax-avoidance transactions have emanated from this holding. The most prominent of these is the 'substance over form' doctrine, under which a court has the power to recharacterise a transaction in accordance with its true substance if such substance is demonstrably contrary to its outward form. Other doctrines, such as the 'business purpose' doctrine, the 'sham transaction' doctrine, the 'step transaction' doctrine, and the 'economic substance' doctrine have also emanated from *Gregory*, each with its own distinctive flavor and focus on different factors, but in essence, their unifying purpose and effect is to ascertain and give fiscal effect to the underlying reality of a transaction. As stated by one court, '[t]he terminology used, whether sham, profit motivation, or economic substance is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance . . .' *Long Term Capital Holdings v United States*, 330 F Supp 2d 122, 171 (D Conn 2004), aff'd, 150 Fed Appx 40 (2d Cir 2005).

From the starting point of *Gregory*, US courts in general have been quite confident in applying various of these doctrines, sometimes in combination, to peer under the legal form of a transaction to ascertain and discover the underlying 'substance' and tax the transaction accordingly. The Internal Revenue Service (IRS) has been, to a significant extent, successful in advancing these doctrines in order to shut down perceived tax-avoidance transactions. Elements of some of these doctrines have also appeared in UK case law, and some of the specific parallels and distinctions are described below.

Composite transactions / step transaction doctrine

In the landmark *Ramsay* decision in the UK, the House of Lords used a 'composite transaction' approach to conclude that in determining the tax treatment of a 'pre-ordained' series of transactions, any steps inserted merely to avoid tax could be disregarded and the transaction viewed and taxed as a whole (*WT Ramsay Ltd v IRC* [1982] AC 300). This approach was not introduced as a new principle of law, but rather as an approach that would 'apply to new and sophisticated legal devices the undoubted power and duty of the courts to determine their nature in law and to relate them to existing legislation.'

Following the decision of the House of Lords in *Barclays Mercantile Business Finance Limited v Mawson* [2004] UKHL 51, it is now clear that the *Ramsay* approach is not limited to the disregard of steps with no commercial purpose inserted into composite transactions. Rather it is an approach to statutory interpretation: 'The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically' (Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46, quoted with approval in *BMBF*).

That there are limits to the *Ramsay* approach can be illustrated by reference to certain cases in which the taxpayer has successfully resisted HMRC arguments that the approach should apply. An example is *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311 in which a struggling debtor borrowed additional capital from its creditor which it immediately paid back to the creditor as interest on the pre-existing loan. The House of Lords accepted that this was a 'payment' of interest for the purposes of the relevant statute so that a tax deduction was available, notwithstanding the circular nature of the payment and its tax avoidance purpose (see *BMBF* para 37).

In general, American courts apply the step transaction doctrine where taxing the individual steps would contravene the substance of the transaction or series of transactions taken as a whole. In the US, three different tests apply to determine whether transactions should be stepped together:

- The 'binding commitment' test, which requires, at the time the first step takes place, that the taxpayer be under a commitment to complete the remaining steps;
- The 'end result' test, which requires the steps to be part of a single scheme to achieve a single result; and
- The 'mutual interdependence test,' which requires the steps to be interdependent.

Which test applies sometimes depends on the nature of the transaction; for example, corporate transactions are often tested under the mutual interdependence test, and the binding commitment test is more commonly used when longer periods of time separate the steps.

Sham transactions

Both the US and the UK have variants of a 'sham transaction' doctrine.

In the UK, HMRC has had limited success in arguing sham transaction cases. The UK formulation of the sham transaction doctrine is also stricter than the US version. As set forth by the Court of Appeal in *Hitch v Stone* [2001] STC 214, in order to be treated as a sham transaction:

- The parties must have intended to create different rights and obligations from those appearing from the relevant documentation; and
- The parties must have intended to give a false impression of those rights and obligations to third parties.

Importantly, an act or an arrangement can lack business purpose or be artificial without constituting a sham.

In the US, a broader category of transactions fall into the purview of the sham transaction doctrine. While, in general, the sham transaction doctrine applies where a taxpayer has adopted a form that differs from the substance of the transaction and has presented false or incomplete facts about those transactions (see, eg, *Knetsch v Comr,* (1960) 364 US 361), the Court of Appeals for the Eleventh Circuit has adopted a broader definition: a transaction with the sole function of producing tax deductions is a sham regardless of the taxpayer's motives. (*Kirchman v Comr*, 862 F 2d 1486 (11th Cir 1989)). The absence of arm's-length terms may also indicate that a transaction is a sham. *United Parcel Services v Comr*, TC Memo 1999-268 (US Tax Ct 1999), rev'd 254 F 3d 1014 (11th Cir 2001). Some courts have also distinguished between 'shams in substance' (generally, transactions that lack economic substance) and 'shams in fact' (where the disputed transactions really never occurred or were only created on paper but never actually took place*).* See, eg, *Krumhorn v Comr*, (1994) 103 TC 29.

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Codification of the economic substance doctrine: US developments and potential application in the UK

Another judicial doctrine that has been applied with increasing frequency by the IRS and US courts is the 'economic substance doctrine.' What is the test for economic substance? Transactions have been recognised as having economic substance if (1) the transaction is rationally related to a useful nontax business purpose that is plausible in light of the taxpayer's conduct and economic situation, and (2) the transaction results in a meaningful and appreciable enhancement in the net economic position of the taxpayer (other than to reduce its tax). However, judicial formulations of the doctrine have varied among the US Circuit Courts of Appeal since they have differed in their application of the test: some courts require only one prong to be satisfied while others require both, and some consider the test to be exclusive while others combine it with other factors. Accordingly, prior to the enactment of new s 7701(o) of the Internal Revenue Code of 1986, as amended (the 'Code'), described below, no unified definition of the economic substance test existed.

Recent US developments: a harbinger for the UK?

In March 2010, the economic substance doctrine was specifically added to the Code (ie, codified by the US Congress). This development may be of significant interest to taxpayers and tax practitioners in the UK, because in the recent UK Budget, the Government has proposed consultation on the possible introduction of a general anti-avoidance rule. The form of any such rule may bear some parallels to the US statutory provision and give rise to similar issues and questions that have arisen in the US with respect to the codification of the economic substance doctrine. All the more so because, as we have seen, the UK may have further to travel.

Under new s 7701(*o*) of the Code, for a transaction (or series of transactions) with respect to which the economic substance doctrine is determined to be 'relevant,' the transaction will be treated as having economic substance only if:

- The transaction 'changes in a meaningful way' (apart from US federal income tax effects (including any state or local income tax effect)) the taxpayer's economic position; and
- The taxpayer has a 'substantial' purpose (apart from any US federal income tax effects (including any state or local income tax effect) or financial accounting benefits) for entering into such transaction (s 7701(*o*)(1), (3), (4) of the Code).

A special rule applies where the taxpayer relies on 'profit potential' in order to prove economic substance. Fees and other transaction expenses, as well as foreign taxes in certain situations, are to be treated as expenses in determining the pre-tax profit (s 7701(*o*)(2)(B) of the Code). Disqualification under the new statutory economic substance standard results not only in the denial of the contemplated tax benefits, but also in the imposition of a substantial strict liability penalty of up to 40% of the amount of the understatement attributed to the disallowance of the contemplated tax benefits.

One key question under the new provision is how to determine whether the economic substance doctrine is 'relevant.' The statute provides that the relevance of the doctrine is to be determined as if the statute had never been enacted – presumably, this means that the factors that would trigger the application of the economic substance doctrine under existing judicial law would trigger the application of the new statutory rules. Certain factors that have been indicated as pertinent in making this determination include:

- whether the transaction satisfies the terms of the Code and the Treasury Regulations;
- whether the benefits claimed are consistent with a Congressional purpose or plan; and
- whether any safe harbors (where the transaction has been respected under longstanding judicial and administrative practice) apply.

Other key issues and questions

The codification of the economic substance doctrine in the US has given rise to significant questions and concerns in the taxpayer and tax practitioner communities. To the extent the UK is considering the enactment of a similar rule, there are certain questions and concerns that need to be taken into consideration in order to make any such rule workable and effective. For example:

- What does being consistent with legislative purpose or plan mean? The language of the statute or the legislative history may not express the underlying policy or intent. Thus, in the face of ambiguity, legislative intent could be defined either too narrowly or too broadly.
- Are all tax benefits that are 'unintended' or unanticipated by the legislature to be deemed inconsistent with legislative intent and therefore subject to the economic substance doctrine?
- How will the new statute interact with and/or override prior case law?

The UK and the US are already co-operating and co-ordinating their approaches to tax-avoidance transactions through participation in multilateral institutions like JITSIC (the Joint International Tax Shelter Information Center) and, possibly in the near future, even through the conduct of joint audits. It is possible that this co-operation and co-ordination will expand into collaborating on new statutory and regulatory laws designed to prevent perceived tax abuses. To that end, a comparative analysis of US and UK approaches to tax-avoidance transactions is useful in predicting what may be in the future and for multinational taxpayers to co-ordinate their tax planning to satisfy the requirements of both jurisdictions. ■