Tax Representation

TAX FACULTY

TAXREP 07/07

AVOIDANCE THROUGH THE CREATION AND USE OF CAPITAL LOSSES

A memorandum submitted to HMRC by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an HMRC statement, draft legislation and draft guidance note published on 6 December 2006.

Contents **Paragraph(s)**

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AVOIDANCE THROUGH THE CREATION AND USE OF CAPITAL LOSSES

INTRODUCTION

1 We welcome the opportunity to comment upon the HMRC statement, draft legislation and draft guidance note *Avoidance through the creation and use of capital losses.*

2 We also welcome the opportunity afforded, through the capital gains tax review group, to consider the issues raised in this consultation.

3 We have seen a draft copy of the representation submitted by the Chartered Institute of Taxation, which has been endorsed by the Society of Trust and Estate Practitioners and the Law Society. We are supportive of that representation and the detailed points made therein.

4 Further information about the ICAEW and the Tax Faculty is set out in Appendix 1.

5 We measure all tax proposals against ten fundamental principles that we identified should underpin a good tax system. These are set out in Appendix 2.

EXECUTIVE SUMMARY

6 We think that the expression 'targeted anti-avoidance rule' is actually a misnomer, as in our view this is not a targeted rule. The proposed rule is, in effect, a 'mini' general anti-avoidance rule (GAAR) but applying only to the creation and utilisation of capital losses.

7 The draft legislation is fundamentally flawed. The wording is so wide in its scope that a literal interpretation would catch many transactions which we understand the government had no wish to target. We do not see that this can be said to be in the best interests of anyone who has a stake in the tax system.

8 We appear to be in the situation so disapproved of by Walton J in *Vestey v* IRC *(*1977*) 3 All ER 1073* in his famous quote "one should be taxed by law, and not be untaxed by concession", only in this case the taxpayer does not have a formal extra statutory concession to rely but just guidance.

9 It is not enough to merely revise the guidance to provide more examples of common situations and greater analysis of whether HMRC believe that the taxpayer, within that situation, would or would not be caught by the legislation.

10 We think it is essential that the primary legislation is reworked as set out further below so as to ensure that the rules are properly targeted and certain so that taxpayers do not need to rely on HMRC's guidance.

11 The legislation should include a clearance mechanism.

DETAILED COMMENTS

The principles of anti-avoidance legislation

12 As we have stated repeatedly in past consultations on anti-avoidance rules, we understand the Government's policy objective of countering tax avoidance. In principle we support the Government's aim of countering the use of artificially created losses to avoid capital gains tax.

13 However, we do not agree with the proposed method that has been adopted to achieve this policy objective. We believe that all anti-avoidance legislation should meet three criteria, as follows:

- it should be properly targeted at the perceived mischief;
- it should be statutory ; and
- it should provide certainty in virtually all circumstances.

14 For the reasons set out in the paragraphs below, we do not think that the proposed method meets these criteria, and we think that it needs to be redrafted so that it does.

Extending the FA 2006 TAAR to all taxpayers

15 We appreciate that the proposed clause to counter the artificial use of losses is based on an existing provision (section 69 Finance Act 2006) introduced last year for companies. We did not have any major issues with this wording in respect to the FA 2006 TAAR, which was part of a package of measures specifically designed to block the emergence of highly artificial corporate capital loss schemes,

16 The principle behind the TAAR is said to be "that relief for capital losses should be available only where a person has suffered a genuine commercial loss on a real disposal". Whilst we think this is a reasonable principle in relation to companies, its application to individuals, trustees and personal representatives is a very different proposition, because it brings with it a range of transactions that are not undertaken by companies. As stated in the CIOT paper, "companies rarely create trusts; they have few occasions on which they make deemed disposals; they do not generally make gifts and they do not transfer assets to their spouse. Therefore, extending the TAAR in the FA 2006 to cover all taxpayers raises issues of wider concern.

17 We do not think that the FA 2006 rule will work effectively when applied to all taxpayers. Determining their tax liabilities in line with guidance, which could be amended or withdrawn, rather than the law causes all taxpayers unnecessary anxiety but this is especially true in the arena of personal tax where taxpayers are not so used to interaction with HMRC.

A 'mini' GAAR?

18 We think that the expression 'targeted anti-avoidance rule' is a misnomer. The proposed TAAR is, in effect, a 'general anti-avoidance rule' (GAAR) but applying only to the creation and utilisation of capital losses, in other words a 'mini' GAAR. The advantages and disadvantages of introducing a GAAR have been debated in the UK over a number of years. We contributed comments when the then Inland Revenue consulted on a possible general anti-avoidance rule back in 1998.

19 Ultimately, the introduction of a GAAR is a policy question for the government to decide. However, we believe that all stakeholders recognise that whatever decision is taken in this area, taxpayers' rights must be safeguarded. The right to certainty is fundamental and if a GAAR is ever introduced, it must be accompanied by a clearance mechanism.

The need for certainty and a clearance mechanism

20 In our view, this TAAR is little more than a 'mini' GAAR but without the necessary safeguard of a clearance mechanism that would be afforded by a GAAR. We think that in a tax system where taxpayers have to self assess, this development is wrong in principle because it does not provide taxpayers with the necessary degree of certainty to be able to fulfil their statutory duty.

21 The lack of a clearance mechanism does not sit comfortably with the proposals set out in Sir David Varney's '*Review of Links with Large business'.* That review was published on 17 November 2006 and proposes:

> *An advance rulings process about the tax consequences of significant investments and corporate reconstructions, and the extension of existing clearance practices for significant commercial issues – giving UK and international business easier, earlier and speedier certainty.*

22 We have already welcomed the proposals in the Varney review as a helpful step in achieving certainty with respect to the tax consequences of most business transactions. It seems to us that the very laudable policy proposals underlying the Varney review are to some extent at odds with the proposals outlined in this TAAR.

23 We are concerned that, if as a result of the Varney review businesses are able to obtain a clearance on transactions that generate capital losses in circumstances where other types of taxpayer are not able to do so; corporate taxpayers will be at an advantage as compared to other taxpayers. We believe that as a matter of policy all taxpayers should be treated equally, not just in order to preserve the integrity of the tax system and provide a level playing field but also because with the increased emphasis on observing human rights in tax matters, any other approach might be regarded as discrimination.

Proper targeting of the TAAR

24 The draft clause is worded too widely. It is not targeted at contrived schemes to create capital losses, and taken at face value the new rule will catch many normal transactions which result in the creation of capital losses that are then used against gains.

Interpretation of the TAAR and vires of HMRC guidance

25 In order to try and ensure that the application of the legislation is properly targeted, HMRC have set out in the non-statutory guidance note examples of when they will not seek to apply the new provisions. The result is that the 'boundary' between when this legislation will apply and when it will not is set by HMRC. As an example, whilst we welcome confirmation that HMRC would not seek to apply this rule in transactions between a husband wife/civil partners (see example 5 of the draft guidance note), it seems to us that on a straight reading of the section the loss generated would be caught.

26 Legislation should not be made in this way. It gives considerable flexibility to HMRC to change its mind and provides little in the way of certainty or safeguards for taxpayers.

27 The HMRC guidance does not have any legal standing. In determining tax law one has to look to the wording of the legislation. As is demonstrated in the CIOT response, the actual wording used in the current draft legislation is far wider in scope than the guidance. Indeed if one looks to the actual wording of the draft legislation, it becomes apparent that the guidance is not in line with the draft legislation. Whilst not being referred to as a series of extra statutory concessions, the guidance note and in particular the examples make clear that HMRC will not seek to apply the full rigour of the law.

28 We think it is wrong in principle to enact a piece of legislation in the full knowledge that the wording is wider than intended, with the result that it catches transactions not intended to be caught and that the only safeguard for the taxpayer is that the administrative body has no current intention to apply the legislation in certain situations.

29 We understand that it is intended that the legislation be interpreted purposively but, despite the growing influence of EU law, the literal approach to interpretation is still dominant in our legal system. As expressed by Lord Scarman in *Shah v Barnet LBC* (1983) 1 All ER 226 "Judges may not interpret statutes in the light of their own views as to policy. They may, of course, adopt a purposive interpretation if they can find in the statute read as a whole or in material to which they are permitted by law to refer as aids to interpretation an expression of Parliament's purpose or policy."

30 Historically the Courts have adopted a restrictive approach to the material which they are permitted by law to refer to as aids to interpretation. In *Pepper v Hart (*1993) 1 All ER 42 it was held that references could be made to *Hansard* but only where the precise wording of legislation was uncertain or ambiguous, or where the literal reading of the act would lead to a manifest uncertainty.

31 In our view the meaning of the draft legislation is clear and there is no uncertainty. However, uncertainty arises because of the mismatch between the wording of the statute and how we are being told the legislation will be applied.

32 Should the draft legislation be enacted as it currently stands it is arguable that the Courts will have no option to do anything but interpret it literally. There is nothing in the wording to argue for a purposive interpretation and no ambiguity that would mean that *Hansard* could be consulted as an aid to interpretation.

33 Guidance produced by HMRC is not scrutinised by Parliament. It is merely HMRC's current view of how legislation should be interpreted. The Court of Appeal judgment in the case of *Jones v Garnett (2006) 2 All ER 381* showed that HMRC's guidance is not necessarily correct and, as was mentioned in the judgments of Dr Brice in *Shepherd* v *IRC (2005*) *STC (SCD) 644* and *Robert Gaines-Cooper v HMRC, SpC 568,* it has no legal standing.

34 A Judge would not use HMRC guidance as authority upon which to base his or her judgment and therefore, we are unable to accept assurances from HMRC that the concerns of the professional bodies with respect to the scope of the draft legislation are unfounded and that the legislation will be interpreted in line with their guidance.

35 Further, the approach that has been adopted has come under increasing scrutiny in the courts. Questions have been raised in recent years about whether some of HMRC's practices and concessions may be ultra vires, see for example the comments in the *Wilkinson* case (*R v IRC, ex parte Wilkinson* [2005] UKHL 30) and, more recently, in the case of *Robert Gaines-Cooper v HMRC, SpC 568*.

36 The comments made in those cases related primarily to extra-statutory concessions and practices of the former Inland Revenue. As noted above, the guidance set out in this latest note as to when the TAAR will apply appears to go beyond the wording of the legislation, and, in principle, the situation does not appear different to the issues raised in the *Wilkinson* and *Gaines-Cooper* cases. It raises the concern that, if HMRC took a case 'at the boundary', would the courts strike out HMRC's published guidance on the grounds that it clearly went beyond what Parliament had approved when it enacted the legislation and was therefore ultra vires?

The use of safe harbours

37 We have already explained our fundamental objections to individuals being taxed by statute and untaxed by guidance. Given that HMRC can change its view on guidance this also leads to unacceptable uncertainty for the taxpayer. In order to reduce the uncertainty and establish a clearer 'boundary' as to when capital losses will be allowed, examples of circumstances when the rule will not apply should be set out in statute. The provision in the legislation of a list of what is known in the US as "safe harbours" could cover standard situations where the provisions are not to apply. Assuming that a clearance mechanism is also introduced, the use of safe harbour examples would have the added advantage of reducing the number of necessary clearance applications. This would save time and effort on the part of both taxpayers and HMRC.

38 Whilst details of the safe harbours should be included in primary legislation, we would be satisfied with a list of the safe harbours being given in the Finance Act and provision made for tabling a regulation which will provide the full details. To aid understanding, the statutory instrument should provide examples of situations coming within and falling outside of each safe harbour.

Changes required to the draft legislation

39 We set out below the key changes we feel need to be made in order to achieve the stated purpose of producing properly targeted anti-avoidance legislation. We acknowledge that the changes will lead to longer, more detailed, legislation but given the vital importance of producing properly targeted anti-avoidance legislation we think that this is a price worth paying.

40 In line with the approach adopted by the Tax Law Rewrite Team, we suggest that an introduction to the provisions be inserted. This introductory clause would explain the principle behind the TAAR and that the legislation should be interpreted purposively.

41 The term tax avoidance should be substituted for tax advantage. The TAAR is targeted at tax avoidance and it is right that the legislation should use this term rather than the far wider term tax advantage. Whilst we accept that there are differences of opinion over the definition of the term tax avoidance, there is a body of case law to draw upon and use of this term will cause far less difficulty than the term tax advantage which taken literally catches so many standard transactions which hereunto have not been viewed as objectionable.

42 The primary legislation should be amended to set down circumstances in which the provisions will not apply. As noted above, the primary legislation could provide for a list of the safe harbours with provision made for a statutory instrument to provide the detail.

43 The legislation should include a proper advanced clearance mechanism.

Clarification of status of certain existing tax planning transactions

44 The guidance notes indicate that it is only contrived arrangements that are being targeted and not standard tax planning transactions such as the variations on the "bed and breakfasting technique" outlined in the CIOT paper. The draft wording of the legislation could conceivably catch such transactions. This does not appear to have been the intention on the part of government. Given that the legislation applies from 6 December 2006 the issue needs to be clarified as a matter of urgency. If, as we hope will be the case, the legislation is not to apply to such transactions, then they must be included in the list of safe harbours. If the legislation is to apply then there needs to be an urgent publicity effort to alert taxpayers so they do not engage in what they understand is legitimate tax planning only to find that they have fallen foul of the new legislation.

FJH
8 February 2007

APPENDIX 1

WHO WE ARE

1. The Institute of Chartered Accountants in England & Wales is a professional body representing some 128,000 members. The Institute operates under a Royal Charter with an obligation to act in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).

2. The Tax Faculty is the centre for excellence and an authoritative voice for the Institute on taxation matters. It is responsible for tax representations on behalf of the Institute as a whole and it also provides services to more than 11,000 Faculty members who pay an additional subscription.

3. Further information is available on the ICAEW website, www.icaew.co.uk.

APPENDIX 2

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**