UK Tax: General Anti-Avoidance Rule

Graham Aaronson QC’s Study Group Recommends a Narrow GAAR

SUMMARY

Late last year the UK Government asked leading tax barrister Graham Aaronson QC to lead a study programme to establish whether the UK should introduce a general anti-avoidance rule and – if so – what it should look like. Mr Aaronson has now reported. He recommends introducing a “narrow” GAAR, which catches only “highly abusive contrived and artificial schemes which are widely regarded as intolerable”.

The proposal

The key features of the proposed GAAR are these:

- “reasonable tax planning” would not be caught;
- an Advisory Panel would provide non-binding opinions on what was “reasonable”;
- HMRC would bear the burden of proof;
- there would be no general advance clearance procedure;
- initially it would apply to:
  - income tax;
  - corporation tax;
  - capital gains tax;
  - petroleum revenue tax; and
  - national insurance contributions;
- later it might be extended to other taxes, like stamp duty and stamp duty land tax (“SDLT”).

Issues

The proposal raises two main questions:

- where will the line between “reasonable tax planning” and “abusive schemes” be drawn; and
will the taxpayer be able to predict that with any certainty, especially without an advance clearance procedure?

BACKGROUND

The GAAR Study Group

The study group established by Graham Aaronson QC was mandated to consider a GAAR which could meet four objectives:

- deterring and countering tax avoidance;
- treating taxpayers fairly and not pushing business away from the UK;
- maintaining certainty of tax treatment for businesses and individuals without undue compliance costs; and
- minimising any increase in resource costs for HMRC.

What is a GAAR?

A GAAR is a wide-ranging anti-abuse rule enabling tax authorities to counteract or override what would otherwise be the tax treatment of a targeted transaction. It is not the same as a substance over form approach to applying tax legislation. In particular, only the tax authorities may invoke a GAAR whereas (at least in principle) a substance over form doctrine can be invoked both by and against a taxpayer. A GAAR is meant to neutralise the tax benefits which would otherwise arise from transactions seen as “abusive”, whatever the perceived economic substance of such transactions. Accordingly, it also differs from the “economic substance doctrine” recently codified in the United States.

That said, when the tax authorities counteract a scheme using a GAAR, they may look to a hypothetical transaction with the same economic outcome but less advantageous tax treatment. They will then try to apply that tax treatment to the scheme transaction. In that limited sense, the economic substance of a transaction may dictate how it is affected by a GAAR. But – as the Report makes clear – this will not always be the case: there will not always be a comparator transaction.

Other jurisdictions

A number of common law jurisdictions already have GAARs: in particular, Australia, New Zealand, Canada, South Africa, Ireland and Hong Kong. Experience has been varied and a full summary is beyond the scope of this memorandum.

The Australian GAAR (on which the Hong Kong GAAR is largely based) has been applied very extensively to attack a wide range of transactions, including transactions which would be regarded in
many quarters as quite limited and routine tax mitigation: see, for example, the decision of the High Court of Australia in Hart¹.

The history of the New Zealand GAAR also illustrates the inherent uncertainty created by such rules; the considerable scope they offer for judicial creativity; and the fact that changes in judicial approach may significantly affect the impact of a GAAR after an affected transaction has taken place. The New Zealand courts took a relatively conservative approach to applying the New Zealand GAAR from the 1980s until New Zealand’s Privy Council appeal was abolished: see, for example, the Privy Council decision in Peterson². The New Zealand courts have now adopted a significantly more expansionist stance: see the 2008 Ben Nevis decision³ and the 2009 decisions in BNZ and Westpac⁴.

Continental European jurisdictions such as the Netherlands and France have developed the Roman law doctrine of fraus legis, often translated as “abuse of law”. This is somewhat similar to, although often narrower than, a GAAR. This concept has been brought into EU law, most notably (from the tax perspective) in the Halifax VAT case⁵. It took over thirty years from the introduction of VAT in the UK before the European Court of Justice decided that the “abuse of law” principle could apply to it; and the five years since then have not exhausted the questions on how it should apply.

The courts may well (indeed probably will) change how they approach a GAAR after the taxpayer has done the transaction, so it is difficult for the taxpayer and its advisers to assess risk accurately before

¹ Commissioner of Taxation v. Hart [2004] HCA 26. Here the taxpayer borrowed to acquire residential and commercial real estate. The loan allowed the taxpayer to elect to capitalise (on a compounding basis) on commercial terms the interest attributable to the borrowing which funded the commercial real estate. Meanwhile it applied its monthly payments solely in paying down the loan to acquire residential property. Only the interest allocable to the commercial real estate gave rise to a tax deduction.

² Peterson v. Inland Revenue (New Zealand) [2005] UKPC 5. The taxpayers invested in films using their own money and funds borrowed under non-recourse loans. The UK Privy Council accepted that these were tax avoidance schemes. Although the borrowed funds were not needed for the film and were recycled to the lenders, the taxpayers did not know this. The majority of the Privy Council said the GAAR did not apply.

³ Ben Nevis v. CIR [2008] NZSC 15. The investors in a forest were to pay a “licence premium” 50 years after the arrangements were set up. They claimed to deduct 1/50 of the premium each year as the payment was for a right to use land. The Commissioner of Inland Revenue invoked the GAAR and was upheld by the Supreme Court.

⁴ BNZ Investments Limited v. Commissioner of Inland Revenue [2009] NZHC 822 and Westpac Banking Corporation v. Commissioner of Inland Revenue [2009] NZHC 1388. BNZ and Westpac both involved the payment to New Zealand financial institutions of enhanced dividends on shares issued to them by non-New Zealand issuers. The New Zealand financial institutions borrowed to fund those share acquisitions and set the interest deductions against other income taxable in New Zealand, while claiming that the enhanced dividends were tax-exempt in New Zealand, mainly because of so-called “conduit relief”. Various forms of credit support were put in place to ensure that the New Zealand financial institutions were not subordinated creditors of the share issuers. The taxpayers lost.

⁵ Halifax plc and others v. Commissioners of Customs & Excise (C-255/02).
doing it. Without an adequate pre-transaction ruling procedure, a taxpayer is very exposed to post-transactional changes in judicial fashion. None of this is readily reconcilable with the need for certainty in organising one’s tax affairs.

Previous consideration of a GAAR
In 1997 the Institute for Fiscal Studies Tax Law Review Committee produced a report considering a GAAR for the UK. The TLRC concluded that the right sort of GAAR would help to deter and counteract tax avoidance without too much disruption for taxpayers and tax authorities. Graham Aaronson QC chaired the TLRC.

The government took up the baton and in 1998 the Inland Revenue published a consultative document. The GAAR it put forward would have:
- applied only to companies;
- been broad in scope, but with an exception for “acceptable tax planning”; and
- offered an advance clearance procedure, for which taxpayers would have had to pay.

Tax planning would have been “acceptable” if it did not “conflict with or defeat the purpose of the tax legislation”.

The 1998 consultation discussed and drew on the TLRC’s recommendations. The TLRC, however, did not think it drew heavily enough on the TLRC’s report. Several of the TLRC’s criticisms are reflected in Mr Aaronson’s 2011 report. For example, the TLRC objected to the idea that the taxpayer should have to prove what the purpose of legislation was. The Inland Revenue itself was reluctant to take on the burden of a GAAR clearance procedure.

In the end, nothing came of the 1998 consultative document. In the meantime, the Inland Revenue (and now HMRC) has focussed on other ways of addressing tax risk. The net result is that it already has a formidable armoury for tackling tax avoidance.

The UK’s approach to avoidance

The courts
In the early to mid-20th century the courts took a fairly hands-off approach to tax avoidance: “No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.” The legal climate has since changed.

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7 Lord Clyde in the Ayrshire Pullman case (1929) 14 TC 754.
The 1981 case of *Ramsay*\(^8\) heralded a new era of judicial activism against tax avoidance schemes. This set a precedent of disregarding steps inserted into a transaction merely to avoid tax. More recent cases have expressed the *Ramsay* doctrine as one of interpretation: tax legislation should be read in accordance with its purpose, then applied to a “realistic” view of the facts. Most decisions have gone against the taxpayer. The recent case of *Mayes*\(^9\) was a fairly rare exception: the higher courts were (reluctantly) unable to read the legislation so as to defeat the taxpayer.

**Legislation**

Parliament has also deployed targeted anti-avoidance rules (“TAARs”) in many areas. These usually focus on what were the “main purposes” of a taxpayer.

Indeed the UK already has experience of wide-ranging GAAR-like counteraction powers in its anti-avoidance legislation, notably the counteraction regime affecting “transactions in securities”. This has objectively defined internal limits and a formal advance clearance procedure, with a 30-day time limit for HMRC responses. Although it was introduced as a measure targeted only at dividend-stripping and bond-washing, with political assurances to match, it has been expansively interpreted by the courts and successfully applied by the Inland Revenue/HMRC. This should be borne in mind when considering the latest GAAR proposal.

Rules introduced in 2004 requiring the disclosure of tax avoidance schemes (“DOTAS”) have allowed the government to block new schemes much more quickly. By common consent, they have been most effective.

**Political climate**

The Coalition Agreement between the Conservatives and the Liberal Democrats in May 2010 pledged to tackle tax avoidance by developing Liberal Democrat proposals such as a GAAR. Indeed, the Liberal Democrats were on record as favouring a GAAR based on the Australian model.

Tax avoidance has also become a more highly politicised and emotive issue since the start of the global economic downturn in 2008. Several pressure groups have mounted campaigns against tax avoidance in the past year.

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The Study Group and the Report

Mr Aaronson’s Study Group consisted of himself, three current or former judges, two academics and a representative of industry. He also held discussions with various representative bodies. He submitted his report on 11 November and the Treasury published it on 21 November.

SHOULD THE UK HAVE A GAAR?

The problem of tax avoidance and possible solutions

Mr Aaronson’s premise is that “it is reasonable to impose some limit on the ability of taxpayers to escape their share of the tax burden by looking for loopholes or weaknesses in the tax rules, and then constructing elaborate schemes designed to exploit them.” He lists three main ways used in the UK to impose that limit:

- *purposive interpretation* of tax statutes by the courts;
- specific *anti-avoidance legislation*; and
- the *DOTAS* rules.

Mr Aaronson notes drawbacks to each of these three techniques:

- courts have sometimes gone beyond what can fairly be called interpretation in order to thwart tax avoidance schemes they see as abusive;
- the volume and complexity of anti-avoidance legislation continues to increase; and
- the DOTAS rules bring compliance and administrative costs for taxpayers and HMRC; while they allow HMRC to react faster with countermeasures against new schemes, those schemes may still work for a period of time.

For him, though, the key point is that some highly artificial schemes may still get through. He gives the *Mayes* case as an example. In principle, he concludes, the UK should have a GAAR. (It is actually far from clear that there are significant numbers of “egregious” schemes which succeed under current law.)

WHAT SHOULD IT LOOK LIKE?

This part of the Report can be divided into three:

- a statement of high-level principles;
- discussion of how a GAAR could be structured to implement the principles; and
- illustrative legislation.

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10 The report is explicitly his, although he notes that the other members of the Study Group agreed with it. There was one exception: the two serving judges did not think it appropriate to say whether there should be a GAAR or not; but they agreed that, if there was, that was what it should look like.

Principles

*Extreme schemes only.* For Mr Aaronson the overarching principle is that the GAAR must target only “highly abusive contrived and artificial schemes which are widely regarded as intolerable”, not “the large centre ground of responsible tax planning”.

*Tax intent.* The GAAR should never catch any arrangement made entirely for non-tax reasons.

*Certainty.* The GAAR will bring with it some uncertainty, but this should be reduced as far as possible.

*Limit on HMRC discretion.* The GAAR should not increase HMRC’s discretionary powers or be used as a threat where it should not apply.

Proposal: structure and draft illustrative GAAR

*Scope.* At least initially, the GAAR should apply only to:

- income tax;
- corporation tax;
- capital gains tax;
- petroleum revenue tax; and
- national insurance contributions.

Other taxes, like SDLT, could be added later. (In any case, SDLT already has its own very broad anti-avoidance rule.) The GAAR should not apply to VAT, as it is a harmonised EU tax to which the EU “abuse of law” doctrine already applies.

Mr Aaronson envisages the GAAR applying to arrangements which rely on the use of a double tax treaty (so long as that is lawful under the treaty and any relevant OECD Commentary).

*Substance.* An arrangement must, if it is to be caught by the GAAR:

- achieve an *advantageous tax result*; and
- be abnormal or use *abnormal features* to do so; and
- not be *reasonable tax planning*.

These concepts are fleshed out in the illustrative draft legislation. “Abnormal features”, in particular, is wider than it sounds and is not exhaustively defined. Features which are likely to be abnormal include:

- transactions which are uncommercial or inconsistent with the legal duties of the parties;
- the inclusion, omission or offshore location of any asset, transaction or party to a transaction if that is intended to achieve an abusive tax result.
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Tax results which depart from the underlying economics of the transaction (deductions greater than economic losses or taxable profits less than economic profit) may also be considered abnormal “features”.

On the other hand, the draft legislation says that getting the advantageous tax result must be the sole purpose, or at least one of the main purposes, of the arrangements viewed as a whole.

“Reasonable tax planning” means planning “which can be regarded as a reasonable response to choices afforded by the legislation”.

General guidance. Guidance notes should explain the sorts of cases to which the GAAR should apply. (The illustrative guidance notes at the end of the Report are similar to the explanatory notes usually published alongside legislation, but expanded.) The guidance notes should be authoritative, perhaps by forming part of the legislation itself.

Area-specific guidance. Mr Aaronson notes that some areas of tax legislation, such as the taxation of trusts, are extremely complex and give rise to anomalous consequences. Specific guidance notes on these areas should be agreed between HMRC and representative bodies.

HMRC management. Any decision to apply the GAAR should be taken at a senior level within HMRC.

Advisory Panel. The Report recommends that a panel be set up to advise on the GAAR. Most members should come from outside HMRC. This would have one, or possibly two, functions.

- First, if HMRC proposes to apply the GAAR, the case should go to the Advisory Panel for a non-binding review. The taxpayer must be allowed to put its own arguments to the Panel.
  - HMRC and the taxpayer might both accept the Panel’s conclusion, in which case any dispute would be nipped in the bud.
  - If not, the Panel’s view would be available as evidence in a tax appeal.
  - In any case, synopses of the Panel’s opinions should be published in anonymised form.
- Second, the Advisory Panel might update the guidance notes.

Burden of proof. In general, any doubt should be resolved in favour of the taxpayer. There is one exception: a taxpayer who claims that tax was not in his mind when he entered into an arrangement must prove that to the court. (Proof in each case would be to the civil standard of the balance of probabilities.)

Evidence. Any official material or evidence of HMRC or widespread taxpayer practice should be used in considering whether an arrangement counts as “reasonable tax planning”: the rules on admissibility of evidence should be widened if necessary.
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How the illustrative draft GAAR would work: flowchart

Does the arrangement achieve an "advantageous tax result" absent the GAAR?

Yes

Does it do so by "reasonable tax planning"?

Yes

No

Can the taxpayer show that this was not deliberate?

Yes

No

The arrangement achieves an "abusive tax result"

Is that its sole significant purpose?

Yes

No

Is that one of its main purposes?

Yes

No

Does it have "abnormal features"?

Yes

No

GAAR applies

Is there a "corresponding non-abusive arrangement"?

No

Yes

Compute receipts and deductions as for corresponding non-abusive arrangement

Compute receipts and deductions as reasonable and just

GAAR applies
Counteraction. Where the GAAR applies, how it should apply would depend on the facts. Where the arrangements have a commercial purpose, counteraction of the tax planning should take account of how that purpose could be achieved without falling foul of the GAAR. The overall result should be reasonable and just. This may mean that less tax should be paid in another period or by another taxpayer, so that there is no double taxation.

Penalties. A taxpayer caught by the GAAR should not suffer penalties or penal interest rates. (This contrasts with – for example – the French “abuse of law” or US “economic substance” doctrines.)

Clearances. If a GAAR is introduced in the narrower form he proposes, Mr Aaronson sees no need for a statutory GAAR clearance procedure. The expense of a clearance procedure has been the sticking point for HMRC in the past. Interestingly, Mr Aaronson sees the discretion it gives to HMRC as another objection, although any such discretion could be limited by requiring HMRC to publish advance clearances in anonymised form.

However, where a taxpayer would be making use anyway of an existing clearance procedure (for example, under the “transactions in securities” rules), that should be extended to cover the GAAR. (However, there is no requirement in such cases for HMRC to publish advance clearances in anonymised form.)

Transitional rule. Mr Aaronson does not think any grandfathering rule would be appropriate: arrangements entered into but not yet completed when the GAAR comes into force should be caught by the GAAR.

WHERE TO FROM HERE?

The Government has said that it “will discuss the implications of the proposed rule with business and tax practitioners and respond fully at Budget 2012, setting out its plans for further, formal public consultation, if appropriate.” A further round of consultation is likely if the Government decides to go ahead, possibly leading to legislation in Finance Bill 2013.

COMMENT

Who would draw the line?

First-tier tribunal. In practice the line would probably be drawn by a combination of the Advisory Panel and first-tier tribunal judges. The question of what is a “reasonable response” must be one of fact (or mixed fact and law), rather than pure law. This limits the scope for any first-instance decision to be overturned on appeal. This may concern taxpayers.
Advisory Panel. This may in practice put much of the responsibility on the Advisory Panel. But would the Advisory Panel see the wide range of evidence of taxpayer and HMRC practice which Mr Aaronson recommends should be available in any dispute?

Where would the line be drawn?

One of Mr Aaronson’s objections to the GAARs in other common law jurisdictions is that they have been presented as targeting egregious schemes, but been drafted, interpreted and applied much more widely. Would his GAAR avoid this?

The Report gives conflicting signals. On the one hand, it is intended to “target those highly abusive contrived and artificial schemes which are widely regarded as intolerable”. On the other, Mr Aaronson takes inspiration from the Hong Kong courts’ approach to their GAAR: “[its] purpose … is not to attack arrangements made to secure benefits which are legislatively intended to be available to the taxpayer”. But many arrangements could fall short of that without being “widely regarded as intolerable”. It is not clear where he thinks this highly subjective and contentious line should be drawn.

The main battleground would be “reasonable tax planning”. (As the Report notes, the definition of “abnormal” arrangements which achieve an “advantageous tax result” is deliberately wide.) Wherever Mr Aaronson sees the line, it would be hard to sustain an objective distinction between what is “reasonable tax planning” and what is not. Views are very likely to be polarised along political lines, especially in the current economic climate. Furthermore, much tax planning is designed to avoid the many traps for the unwary (often unintentional) in the UK’s very complex tax code. Is such planning immune from GAAR counteraction? After all, HMRC has often applied the tax rules harshly against taxpayers who have fallen foul of technicalities without having any particular avoidance purpose.

An illustration. One of the few areas of the UK housing market which is not struggling is prime residential central London property. It is fairly clear that much of this property is owned through non-UK companies. Selling the shares in the companies, rather than the underlying real estate, avoids the high UK stamp duty land tax on the sale of real estate. This is of most benefit to rich non-domiciled or non-resident individuals. Using such a structure is a choice which is clearly available under UK tax law. It is well-known and accepted (if not advocated) by HMRC. Yet this clear choice is coming under ever sharper scrutiny. If the proposed GAAR covered SDLT, the use of an offshore company would be an “abnormal feature”. It would be a brave adviser who would assure a client that such property-holding arrangements clearly fall within the “reasonable tax planning” safeguard. In practice it would probably be relevant that SDLT would otherwise be the single biggest transctional cost in such purchases; that SDLT is a major source of state revenue; and that such mitigation techniques are not readily available to ordinary taxpayers.

12 To the rich as SDLT is markedly progressive; to the non-domiciled or non-resident because of the way the capital gains tax rules apply to residential property and gains of controlled companies.
Would the GAAR bring greater certainty?

These difficulties in drawing the line make it unlikely that the GAAR would make the position of taxpayers any more certain than it is now: in fact it may increase uncertainty. The GAAR might also be hard to apply: if a scheme fell within an arcane and highly technical area of the tax code, most obviously one of those dealing with financial transactions, it might not be clear what the reasonable alternative comparator to a transaction was.

On the credit side, courts might indulge less in “stretched interpretation” – though the GAAR would not prevent them from doing so. However, taxpayers and their advisers would still have to grapple with the Ramsay doctrine, as well as the many uncertainties and complexities in existing anti-avoidance legislation.

It could also be some years before it became clear how the line was being drawn. Cases take some time even to reach the first-tier tax tribunal. Then there is the question how many cases there would be. The more cases, the clearer the position (one would hope). A GAAR would probably be litigated reasonably quickly – particularly if, as Mr Aaronson suggests, it is not subject to any transitional rule. The Advisory Panel should produce guidance somewhat faster. But even the Panel will not be able to give opinions on cases referred to it until HMRC has gathered its facts and is ready to submit the cases for outside scrutiny.

A final point is that the law does not stand still. Indeed, one concern raised by representative bodies was that the safeguards intended to protect the taxpayer would be eroded by amendments to the GAAR following its introduction. This has been true of the UK “transactions in securities” rules since their introduction in the early 1960s, as well as the DOTAS rules.

In view of all this – and the Report’s optimistic hope that HMRC and representative bodies will somehow agree guidance in areas where the GAAR would be particularly hard to apply – taxpayers are likely to regret the Report’s recommendation that no formal clearance procedure is necessary. In some situations HMRC is inclined to be helpful, such as debt restructurings of insolvent or struggling companies. In those cases, taxpayers with concerns should look for non-statutory confirmation on whether the GAAR applies or to cover it off under another clearance procedure.

Would the UK’s tax code be simplified?

Existing anti-avoidance rules. Mr Aaronson expresses the hope that – once confidence is established in the GAAR – an attempt might be made to reduce and simplify the anti-avoidance rules already in place. The first point here is that it would be some time before HMRC could become confident that the GAAR was working as HMRC would like. Second, the GAAR is not supposed to apply where reasonable people can disagree on whether planning is a “reasonable exercise of choices of conduct afforded by [the legislation].” In that case, some of those transactions would be ones which HMRC would consider “avoidance” and want to catch by other means. So HMRC would probably take the (entirely respectable)
position that the GAAR did not make existing anti-avoidance provisions obsolete. The experience of other countries is not encouraging. For example, the Australian tax system has many complex anti-avoidance rules, despite the existence of a very broad GAAR.

**Other existing legislation.** Might HMRC revisit existing provisions more generally? According to the Report, “A GAAR would not remove the need to improve the specific legislation [where it is complex and gives rise to anomalous results]. Indeed, it will highlight the need for this …” Complex legislation can cause problems for both HMRC and taxpayers. One might fear that HMRC would be less concerned to remove anomalies if the GAAR served as a get-out-of-jail free card from their standpoint. By contrast, a mitigating feature of stretched interpretation by judges is that it can – in theory at least – cut both ways.

**Future legislation.** There is more chance that legislation brought in after the GAAR could be drafted more simply. But that too might need to wait for HMRC to be confident that the GAAR was working.

**Would the GAAR bring fairness?**
The GAAR should achieve its intended effect of levelling the playing field between the more and less aggressive taxpayer.

It does raise issues of fairness, however. First, as just mentioned, the GAAR is a one-way provision and it is up to HMRC whether or not to operate it. Second, if HMRC gives some taxpayers non-statutory clearances but does not publish its analysis of the points at issue in guidance, it will be tilting the playing field in favour of taxpayers and advisers with private knowledge of its practice. This is yet another argument in favour of a formal advance clearance procedure with regular publication of anonymised rulings. Such an approach would also sit much better with the Government’s stated policy of making the UK tax system more internationally competitive.

**CONCLUSIONS**

A GAAR is likely to be introduced. It is hard to predict how the form of GAAR suggested in the Report would work out in practice, but it is unlikely to lead to greater certainty for taxpayers. Indeed, the reverse is more likely to be true. Bearing in mind the Report’s recommendation that the GAAR cover pre-existing transactions, taxpayers should have an eye to its effects on transactions they are considering now.

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