TAXREP 8/99

VAT: MINI-GENERAL ANTI-AVOIDANCE RULE FOR CONSTRUCTION SERVICES

Memorandum submitted in March 1999 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to Customs in response to a consultative document issued in January 1999

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GENERAL COMMENTS

Introduction

1. We welcome the opportunity to comment on the proposals in the consultative document issued in January 1999. We trust that, before the laying of any legislation, there will indeed be the 'genuine and positive dialogue' promised by the Paymaster General. We had anticipated that the mini-GAAR would be tailored to construction services but the draft Schedule in the consultative document seems to be apt for any aspect of VAT.

2. We responded in December 1998 (published as TAX 38/98) to the Revenue on their proposals for a general anti-avoidance rule issued in October 1998. Our comments in TAX 38/98 apply *mutatis mutandis* equally to Customs' proposals. That document is reproduced in the annex, the relevant parts of which should be read as part of this response.

3. We would in particular draw your attention to Part I of TAX 38/98 in which we discuss whether a GAAR should be introduced (paras 9-11), the importance of certainty (paras 12-15 and 51-54) - essential in a transactions-based tax such as VAT where it is necessary to know contemporaneously the VAT effect of a transaction, the consequent need for a clearance system staffed by appropriate people (paras 16-22) and the increased amount of administrative discretion that a GAAR transfers to the revenue departments (paras 23-24).

4. Other considerations that apply to a direct tax GAAR apply also to a GAAR relating to VAT such as that suggested in Customs' consultative document. These are discussed in Part II of TAX 38/98. The issues that go to the heart of the debate are taxpayer compliance and honesty (paras 30-34), the experience of other jurisdictions (paras 35-39) and established legal principles (para 40).

5. We are of the view that even if a GAAR were introduced, specific legislation to counter abuses would still be required (paras 47-50); for VAT further such legislation could be avoided if Customs made full use of their existing powers and ensured that the basic initial legislation was properly drafted.

6. Certainty for all parties to a transaction is fundamental to VAT. The need for certainty generally is covered in paras 51-54 of TAX 38/98. In the absence of a clearance and the taxpayer self assessing himself, the proposed mini-GAAR envisages Customs' recasting transactions possibly up to three years later and involving third parties in the recasting which is unacceptable.

Summary response

7. Much of what some might consider to be unacceptable avoidance of tax arises from the commercial necessity of businesses to simply order their affairs to minimize costs, of which VAT forms but one element. Whilst we have observed the growth of contrived tax avoidance schemes especially over the past 6-7 years and do not condone their use and appreciate the apparent attractiveness of the idea of a general anti-avoidance provision which could operate as a deterrent to prevent abuse of the tax system, drafting a general anti-avoidance rule that is workable in practice and targets what should be countered is very difficult, if not impossible. This is an experience that has been mirrored in other countries which have introduced general anti-avoidance provisions.

8. Whilst we do not dismiss completely the idea of a GAAR, we do see difficulties in the way the present draft is worded. It introduces more uncertainty into an already complex area of VAT. The use in para 6(2) of the draft Schedule of the words 'or one of the main purposes' makes it apply to almost any transaction. As noted below (comments on Section 5: Clause and Schedule), the draft leaves much to be determined by the Courts and includes other provisions which the Courts are unlikely to apply in practice. The GAAR as proposed also affects third parties even if they are not party to the transaction being redefined. It is more likely to deter businesses from entering into commercial transactions than succeed in countering tax avoidance and it hands an unacceptable degree of discretion to Customs, which runs contrary to constitutional principle.

9. We believe that before any such measure is introduced, Customs should reassess their objectives, in particular regarding the meaning of avoidance and should target any GAAR only to at those transactions where the saving of tax is the sole or main reason. This would avoid the considerable uncertainty that is bound to arise from the use of the 'one of the main purposes' test in para 6(2) and the very difficult task of identifying the relevant 'corresponding normal transaction' - particularly where some alternatives give rise to a greater tax liability than others.

10. Furthermore, Customs as a prequisite to an acceptable GAAR will need to operate a rulings system which will be a drain on manpower and resources. We would suggest that Customs do not have the business expertise to decide what is a normal transaction: indeed, the absence at present of a clearance culture within Customs forces us to question whether Customs would, in practice, be able to administer a clearance system on an equitable basis.

11. We consider that it is better to tackle problematic areas of tax avoidance with specific anti-avoidance provisions. We believe that such provisions would be necessary even if a GAAR were introduced.

12. Having said that, it may be unnecessary to legislate yet more anti-avoidance provisions. It seems strange that Customs are considering a GAAR: much abuse could be countered if Customs used their existing powers, for example the connected persons valuation rules (for example, in reply to Customs' comment in para 4.3, we suggest that Customs could counter the delaying of payment by directing under para 1 Sch 6 VATA 1994 that the open market

value of those supplies and hence the VAT was higher than had payment not been delayed, and thereby avoid the need to enact new legislation), partial exemption rules, and grouping provisions.

13. Indeed, the UK law on time of supply for construction services could be redrafted to conform with Article 10(2) of the EC Sixth Directive which may obviate the need for further anti-avoidance legislation in this area.

COMMENTS ON THE CONSULTATIVE DOCUMENT

Section 2: Why a More Strategic Approach is Needed in VAT

14. Customs in para 2.2 base their justification for these measures on an estimated loss of £1 billion from 'packaged avoidance schemes'. It is very difficult to challenge this figure, but we have considerable doubts about whether it is correct. It is our understanding that it was concluded that the main reason for the shortfall in VAT receipts was forecasting errors and that it was acknowledged that it was not possible to substantiate the estimated £1 billion lost through avoidance schemes. We recall that this figure was subsequently revised downwards.

15. There are several places in Customs' consultative document (eg paras 2.2, 2.3, 4.2) where they seek to justify the introduction of a GAAR because of the proliferation of avoidance schemes. However, this may be missing the point. For example, the observation that more and more anti-avoidance legislation spawns more and more 'devices' (2.2), of avoidance leading to unfair competition between broadly similar businesses (2.3) and the significant incentive to use artificial schemes to avoid and probably evade VAT (4.2) may be indicative that the law might be fundamentally flawed.

16. Businesses will always seek to minimize costs: this is a commercially expedient course of action. Whilst we appreciate that the UK is constrained by the EC Sixth Directive, it would be better if Customs were to seek to change the underlying law by removing illogical distinctions than simply to add to and complicate it.

17. We do not agree (para 2.4) that specific anti-avoidance measures have the disadvantages cited. The main problem is that recent measures have been drafted in haste and without the care that they warrant. Properly drafted and skilfully targeted specific anti-avoidance legislation would eliminate much tax avoidance. Tax avoidance which is considered unacceptable during the period between discovering the abuse and enacting appropriate legislation can be countered by an appropriate announcement.

Section 3: The EC Dimension

18. The approach taken by the mini-GAAR is described by Customs as deriving from the 'abuse of law' concept. This has a number of difficulties. The legal fiction of substituting a 'normal transaction' for what actually happened appears to go so far beyond the scheme of the tax that we question whether the mini-GAAR as drafted is *intra vires* the Sixth Directive

Section 4: Construction Services

19. We would welcome clarification of the undefined 'other kinds of avoidance' referred to in para 4.5.

THE DRAFT MINI-GAAR

Section 5: Clause and Schedule

20. It is our understanding that this VAT mini-GAAR was intended to be targeted at the construction industry. However, the wording of the Schedule which is very wide and para 11.5 indicate that it is intended as a general anti-avoidance rule.

21. The draft legislation seems deficient in the round and in detail. In the round it does not cater for rulings (for which a statutory procedure would be required) or for appeals (for which an amendment to section 83 VATA 1994 would presumably be necessary).

22. The VAT mini-GAAR introduces the concept of a 'VAT avoidance transaction' and a 'corresponding normal transaction'. The proposals appear to impose an obligation on the taxpayer to apply the mini-GAAR against himself. He must choose that transaction, or combination of transactions, which imposes the maximum VAT cost at the earliest time, or risk having a mini-GAAR adjustment, with penalties and interest, imposed by Customs in hindsight.

23. Our reason for saying this is the way in which the purpose of the transaction is to be ascertained. Customs seek an objective approach, so as not to concern themselves with the intention of the parties. It is likely that any transaction which is not a sham is likely to satisfy all of the tests, except that of impact on the tax liability. Thus, it is likely that tax will be the only distinguishing factor between transactions, automatically imposing an avoidance purpose on any transaction which does not result in the maximum tax liability

24. As to the detail, the definitions are unclear and we would welcome clarification of the terms used, namely in clause 1(1) 'associated with' (as presently drafted, it is not possible to determine the activities that this clause is intended to counteract), clause 1(2) the services within 'construction services' (which would appear to encompass, for example, cleaning) and para 2(2) the 'corresponding normal transaction'. As to para 6(2) 'VAT avoidance transaction', all businesses seek to reduce their exposure to VAT which is a business expense: the extent to which this will be considered 'one of the main purposes' should be described.

25. Paragraph 3(1)(b) seems meaningless as the purpose of VAT legislation is not relevant in the context of UK law and is not drafted into statute: the purpose would need to be determined by the Courts.

26. Para 3(1)(2) appears to undermine the supremacy of Parliament in enacting legislation and is unlikely to be applied by the Courts in practice.

27. Para 5(2) seems to imply that the mini-GAAR would apply if a person's decision to, for example, lease or buy was influenced by VAT considerations.

Sections 6 - 13: Comment on Draft Mini-GAAR

The GAAR

28. Par 8.2 refers to cases of dispute being resolved by the Tribunal. However there appears to be no provision in the clause or Schedule for this.

29. We would welcome confirmation that para 8.3 envisages that input tax would be recoverable where this was due under a recharacterised transaction.

Meaning of VAT avoidance transactions

30. Para 11.2 says that the tests are objective. We would have thought that it is the taxpayer's motive which needs to be considered in the context of avoidance.

Legal consequences

31. The effect of the schedule seems to be to change the particular transactions. We question whether this is lawful under the Sixth Directive

DRAFT SPECIFIC ANTI-AVOIDANCE MEASURE

Section 14: Draft Statutory Instrument

32. The draft measure illustrates the advance of targeted anti-avoidance provisions brought in using the *vires* of existing primary legislation: namely that it can be amended speedily. A GAAR brought in by primary legislation can be changed only by Parliament.

Section 15: Comment on Draft Specific Anti-Avoidance Measure

33. Whilst it is complicated, the targeted draft anti-avoidance legislation appears to achieve the objects as described in section 15. We would welcome clarification of the points in the following paragraphs.

34. The draft regulation seems to have a main purpose of establishing a tax point at the time of performance in the case of exempt land. The value of the supply can be open to significant argument between builder and customer over variations, and such argument can extend over more than 18 months. In such circumstances, what is the right value at the deadline date?

35. The regulations are likely to cause confusion because of the reference to occupation. In this context we are not at all certain who is the 'occupier' when a landlord opts to waive exemption and charges VAT on rent to a tenant who makes exempt supplies.

36. There will also be confusion because of the special meaning given to 'exempt' land. The land could be exempt for the purpose of this regulation but not exempt for the purpose of VAT generally.

Section 16: CLEARANCES

37. A clearance system is a prerequisite for a GAAR, generally on the lines envisaged in section 16. Such a system would need to be statutory, with statutory rights of appeal. Legislative provision would need to be made for this if a GAAR is enacted.

38. The 30 day time limit is envisaged in para 16.3 should be considered a maximum turnaround time, not a minimum. Given the need for the taxpayer to fully disclose details of the transaction in the clearance application, we see no reason why Customs should not be able to give a considered ruling within, say, 10 days where necessary.

39. As to appeals, we recommend an expedited system. However, internal review should take place first, preferably at a senior level, otherwise in the early days of a GAAR the Tribunals are likely to become overwhelmed causing other appeals to be delayed. As all the details should have been furnished with the clearance application we anticipate that a decision should not be too long forthcoming. We favour publication of decisions, general comments etc. as envisaged in para 16.6.

40. Para 16.8 underestimates the damaging effect of the GAAR on businesses and the associated costs of seeking professional advice, rulings etc. We can see no savings on the lines envisaged by Customs. Given that the mini-GAAR recharacterises transactions and is not focused at all, even those not involved in 'avoidance' will feel obliged to obtain a ruling. The comment about accounting for tax before receiving the payment is a known hazard of business life by slow payers.

Section 17: QUESTIONS

Q1: *Is the mini-GAAR or the specific solution using the funding test the preferred solution to the current problem? Which option gives the best balance between revenue protection on the one hand and certainty and business costs on the other?*

41. The question presumes that these are the only alternatives and, indeed, that action is necessary. Even if this is accepted, there may well be better solutions, including redrafting the VAT law and paying proper attention to the key issues of liability, deduction and valuation. Of the two solutions offered by Customs, the specific solution targets the perceived abuse and is the better way to proceed. The uncertainty and associated business costs arising from the GAAR as drafted outweigh the benefits of any additional revenue raised

Q2: *What advantages/disadvantages does the mini-GAAR have over one or more specific anti-avoidance measures designed to counter specific problems?*

42. If only the mini-GAAR or the specific solution is offered, then the specific legislation is the least worst. The mini-GAAR imposes an unacceptable degree of uncertainty and transfers unfettered administrative discretion to Customs. The specific legislation would avoid this. However, the proposed legislation requires redrafting to limit its scope to transactions specifically intended to defer VAT. We do not accept the implication that any transactions between connected parties automatically imply avoidance. It is also necessary to ensure that the legislation does not produce a distortive result, for example, the provisions restricting the option to tax (section 37 Finance Act 1997) have the distortive effect of blocking input tax recovery even where there is material taxable use of the property.

43. The only advantage of a mini-GAAR is that it might shorten legislation if it led to the reduction or elimination of specific anti-avoidance measures. However, the consultation document suggests that this will not be the case and the disadvantages of uncertainty and the need for rulings etc. far outweigh any advantage.

Q3: *Is there a need with mini-GAARs for a system of rulings? If there is a system for giving rulings, should this be administrative or statutory?*

44. The taxpayer must be able to seek a ruling: this is a prerequisite of making a GAAR acceptable. VAT is based essentially on the economic result of a transaction where it is essential to ascertain the VAT liability at the time the transaction is entered into. Taxpayers should have the certainty that their tax costs will reflect the economic realities of their actual transactions and not some theoretical alternative chosen because it may result in a greater tax burden. In consequence, particularly within the context of a self-assessed GAAR, there must be a system of rulings. The mini-GAAR imposes on the taxpayer the obligation to identify other ways of achieving his commercial objective and determine whether these should be regarded as the 'normal transaction' in determining his VAT liability. Given the difficulty of establishing what is 'normal', it would be easier there was a 'sole or main purpose' test.

45. It is important that those who are responsible for giving rulings are able to maintain an objective view and not be swayed by what appears to be the Department's current emphasis on obtaining the maximum tax at the earliest opportunity and are not so restrictive in their interpretation of the law as to normally refuse to give clearances. Whilst we acknowledge that Customs do presently operate an informal non-statutory system of rulings, we are concerned that the absence of an established clearance culture within Customs may render seeking a clearance pointless. In this event we suspect that evasion would become widespread.

46. We suggest that rulings (on a no-names basis if necessary) and general consents should be published.

47. Given the inherent uncertainty of a GAAR any accompanying ruling system should be statutory.

48. We suggest that the law provide for a standardised form of applications for those seeking a ruling. This would make it quicker for Customs to consider the application and assist taxpayers in determining what details Customs need.

Q4: *Would 30 days be sufficient to meet most business needs? Should the limit be statutory or, as with the Charter Standard, administrative? Should there be a built-in compensation for delay due to official action?*

49. Thirty days would be sufficient for most business needs. However, given the speed at which some contracts are finalised once the details have been negotiated we suggest that there should be a fast track mechanism which can be invoked where there is special need for speed. VAT is a transactions tax and the factors that shape a transaction, for example, the progress of negotiations between the parties, may be the subject of frequent change. The final form of a deal is often settled only shortly before the contract is entered into. A thirty day delay may have a significant detrimental effect because other factors could emerge in that time leading to deals being either further changed or aborted.

50. Any time limit should be statutory.

51. Compensation should not be available for delays, but if a decision has not been given within the deadline then the transaction should be deemed acceptable. This would not deprive Customs of remedies in that the consultation document contemplates that rulings would be given on the basis of full disclosure. If a ruling has been given, or the default mechanism has operated, Customs would appear still to have the power to reopen the case if adequate disclosure was not made.

Q5: *Would businesses be prepared to pay for clearances and what would be the best and fairest basis for charging?*

52. Given that businesses already act as unpaid tax collectors, we have reservations about requiring taxpayers to fund requests for confirmation that a business transaction is 'normal'. If there were to be a charge, it should be based solely on the administrative costs of the staff involved and it should be kept low so as not to discriminate against small businesses.

Q6: *What is the likely level of demand for clearances?*

53. It is difficult to predict demand Any business entering into any material transaction likely to be affected by the GAAR will wish to obtain professional advice, but as advisers are unlikely to be prepared to second guess Customs they are likely to recommend that a clearance be sought; therefore the likely level of demand for clearances is likely to be substantial.

Q7: *Should there be a statutory right of appeal against a refusal to give a clearance? Or only against the eventual triggering of the mini-GAAR?*

54. There should be a statutory right to appeal against a refusal to give a clearance. A number of factors enter into the consideration of whether there should be a right of appeal against a refusal to give a clearance. Timing is certainly one of

these: could business wait for this process to occur? On the other hand, would the consequence of carrying out the transaction when a clearance application has been turned down be the automatic application of a penalty (subject to the trigger limits)? Would Customs argue that there could not be a 'reasonable excuse' for the treatment adopted by the taxpayer when he had not obtained a clearance? If this is the case, there needs to be an appeal at this stage.

55. Another factor is the nature of the ruling. If the application is refused without reasons, the taxpayer would not know against what 'normal' transaction he was being judged and what alternatives were available to him. In the absence of a default clearance suggested in our reply to Q4, it would be most unsatisfactory if he could not carry out the transaction because he had no clearance and no means of knowing what might be acceptable. In these circumstances, the appeal mechanism might at least give some clarification, albeit not necessarily within a useful time frame.

Q8: *What are the implications for business costs?*

56. The implications for business costs are significant because all businesses entering into material transactions likely to be affected by the GAAR will seek professional advice and a ruling.

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ANNEX

TAX 38/98

A General Anti-Avoidance Rule

Memorandum submitted to the Inland Revenue in December 1998 in response to a consultation paper issued in October 1998.

CONTENTS

A GENERAL ANTI-AVOIDANCE RULE

INTRODUCTION

1. We welcome the opportunity to comment on the Consultative Document published in October 1998 on a General Anti-Avoidance Rule ('GAAR') for direct taxes.

2. We trust that this will indeed prove to be 'a genuine and open consultation' as referred to by the Financial Secretary to the Treasury, Dawn Primarolo, in her foreword to the Consultation Document.

3. This representation is divided into two parts. Part I considers the concept of the GAAR and whether it is desirable or necessary. Part II considers the detailed proposals as set out in the Consultation Document. We also make recommendations for possible alternative courses of action. The main findings of our review of the GAAR are set out below in our summary response.

SUMMARY RESPONSE

4. The Tax Faculty appreciates the problems that have arisen due to the use of highly artificial tax avoidance schemes. We do not condone the use of such schemes and can see the attractiveness in the idea of a general anti-avoidance provision which could operate as a deterrent to prevent abuse of the tax system.

5. However, the reality of drafting a general anti-avoidance scheme shows the inherent difficulties of producing legislation that is workable and fulfils the purpose it is intended for. This is an experience that has been mirrored in other countries which have introduced general anti-avoidance provisions.

6. The GAAR, as outlined in the Consultation Document, will introduce more uncertainty into the already complex area of tax. It is unlikely to succeed in countering tax avoidance and it hands an unacceptable degree of discretion to the Inland Revenue, which runs contrary to constitutional principle. Furthermore, in order to operate the GAAR there will need to a clearance system that will be draining in both terms of manpower and resources for the Inland Revenue.

7. Therefore whilst we are not conceptually opposed to the introduction of a GAAR, it is very difficult, if not impossible to draft a provision successfully. In particular the draft in the Consultation Document does not produce an acceptable solution. We consequently believe that it is better to tackle problematic areas of tax avoidance with specific anti-avoidance provisions. We also believe such provisions will be necessary even if a GAAR is introduced.

8. If a GAAR is implemented, our recommendation is that it should be limited only to large companies. This will remove from the ambit of the provision the smaller companies who are least able to cope with the GAAR as drafted whilst still providing a deterrent to the kind of corporate avoidance identified in the Consultation Document.

PART I

SHOULD A GAAR BE INTRODUCED?

9. The Consultation Document concludes with 16 questions about the GAAR. None of these asks whether the GAAR should be implemented at all.

10. Before discussing the details of how a GAAR could work, we believe it is essential to consider whether it is the right approach to take in the first place. Our view is that it is not. Countering 'unacceptable avoidance' schemes, as drafted in the Consultation Document, will add significantly to uncertainty in the tax system and provide inadequate safeguards for taxpayers. We think this is too great a price to pay for a provision which we believe will be largely unworkable. Furthermore the taxpayer should not be obliged or expected to adopt a position which produces the greater tax burden.

11. We are not alone in finding difficulty in seeing how a GAAR can successfully operate in practice. In the Labour Party's Leaflet entitled 'Tackling tax abuses - tackling unemployment' which was issued in November 1994 it says:
'We have rejected a general anti-avoidance provision for two reasons. Firstly, experience elsewhere reveals that it has severe limitations in its success. Secondly, as a matter of principle we believe that the citizen is entitled to know where he or she stands before the tax law. A catch-all provision that came into play when all else fails is unacceptable in a fair tax system.'

UNCERTAINTY

12. Every taxpayer is entitled to know with a reasonable degree of certainty the tax impact of any transaction he or she undertakes. The GAAR as suggested will take away from that certainty. The heart of the problem is the fact that no one has ever been able to define 'tax avoidance'. The Tax Law Review Committee (TLRC) could not arrive at any agreed definition and it is doubtful if any one else can. If it is not possible to fully explain what constitutes 'avoidance', it is impossible for a taxpayer to be certain that a particular transaction does not fall foul of a provision seeking to tackle such 'avoidance'.

13. There has been a worrying tendency in recent years for the word 'avoidance' to be used loosely to cover any tax planning situation which the Inland Revenue or other Government Department finds unacceptable. It is worth stressing at the outset that a liability to tax only exists where a transaction falls within the clear words of Parliament authorising the Government to tax it. If the transaction does not fall within those parameters, the liability does not exist to be avoided. This is a constitutional right for taxpayers and should be protected.

14. Whilst the highly artificial (albeit legal) tax schemes that have been marketed in the past could clearly be categorised as avoidance, there are examples of tax planning that result in a reduction in the overall tax burden, are also within the confines of the law and are not of an artificial nature. These types of tax planning would not be perceived as avoidance by most people. Example include husband and wife transactions or incorporation. The inherent difficulty of couching a very general anti-avoidance provision is that whilst trying to prevent the former type of artificial scheme it also can catch the latter uncontentious tax planning.

15. The Consultation Document refers to the concept of protecting the purpose of tax legislation. Leaving aside for the moment the question of the correctness of this concept, the cases that have come before the courts show that the intention of Parliament in enacting certain provisions is often unclear. This leaves the taxpayer in a fog of uncertainty.

CLEARANCE SYSTEM

16. One proposed method to counter some of the problems with uncertainty is to establish some form of clearance system to assess whether a transaction falls within the ambit of the GAAR. It is generally accepted that for any anti-avoidance provision to work, a clearance system would have to run in tandem with it. This is acknowledged in the Consultative Document.

17. To be effective, such a clearance system would have to be a quick-response service, thus enabling businesses to make important decisions with the necessary speed. Innovative businesses, especially those in the financial markets, will simply take their business to other centres overseas if transactions are being hindered because of the time taken to obtain a clearance from the Revenue. This could have serious consequences for the UK economy.

18. In order to avoid this problem, a clearance system would therefore need to be fully manned and resourced by the Inland Revenue to be effective. This will come at some considerable cost and there is no current indication of any willingness to provide the necessary funding. The clearance system will also need to be a relatively inexpensive if not free service to provide accessibility to all.

19. If a clearance system is introduced advisors are likely to feel obliged to use it for even straightforward cases as a protective measure against possible negligence claims. This would mirror the current practice in respect of clearance applications under section 707, ICTA 1988 and section 138, TCGA 1992. The courts have also indicated that where a clearance procedure exists, a taxpayer that does not use it cannot complain about being unwittingly caught by

related provisions. The result of these factors is that the system may easily become clogged up with a back log of cases placing a substantial administrative burden upon the Inland Revenue.

20. Another practical problem faced by advisors and their clients would be in deciding how much information they would have to provide in order to ensure that any ruling was valid. There is case law on this point but no absolute clarity.

21. There are also similar problems to a clearance system as would arise in a pre or post transaction ruling system. These were covered in the Tax Faculty's representations found in TAX 7/96 and we believe these matters are still relevant.

22. We believe therefore that even a clearance system will not wholly remove the issue of uncertainty for taxpayers, particularly if, as proposed, later events could trigger the application of the provision.

UNACCEPTABLE ADMINISTRATIVE DISCRETION

23. A further inherent difficulty with introducing a GAAR is that it will hand an unacceptable degree of administrative discretion to the Inland Revenue. This is closely linked with the issue of uncertainty.

24. Due to the fact that any anti-avoidance provision will inevitably be uncertain, taxpayers will be obliged as a matter of practicality to accept that it means whatever the Revenue says it means. This is already happening with existing clearance procedures where clearances are sometimes being refused because the Revenue perceive as avoidance something else the taxpayer has done which is not an integral part of the transaction but has been disclosed as background information. The problems caused by the handing over of such a large amount of administrative discretion under the proposed GAAR will be even stronger if the clearance procedure is operated by the Revenue.

PART II

DETAILED COMMENTS ON THE CONSULTATION DOCUMENT

25. Set out below is a detailed analysis of the GAAR Consultation Document. This follows the document through chronologically and references are to the paragraphs within the document.

Paragraph 4.2

26. Coming so early in the paper the example given by the Inland Revenue in paragraph 4.2 provides a simple but telling illustration of the inherent difficulty in operating a GAAR. It seems that by the strategy adopted in the example, the company is delaying the time at which tax is accounted for on an accretion of profit which might be characterised as interest, or possibly avoiding tax on that accretion altogether.

27. A GAAR would presumably operate to create one or more artificial deemed realisations of the investment and to tax the deemed profit as income. This artificiality requires many questions to be answered, such as:

* How would the deemed realisation work?

* Would there be a deemed liquidation of the new company at the time when the purchaser took delivery? If so what would happen to the new company after it had been deemed to be liquidated, and what would the purchaser be deemed to have done with the proceeds of the liquidation? If there was not a deemed liquidation, would it be deemed to have been sold and re-acquired, and would there be further deemed disposals at intervals thereafter?
* How would the fact that its income had already been taxed be dealt with?

* Alternatively, would the acquisition of the new company be ignored altogether and the taxpayer company be deemed to have made some other investment? If so, how does one decide what investment it would have made? Why should it be assumed to be one which generates taxable income rather than, for example, being an investment in preference shares? Is the taxpayer to be taxed on more profit than it has actually made, if (as is likely) the bank

has retained a share of the expected profit so the actual yield to the taxpayer is less than it would have been on a simple deposit?

* What happens to the chargeable gain arising when, at some later stage, the new company (which is deemed never to have existed) is liquidated or sold?

28. Clearly the example raises a considerable number of issues many of which have no straight forward solution.

Paragraph 4.3

29. Paragraph 4.3 raises three important issues that go to the heart of the debate concerning the introduction of a GAAR. Firstly, there is the issue of taxpayer compliance and honesty, secondly the matter of the success or otherwise of GAAR's introduced in other jurisdictions and finally the issue of established legal principle. These three issues are dealt with below.

TAXPAYER COMPLIANCE AND HONESTY

30. The UK has never had a GAAR but it must be remembered that the UK has enjoyed and still does enjoy a very high level of taxpayer compliance and honesty as compared with some of its developed European counterparts. Taxpayers are much more prepared to comply with a tax system they feel is fair and which maintains what they consider to be a proper balance between the interests of and powers given to tax-gatherer and taxpayer.

31. There is a real danger that the introduction of a GAAR, which provides administrative power to the Inland Revenue and where appeal to the courts is over costly and possibly ineffective, will pressure previously honest taxpayers into non-compliance, including non-reporting.

32. It is also likely to drive business out of the UK into less uncertain fiscal jurisdictions. This will especially be so under the climate of sharply increased local competition which will follow introduction of the Euro. We are seriously concerned about the potential damage to the UK economy if this proved to be the case.

33. We believe it is fundamental that taxpayers see the tax system as fair and certain and not unreasonably biased in favour of government. It is far easier to collect tax in a compliant society. At the very least, the cost of collection would rise many times over if there were general non-compliance.

34. Government should recognise that this tax position has been built-up over the last 200 years but once lost it cannot easily be regained.

OTHER JURISDICTIONS

35. Although the UK has no general statute to counter tax avoidance it is by no means alone in this regard. Neither the United States nor many European countries have introduced a GAAR.

36. In those countries which have opted for a general anti-avoidance provision it is important to review how successfully these provisions have worked, especially in those countries with a tax system bearing some similarities to our own. Canada has had a decade's experience with its provision. In that period a limited number of cases have been brought under the statute. Authoritative commentators have suggested that very few transactions that would have been carried out prior to the introduction of the GAAR have been prevented by its introduction (for example, see Brian Arnold, tax consultant, who has worked with both the Canadian Government and the OECD, writing in 'Tax avoidance and the rule of law' published by the IBFD in 1995).

37. Another part of the Canadian experience has been the development of a major industry in the giving of legal opinions on whether a proposed transaction falls within or outside of the GAAR. This shows the inherent uncertainty in the provision and the extra costs that a taxpayer can incur under such a regime.

38. Australia has had two attempts at a GAAR. The second was enacted in 1981. Professor Jeffrey Waincymer of the Taxation Law and Policy Research Institute of the School of Law at Deakin University, Australia has commented on the second attempt as follows:

'In spite of a fair amount of drafting effort, too many key policy questions have been left for judges to answer. If we are concerned about the philosophical questions as to the rule of law in a complex society and not just about revenue collection, we should as a result have concerns about the present GAAR operative in Australia.'

(Extract from 'Tax avoidance and the rule of law' published by the IBFD in 1995).

39. New Zealand has had a GAAR for many years. It is now recognised in that country that the GAAR attempts to treat a perceived symptom of a poor tax regime and the move is now towards an integrated policy of structural and substantive tax reforms. This is a considered response in the light of experience and reveals that the scope of a GAAR provision can lead to many years of uncertainty with only partial resolution through case law.

ESTABLISHED LEGAL PRINCIPLE

40. Although the UK has no statutory GAAR the courts have shown themselves ready to counter tax avoidance where they find it. It has been 17 years since the landmark decision in *Commissioners of Inland Revenue v W T Ramsay* [1981] STC 174 and this has been followed by over 10 other cases refining the distinction between unacceptable tax avoidance and acceptable tax mitigation.

SCOPE OF THE PROVISION

Paragraph 4.5

41. Given that the Consultation Document accepts that the avoidance which it seeks to stem arises predominantly in the large corporate sector (*paragraph 1 of the Foreword*) and the acknowledged difficulties any GAAR would create, we believe there must be a very strong case for restricting its application to the largest companies only. This would reduce the overall new burden on taxpayers very considerably by removing the large bulk of companies by number from its ambit. It is the smaller companies that are least able to risk the uncertainty and the large amount of management time and professional costs that would need to be incurred to determine if clearances were needed, to obtain them if they were needed and to litigate if required.

42. Furthermore, small private companies are often no more than an alternative to engaging in sole trade or in trading partnerships. To apply a GAAR to all companies would be further to distort what should be a purely commercial decision as to whether or not to incorporate. The limit on the applicability of the GAAR could be expressed using the Companies Acts definitions of small or medium sized companies but since it is acknowledged that the kind of corporate avoidance identified in the document arises mainly in large groups, it could instead be linked to total group net assets or total group profits. For example, one could apply a lower limit of group net assets of £100,000,000 or annual group accounting profits of £20,000,000.

43. Because of the financial and trained manpower costs of operating a GAAR, it might be easier to implement a system which affected only the largest groups. Many tax districts will already be deploying staff to assist on issues arising from specific larger companies and their existing expertise could be used to help operate the introduction of a GAAR related clearance system.

Paragraph 4.8

44. There will be many more 'borderline cases' under a GAAR, especially bearing in mind the additional litigation possibilities attaching to the new general clearance procedure. The Consultation Document is right that costs for both sides will be increased, as will the burdens on business of compliance.

Paragraph 4.10

45. This paragraph in the Consultation Document appears to raise the interesting point that the complexity of the tax system creates the scope for avoidance in the first place. Taken to its logical conclusion this point suggests that if the tax system could be made simpler, then at the very least some of the avenues for avoidance would reduce. We are whole-heartedly in favour

of simplifying the UK tax system and believe it is to this end that resources should be channelled.

46. As to the introduction of 'mini-GAARs', these would need to be very narrow in order to avoid the pitfalls associated with a single GAAR provision. It is interesting that Customs and Excise appear to be favouring the 'mini-GAAR' approach rather than a single all encompassing provision. This perhaps reflects their own misgivings about the chances of successfully producing a one-off anti-avoidance rule, which mirrors our own concerns.

SPECIFIC LEGISLATION STILL REQUIRED

Paragraph 4.12

47. Although in principle, one might argue that a well drafted GAAR could replace all other anti-avoidance provisions the reality, of course, is that there will remain a need for specific anti-avoidance legislation. This is because the Inland Revenue cannot be sure that the GAAR will apply to a particular transaction so there will remain a need for specific legislation to close any loopholes. There will consequently need to be an agreed method for determining which provision is used first in any dispute and serious consideration should be given to reflecting this method of ordering in statute.

48. If a GAAR was introduced, we believe the specific anti-avoidance legislation should be the front-line 'weapon' of the Inland Revenue and the GAAR only used as a last resort. We therefore believe the provision should be operated in a less confrontational manner than specific anti-avoidance legislation.

49. This paragraph in the Consultation Document also raises the issue of what other changes would be possible and indeed necessary if a GAAR was enacted. The most obvious is whether there should still be any need for the *Ramsay* judicial doctrine (it having been enacted in a stronger form in the GAAR) together with the developed doctrines which followed that case. After the GAAR it would not be for the courts to construct 'innovative anti-avoidance techniques' but for the Revenue (with recourse to the courts where the taxpayer did not agree with the innovation). This leads to the question of whether with a GAAR there should be concomitant statutory provisions reversing the Ramsay line of cases and reasoning. We believe that there should be but there is nothing in the Consultation Document which considers this issue.

50. We believe it is essential that sensible proposals are made to tackle this difficult area. In our view the principle should be that where the Revenue chose not to use the GAAR, the courts would be required to interpret the effect of transactions on the traditional, pre-Ramsay basis, and innovative techniques would properly be reserved for the statutory GAAR system. This would go some way to answering the criticism of the present system made by the TLRC which considered that non-statutory judicial innovation on a large scale causes difficulty.

PROVIDING CERTAINTY IN TRANSACTIONS

51. Section 5 of the Consultation Document discusses the issue of certainty, which has been covered earlier in this representation. However, there is one further point to stress. For at least one of the parties involved, the purpose of most corporate transactions is commercial rather than tax-avoidance, because primarily corporate taxpayers are involved in business and not tax avoidance. Whilst acknowledging it may happen within groups of companies, unconnected parties trading with each other at arms length do not normally enter into transactions for a purely or even largely tax avoidance motive.

52. But sometimes one party will have a strong element of tax avoidance motive while the other has little or none. Should a whole transaction be re-cast for both parties if one party has a tax avoidance motive? If not, should it only be re-cast for the tax avoiding party? If so, surely it would be wrong to penalise the non-tax avoiding party? Since the parties to a transaction must between them pay all the tax arising from it, would it be right to re-cast the transaction so that a disproportionate part of its tax burden falls on the tax avoiding party, because it avoided tax and must be punished? In any case, is it accepted that tax should only be paid once overall on the transaction? If so, will there be redress against a non-tax avoiding party if the tax he pays becomes less as a result of the re-casting of the transaction? Generally, in this entirely artificial system how will equity be maintained between the unconnected parties trading at

arms length, bearing in mind that at paragraph 1.3 the whole purpose of a GAAR is to make tax 'fairer'.

53. The above point is referred to in the Consultation Document at paragraph 6.8.9 but we do not believe it considers all the possibilities raised above.

54. A clear distinction also should be made between the purpose of a transaction and the purpose of doing it in a particular way. Paragraph 5.1 seems to be saying that a GAAR should only apply to a transaction one of whose main purposes is tax avoidance. Thus a commercial transaction carried out with a tax avoiding structure would seem not to be caught. Is that what is intended?

WHAT A GAAR MIGHT LOOK LIKE

55. Section 6 of the Consultative Document sets out the possibilities for implementing a GAAR.

Paragraph 6.1

56. This paragraph contains the worrying proposal to extend the established *Ramsay* doctrine extensively. It appears to suggest that there should be no limit on the time which may elapse between one step of a transaction and another when considering if the steps are of a circular nature. If that is the case, a taxpayer can never be certain of the tax treatment of the transaction. We believe there must be a limit on the time which may elapse after a transaction within which it remains subject to re-casting.

Paragraph 6.2.1

57. This introduces the concept of a ‘normal’ transaction. The Consultation Document provides some indication of what this will be defined at in paragraph 6.5.10 but the point we wish to stress here is the considerable difficulty in identifying the 'normal' transaction. Some transactions structured to avoid tax have become so generally used that the tax avoiding structure is itself the 'normal' commercial transaction e.g. transferring assets pregnant with capital gain within a group to a member with losses before external sale or paying a dividend to clear accumulated profits when selling a subsidiary. These and other commonplace structures are clearly tax avoidance although it is thought that the Inland Revenue has decided that they are acceptable. This once again illustrates the difficulty of drawing the acceptable/unacceptable line, which a GAAR in the proposed form must necessarily deal with.

58. Another example may help highlight the inherent difficulties of the approach taken in the Consultation Document. Assume a company has a share capital of £1,000, assets of £1 million and reserves of £999,000. The company is a 100% subsidiary of another company. The parent company wishes to obtain and use the assets. It can legally pay a dividend as a group dividend of £999,000 with no tax to pay and then liquidate the subsidiary, obtaining the remaining £1,000 tax free. Alternatively it can put the subsidiary into voluntary liquidation and corporation tax on the capital gain on the disposal of the shares (£999,000). Both methods are perfectly legal. The first is available because it is advantageous to be able to pass funds up and down groups of companies without levying a charge. However, there are good reasons why a government would want instead to see capital gains tax on the liquidation of companies. Will the GAAR catch the first method used because less tax is being paid than under the second method? What if the dividend precedes liquidation by a period of 6 years, 2 years or just 6 months? At what stage would a GAAR be invoked? Is the first method acceptable tax planning? Finally which of these methods can be described as ‘normal’?

Paragraph 6.3.2

59. This paragraph states that one of the main reasons for having a GAAR is to ‘help realise the true purpose of other legislation’. It is hard to see how this can be achieved. Our concern is that in reality such an aim will see the Inland Revenue deciding what the ‘purpose of other legislation’ is rather than companies paying tax by reference to written law. We believe this would be unacceptable and contrary to a fair rule of law.

DEFINITION OF TAX AVOIDANCE

Paragraph 6.5.1

60. As the document accurately states, this is the nub of the whole issue. Of course it is for government to define the tax system and therefore to determine what tax planning is acceptable. However, the drafting of a wide definition coupled with exemptions leaves considerable discretion and control in the hands of those operating the system.

Paragraph 6.5.2

61. It is easy to pick holes in this so called 'definition' of tax avoidance. The main problem area words here are 'than would otherwise be the case' because their meaning is not defined nor able to be determined. This emphasises the point that no one has or appears able to draw up a working, clear definition of tax avoidance.

62. The 'definition' is in fact not a definition of tax avoidance at all. It quite clearly covers, for example, the incurring of normal business expenditure as a result of which a tax deduction is obtained. As a result, the scope of the GAAR is determined not by this supposed definition, but by what can be excluded under the "acceptable tax planning" provision in paragraph 6.5.10. This is itself fatally flawed as we will consider below.

63. As presently drafted, the consequences of paragraph 6.5.2 would cause considerable difficulty for taxpayers and advisors as it is so wide-ranging. For example, it could be interpreted to 'catch' such transactions as incorporation and husband and wife transactions. Neither of these are the type of transactions that we believe should be attacked as 'avoidance'. The uncertainty that such a wide-ranging definition would introduce runs counter to the principle of a fair tax system.

Paragraph 6.5.10

64. We believe the definition of 'acceptable tax planning' found in this paragraph is unacceptable for lack of certainty. Since the purpose of the legislation is usually unknowable (at least in its application to facts which Parliament never considered), and since what is "acceptable" is an entirely subjective question, the proposed GAAR effectively hands unfettered discretion to the Revenue. This is shown in the examples given above in our paragraphs 57 and 58. The whole tone of the definition is reminiscent of the famous phrase known as Walton's dictum (which was endorsed by Lord Wilberforce) that one should be taxed by law not untaxed by concession. Part (b) of the definition is particularly unhelpful since if the indication is not conclusive it is not adding anything.

65. Furthermore, the definition highlights a conundrum at the root of the whole consultation. The suggested definition of tax avoidance excludes any mention of legislative purpose on the grounds that it is difficult if not impossible to ascertain. The same argument was used against the TLRC definition of 'protected transactions' (see paragraph 6.3.8). However, 'acceptable tax planning' is defined by reference to the 'purpose of the tax legislation'.

Paragraph 6.6.3

66. Some of the issues arising out of the interaction of different parties to a transaction under the GAAR have been raised above. Whether the GAAR applies to persons or transactions is a key issue. But if it applies to transactions it is fundamental that the re-cast transaction is the same one for all parties. On the basis of a fair tax system, a recast of a transaction, even though artificial, must be able to be shown to be capable of existing for all participants. Different recasts of the same transaction will often lead to tax on the transaction being paid more then once. Also the cost of multiple appeals on the same transaction will be prohibitive for all. Such freedom also confers far too much power on the Inland Revenue relative to the taxpayers.

Paragraph 6.6.4

67. We suggest that the reference to 'one of the main purposes' be dropped. Where taxable transactions are in point and with a mainstream corporation tax rate of 30%, the amount of tax payable will always be one of the considerations relevant to a transaction and will probably be one of the main considerations. Therefore if a GAAR is to be introduced, its scope, at least in the first instance, should be restricted to transactions that have as their only or main purposes tax

avoidance. If there are other main purposes which are commercial, then the GAAR ought not to apply, since it would necessarily inhibit genuine commercial activity.

Paragraph 6.7.5

68. The GAAR should apply just to the tax avoidance-motivated step rather than to the composite transaction as a whole It is hard to see why it is necessary to provide that a composite transaction is caught when tax avoidance is inherent in any step in the transaction. The composite transaction, being composite, will always be for the purpose of tax avoidance if one of its steps is mainly for tax avoidance. Under the composite transaction definition proposed, a step in a transaction will not be capable of separation from the overall transaction unless the Inland Revenue require it.

Paragraph 6.7.8

69. Electronics aside, many transactions entered into at one time have composite steps entered into simultaneously. For example, in the sale of a company, there may be a completion meeting at which many documents are executed relative not only to the sale of the company but perhaps the financing of the acquisition, the repayment of debt owed to the old parent, the re-financing of assets held, the stripping out of existing subsidiaries to be retained by the vendor and so on. In practice all these documents will be executed in escrow during the meeting and only exchanged in a simultaneous completion at the end of the meeting once all documentation is in place. Is this a composite transaction or a series of distinct transactions? The lack of clarity here adds yet more uncertainty.

Paragraph 6.8.4

70. There will indeed be many situations where it will not be possible to identify a corresponding normal transaction. This difficulty will be particularly acute in the case of financial and fiscal results that occur after the comprehended final element of a composite transaction which falls to be ignored under this GAAR proposal.

Paragraph 6.8.10

71. If the Board of Inland Revenue are to be in control of the quantification of the relief referred to in the above paragraph, there should properly be a full appeal provision, with the usual costs rulings applying. The relief should apply to the taxation of future money flows resulting from a (composite) transaction which ended before those flows, where the flows resulted from the transaction or from an applied re-characterisation of it.

Paragraph 6.8.11

72. This is letting the government have matters both ways. The Inland Revenue should not have the choice of taxing the 'enduring' real consequences and the re-characterised consequences. The rule should only apply to re-characterise a transaction for all parties to it and for all time.

Paragraph 6.8.14

73. If the Inland Revenue is to be given a prima facie right to determine what transactions form part of a composite transaction then it is only proper that a taxpayer should have the same right. Thus it should be open for the taxpayer to show that there are future transactions or contemplated transactions which should form a part of the composite transaction.

Paragraph 6.8.17

74. There should be a right of appeal against the definition of the transaction.

APPLYING THE RULE

75. Section 7 of the Consultation Document considers how the GAAR should be applied. If a GAAR is introduced it is important that a specialist section of the Inland Revenue should deal with this very difficult area.

76. There must be statutory provision for all aspects of any GAAR, including the definition of the affected transaction.

SELF ASSESSMENT

77. One point not clarified in section 7 is whether a GAAR would be self-assessable. The legislation dealing with the introduction of corporate self assessment specifically did away with the need for a direction from the Board of Inland Revenue for adjustments relating to foreign exchange, transfer pricing and controlled foreign companies so as to make the relevant provision self assessable under corporate tax self assessment. Would invoking a GAAR need a prior notice and therefore not be self assessable or just the Board's sanction before applying it in a determination, so that it would be self assessable?

78. Our view is that any GAAR should not be self assessable because the scope of the section is extremely subjective and uncertain and it would not be reasonable to require taxpayers to self assess.

ADMINISTERING THE GAAR

79. Section 8 and 9 of the Consultation Document considers the administration of the GAAR, in particular the operation of the Clearance System. This has been referred to already in this representation. However, it is worth emphasising that an efficient binding pre-transaction clearance system is essential to the reduction of costs and uncertainty under a GAAR as proposed.

80. It is agreed that clearance applications would need to be dealt with speedily if they are to be of commercial use and if they are not to hamper commercial activity further than the GAAR necessarily must.

81. It is not reasonable to challenge the motives that companies may have for making clearance applications. For some time after commencement of any GAAR there will be little or no objective knowledge of what kinds of transaction will be acceptable or challenged. During that period it must be accepted that there will be a heavy workload of applications as companies determine exactly what the boundaries of the new system are.

82. Further as regards 'insurance' applications, it must be accepted that these will be usually be made on the advice of professional firms who will see the clearance as providing an essential protection both for their clients and for themselves, as it will reduce their professional indemnity exposure. In a business world where entrepreneurs are only too willing to sue their advisers if things go wrong such applications are not only likely but should not be discouraged. In addition, if the applicant is expected to pay the commercial cost of the application it is also hard to see why they should be discouraged.

APPEAL SYSTEM

83. We believe there should be an appeal procedure for clearances. The Consultation Document is not entirely clear that this is accepted but we believe it is essential to the proper and fair operation of such a system.

84. It would also appear essential for the Inland Revenue to provide reasons for refusing clearances as this would discourage over-zealous refusal of clearances without proper grounds. Any published details could be anonymised and it would be possible to provide sufficient detail without having to reveal every aspect involved.

85. On the issue of publication of clearance information, it is appreciated that some schemes will be commercially sensitive and hence there may be a need for a short time lapse before publication. However, too long a time delay will reduce the value of a ruling. Therefore we suggest some guidance is produced at an early stage to meet these conflicting demands. This guidance needs to be available early enough to influence the public debate in view of the critical importance of the clearance system to the acceptability of any GAAR.

86. Given the time pressure on transactions likely to be made the subject of clearance applications, there seems little benefit in a system allowing appeals further than the Special Commissioners.

The delays in hearing of High Court cases would in most cases remove the commercial benefit of any clearance ultimately given. In support of this, it must be acknowledged that currently the Special Commissioners are a very strong, impartial and reliable body in general making fully reasoned and well considered decisions.

TURN-ROUND TIME FOR CLEARANCES

87. It is essential to have a short, fixed, statutory turnaround time. Thirty days has been accepted before by the Inland Revenue for clearances on similar complex transactions, e.g. s707, ICTA 1988. There is accordingly no reason for a longer turnaround time, especially as the current proposal is for applicants to pay the economic cost of their applications.

88. The Inland Revenue should be required to give proper reasons for requiring further information and their decision on this issue should be appealable.

89. Where a clearance is not dealt with in the specified time limit there should be a rule, as with the existing clearance procedures, that such an application should be deemed to be cleared. This would be more useful than offering financial compensation.

90. Some transactions might require a faster turn-round time for clearance than others. However, we do not believe there should be a 'two-tier' system for 'fast' and 'slower' clearances as this would inevitably ensure that those on the slower track received clearances considerably later than would otherwise be the case.

DOCUMENTATION AND DISCLOSURE

91. Section 14 of the Consultation Document deals with documentation and disclosure in relation to the operation of the proposed clearance system. We believe the points outlined in paragraph 14.3 go too far. These points list what an applicant could be asked to provide to obtain a clearance but they place too much of a burden upon the taxpayer. In particular, although it is not unreasonable to expect the taxpayer to describe his view of the tax treatment of the transaction it is for the Inland Revenue, not the taxpayer, to consider if other tax treatments are possible or more appropriate. It would be too difficult to expect a taxpayer to provide 'an analysis of the possible tax treatments of the transaction'.

92. It is not clear that reference to statute and case law is much use in relation to such a ground-breaking provision as this proposed GAAR. It will therefore be impossible for the taxpayer to 'identify' the passages which he thinks are 'key'. It is for the clearance body, armed with the required explanation of the transaction to determine this matter for itself.

EXPLANATIONS

Paragraph 15.2

93. Whilst it is encouraging that it is accepted that the clearance body should be required to give reasons for a refusal, we can not accept the suggestion that this should not be done where there is a perception that new methods of tax avoidance are being developed. Especially in the early years of GAAR, it is entirely natural and necessary that taxpayers will wish to seek clearance for proposed transactions which might seem to be slightly beyond the ill-defined borderline separating acceptable tax avoidance from the unacceptable.

CHARGING

94. The proposal to charge for the clearance system is a new departure for the UK tax system. Many taxpayers and their advisors will find the imposition of such a charge wholly unacceptable in principle and in practice. In principle it falls down on the basis that the law is meant to be clear and one should not have to pay to discover the meaning of unclear words. In practice, there is a real danger that the system will work unfairly as smaller businesses will not have the funds to obtain clearances whilst larger concerns will.

95. This latter point would of course be removed if smaller businesses were not subject to a GAAR, as suggested earlier in our representation. Equally if the GAAR only affected larger companies, the resources already deployed within the Inland Revenue to monitor such companies could

perhaps be used to introduce a charge-free clearance procedure at very little cost.

96. It is appreciated that the cost for a clearance system may well be prohibitive without some form of charge. However, if a charge was levied it would have to be 'reasonable' to prevent those with less resources being penalised. Furthermore, the imposition of a charge could be more easily justified if there was clear evidence that the charge was producing better decisions than would otherwise be the case.

97. The cost measurement system proposed in paragraph 16.3 is unreasonable. It is incorrect to suggest that the charges should meet the opportunity costs of Revenue staff dealing with clearances. It is not the applicant taxpayers who will have deprived the Revenue of such an opportunity, but government who determined that the necessary system required to gain the perceived financial benefits of the GAAR is a better use of the resource. The charging basis should be the time costs of the staff involved with a reasonable allowance for overheads consumed.

98. On this assumption it is probably best to have a variable charging system based on time taken. Given that, the fairest system might be for the clearance body to look briefly at an application and then within a short statutory fixed time limit issue a binding quotation for consideration of the application. The applicant would then confirm whether or not he wished to go ahead. In order to provide the Revenue with financial security perhaps paying a proportion of the charge in advance with the balance to be met by bank transfer simultaneously with a completion meeting at which the clearance decision would be handed over having been held in escrow by solicitors acting for the Revenue.

CONCLUSION

99. In Section 18 of the Consultative Document a number of questions are raised covering the contents of the whole paper. Our response to these are summarised in the Appendix. We are happy to discuss any of the matters raised further if this will be of assistance.

100. We conclude that although we are not opposed to the idea of a GAAR, there are inherent and possibly insurmountable problems in drafting a workable and successful provision. For the reasons set out above, we believe the proposed GAAR is highly flawed. It would introduce an unacceptable degree of uncertainty into the UK tax system and place a high degree of administrative discretion into the hands of the Inland Revenue. It would also potentially be very costly to both the UK economy and in terms of resourcing the necessary clearance procedure. We therefore recommend that the GAAR as proposed should not be implemented.

Appendix

Tax Faculty summary responses to questions raised in Section 18 of the Consultation Document

Question 1

'Is the difficulty of applying the GAAR to losses best tackled as outlined in paragraph 6.5.2 of the Consultation Document or is there a better and equally effective alternative?'

How to define unacceptable tax avoidance is the 'crunch' question. No one has produced a workable definition acceptable by all sides to date and it is highly unlikely that anyone can so do. This means that the 'definition' of tax avoidance found in paragraph 6.5.2 would not be effective and there is no available alternative definition to suggest. (See paragraphs 61 to 63 in our representation for further details.)

Question 2

'Does paragraph 6.6.4 identify all the appropriate factors to be taken into account in determining whether the sole or one of the main purposes of the transaction is avoidance?'

There are important issues here as to whether the trigger should apply to transactions or their structure. The considerations to which regard shall be had need some expansion. In part (a) of paragraph 6.6.4 the rights and obligations should include the rights and obligations which would have resulted from the transaction re-cast, as proposed by the Inland Revenue (or each separately if more than one). In part (d) the same point arises; the change in financial or other circumstances should include the change triggered by the transaction as re-cast. The same with part (e).

Question 3

'What are the disadvantages and advantages of a GAAR constructed on the lines set out in Chapter 6? Are there alternative approaches, in general or in detail, that might work better?'

The proposed GAAR is impractical and we do not believe that any alternative can be devised which navigates all the problems we have identified. Our views are set out further is paragraph 55 to 74 of our representation.

Question 4

'Should all appeals against a determination or assessment where the GAAR has been invoked be made to a Special Commissioner?'

The appeal should be only to the Special Commissioners, since artificial re-characterisations are extremely complex.

Question 5

'Some countries with rulings systems may refuse to give a ruling where the point of law at issue is considered clear. Would applying this principle to GAAR clearances deter 'insurance' applications?'

We do not believe 'insurance' applications could or should be deterred. Our views are set out further in paragraphs 81 to 82.

Question 6

'Which appeal option gives the best balance of certainty and speed on the one hand and revenue protection and thoroughness on the other?'

Speed is the most important factor. Perhaps the balance lies in an Inland Revenue special unit clearance body having to give cogent reasons for clearance refusals, with a right of appeal to the Special Commissioners against refusals, whose decision on the clearance issue would be final.

Question 7

'Would the publication of clearance application decisions help to reduce the need for clearance applications without compromising taxpayer or commercial confidentiality?'

It would be very helpful to publish anonymised decisions, especially in the early years of any GAAR. The sufficiency of anonymity is not a major problem. Guidelines learned from the publication of Special Commissioners decisions could be adopted. We discuss this point further in paragraph 85 of our representation.

Question 8

'How soon after clearances have been given (or refused) could the anonymised account be published?'

They would be anonymised but a short time delay would be in order to preserve any commercial advantage held by the taxpayer.

Question 9

'What is the best way of disseminating information on precedents?'

Publication in the Inland Revenue Tax Bulletins would assist in part. These are widely read by tax professionals. However, they are not generally seen by company directors, managers and the entrepreneurial classes. New methods of dissemination should be sought as well which would bring this information to the attention of deal makers as well as professionals and tax advisers generally.

Question 10

'In what particular area would consents be useful?'

General consents would not be very useful because they would necessarily be narrow in the context of the extremely wide nature of the proposed GAAR. To consider the example given in the Consultation Document, whilst it is fairly clear that the Revenue already do not object to 'straightforward transfers of assets between members of the same group' the vague definition of 'composite transaction' would mean that groups would need to know whether any other possible transactions involving the assets in question might be capable of re-characterisation as a part of the same composite transaction, thus taking it outside the general consent given. Warnings, whilst superficially useful, take an unfortunate tone and would probably be seen rather as threats, tending to worsen the image of the Inland Revenue in the eyes of affected taxpayers and their advisers.

Question 11

'Is an administrative target of 30 days preferable to a longer statutory target? Would it be useful to have both?'

Our views on the turn-round time for clearances can be found in paragraphs 87 to 90 of our representation.

Question 12

'What demand would there be for an informal system such as that outlined in paragraph 13.6?'

The demand for the clearance system outlined in the Consultation Document is likely to be very high indeed.

Question 13

'How desirable is it to make laws or regulations governing the documentation which should be provided? Are the conflicting interests of speed and thoroughness best served by rules, or by the common sense and good faith of parties?'

If the clearance body is the Inland Revenue, we would have objections to the requirements which it is likely to prescribe. Even if an independent body is set up to handle clearance we would prefer the

‘common-sense and good faith’ approach to a prescriptive system, which could never be flexible enough to cover all cases.

Question 14

‘Does the approach suggested for explanations offer an acceptable balance between responding to the genuine needs of business and protecting the Exchequer from misuse of the system to develop new avoidance schemes?

We have dealt with this question in paragraph 93 of our representation.

Question 15

‘Which method of charging for clearance would be the fairest and most desirable?’

It is noted this is a closed ended question which assumes that a charge will be made for any clearance system. Our views on charging are set out in paragraph 94 to 98 of our representation.

Question 16

‘Are there any other ways of limiting routine applications?’

Our views on this matter are set out in paragraphs 81 to 82 of our representation.