UK tax avoidance cases

The UK substance-over-form principle following the recent judgments in Mayes and Tower MCashback

SUMMARY

The Court of Appeal and the Supreme Court have recently released decisions on two marketed tax avoidance schemes. Result – Taxpayer 1 : HM Revenue and Customs 1.

Viewed together, the two cases help delineate the scope of the so-called “Ramsay” substance-over-form doctrine developed by the UK courts in tax cases:

- the principle is one of statutory construction: it is more relevant to some statutes than others;
- the 2004 decision of the House of Lords in Mawson cannot be treated as Year Zero in applying the doctrine: the earlier cases (which go back to 1981) remain good law.

On a more practical note:

- the courts remain hostile to artificial tax avoidance arrangements;
- off-market terms act as a red flag;
- as always, such arrangements must be implemented carefully;
- certainty (whether for HMRC or the taxpayer) remains as far off as ever; in particular, a taxpayer putting in place a structure in one year is at risk of being affected by post-transaction changes in judicial thinking, if HMRC challenge the structure in the courts.
BACKGROUND

It is now thirty years since the seminal case of *Ramsay*\(^1\), in which the House of Lords\(^2\) endorsed a limited “substance over form” doctrine in applying United Kingdom tax law. The “*Ramsay principle*” quickly became one of HMRC’s favourite weapons against tax avoidance schemes. What exactly the *Ramsay* principle was, and how far it extended, was the battleground for many cases in the years that followed.

HMRC saw it as allowing them to disregard steps inserted into transactions purely for tax purposes, and some of the earlier decisions lent support to this view. However, in *MacNiven*\(^3\) the House of Lords re-emphasised that the *Ramsay* principle was simply one of purposive statutory construction. Moreover, some statutes (those referring to “commercial” concepts) could be more readily applied to the economic substance of transactions than others (which used “legal” concepts).

*MacNiven* was controversial within the judiciary and there remained a feeling of uncertainty. In *Mawson*\(^4\) the House of Lords was urged by the tax profession to give definitive guidance as to what the *Ramsay* principle meant. The Lords gave a single judgment in order to “achieve some clarity about basic principles”. They reiterated that the principle was one of statutory construction: the courts should construe the relevant statutory provisions purposively and apply them to the transaction in question, viewed realistically. They did, however, step back from the elusive distinction made in *MacNiven* between “commercial” and “legal” concepts.

The judgment in *Mawson* appeared to have rendered a number of decisions over the previous twenty-five years irrelevant. But clarity has still been elusive. Some judges – particularly at first instance – have been ready to go back to the cases before *Mawson* in applying the *Ramsay* principle.

Two cases, both on marketed income tax avoidance schemes, have recently given the higher courts another opportunity to shine some light in this area. The Court of Appeal gave judgment in *Mayes*\(^5\) on April 12, the Supreme Court in *Tower MCashback*\(^6\) on May 11.

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\(^1\) in *W T Ramsay Ltd v Inland Revenue Commissioners; Eilbeck (Inspector of Taxes) v Rawling* [1981] STC 174
\(^2\) now replaced by the Supreme Court
\(^3\) *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6
\(^4\) *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51; the same panel of judges gave another single judgment on the same day in *Inland Revenue Commissioners v Scottish Provident Institution* [2004] UKHL 52, also a case on the *Ramsay* principle. In *Scottish Provident Institution*, unlike *Mawson*, the court ruled against the taxpayer.
\(^5\) *Commissioners for HMRC v David Mayes* [2011] EWCA Civ 407
\(^6\) *Commissioners for HMRC v Tower MCashback LLP 1 and another* [2011] UKSC 19
MAYES

A. FACTS

The scheme was made up of seven steps:

Step 1  A Mr Lovell, resident in Jersey, purchased two “bonds” (sets of life assurance policies) from AIG Life for £10,000

Step 2  Mr Lovell sold the policies to JSI, a Luxembourg company

Step 3  JSI invested £425,000 in the policies

Step 4 (under a month later)  JSI withdrew that sum

Step 5  JSI sold the policies to one of the promoters of the tax scheme

Step 6  The promoter sold them to Mr Mayes

Step 7 (under two months later)  Mr Mayes surrendered the policies

Mr Mayes then sought to claim an income tax loss in respect of that surrender

The attention of the Special Commissioner\(^7\) was caught by several unusual points. In particular, many of the documents used the language of finance, rather than insurance. Similarly, although the policies were on their face life assurance policies on the life of Mr Lovell, no one seemed to have been interested in whether Mr Lovell was still alive by the time Mr Mayes surrendered the policies.

B. AIM OF THE SCHEME

The theory was that the surrender of the policy would give rise to a “corresponding deficiency”: a negative tax charge which could be set off against Mr Mayes’s income tax liability on unrelated income.

The scheme relied on the detailed provisions of the Income and Corporation Taxes Act 1988 (ICTA) dealing with life policies. These provisions include a mechanism for charging a taxpayer when he or she surrenders a life policy, whether in whole or in part. In calculating the charge the taxpayer may deduct a portion of the premiums paid up on the bonds. In the early years of the policy, only a small proportion of the premiums is deductible. However, there is a catch-up on final surrender, so the total tax charge over the policy’s life should be the total paid out on the policy less the total premiums subscribed.

The result, said Mr Mayes, was that JSI, had it been a UK taxpayer, would have suffered a significant tax charge when it withdrew its investment in the policies at step 4, even though it would not have made a significant profit in economic terms. Mr Mayes claimed that, when he computed his own liability as a result of his surrender of the policies at Step 7, he was entitled to a deduction for the amount of the tax charge.

\(^7\) The Special Commissioner was the judge of first instance, with sole responsibility for findings of fact. The Special Commissioners have now been replaced by the First-Tier Tribunal (Tax).
charge JSI would have suffered at Step 4 had it been a UK taxpayer: this gave rise to a significant “corresponding deficiency”. He also claimed a loss for the purposes of capital gains tax.

C. HMRC’S CASE
HMRC argued that steps 3 and 4 were a self-cancelling unity: the court should therefore disregard them for tax purposes.

D. CASE HISTORY
Mr Mayes lost his case before the Special Commissioner, but was successful on appeal to the High Court. HMRC appealed to the Court of Appeal.

E. COURT OF APPEAL
The Court of Appeal found for the taxpayer. Lord Justice Mummery gave the leading judgment. He said that the detailed and specialised ICTA provisions for the taxation of life assurance policies “do not readily lend themselves to a purposive commercial construction”. Accordingly, the court was not entitled to disregard the payment of premium and partial surrender in assessing whether Mr Mayes could claim a “corresponding deficiency”. As the High Court had noted, “if … JSI had been a UK taxpayer the gain and loss would have been offset and there would and could have been no HMRC objection.”

Moving beyond the immediate result, taxpayers could take heart from Mummery LJ’s approach to the analysis. The natural instinct that schemes like this should not work, said the judge, must be checked by the process of construing the legislation and applying it to the facts. And the courts should now usually be able to found their approach to the Ramsay principle on Mawson, rather than “return each time to the base camp in Ramsay and trek through all the authorities from then on”.

HMRC have applied to the Supreme Court for permission to appeal.

TOWER MCASHBACK
A. FACTS AND AIM OF THE SCHEME
MCashback had developed software to allow retailers to provide mobile phone airtime as customer rewards. MCashback needed further finance; Tower agreed to help procure it. Tower proposed that MCashback sell interests in the software to outside investors, acting through limited liability partnerships. The investors (individual members of purpose-formed LLPs) would claim accelerated capital allowances (tax depreciation) by reference to the purchase price paid for the interests in the software. It was intended that the investors would be lent three-quarters of the amount they invested in the LLPs on limited-recourse terms. This would be funded indirectly by MCashback, as shown in the diagram below.

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8 SpC 729
9 [2009] EWHC 2443 (Ch)
There were a number of odd features to the scheme.

- Most importantly, the purchase price of the software appeared to be significantly inflated. The valuation of the software rights was supported by a business plan produced by MCashback. Its projections of revenue were not independently audited. This did not disadvantage the investors: they expected their ability to shelter other income from income tax with the accelerated capital allowances to outweigh the amount of the investment even if it made no money.

- The original proposal had been that each of four LLPs would purchase a percentage interest in the software, totalling 13% of the rights to certain classes of fee from its exploitation. At a relatively late stage this was amended, so that the LLPs would each acquire the rights to specific software modules. This change to the assets sold did not have any effect on the overall price to be paid.

- Not only did the loans limit recourse to the investors, but a mere half of the LLPs’ income was to be used in paying them down. (40% was to be distributed to the investors and retained by them to cover tax on the income, 5% distributed to them as a “bonus” and 5% retained by the LLPs as a reserve.) Even if the projected revenue figures had been met, a substantial proportion of the loans would have been written off.

- The interest payable by the investors on the loans was set off in part against the interest on the security deposit provided by MCashback – this covered interest up to LIBOR. The remaining spread was used to fund an upfront fee.

- The witnesses could not offer any convincing commercial reason for the banks to be part of the lending chain.
B. HMRC’S CASE

HMRC’s argument on the Ramsay principle (there were several other points in issue) was that the amount paid by the LLPs was excessively large as the purchase price for the software. In reality the LLPs had paid it for two things: the software rights and beneficial finance. Only 25% of the purchase price was attributable to the software for the purposes of calculating capital allowances.

C. CASE HISTORY

The Special Commissioner\textsuperscript{10} took a position between that of HMRC and that of the taxpayers.\textsuperscript{11} He held that capital allowances should be available as and when capital was provided by the members of the LLPs on an outright basis: initially 25% of the price paid, but further amounts later on as the members’ borrowings were paid off.

The Special Commissioner looked at two precedent cases in the capital allowances field: Ensign Tankers\textsuperscript{12} and Mawson. Ensign Tankers was a case about a film scheme based on accelerated capital allowances and also involved circular limited-recourse finance.\textsuperscript{13} The House of Lords took the view that the limited-resource finance, over which the taxpayer never had meaningful control, was not real and – to that extent – the taxpayer’s expenditure was not real either: the taxpayer was entitled to capital allowances only for the capital it had put up itself. The asset in Mawson was a pipeline, this time entirely paid for out of circular finance. In Mawson – unlike Tower MCashback – the purchase price was not challenged as being off-market. The taxpayer succeeded before the House of Lords.

The Special Commissioner in Tower MCashback considered that the facts in front of him were sufficiently different from those in Mawson that it did not assist him. He also said that more recent authorities (which he did not name, but will have included Mawson) might have rendered Ensign Tankers unreliable.

The taxpayers appealed to the High Court.\textsuperscript{14} Mr Justice Henderson referred to Mawson as now being the leading case in the area: on that basis, he thought, the taxpayer must clearly succeed. Henderson J neither distinguished nor relied on Ensign Tankers.

The taxpayers won again in the Court of Appeal.\textsuperscript{15} Here, however, the judges took Ensign Tankers to be good law, but distinguishable on the facts.

\textsuperscript{10} Howard M Nowlan.
\textsuperscript{11} SpC 619
\textsuperscript{12} Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) [1992] STC 226
\textsuperscript{13} The film, incidentally, was the 1981 film Escape to Victory – in North America released as Victory – starring Michael Caine, Sylvester Stallone and Pelé, among others.
\textsuperscript{14} [2008] EWHC 2387 (Ch)
\textsuperscript{15} [2010] EWCA Civ 32

UK tax avoidance cases
5 July 2011
D. SUPREME COURT

The Supreme Court said in terms that Ensign Tankers and Mawson were both good law. Following Mawson, “the court is concerned to test the facts, realistically viewed, against the statutory text, purposively construed.” The facts here were not on all fours with Ensign Tankers: in Tower MCashback the limited-recourse finance was real, though uncommercial. But the question was whether all of the expenditure was on the software rights. The judges decided that it was not. Instead, 75% of it was paid as part of a tax avoidance scheme. Only 25% qualified for accelerated capital allowances.

PRACTICAL IMPLICATIONS

Where does this leave the taxpayer?

- Mawson clearly remains the leading case on the scope of the substance-over-form doctrine in UK tax law. It is a principle of purposive statutory construction, applied to a realistic view of the facts. There is no need to “trek through all the authorities”, from Ramsay on, to support this.

- Nonetheless, if the statutory provision at issue has been considered in cases pre-dating Mawson, those cases may still be relevant: witness Ensign Tankers in the capital allowances field.

- If the statute determines the liability for tax on the basis of a formula or other hypothesis which is not rooted in any commercial reality, it is less susceptible to HMRC attack on the basis of purposive statutory construction.

- Arrangements must be implemented with care. The cases often turn on a realistic view of the facts, where the findings of fact of the First-Tier Tribunal (Tax) will be very important. Where the taxpayer takes an uncommercial attitude to price – as in Tower MCashback – it will be hard to persuade the courts that it has spent all the money it claims on the asset.

- The doctrine is a flexible one and it is becoming harder to predict whether and how it will apply: Tower MCashback was heard at four levels and the courts gave three different answers.

A final thought. Mayers and Tower MCashback show that the courts are increasingly hostile to artificial tax avoidance structures. Mayes demonstrates that this instinct is not always enough to undermine such structures – at least for now.

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16 And with it Scottish Provident Institution

17 Of course, there is scope for dispute as to whether a provision falls within that class: see Andrew Berry v HMRC [2011] UKUT 81 (TCC), one of a number of income tax avoidance cases based on losses arising under the UK rules for taxing discounted debt securities.

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