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EU/UK Taxation

- **The Tax Treaty Network of the United Kingdom** - PHILIP BAKER
- **The United Kingdom and Direct Tax in the European Union** - TOM O'SHEA
- **The UK's Statutory Residence Test** - APARNA NATHAN
- **Indian classification of foreign entities** - NED SHELTON
- **Commercial Uses of Trusts** - KATHARINA BYRNE
- **The Enactment of a UK GAAR** - IAN CARNOCHAN
- **The Importance of Pre-Legislative Processes in Taxing Statutes: Experiences with the Indian GAAR** - ADHITYA SRINIVASAN/GAUTAM SWARUP
- **Tax competition in the New Era - The UK enters the arena** - DIANE HAY/MATT RYAN
- **Tax planning considerations for Tier 1 (Investor) migrants** - DMITRY ZAPOL
- **Withholding Tax on Financing UK Corporate Acquisitions** - NIKHIL V. MEHTA
- **Breaking the Deadlock - Resolving Tax Disputes by ADR** - HUI LING MCCARTHY/ ANDREW GOTCH
- **Dispute Resolution in Tax Matters: An India-UK Comparative Perspective** - SRIRAM GOVIND/SAMIRA VARANASI
- **Recent EU Cases/Developments and comparison with Indian judicial precedents** - SHEFALI GORADIA/PARUL JAIN

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Commercial Uses of Trusts

The common law trust has long been a feature in many kinds of commercial arrangements. It has certain unique characteristics which set it apart from other contract-based relationships. This article sets out some of the many uses to which it has been, and may yet be possible, to put a trust.

Katharina Byrne *

1. Introduction

First, however, we shall review the core elements of a trust and why it lends itself to commercial applications.

1.1 What is a trust?

A basic definition is a legal arrangement which involves a person (the "**settlor**") transferring legal title to assets to another person or body (the "**trustees**") to hold for the benefit of one or more persons (the "**beneficiaries**"), which may include the settlor. The terms of the trust are usually set out in a written instrument, often in the form of a deed. The trust imposes onerous duties on the trustee; failure to fulfil those duties properly may result in the trustee being held personally liable.

In order to determine whether the settlor has created a trust, as opposed to another kind of obligation, the three certainties must be present: certainty of intention to create a trust; certain of subject matter; and certainty of beneficiaries (or objects). Although these concepts can sometimes raise difficult questions in the context of private trusts, they are usually less of a concern in a commercial arrangement, as the parties often will have decided in advance what form they want the venture to take and have recorded that in the trust deed.

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1.2 Advantages of a trust

Certain features of the trust make it a very useful vehicle for commercial purposes. First, the segregation of the trust fund so that it does not form part of the patrimony of either the trustee or the beneficiary is an extremely valuable feature for a number of reasons. For example, creditors of the trustee will have no claim to the trust fund; this is also broadly true in the case of creditors of the beneficiary.

Second, in certain circumstances it may not be possible for the beneficiary to hold property in his own name, whether because of a lack of legal capacity to do so, or because of fiscal or other regulatory reasons.

Another important feature is the inherent flexibility of a trust. As a general matter, the provisions of any trust can be whatever is agreed between the settlor and the trustee. Trusts, apart from certain exceptions, such as pension fund trusts, are subject to relatively little regulatory control. This is in stark contrast to other commercial vehicles, whose governance is externally controlled to a large extent by legislation. For example, the very creation of a trust involves very few formalities in comparison to the incorporation of a company.

A third advantage is the tax treatment of trusts. Because of the lack of legal personality, the beneficiaries are often treated as the direct owners of the underlying trust property and taxed accordingly. Such flow-through treatment for tax purposes is particularly important in commercial transactions; for example, where several independent parties pool their resources in order to undertake an investment and each wishes to share in the deductions for tax purposes, as well as the profits, of the venture.

A fourth benefit is the confidentiality inherent in both the creation and the operation of a trust.

Having reviewed some of the general advantages of trusts, what then of the specific commercial uses of trusts?

Commercial trusts can be divided into three broad categories: trusts for investment purposes, trusts acting as a security device, and trusts for other business purposes that do not fit neatly into one of the other two categories.

2. Investment Trusts

As an investment vehicle, trusts can take the form of unit trusts, and pension fund trusts. Unit trusts allow several persons to invest in the same assets by way of what is often a small contribution compared to the total value of the trust fund. The interests of the unit-holders in the trust are represented by units of beneficial interest, the value of which are directly related to the value of the assets in the trust fund. The terms of the trust instrument regulate the rights of the unit-holders, often providing that a unit-holder does not have a direct proprietary interest in the assets of the trust fund, but only a right to the income arising in respect of units held, as well as the proceeds of sale of units.

2.1 Pension schemes as trusts

Occupational pension schemes are also often established using trusts and here, too, the fiduciary nature of the trust and the segregation of trust assets provide a valuable mechanism for protecting the interests of the employee-beneficiaries. As with unit trusts, pension schemes are often subject to regulation in the interests of the beneficiaries.

3. Security Trusts

3.1 Debenture trusts

With respect to the second category of trust, security trusts, a typical example is the debenture trust, whereby multiple parties can participate in lending to a company through the medium of a trust. The lenders receive marketable securities issued by the trustee, which holds upon trust for the lenders the right to enforce repayment of the loan, as well as property provided by the borrower as security for the loan.

Such an arrangement provides benefits for both the lender and the borrowers. For example, as far as the lender is concerned, the size or nature of the loan may be such that it is difficult to find willing lenders unless their individual participation is limited to a certain amount. In the case of a debenture trust, it is possible to have any number of lenders providing loans of varying amounts. Another advantage for an individual lender is that the trustee will be responsible for ensuring that the borrower complies

with the terms of the loan. A further advantage, which draws upon the trustee's inherent fiduciary office, is that the trustee will act even-handedly *vis-à-vis* all the bondholders, and not allow itself to be forced to take action by a small group of 'rogue' bondholders, which may be detrimental to the bondholders as a whole.

The centralisation of control of the debt in the hands of the trustee is also of benefit to the borrower, since it has to deal with only the trustee and not each of the bondholders.

This also ensures that the borrower's financial condition is kept confidential so that it is the trustee and not any one bondholder who decides whether action needs to be taken to protect the interests of the bondholders.

3.2 Employee benefit trusts

The security benefits of a trust are also important reasons why it is often used as the holding vehicle for shares or cash which is to be distributed to employees in accordance with a particular mechanism. By holding the property in such a separate vehicle, it is isolated from the risk of the employer becoming insolvent, or from claims of creditors of the employer. Such protection can be vitiated in certain circumstances; however, provided that proper advice is sought from the outset, the risk of attack can be minimised.

3.3 Sinking fund trusts

Another form of security trust is one which creates a sinking fund out of which potential claims can be settled over a fixed number of years. An actual example of such a trust is one that was established for the benefit of shareholders of a company whose business had involved the use of hazardous materials. The shareholders wished to place the company into liquidation, yet were concerned about possible claims being brought against them in respect of the company's products even after the company had ceased to exist.

Therefore, it was agreed that a sum of money would be placed into trust for the benefit of the shareholders and would be disbursed over a number of years according to a set formula to the shareholder - beneficiaries, provided no claim was brought against them in respect of the company's products.

3.4 Trusts of insurance monies

Another example of a security trust involved an arrangement whereby the holders of policies issued by a particular insurance company agreed to the proration of payments made in respect of their policies. Such an arrangement was necessary to ensure the solvency of the insurance company and allow a scheme of arrangement to be put in place for the benefit of creditors of the company.

Pursuant to the trust, a percentage of claim payments were assigned to a trustee, to be disbursed according to the instructions of the insurance company.

In addition to ensuring the protection of creditors, a trust can also be used to protect rights of a more intangible nature. For example, the redomiciliation of a company from one jurisdiction to another may give rise to a conflict between the rights of shareholders under the laws of the home jurisdiction and those under the new jurisdiction. In some jurisdictions, changes to certain shareholder rights require unanimous shareholder consent. However, in other jurisdictions, only a specified majority is required. In such a situation, a possible solution would be to issue a special voting share to a trustee to hold on trust for those persons who are shareholders at the time of redomiciliation. The terms of the trust provide that the rights of those shareholders can only be amended if the trustee does not vote against the resolution. How the trustee will cast its vote will depend on the terms of the trust; for example, the trust may state that the trustee can veto such a resolution if not all of the shareholders agree to the amendment.

4. Business Purpose Trust

The third category of commercial trusts, the business purpose trust, is very broad and can encompass a myriad of arrangements.

4.1 Voting trusts

An example of a trust with a general business purpose is that of the voting trust. This is a device for separating the economic and control

aspects of share ownership. Although shareholder agreements are not uncommon, a voting trust strengthens such agreements by vesting the voting rights of the individual shareholders in a trustee who is to exercise those rights in accordance with the terms of the agreement. Whereas under a shareholder agreement one shareholder can choose not to abide by the terms of the agreement and thereby undermine its whole purpose, this is less likely to happen where voting rights are vested in a neutral party *i.e.*, the trustee, who is bound not only by the terms of the trust agreement, but also by the general principles of trust law. As a fiduciary, the trustee must act in the best interests of all the beneficiaries' shareholders, and cannot favour one over the other.

A voting trust can also be an integral part of a dual-listed company ("DLC") structure, whereby two companies merge their economic interests while at the same time remaining separate entities. Both companies also continue to remain listed on their respective stock exchanges. DLC structures have a long history: the Royal Dutch Petroleum and Shell DLC dates back to 1903 whereas the Unilever DLC was created in 1930. Other examples of DLC structures include Rio Tinto Limited/ Rio Tinto PLC, and BHP Billiton Limited and BHP Billiton PLC, and Reed Elsevier.

A DLC may involve special voting shares in one of the participant companies being held in a trust for the benefit of the shareholders of the other company. The terms of the trust set out how the trustee will vote in particular circumstances. In essence, the purpose of the arrangement is to ensure that the voting rights attached to the special voting shares are cast in such a way as to replicate the voting that has taken place at the general meeting of shareholders of the other company.

A trust which holds shares can also be used to meet regulatory requirements. The author has advised on a structure where a major airline established a trust to hold the shares in its subsidiary which ran the airline's frequent flyer programme. The trust enabled the airline to comply with certain EU competition law obligations. In another case, using a voting trust allowed a party to acquire a regulated business despite the fact that the regulator did not consider the purchaser to be a suitable person to operate the regulated business. The regulator allowed the transaction to proceed on condition that voting control of the regulated business was placed in the hands of an independent professional trustee. The economic rights associated with the business remained with the new owner.

Another type of business purpose trust concerns the use of a trust as a holding and distribution mechanism of monies for several parties representing payment for services rendered by those parties to each other. A simplified structure involves the trustee receiving monies representing advance payment for services. Provided that certain conditions are met, the trustee makes payments out of the trust account to contractors of the named beneficiary, as well as to the beneficiary itself. In certain cases, however, payments represent refunds of the prepaid sums.

Because the trustee only pays funds out of the trust when certain conditions are met, such an arrangement can, as noted above, mitigate the insolvency risk of a party. However, using a trust in this way can also have practical benefits: for example, administration is centralised in the hands of the trustee. In addition, the trust can create a "level playing field" where the parties are not otherwise equal in terms of financial strength, for example.

4.2 Purpose trusts

Although many commercial arrangements can be analysed from a beneficiary trust perspective, it can be difficult to identify where the beneficial interest in the trust fund lies at any given time. For example, it is arguable that the beneficiaries of the sums paid into the above kind of trust include not only the party which will render the relevant services but also the payers of those sums. Would the creditors of those payers also have a claim to those paid sums in the event of a payer becoming bankrupt? Furthermore, do the contractors of a beneficiary have an interest in the monies held in the trust? Unfortunately, these issues tend to be overlooked unless and until a dispute arises among the parties, or one or more of them experiences financial difficulties.

Such an arrangement could also be characterised as a purpose trust, on the basis that its key feature is the mode of application of the trust fund, not the identity of the ultimate recipients of the trust fund. As a purpose trust, the arrangement still retains the advantage of creating a pool of assets which is kept separate from the property of the individual parties. Moreover, this feature is enhanced by the fact that there are no beneficiaries. As indicated above, in a beneficiary trust, it could be argued that the trustee holds the trust fund on a bare trust, so that each beneficiary has a clearly discernible interest in the underlying assets of the trust fund. Consequently, a creditor of the beneficiary could also lay claim to that interest in bankruptcy proceedings.

Although English law recognises purpose trusts (other than those for exclusively charitable purposes) only to a limited extent, several jurisdictions[1] have introduced legislation that allow for the creation of trusts for purposes, or in some cases, trusts with both beneficiaries and purposes.

Key features of a purpose trust

Most of the jurisdictions which have passed purpose trust legislation have taken a similar approach in defining the parameters of the purpose trust, based on the interpretation of the reported English cases in which such trusts have been considered.

Consequently, many of the statutes provide that non-charitable purpose trusts are valid, provided that the purpose is specific, reasonable, and capable of being fulfilled. Moreover, the purpose must not be immoral, unlawful, or contrary to public policy. In some jurisdictions, the definition of "charitable purpose" has been extended to allow the creation of trusts for philanthropic (but not necessarily charitable) purposes or for the mixed benefit of worthy causes and individuals.

Many of the jurisdictions have also done away with the common law principles against inalienability, thereby allowing for the creation of trusts whose purpose is very long term.

Since a purpose trust has, by definition, no beneficiaries to enforce it, the relevant jurisdictions have included enforcement mechanisms in their trust legislation. In some cases, the trust must provide for the appointment of a person to act as enforcer of the trust. The enforcer is under a duty to ensure that the trustee carries out the terms of the trust in connection with the specified purposes.

5. Other commercial uses of purpose trusts

5.1 Off balance sheet arrangements

Another example, albeit a simple one, of a trust for commercial purposes is in off-balance sheet arrangements where the trust holds the shares of a "quasi-subsidiary". The reasons for such arrangements include circumventing of controlled foreign company taxation rules, asset protection by isolating speculative economic activities from the assets of the 'parent', and off-balance sheet treatment for accounting purposes.

For example, the finance subsidiary of a corporate group may have issued some form of debt instrument supported by a guarantee from its parent company. By transferring the obligation of the subsidiary to a purpose trust, it may be possible to release the parent company from its guarantee and remove the liability from the consolidated balance sheet liabilities of the group. Such a restructuring may be desirable in order to improve the group's credit rating with a view to putting in place another financing transaction, or to facilitate a sale of the parent.

5.2 Future reserves or provision

Purpose trusts are ideal vehicles for creating a fund to pay the present and future creditors of the settlor. Without the need to satisfy one of the three certainties, that is, having an ascertainable beneficiary in existence at the time of the creation of the trust, a purpose trust could even be for the future creditors only.

Such a trust is less vulnerable to attack under insolvency law principles[2], for the following reasons:

- there is no 'gift' to another person, since it is a trust for purposes, not persons;
- there is no transaction at an undervalue, since the trustee is not benefiting personally from the transaction; and
- no one creditor is preferred.

Such a trust could be used in a situation similar to that discussed earlier where a company which had engaged in a hazardous business was to be put into liquidation, but shareholders were concerned about possible claims being brought against them personally once the company had been liquidated. As an alternative to a beneficiary trust, the company could set aside funds to cover potential claims in a purpose trust which would last for a specific number of years. The company could then be put into liquidation. Once the trust period has expired, the balance of the trust fund can be paid out in the manner specified in the trust deed. The ultimate recipients could be the former shareholders, or perhaps a charitable purpose related to the business of the company. Such a trust would not require an identifiable beneficiary on the day that it is created; this requirement is often overlooked, yet is crucial to ensuring the validity of a beneficiary trust. Secondly, the trustee need not concern itself about the nature of the interest of any beneficiaries and the duties which it may owe to them; instead, enforcement of the purposes of the trust is the responsibility of the person designated in the trust deed or under the relevant legislation. If the trust deed provides that the former shareholders are to receive any balance left in the trust fund at the end of the trust period, such a right is arguably not a contingent equitable interest as might otherwise be the case with a beneficiary trust.

5.3 Quistclose Trusts

A purpose trust also appears to offer a solution to the legal problems which arise in connection with so-called Quistclose trusts.

A *Quistclose* trust arises when A makes a transfer to B for a specific purpose and **for no other purpose**. The significance of the *Quistclose* trust is that the funds transferred remain the property of the **transferor** unless the recipient applies them for the specified purpose. If the recipient becomes insolvent before applying the funds for that purpose, those funds cannot be used to satisfy its creditors. For this reason, cases involving *Quistclose* trusts are often insolvency cases where it is necessary to establish who is the beneficial owner of the funds: the creditors of A or B, or the persons to whom B was to make payment? The House of Lords attempted to elucidate the situation first in *Barclays Bank Ltd.* v. *Quistclose Investments Ltd.*[3] and then in *Twinsectra Ltd.* v. *Yardley and others*[4]. However, views differ widely on the extent to which the House of Lords has succeeded in doing so. In contrast, if a purpose trust were used, problems such as the situs of the beneficial interest at any given time fall away. Furthermore, the monies are secure from the creditors of both A and B.

The classic *Quistclose* trust arises when a loan is made for a specific and exclusive purpose. However, the basic principle is derived from earlier case law and the courts have also found that *Quistclose* trusts apply in the following situations:

- A company paid funds to its advertising agency for the sole purpose of paying third parties for work on behalf of the company (*Carreras Rothmans Ltd.* v. *Freeman Matthews Treasure Ltd* [1985] Ch 207).
- A company that was a debtor of a second company paid funds to the administrator of the second company for the sole purpose of allowing the administrator to pay a subcontractor for further work on behalf of the first company (*Re Niagara Mechanical Services International Ltd.* [2000] 2 BCLC 425).
- A firm of solicitors gave an undertaking to use funds only to complete the purchase of a specified property. The firm could not use the funds for other purposes such as paying disbursements (*Templeton Insurance Ltd* v. *Penningtons Solicitors LLP* [2006] EWHC 685 (Ch)).
- Individuals paid funds to the promoter of a film tax relief scheme, while the funds were held in a client account before investment (*Bieber and others* v. *Teathers Ltd* [2012] EWHC 190 (Ch)).

It is clear from the preceding overview that trusts have wide applications in the commercial as well as the private sphere. The inherent flexibility of a trust makes it an ideal vehicle for various kinds of business transactions. Moreover, where the trust used takes the form of a purpose trust, the advantages can be even greater.

6. Taxation

The taxation of a commercial trust will often depend on a number of factors, including the residence of the settlor, beneficiaries and trustee, the nature of the beneficiaries' interests in the trust assets, where the activities of the trust are undertaken, and the location of the trust assets. In the UK, the general thrust of the income tax and capital gains tax regimes is to exempt trusts that form part of *bona fide* commercial arrangements. However, this is not the case with inheritance tax, despite the fact that the main purpose of the inheritance tax legislation is to charge individuals or their estates to tax when they die, or when they make certain kinds of gifts.

There are very few UK cases which consider the taxation of trusts for genuine commercial purposes, where mitigation of IHT is not in issue. Nor has HMRC produced very much public guidance on the matter. Clarification from the courts, if not the legislature, would therefore be welcome.

The taxation of commercial trusts is less complicated if the trust is a bare trust[5], as it will be taxed as if the trust assets belong to the beneficiary absolutely. However, a bare trust is much less robust in terms of protecting the trust assets from the claims of creditors of the settlor. As noted above, a non-charitable purpose trust is arguably less vulnerable to attack from the creditors of the settlor than a traditional trust. However, it is not clear how the UK revenue authorities would characterise such a trust for tax purposes.

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1. For example, international financial centres such as Bermuda, Jersey, Guernsey, the Isle of Man, the Cayman Islands, the British Virgin Islands, Belize, the Cook Islands, Cyprus and Labuan. However, onshore jurisdictions, including the US state of Delaware and the Canadian province of Quebec also permit purpose trusts under domestic law.
2. For example, as a preference, or a transaction at an undervalue. See UK insolvency Act, 1986, sections 339,340 and 423.
3. [1968] UKHL 4
4. [2002] UKHL 12
5. Broadly, a bare trust is a trust where the beneficiary (or beneficiaries) has an immediate and absolute right to both the capital and income of the trust. The property is held in the name of the trustee (or trustees), but the trustee has no discretion over the assets held in trust.

The Enactment of a UK GAAR

Ian Carnochan*

On 17 July, 2013, the United Kingdom introduced its version of a general anti-avoidance rule. The proposals for such a rule, as noted in previous editions of this journal (see, in particular, Vol. 6, May 2012), have been subject to a long period of consultation. Going back further, the idea of a general anti-avoidance rule is something that previous UK governments have looked at, but never felt able to enact. The main issue has always been one of uncertainty, or defining what should be caught by such a rule.

Tax avoidance is not a straightforward issue for any jurisdiction to address, not least because of the difficulties in deciding what is actually meant by the concept. Clearly doing anything that results in paying less tax, whether that is investing in a tax-free savings product in line with relevant statutory rules or deliberately failing to declare earnings, could be seen to be "avoidance". Therefore, there is at least another, more significant dimension to the question: what type of behaviour is to be permitted?

The UK's general anti-avoidance rule, or the general anti-abuse rule ("**GAAR**") as it has been called, quite deliberately seeks to target tax avoidance behaviour that is "abusive". In other words its focus is on behaviour which, whilst not unlawful or criminal, is beyond what might reasonably be regarded as a reasonable course of action. This central question as to what is "abusive" may not always be easy to answer. However, any additional uncertainty this creates is intended only to apply in respect of avoidance arrangements where the tax treatment is already uncertain.

This article considers the background to the GAAR and how the rule fits into the UK's anti-avoidance landscape. As will be seen, the GAAR is a powerful weapon; however, a number of safeguards have been built in to give taxpayers comfort that it will achieve its stated aim of targeting abusive tax avoidance.

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As well as looking at how the legislation operates, two novel features of the GAAR (namely the role non-statutory guidance is to play and the functions of a specially created advisory panel) are also discussed.

1 The genesis of the GAAR

The recent history of how the UK GAAR came about has been well charted in this journal. To give a very brief recap, in 2010, the UK Coalition Government asked a leading tax counsel, Graham Aaronson QC, to form a study group to report on the feasibility for the UK tax system of a general anti-avoidance rule. Following an eleven-month review, the study group published its report in November 2011. It recommended a narrowly-focused GAAR with the specific aim of deterring abusive tax avoidance schemes. The report concluded that a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system. This is perhaps not a surprising conclusion, given that the study group's terms of reference required it to consider whether a UK general anti-avoidance rule could deter and counter tax avoidance, whilst at the same time providing certainty, retaining a tax regime that is attractive to businesses, and minimising costs both for businesses and the UK tax authority ("**HMRC**").

The Government then spent a period of time considering the study group's report before announcing in the March 2012 Budget that it would consult formally on introducing a "general anti-abuse rule" with a view to bringing forward legislation in the Finance Bill in 2013. The GAAR which has now been enacted (in Part 5, Finance Act, 2013) remains true to the principles behind the study group's recommendations, although it has been refined with the benefit of considerable input from both HMRC and taxpayer representatives as part of the consultation process.

2. Something new?

How does the GAAR fit into the existing UK anti-avoidance landscape? UK tax legislation (especially new legislation) often includes a targeted anti-avoidance rule (or "**TAAR**") in some form or other; and specific TAARs are often enacted to close down particular avoidance schemes which come to the attention of HMRC. (Often such schemes have been disclosed through the Disclosure of Tax Avoidance Schemes or DOTAS rules.) Whilst TAARs apply only to specific areas of the tax legislation, they may be targeted at arrangements which might not necessarily be regarded as abusive, and so in that sense may be seen to apply more widely than the GAAR.

HMRC also often argues that tax avoidance schemes do not work when the relevant legislation is applied using a "purposive construction" of that legislation. This is a judicial principle of statutory interpretation (often referred to as the *Ramsay* principle) whereby Courts construe legislation with regard to its purpose. This requires a determination of the nature of the transaction to which relevant legislation was intended to apply and then a decision as to whether the actual transaction, viewed realistically, answers to that statutory description. Whilst of general application, the principle has often been used in tax avoidance cases to "do down" the offending scheme, possibly leaving some judgments open to criticism that legislation is being unduly stretched to achieve a particular result. (It will be interesting to see whether the Courts are less willing to stretch legislation in this way now that the GAAR has been enacted.)

Other tools the UK Government has used to discourage tax avoidance include signing banks up to a "code of practice on taxation for banks" and issuing "spotlights" highlighting marketed avoidance schemes which HMRC considers to be ineffective. The Government is also consulting on ways to curtail the activities of promoters of egregious schemes (to deal with the "supply side" of tax avoidance).

Thus, the GAAR is not the only anti-avoidance tool available to HMRC. A key question is whether the GAAR does anything new. In a way, it takes the *Ramsay* principle a stage further. Rather than seeking to determine Parliament's intent from the words of the legislation alone, the GAAR allows the Court to go beyond that, not least by looking at a much wider range of material in order to assess taxpayer behaviour. The GAAR is intended to prevent abusive results which Parliament had not anticipated but which it would not have intended (in a much broader sense

than rules of statutory construction allow). Just as *Ramsay* liberated the Courts from having to apply a literal interpretation of revenue statutes, the GAAR may be seen as liberating the Courts from the limits of the *Ramsay* principle.

The GAAR is aimed at abusive tax arrangements which would otherwise achieve their intended result, and which might otherwise side-step any existing TAAR or the application of a "purposive construction" of relevant legislation. In theory, at least, the GAAR should only affect the outcome of a very small percentage of cases (often where very prescriptive legislation is being exploited that does not lend itself particularly well to a purposive construction and where there is no applicable TAAR). However, the GAAR can still be used even if there are other grounds of challenge open to HMRC.

Fundamentally, therefore, the GAAR may be seen as something new in the UK anti-avoidance landscape. Where the GAAR applies, Parliament has given the Courts the ability to override the application of other legislation enacted by Parliament. In that respect the GAAR may be seen as a very powerful provision. The GAAR might even be regarded as falling into a similar category as the European Communities Act, 1972, insofar as that Act has come to be regarded as a voluntary limitation by Parliament of its own sovereignty (in that case, by enabling the principle of supremacy of directly effective European Community law over other legislation enacted by Parliament to apply).

3. Taxpayer safeguards

Because of what the GAAR can do, the UK Government has recognised that there need to be appropriate taxpayer safeguards. There are a number of such safeguards and they give considerable confidence that the GAAR is not capable of being used in most cases involving mainstream tax planning. Some of the key safeguards are set out below.

- The legislation has been drafted with the stated purpose of counteracting only abusive tax avoidance. Although what is "abusive" is defined by the legislation, such a statement of purpose does set the context of the GAAR. Leaving aside all other safeguards, a Court may be expected to construe the GAAR legislation according to this purpose.
- In addition to the legislation and how it has been formulated (see further at section 4), a further safeguard is that there is a body of guidance (the "**Guidance**") which is intended to explain how the GAAR should work in practice. The Guidance includes a number of examples (in a separate document running to 136 pages) which illustrate where and for what reasons the GAAR does and does not apply. Whilst many arrangements are unlikely to match exactly these examples, the Guidance does address many of the concerns regarding uncertainty of the GAAR legislation and illustrates the principles that should be applied. The Courts must have regard to this. Furthermore, there is a mechanism in place to ensure that the Guidance is prepared and kept up-to-date independently of HMRC.
- Before HMRC can apply the GAAR, a number of procedural steps have to be taken:

  (*i*) First, a senior officer of HMRC (who must be designated for these purposes by the HMRC Commissioners) has to consider whether or not the GAAR should apply.

  (*ii*) Secondly, notice has to be given to the taxpayer who has 45 days (which may be extended) to respond.

  (*iii*) Thirdly, if the taxpayer either does not respond, or does respond and HMRC wishes to proceed in applying the GAAR, a reference has to be made to an advisory panel (the "**Advisory Panel**"). The Advisory Panel is not supposed to be carrying out any judicial function. Both the taxpayer and HMRC have the right to make written representations. A three person sub-panel of the Advisory Panel then gives its opinion (or separate opinions if the members disagree).

  (*iv*) Finally, after considering the Advisory Panel opinion(s), the HMRC officer

has to decide whether or not to proceed with the GAAR. The Advisory Panel's opinion is not binding, but in practice it is very unlikely that HMRC would continue with a case (without very good reason) if even one member of the Advisory Panel were to give an opinion that the arrangements in question were reasonable.

- If, following the Advisory Panel process, HMRC wishes to apply counteraction under the GAAR, the taxpayer still has rights of appeal to the relevant tribunal or court. Here there are further safeguards for the taxpayer. First, the burden of proof is on HMRC (both in terms of showing that there are abusive tax arrangements and that the proposed counteraction is just and reasonable). Secondly, the tribunal or court is required to take into account both the Guidance and the opinion(s) of the Advisory Panel. The court may (but this is not mandatory) take into account a range of other relevant material, even if not otherwise admissible in evidence, which was in the public domain at the time the arrangements were entered into or other evidence of established practice at that time. Whilst this is presented as a safeguard, there are practical and cost implications for taxpayers and advisers (either in ensuring that sufficient contemporaneous evidence is retained or in obtaining expert witness evidence as to what established practice was).

4. Outline of the legislation

A very brief overview of the GAAR legislation, as enacted, is as follows.

- The legislation contains a clear statement of purpose. The purpose of the GAAR is to counteract tax advantages arising from tax arrangements that are abusive.
- The GAAR applies to a list of taxes, including income tax, capital gains tax, corporation tax, inheritance tax, and stamp duty land tax. Certain taxes such as stamp duty (a documentary tax) and VAT (which is a European tax subject to its own abuse of law doctrine) are not included.
- Arrangements are "tax arrangements" if, having regard to all the circumstances it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose or one of the main purposes of the arrangements. This is an objective test. "Tax advantage" is defined very broadly. Quite deliberately, therefore, the GAAR sets a low threshold as to what may be seen to be tax avoidance. The real heart of the GAAR, and its focus, is on what is not permitted or, in other words, what is "abusive".
- Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances, including:
  - (*a*) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions;
  - (*b*) whether the means of achieving those results involves one or more contrived or abnormal steps;
  - (*c*) whether the arrangements are intended to exploit any shortcomings in those provisions.
- Where the arrangements form part of other arrangements, when determining whether that part is abusive, it is necessary to have regard to those wider arrangements.
- The legislation includes examples of factors which "might indicate" abusiveness:
  - (*a*) Income, profits or gains for tax purposes which are significantly less than the economic profit;
  - (*b*) Tax losses which are significantly greater than the economic loss;

(c) Obtaining a tax credit in respect of tax (including foreign tax) which is unlikely to be paid.

- The legislation also includes an example of something which might indicate non-abusiveness, i.e. where the arrangements are consistent with established practice accepted by HMRC at the time. The Guidance notes that the nature of HMRC's acceptance is relevant; a grudging acceptance that the legislation does not work to stop an abusive scheme is likely to carry little or no weight.
- If the GAAR applies, the tax advantages that would otherwise arise are to be counteracted by making adjustments that are "just and reasonable". What is just and reasonable is not defined in the legislation. Any adjustments are to have effect for "all purposes".
- If there is counteraction under the GAAR, this could lead to double taxation. This possibility is addressed through a mechanism that enables consequential relieving adjustments to be made. Such adjustments must be just and reasonable and cannot increase a person's liability to tax.

5. The Guidance and the Advisory Panel

The heart of the GAAR is the concept of taxpayer behaviour which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions. This is the key test of what is abusive.

This "double reasonableness" test, as it has come to be called, itself provides a safeguard for taxpayers. If there is a reasonable view that an arrangement was a reasonable course of action (even if others hold different views), the Court must hold that the GAAR cannot apply. Of course, just because a reasonable person expresses a view that an arrangement is a reasonable course of action does not mean that it is; promoters of tax avoidance schemes will not be able to GAAR-proof the scheme simply by obtaining counsel's opinion that the arrangement is reasonable.

Whilst the double reasonableness test contains an inherent safeguard, there is always the risk that Courts might interpret the test so that the GAAR applies more widely than anticipated. Arguably, the objective phrasing could be seen as masking what is essentially a subjective "smell test", and how is a taxpayer to be certain when such a test applies? As mentioned above, the legislation contains examples of arrangements that might be treated as abusive, including for example being taxed or relieved on amounts which do not match economic reality. Such examples are not entirely helpful and whilst they may be features of abusive arrangements, their presence in an arrangement does not necessarily mean that it is abusive (and the legislation recognises this). There would be a concern, if the GAAR, construed by reference to such examples, opened the door to HMRC being able to tax according to economic reality (an argument that is usually given short shrift by the Courts).

The real and practical answer to such concerns is to be found in the Guidance and the role of the Advisory Panel. Importantly, as mentioned above, the Guidance contains a number of examples, covering the main taxes covered by the GAAR and illustrating a range of situations where the GAAR does or does not apply. As is pointed out, these are illustrative of the principles (and it has to be recognised that what is normal behaviour in one context may not be in another; similarly, a slight amendment to a set of facts could change the overall conclusion). One example in particular, which deals with borrowing to mitigate inheritance tax, sets out various variants with increasing levels of abnormality; this helps show approximately at what point the boundary is crossed.

In order to provide a guide as to what may or may not be considered to be abusive, the Guidance identifies seven different categories of behaviour:

- Straightforward legislative choice;
- Long established practice;
- Situations where the law deliberately sets precise rules or boundaries;
- Standard tax planning combined with some element of artificiality (this begins to move into GAAR territory where arrangements could fall on either side of the line);

- Transactions that are demonstrably contrary to the spirit (or policy and wider principles) of the law;
- Exploiting a shortcoming in legislation (including a TAAR) whose purpose is to close down a form of activity;
- Arrangements that are contrived or abnormal and produce a tax position which is in no way consistent with the legal effect and economic substance of the underlying transaction.

The Guidance also gives comfort to taxpayers that the GAAR will not operate in relation to arrangements entered into for the purpose of avoiding an inappropriate tax charge that would otherwise have been triggered by a more straightforward transaction. Thus, simply taking what appear to be contrived steps in order that a taxpayer might avoid a "bear trap" (e.g. avoiding a tax liability on more than the economic gain) would not generally be regarded as abusive.

It is important to bear in mind that there is a requirement for the Guidance to be approved by the Advisory Panel (which is independent from HMRC). The current version of the Guidance was approved by an interim Advisory Panel with effect from 15 April, 2013. It is envisaged that subsequent approved versions of the Guidance will be published annually in October.

The Advisory Panel is presently chaired by Patrick Mears, formerly a tax partner at an international law firm. There are six other members of the Advisory Panel. When a specific case is referred to the Advisory Panel, the Chair will choose a sub-panel of three members (which need not include the Chair). The Chair may also recommend the temporary appointment of additional persons to the Advisory Panel in order to ensure that the sub-panel has appropriate expertise to consider a specific case. (Such *ad hoc* appointments would only be for the purpose of that specific case.) The sub-panel will normally aim to deliver its opinion(s) within 60 days of when it receives a referral. The Advisory Panel is not required to answer the double reasonableness test set out in the legislation. It is simply required to give its view (or views) as to whether the tax arrangement is a reasonable course of action. This is deliberate: the Advisory Panel is not intended to exercise a judicial function; it is simply giving an opinion which HMRC must consider when deciding whether or not to proceed with counteraction.

It is anticipated that opinions of the Advisory Panel are to be published (in anonymised form) and this should, it is hoped, give further guidance to taxpayers as to how the GAAR is being applied.

6. Clearances and Penalties

As expected, there is no clearance procedure as such (although if a statutory clearance can be obtained under existing provisions, and full disclosure has been made, the GAAR will not be used to override that clearance). Nor is there a specific penalty regime. However, taxpayers are required to take the GAAR into account under relevant self-assessment regimes; failure to make any appropriate adjustment could render the taxpayer open to a penalty in the normal way. It may seem unlikely that a taxpayer would enter into a tax avoidance scheme only to self-assess that the GAAR applies, although this is not inconceivable. More likely, taxpayers engaging in tax avoidance arrangements may need to consider the use of "white space" disclosures in order to mitigate the risk of possible penalties if there is any concern of the GAAR applying.

7. International aspects

One issue which caused debate in relation to the proposals for the GAAR was the extent to which the GAAR might override the provisions of double taxation agreements, the issue being whether this might put the UK in breach of its international treaty obligations. The Guidance makes clear that where there are abusive arrangements which seek to exploit particular provisions in a double tax treaty, the GAAR can counteract such arrangements. An example is given based on a case where UK resident individuals sought to avoid paying UK income tax by structuring the provision of their services through a partnership and trust structure that took advantage of relief under a double tax treaty. The Guidance is clear that the application of the GAAR in this way should be regarded as consistent with the OECD commentary on the Model Tax Convention. This

provides that States do not have to grant the benefits of a double tax convention where its provisions are being abused. Interestingly, one of the actions (number 6) in the OECD's Action Plan on Base Erosion and Profit Shifting (published on 19 July, 2013) is to develop recommendations "regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances". The GAAR must be seen to be in line with this.

8. Commencement

The GAAR applies to all tax arrangements entered into on or after 17 July, 2013. If the arrangements are part of wider arrangements which began before this date, no regard can be had to these wider arrangements, except to show that the subsequent arrangements are not abusive. This seems to be a very fair approach to commencement, especially given that the enactment of the GAAR had been well trailed in advance.

9. Final thoughts

For most UK taxpayers, the GAAR is unlikely to have any real impact. Advisers can expect to be asked to give a view on the likely application of the GAAR, particularly where any tax planning is being undertaken, and in most cases the conclusion is likely to be that the GAAR does not apply.

Nor is it expected that HMRC is likely to use, or want to use, the GAAR very often. In the early years at least, one might expect that HMRC will seek to apply the GAAR only in the clearest and most extreme of cases. Therefore, it may be some time before any significant body of Advisory Panel opinions or Court judgments builds up on the GAAR. The existence of detailed Guidance goes some way in filling that gap.

Because the GAAR does seem capable of countering abusive tax avoidance, it is likely to have some deterrent effect. Mainstream advisers are likely to be less inclined to promote or otherwise be involved in schemes which would be caught by the GAAR, which may in turn lead to greater focus on less aggressive forms of tax planning. One hopes that this will not in turn lead to a gradual loosening of the GAAR over time (whether by legislative change or through judicial interpretation), although the risk of this cannot be ruled out.

One thing that will almost certainly change over time is what is regarded as acceptable behaviour. This is as true in tax terms as it is in society more generally. (A few years ago, one might have qualified such a statement by noting that people would probably not, however, be taking to Oxford Street to protest about tax avoidance. Even this has changed.) The GAAR, as supplemented by the Guidance, recognises the possibility that norms of tax behaviour may be different at different points in time. In this sense, the scope of the GAAR may fluctuate over time. This may also be true of the way the Courts have approached the principle of purposive construction, but at least with the GAAR the ground rules seem clearer.

In any case, the days of the *Duke of Westminster* are long gone. It is no longer considered right that taxpayers should be able to avoid tax through the ingenious use of tax legislation. And so the tax avoidance debate moves on to new areas. Being narrowly focussed on what is abusive, the GAAR will certainly not stop many of the tax arrangements which multi-national companies and others enter into (and which the wider public might generally regard as being unacceptable). Here the attention may be seen to be shifting to the world stage, as countries recognise the need to work together to prevent multinational enterprises from minimising their tax burden in harmful ways. Perhaps it is not too great a step to imagine the OECD's pronouncements in this area as a move towards a global GAAR.