Moving Beyond Avoidance?
Tax Risk and the Relationship between Large Business and HMRC

Report of a preliminary survey

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Executive Summary

- Concerns about the relationship between large businesses and HMRC have led to initiatives, surveys, reports and proposals from various sources. The Government response is encapsulated in the 2006 *Review of Links with Large Business (‘**Varney Report**’)* and the papers that followed it in March 2007, the ‘***Varney Delivery Plan***’.

- The *Varney Delivery Plan* focuses on **certainty**, an efficient **risk based approach**, speedy **resolution** of issues, **clarity** through consultation and clear **accountability** for delivery.

- This preliminary survey by OUCBT investigates attitudes and opinions, both of large businesses and HMRC representatives, regarding the Varney project. It was a limited and small scale survey and further work would need to cover a greater variety of taxpayers but this survey indicates some issues requiring further consideration. The OUCBT survey was differentiated from other similar surveys by its in-depth nature, the fact that it was conducted by qualified tax experts, and by its use of detailed tax planning scenarios.

- This report summarizes and considers the responses of our interviewees regarding **six topics** that are broadly relevant to the *Varney Delivery Plan*, namely: (1) the risk rating approach; (2) the continuing importance of the ‘boundary of the law’; (3) formal and informal disclosure; (4) clearances and rulings; (5) tax, corporate governance and relationships with HMRC; and (6) tax, corporate governance and relationships with other stakeholders.

- Under the *Varney Delivery Plan*, the volume of HMRC’s interventions in a company’s affairs and the nature of the working relationship between the two depend on a **risk rating** given to the company by HMRC. Whilst agreeing with this approach in principle, a majority of our interviewees raised serious questions about its detail and practical operation. There currently appears to be uncertainty as to what criteria HMRC employ in establishing a company’s risk assessment, their relative weight, and the benefits of being deemed low risk.

    - The risk assessment project revolves around the ability of high risk companies to become low risk by carrying out the necessary changes. Our survey indicates that further explanation is needed regarding whether the existence of structural issues or their management will be taken into account, and thus whether companies of a certain size and complexity can ever become low risk.

    - The large majority of our business respondents felt that risk should be assessed based on a company’s openness and transparency with HMRC and not on its size, complexity or attitude to tax planning.

    - At the same time, a majority of our interviewees believed that there were no obvious benefits associated with being low as opposed to high risk. It was felt that regular interventions are driven by necessity and might even be desirable as a means of obtaining an appropriate level of attention and speedy resolution of issues, despite increased 'hassle' from HMRC. A minority of respondents suggested that HMRC could adopt a light or lighter touch with regard to their business, and that this would result in clear benefits.

- The problem of agreeing which side of the boundary a customer's **tax planning behaviour** falls still seems central to its risk rating. The *Varney Delivery Plan* eschews the word 'avoidance' and instead adopts the term 'boundary of the law', which seems to imply a boundary between so-called 'acceptable' and 'unacceptable' tax planning. The responses of our interviewees indicate that this remains a problematic area which may be preventing other aspects of the *Varney Delivery Plan* from operating as efficiently as might otherwise be possible.

    - It was agreed that there should be greater emphasis on behavioural risk as opposed to structural risk, but business respondents questioned whether 'behaviour' should incorporate a company's tax planning decisions. Several argued that low risk behaviour consists of strong corporate governance, transparency about tax risks, and openness with HMRC, not the particular transactions that a business undertakes.

    - In the view of many large businesses, the use by HMRC of concepts such as the 'boundary of the law' and 'spirit of the law' is unhelpful.

    - Almost all of our interviewees spent time analyzing and considering the detailed tax planning scenarios which we had provided. Any disagreement regarding the 'acceptability' of the scenarios related to the importance of commercial purpose in a transaction. Interviewees tended to focus on the commercial motivations in deciding whether or not they were within the 'boundary of the law'. However, even firms with similar approaches to tax planning took different views on the application of this criterion to the examples.

    - Large businesses do not seem intent on altering their approach to tax planning as a *quid pro quo* for HMRC providing greater certainty, enhanced consultation, or speedier resolution. If the *Varney Delivery Plan* represents a partnership or bargain between HMRC and large business, then the businesses we interviewed see their side of that relationship as a commitment to be open and transparent, not a commitment to curtail tax planning.

- A key theme of the *Varney Delivery Plan* is the expectation that large businesses will endeavour to provide full and contemporaneous **disclosure** of their tax affairs. Our interviewees indicated that the formal disclosure regime has affected

specific approaches, but not general attitudes, to tax avoidance schemes, and that any change in the level of voluntary disclosure will be gradual. There was some indication that complete real-time disclosure will not be achievable without statutory support and additional resources.

- The *Varney Delivery Plan* includes a commitment to enhance commercial certainty by extending the current system of **clearances and rulings**. Most respondents felt that clearances can be useful, but added that they would apply for them only in respect of 'highly commercial' transactions. In such situations a clearance or ruling might be sought in order to provide an extra level of certainty but clearances might be of more use to small or medium sized businesses than to those which are highly complex. The distinction between 'acceptable' and 'unacceptable' behaviour is central to the new clearances regime since clearances will not be available where HMRC believe that the arrangement seems to be included primarily in order to obtain a tax advantage. If this is left simply to HMRC belief, this could give rise to difficulty and the clearance regime might not be seen to be as useful as some are now suggesting since they will not be available in the areas of most uncertainty.

- **Corporate governance** in tax matters is one of the issues that HMRC will consider when assessing a company's compliance risk. Some of our business respondents have formal, somewhat general, tax policies approved by the board. Others rely on tax strategies, codes of conduct or broadly applicable risk policies. The majority of interviewees include board participation at some stage in the decision-making or review process. Some of our interviewees were adamant that their boards are fully aware of their behaviour. Our results suggest that good governance does not inevitably lead to less, or less aggressive, tax planning.

- Our survey indicates that recent efforts to highlight the role of business taxation in corporate governance and **corporate social responsibility (CSR)** have not yet not resulted in changed perceptions or behaviour. All our business interviewees believed that shareholders, analysts, the media and the public do not seem to pay attention to corporation tax, whether due to a lack of comprehension or a lack of concern. Further, respondents were unanimous in saying that the payment of corporation tax is not at present a 'social' issue relevant to CSR.

- It appears that there may be a need for a more sophisticated form of risk rating and that the benefits of a low risk rating need to be made clearer. 'Light touch' companies should nevertheless be able to obtain timely resolution of their problems. It seems doubtful that the benefits of a low risk rating would be sufficient to alter a company's tax planning strategy, especially if there is no common ground as to what is 'acceptable'. If companies perceive unacceptable tax planning for risk rating purposes to be 'what HMRC think it is' they will not be prepared to alter their behaviour.

- There are differences of opinion on what amounts to a commercial purpose but since both HMRC and company tax directors use this concept in practice it

appears to offer a starting point for the finding of common ground on the meaning of ‘acceptability’. Since the concept is not clearly supported by the case law it may need legislative backing to give it full authority and power to provide a framework for further work.

- Good tax governance does not seem to be synonymous with low levels of tax planning. Our interviewees did not accept that CSR has a role to play in relation to tax planning, partly perhaps because its role depends in part on its scope. They would accept a business case for looking at tax risk but there is little evidence at present that tax planning by corporate taxpayers has significant reputational effects with shareholders or analysts.

Introduction

There has been an intense focus recently on the relationship between large businesses and HMRC. Concerns have been building up since long before the *2006 Review of Links with Large Business ('Varney Report').*[1] From Government and some pressure groups there have been fears that large businesses were not paying their 'fair share of tax' and were engaging in behaviour that was 'pushing at the boundary of the law'.[2] In particular there were concerns that globalization and new technology have facilitated an increasing use of cross-border strategies to reduce the tax paid in the UK. On the business side there were issues around the competitiveness of the UK as a tax environment and worries about the costs and burdens of complex legislation, new disclosure regimes and broadly drawn anti-avoidance provisions, which were perceived as creating a climate of heavy compliance costs, uncertainty and to some extent a break-down of trust.

These concerns have led to a number of initiatives, surveys, reports and proposals, from analysts and professional firms and from Government itself.[3] The Government response can be seen clearly in the *Varney Report* and the papers that followed it in March 2007, *Making a Difference: Delivering the Review of Links with Large Business* ('*Delivery Plan'*) and *HMRC Approach to Compliance Risk Management for Large Business* ('*Risk Management Report'*) which will be called here collectively the *Varney Delivery Plan*.[4] Central to the *Varney Delivery Plan* is the allocation of resource according to risk. Another vital element is the desire from both sides for a relationship based on mutual trust. This agenda deals with issues very much wider than the nature of tax avoidance. It focuses on certainty, an efficient risk based approach, speedy resolution of issues, clarity through consultation and clear accountability for delivery.

Nevertheless, the *Varney Report* states that:

> Consultation with business during this review and in the wider context has emphasized the need to establish more common ground in what constitutes unacceptable tax planning and behaviours. More needs to be done to achieve this.

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[1] HMRC (November 2006).

[2] A starting assumption in O'Donnell, *Financing Britain's Future: Review of the Revenue Departments* (Cm 6163, 2004) was that 'it seems likely that the UK has a gap between tax due in law and what is paid (the "tax gap")' though the UK Government has never published figures on this.

[3] For a selection of the literature see: KPMG, *Tax in the Boardroom* (2004); Ernst & Young, *Tax Risk Management* (2004); PricewaterhouseCoopers, *Total Tax Contribution Framework* (2005); Henderson Global Investors*, Tax, Risk and Corporate Governance* (February 2005) and Henderson Global Investors*, Responsible Tax* (October 2005) (collectively '*Henderson Reports*'); L Hickey, *If the Trust Gap Widens Can the Tax Gap Be Narrowed?* ICAEW Tax Faculty Hardman Lecture (2005); HMRC, *Tax in the Boardroom* (2006); HMRC, Partnership Enhancement Programme, *Tax in the Boardroom Agenda: The Views of Business* (2006); SustainAbility, *Taxing Issues- Responsible Business and Tax* (2006); R Murphy (The Tax Gap Limited), *Mind the Tax Gap* (2006); DF Williams, KPMG's Tax Business School, *Developing the Concept of Tax Governance* (2007).

[4] HMRC (March 2007).

Among other things, this survey aims to contribute to that discussion within the wider context of the *Varney Report* and the *Varney Delivery Plan.*

It might be thought, and hoped, that the agenda has moved beyond the problems of tax avoidance and the tax gap which were previously so topical. Arguably, the extension of the disclosure regime in 2006 has made the issues about the boundary line between what some have called 'acceptable' and unacceptable' avoidance less relevant. The UK Courts have rejected a formulaic judicial anti-avoidance doctrine, apparently in favour of a form of purposive construction of statutory provisions applied to the transactions in question 'viewed realistically'.[5] If we have moved on from a debate about where to draw the line, to a more rewarding way forward based on trust, risk assessment, transparency and the availability of certainty through a system of clearances, is there still a great need to establish more common ground on what is 'unacceptable'?

The results of this survey together with consideration of the above issues suggest that, despite the attempts to shift the debate, the problem of agreeing which side of the boundary behaviour falls is still central. Risk rating, which is crucial to the Varney project, depends to a considerable degree on HMRC's view of whether the customer is 'repeatedly pushing at the boundary of the law'.[6] The proposed new clearances will not be available where HMRC 'believes that the arrangement seems to be included primarily in order to obtain a tax advantage'.[7] Quite apart from any more profound questions about how these terms and beliefs are to be applied in a fair and transparent way, they are simply not operationally sound unless a common understanding can be reached around them.

These and other terms are discussed further below in the context of the survey; for now it is merely noted that they place questions about the avoidance boundary line firmly at the core of the debate, despite the changed environment. The discussions around where this boundary lies have become circular and convoluted, bogged down by the terminology of tax planning, tax mitigation, acceptable and unacceptable avoidance, aggressive tax avoidance and so on. These descriptions are used in a confusing and interchangeable way in Government documentation as well as by business users: for example, in an attempt not to use the word 'avoidance', perhaps, the paragraph of the *Varney Report* quoted above refers to 'unacceptable planning' despite the fact that the word 'planning' is often used denote activities that are on the 'right' side of the boundary. 'Acceptable' and 'unacceptable' are themselves very problematic terms, for the reasons outlined below.

This preliminary survey investigates how far a common understanding has been reached and what might assist in this process. It also extends to issues relating to the risk rating approach, disclosure, clearances and rulings, tax and corporate governance, and tax and corporate responsibility. These are all key matters in their own right, and also reveal the centrality of the classification of corporate taxpayer behaviour in terms of 'acceptability'

[5] *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, citing Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* (2004) 1 HKLRD 77. See further section 2 below.
[6] *Delivery Plan*, para 3.3.
[7] HMRC, *Giving Certainty to Business through Clearances and Advance Agreements*, HMRC Consultation Document (June 2007) para 3.27.

or otherwise. It is a preliminary survey because it is small in scale and engaged with only nine very large businesses. These are not held out to be representative, although they do spread across sectors and revealed a spectrum of opinion and approaches. Any further work would need to extend the range of companies being interviewed although it would not necessarily need to be on a very large scale; it could remain qualitative in nature rather than quantitative. The survey is also preliminary in that we are aware that HMRC is conducting its own surveys[8] and consultations related to the Varney project. Ideally the results of these larger scale surveys will be considered together with our survey before deciding how to progress this investigation.

The survey was designed with the assistance of two practitioners (a lawyer and an accountant) and two tax directors not included in the subsequent survey. Their help was invaluable in preparing the questions and two scenarios which were sent to the interviewees in advance in order to make the discussion more concrete. The nine companies surveyed were contacted by the OUCBT in April 2007. Their tax directors all volunteered to take part in in-depth interviews lasting about one hour. Most of them had spent some time beforehand studying the scenarios and this greatly enhanced the quality of the interviews. The interviews were conducted by two lawyers from OUCBT, both of whom have substantial knowledge of tax law and avoidance issues from different perspectives. There was an interview schedule, but the interviews were not highly structured, allowing the interviewees to focus on matters of importance to their companies. All interviewees were guaranteed complete anonymity. The OUCBT survey was differentiated from other similar surveys by its in-depth nature, the fact that it was conducted by qualified tax experts, and by its use of the scenarios.

In addition to the interviews with corporate taxpayers, discussions were held with HMRC representatives from the avoidance team and the Large Business Service and our team had sight of written views from other HMRC personnel. Due to time constraints we were unable to interview other stakeholders and analysts but note that further work on the views of these parties would be valuable.

OUCBT is very grateful for the time and co-operation of all the interviewees.

1. The Risk Rating Approach

1.1 Introduction

One of the four desired outcomes of the *Varney Report* is ‘an efficient risk based approach to dealing with tax matters’.[9] Under this approach, the volume of HMRC’s interventions in a company’s affairs and the nature of the working relationship between the two depend on a risk assessment given to the company by HMRC. The lower the risk, the lighter the touch and the more possible working in real time become.

[8] Not published at the time of writing.
[9] *Varney Report*, para 1.7. See also para 1.6 and the Chairman’s forward at p 1.

By basing its enforcement programme on risk assessment, HMRC are moving into line with the Government's wider approach to better regulation, as recommended by the Hampton Review.[10] Apart from producing a more efficient allocation of resources, however, HMRC also seem to view this approach as a means of enticing business into altering their behaviour in terms of transparency, governance and tax planning.

Whilst agreeing with this approach in principle, a majority of our interviewees raised serious questions about its details and practical operation. In particular, there currently appears to be uncertainty as to what criteria HMRC employ in establishing a company's risk assessment, their relative weight, and the benefits of being deemed low risk.

1.2 New System

In the *Varney Report*, HMRC made a commitment to implement the risk based approach for the largest UK companies managed by the Large Business Service ('LBS') by the 31st of December 2007. Meanwhile, HMRC have delivered on another commitment, namely that of publishing the details of the risk based approach by the 2007 Budget.[11] The *Risk Management Report* published by HMRC in March 2007 explains the criteria HMRC will employ in assessing tax risk, the process by which this will be done, and the meaning of the different risk ratings in practice.

The risk dealt with here is 'compliance risk', which HMRC define as 'the likelihood of failure to pay the right tax at the right time, or of not understanding what the right position might be.'[12] Compliance risk can arise from different sources. It can arise from factors beyond the control of companies and HMRC, such as the complexity of the international economy and the tax policies of other states. It can also arise from factors within the control of companies, such as 'corporate tax strategies including the extent and nature of tax planning and the level of disclosure or co-operation with tax authorities', or within the control of HMRC, such as 'gaps in [their] ability to make sound and consistent decisions about tax and all relevant issues.'[13]

1.3 Old System - Description

As a number of our interviewees pointed out, this approach is not entirely novel. The *Varney Report* in fact builds on the report *Working with Large Business: Providing High Quality Service – Improving Tax Compliance* ('*Working with Large Business*'),[14] which, amongst other things, provided for a risk assessment process. In fact, it appears that HMRC carried risk assessments even earlier than this. Most of our interviewees thus

[10] *Risk Management Report*, para 1.6. See also P Hampton, *Reducing Administrative Burdens: Effective Inspection and Enforcement*, HM Treasury (March 2005).
[11] *Varney Report*, para 4.9.
[12] *Risk Management Report*, para 3.2.
[13] Ibid para 3.5.
[14] HMRC (April 2006).

spoke of risk assessments carried out under this pre-Varney regime, which we shall here refer to as the ‘previous regime’.

1.4 Agree in Principle but not Detail

All our interviewees agree with the risk-rating approach in principle, a few commenting that the allocation of resources to areas of high risk is clearly efficient and desirable. This, it was stressed, is particularly true when resources are limited. One gave a stark assessment of HMRC’s resources in this context, saying that ‘there is no Chinese army working at HMRC’ and that there is a particular dearth of people who have the technical expertise to deal with the challenge presented by large businesses.

Whilst all agree with the basic ideas behind the approach, all but one had reservations about the detail, and its translation into practice. One interviewee summed up these reservations by asking ‘so what?’ and ‘now what?’. These reservations primarily concern the risk assessment criteria and the benefits of being low risk, to which we will now turn.

1.5 Risk Assessment Criteria

1.5.1 The Criteria

The *Risk Management Report* contains a list of the risk assessment criteria in paragraph 4.4 which is then fleshed out in Annex A. The list reads:

> We will make an assessment of the level of tax risk each customer presents. Our evaluation will be based on the extent to which we can be assured there is:
>
> - strong **corporate governance** including transparency in its relations with HMRC;
> - effective **delivery** (e.g. whether systems and internal processes are sufficient for the business to meet its obligations); and
> - successful **management** of inherent risk, i.e,
>
>   **change** (e.g. mergers, acquisitions, strategic, financial and organisational restructuring),
>
>   **complexity** (e.g. complex commercial, legal and financial structures, large numbers of group companies, employees, VAT groups or tax and duty regimes to which the business is subject), and
>
>   **boundary** issues (e.g. extent of a business’ global exposure and level of cross-border and connected party transactions).
>
> And we will want to see how each of these factors affects the tax contribution a

customer makes and take a view of whether this meets what we might expect from the level of its economic activity.

The last item on the list appears relatively straightforward in stating that HMRC will also consider the extent to which a company successfully manages risk arising from change, complexity and boundary issues. Accordingly, it is the **management** of these issues and not their **existence** *per se* which HMRC will consider. This appears to be different from the approach under the previous regime, where the mere existence of these issues was a factor contributing to a high risk rating.[15] It is not entirely clear, however, whether the difference is one of approach or merely rhetorical. If it is a difference in approach, it is of extreme importance. Companies of a certain size and complexity can never be low risk under an approach that takes structural issues into account, but can be under one that considers the management of such issues. The distinction seems to be vital in relation to the incentives provided for a change of behaviour.

Only two of our interviewees hinted at this difference. The rest assumed that the criteria are actually unchanged, and this, obviously, coloured their views on the risk rating approach.

1.5.2 The Weight of the Different Criteria

The criteria can be divided into two general groups: behavioural (e.g. transparency) and structural (e.g. extent of a business' global exposure). Our interviews revealed that there is considerable uncertainty as to what weight will be given to the various criteria. In particular, most of our interviewees were uncertain as to whether a company that has a high score on structural criteria can bring its overall rating down to low risk by having a low score on behavioural criteria.

This appears not to have been possible under the old regime. Our interviewees explained that the risk rating under that regime was based on a score out of 600. Of this, 400 was based on structural issues such as size, operations, international exposure and complexity of the company's treasury. 200 was 'ostensibly' based on behavioural factors such as openness and accounting practice, but other factors were considered which were not behavioural, such as the technical complexity of the company's business. Given that the companies we interviewed are amongst the largest within the LBS, most have large profits, as well as complex financial and legal structures and businesses. A considerable number also have a substantial amount of international interests. It follows that most of these companies could never be low risk under the previous regime.

The majority of our interviewees assumed that the new regime is not different from the previous one. They thus assumed that it is the existence of the structural issues and not their management which is relevant, and concluded that they cannot be deemed low risk under the new regime either. We were told by a majority of our interviewees that their companies are large, run a complex business, pay a huge amount of tax, and thus, 'with the best will in the world', could never become low risk on the basis of HMRC's criteria.

[15] *Working with Large Business*, pp 15-16.

This made the risk rating process 'irrelevant' according to one of them. Another interviewee recounted that, at a recent meeting of tax directors during which risk ratings were discussed, the general view was that most of the companies represented would be high risk.

This view is confirmed by the findings of our interviews. Four out of the nine companies we interviewed had been risk assessed under the new regime, one being rated as low to moderate risk and the other three as high risk. Three were rated under the previous regime as high risk. One had not been rated formally, but HMRC had made it clear they deemed them to be high risk. Finally, one is currently undergoing discussions but a full assessment has not yet been completed.

Both our own and our interviewees' conversations with HMRC broadly support this view too. Two interviewees said they had asked HMRC what they should do to become low risk. One said that HMRC did not really provide an answer but told them that there are a few FTSE 250 companies which are low risk. When asked if there are any FTSE 100 companies that are low risk, HMRC again did not give a straightforward answer. The other interviewee said he asked HMRC the same question because he actually wonders what a low risk company looks like. HMRC told him they could reduce their risk by changing their 'behaviour', in the sense of curtailing their tax planning, but he still thinks the size and complexity of the business are more important factors. He thus concluded that if they reduced their use of planning they would simply pay more tax but still be a moderate to high risk group. This led him to believe that there was no benefit in actually reducing tax planning.

The conversations we had with two sources from HMRC did not dispel these uncertainties. We were told by one source that he did not expect the groups he was responsible for to be classified as low risk. He said that these groups are 'big and the numbers involved are big too', so even if they have the best and most efficient tax departments they are unlikely to be deemed to be low risk. Our second source said that HMRC will need a lot of convincing to believe that a large company running a complex business and having overseas interests is low risk, even if it is very open about its tax affairs. On the other hand, we were also told that 'there may be FTSE 100 companies that are low risk' and that if a company is very open it could be deemed low risk despite its size.

The risk assessment project, as currently framed, revolves around the ability of high risk companies to become low risk by carrying out the necessary changes, and HMRC clearly state that they will help companies become low risk.[16] Our survey indicates that further explanation is needed as to whether the existence of structural issues or their management will be taken into account, and thus whether companies of a certain size and complexity can ever become low risk.

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[16] *Risk Management Report*, para 4.4.

1.5.3 Tax Planning as a Criterion

Tax planning is discussed in considerable detail in section 2 below. We shall here limit ourselves to a few comments. The list of criteria quoted earlier does not include tax planning, however reference to tax planning is made in Schedule A which fleshes out this list. Schedule A is an illustrative list of questions HMRC will consider when assessing a company's risk. One of the questions, found under the heading of corporate governance, reads: 'What is its tax strategy? Is that strategy documented; does it cover all relevant taxes? To what extent is tax planning articulated in that strategy; how does it impact upon decision-making?' It is not here spelt out that having an aggressive tax strategy will contribute towards a high risk rating, but this is implied in other parts of the document.[17] Indeed, parts of the Varney literature indicate that a company's attitude to tax planning is one of the most important of the risk assessment criteria. This again seems to be broadly supported by our interviews. Only one of our interviewees said they were not high risk, but that appears to be partly related to special circumstances. The remainder said they were high risk, apart from one whose risk assessment has not been completed. Out of these companies, one interviewee said that whilst they are not technically low risk as a result of their size and complexity, HMRC 'deem' them low risk because of their openness, their technical ability, and, in our opinion crucially, their very conservative tax planning policy. We believe the last of these factors to be the crucial one because other companies professed to be open and technically able, yet are not 'deemed' low risk.

Business respondents felt that using tax planning as a criterion is problematic because businesses and HMRC can legitimately disagree as to where the boundary lies between acceptable and unacceptable behaviour. One interviewee quipped that an important risk assessment criterion was 'not doing planning that HMRC don't like'. The *Varney Delivery Plan* does not purport to define 'unacceptable' tax planning, but paragraph 5.12 of the *Risk Management Report* contains a list of factors which, if found in transactions, will lead HMRC to scrutinize them carefully. It also seems to imply that companies engaging in transactions containing these factors, such as little or no commercial driver, will be deemed high risk. As the UK does not have a General Anti-Avoidance Rule ('GAAR') or a similar anti-avoidance rule, such factors do not arise from law. The view could thus be formed that HMRC are dissuading companies from entering into transactions containing factors that they, but not the law, take exception to. This is being done by dangling the low risk carrot, or, perhaps, by flashing the high risk stick.

1.5.4 Disagreement on Criteria

Given the above, the majority view of our interviewees on the risk rating criteria does not come as a surprise. They think risk should be assessed on a company's openness and transparency with HMRC and not on their size, complexity or attitude to tax planning. One interviewee went as far as saying that HMRC's interpretation of taxpayers' behaviour is 'offensive' since it blurs the behaviour of a company in terms of its approach to tax planning with whether it is open and transparent.

[17] Ibid paras 3.5, 3.12 and 5.12.

1.6 Lack of Clarity on Benefits

The second area of concern for a majority of our interviewees is the perceived lack of clear benefits of being low risk. One interviewee said that at a recent meeting of tax directors the general view was that it makes no difference whether a company is rated as high, moderate or low risk. Another summed up this view by saying that the various risk ratings are 'a distinction without a difference'.

1.6.1 Benefits of Being Low Risk – HMRC's View

HMRC set out the consequences of being low and high risk in the *Risk Management Report*, particularly in Chapter 5. Low risk companies are to benefit from a light touch approach, whilst high risk companies will be the subject of 'more intensive scrutiny'.[18]

These consequences are usefully summed up in paragraph 1.7 as follows:

Low risk customers:

- Risk reviews only every 2 to 3 years, or longer
- Far fewer interventions
- Increased clarity and certainty through real-time working
- Reduced compliance costs

Higher risk customers:

- At least annual risk reviews
- Increased emphasis on significant risk
- More real-time working and speedier resolution
- Partnership working and support to reduce risk.

1.6.2 Benefits of Being Low Risk – Business Majority View

1.6.2.1 Size and Complexity Dictates Interventions

A majority of our interviewees could not really see the benefits of being low as opposed to high risk. One interviewee asked: 'what on earth is the difference?' He explained that certain companies' size and complexity necessarily mean that they will be subject to constant audit review and regular interventions, whatever their risk rating may be. This view was shared by the majority of interviewees.

[18] Ibid para 1.10.

The same interviewee went on to say that HMRC's need for information and documents is driven by necessity (e.g. where transactions are highly complex) rather than by any supposed risk rating. He said that to think that their company would not be audited is a 'joke'. The size and complexity of their business requires close contact and dialogue with HMRC, so in his view there might be a slight difference in degree but no real difference.

Another interviewee similarly opined that the alleged 'light touch' approach is 'illusory', because companies will still have a great deal of tax compliance work to do. He is thus sceptical of HMRC's suggestion that if they become low risk they would have less work to do and would need to employ less people, because, he explained, they file some 250 returns every year and they were not about to ignore tax returns or be less diligent in preparing them. He also asked HMRC what they should do if they were deemed low risk and subject to a 'light touch' and therefore decided to make some of the staff in the tax group redundant, but a year later HMRC decided to ask for more information. HMRC did not reply to this question.

This view appears to receive broad confirmation from a Customer Relationship Manager ('CRM') who told us that he does not think this approach will have a considerable impact on a CRM's day-to-day work.

Interestingly, a number of interviewees are clearly not displeased with regular interventions as they think that the complexity and size of their business requires it, and it is good to address all issues openly. One interviewee, whose company is high risk, positively looks forward to having more resources allocated to it, as he thinks that that will result in more certainty. He and another interviewee suggested that, for this reason, being given a high risk rating could encourage a company to engage in more tax planning.

Another interviewee seemed to relish the challenge of sparring, as it were, with HMRC. He said that he is not uncomfortable with his company being considered high risk, as he would rather work in a large and complex business, where the tax risk is high, and 'accept the consequences', instead of some simple business with non-contentious tax issues. He continued that he preferred driving a fast, flash car rather than a slow, cheap one, even if the likelihood of crashing is higher in the former due to its speed. Whilst not displaying quite the same enthusiasm, another interviewee spoke of the 'game' whereby HMRC will try and get more tax and taxpayers try to avoid it.

1.6.2.2 Tension between Real-Time Working, Disclosure and Light Touch Approach

A closer look at the *Risk Management Report* reveals that HMRC do in fact foresee the need to continue monitoring, checking and at times even intervening in the affairs of low risk companies.[19] This is unavoidable. What remains unclear is whether it can be kept at a level that is low enough to make a real difference.

A source within HMRC was forthcoming with similar concerns. He pointed out that there appears to be a tension between the intention to apply a light touch approach to low risk

[19] Ibid paras 5.2 – 5.10.

companies, and the desire that companies should be open with HMRC, disclosing everything they are doing, preferably in 'real time'. The latter is also necessary to fulfil the commitment of improving customer services, because if HMRC are to provide real time services they must be aware of companies' activities. If a low risk company has not been followed very closely for some time, one would imagine that their CRM would require some time to get up to speed with their activities before being in a position to respond adequately.

1.6.2.3 Clearances

One of our interviewees pointed out that it used to be that a low risk taxpayer had a better relationship with its CRM and thus was more likely to get clearances, but now, as discussed in section 4, clearances and rulings will be statutory and thus available to everyone.

1.6.2.4 Hassle Factor

Whilst a majority of our interviewees could not easily identify the benefits of being low risk, they had no difficulty identifying a particular negative of being high risk. A majority of interviewees thus said that HMRC can make one's life difficult, especially by asking for a lot of information. Two interviewees used strong language to describe what they perceive as the unnecessary inconvenience caused by HMRC's behaviour in this context.

When elaborating on this 'hassle factor', a common complaint was that HMRC are often indiscriminate, demanding voluminous documentation in areas where the risk is low and perhaps the amount of tax in question is low too. This, it was noted, unnecessarily ties up HMRC's and companies' resources in equal measure.

Whilst bearing in mind our interviewees' interests and perspective, the fact remains that this view of events was shared by practically all of them. The value of this approach appears questionable, as it might lead no further than frustrating and antagonizing companies. In fact, an interviewee told us that whilst they found the hassle factor hugely frustrating, they do not see the benefit of changing their business or behaviour for the sake of reducing it. The interviewee who supplied the fast car metaphor said that HMRC do make life difficult but they do so with respect to 5% of their activities and their tax group is well equipped to manage it. He thus concluded that although the 'hassle' factor might be reduced if his company became low risk, their tax group manage it well, and, in any event, that would also be 'dull' as he 'enjoys the tension'.

A source within HMRC did not dispute the existence of the hassle factor, and in fact spoke of using HMRC's 'statutory hassle tools' if a group 'did not play ball.' Another confirmed that the hassle factor existed in the past, but said that it will not be carried forward into the future. The *Risk Management Report* confirms this intention, as HMRC have made an important and laudable commitment to respond to risk in a proportionate manner and not to take up relatively insignificant risks.[20]

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[20] Ibid para 5.11.

1.6.2.5 What is a Good Rating? Shareholder Perception

A number of our interviewees also noted that it was not even clear, from a shareholders' perspective, whether being low risk was desirable at all. On the one hand, having a low risk rating is positive in that it means that the company's life is more comfortable, but if life is too 'cosy', then that might indicate that the best interests of the shareholders are not being served. Another's views were more definitive. He said that they do not want to be low risk because that would mean that their tax cost is too high.

1.6.3 Benefits of Being Low Risk – Business Minority View

Three of our interviewees have different views to those expressed above. They think that HMRC could adopt a light or lighter touch with regard to their business, and that this would result in clear benefits.

One said that if a company's relationship with HMRC sours it will then have a harder time with enquiries, deadlines and getting certainty in advance. At the moment they have an excellent relationship with their CRM, so if they think they might not make a deadline they will simply call the CRM and he usually gives them more time. Penalties have also been forgiven in the past.

Another interviewee said he was not sure whether they could ever be low risk on the basis of HMRC's criteria, however, if they could, he thought they would benefit from a light touch approach. He went on to say that they are already not challenged very much because of their open approach. Under this new regime the difference could be that one would know in advance that a particular area will not be looked at, whilst now any part of the return might be looked at. He said that being open and transparent with HMRC has 'paid dividends' over the years and thus is preferable to being confrontational, but the benefits of moving from where they are now (moderate/high risk) to a low risk rating are not obvious.

A third interviewee said that they were high risk under the former rating system because of their size and complexity, but they think HMRC 'deem' them low risk and treat them as such. He thus said that HMRC have adopted a light touch towards them over the past two years. Whereas previously they received hundreds of questions a year asking them to explain all sorts of matters, in the last two years the questions have become considerably less and much more focused on areas where HMRC think they should be paying more tax. Last year, for example, they received ten letters from HMRC and only three or four were significant. At times, HMRC actually sends them a draft of the letter they would be thinking of sending them. The two meet and discuss the issue, and usually find a solution obviating the need to even send the letter.

He thus said that the main benefit of being low risk is that they get fewer interventions with more focused questions. There are ancillary benefits too and he gave us two examples.

In the first example HMRC had asked a series of detailed questions about how they determined the controlled foreign company ('CFC') status (exempt or not exempt) of a number of their foreign subsidiaries. They gave answers that satisfied HMRC about the competence of the group's decision-making in this area, so HMRC have not come back and asked the same questions about other CFCs.

The second example concerned two identical transactions they entered into in the past four years involving the setting up of a joint venture. The same question arose in both cases. In one case they sent a letter to HMRC about it and received an answer giving them the green light on the same day. In the other case, the other party in the transaction (which was not low risk) sent a letter to HMRC but they received a response one year later, along with a large list of questions.

1.7 Analysis and Conclusions

The risk rating approach should result in a 'more cost effective use of resources and efficient resolution of issues'.[21] HMRC clearly also see this approach as a means to create incentives for companies to alter their behaviour in terms of transparency, governance, and tax planning.

For this approach to be successful and these goals to be obtained, it must be possible for companies to become low risk. HMRC should thus indicate whether it is the existence of structural issues or their unsatisfactory management that contributes to a high risk rating. It is suggested that the latter should be preferred. Firstly, if companies do have certain structural issues that could be conducive to being high risk, but they are being managed in a satisfactory manner, this does not represent a high compliance risk. Secondly, if this is not the case, the risk rating approach will be fundamentally flawed. If companies cannot become low risk, why should they alter their behaviour in any way?

Also, for the risk rating approach to work the benefits of being low risk must be clear for all to see, including shareholders. In particular, HMRC should address the question of the extent to which a light touch approach can be adopted with companies of a certain size and complexity.

In the light of the above, one could reach the following provisional conclusions. In terms of facilitating a much welcomed efficient allocation of resources, the risk rating approach should be useful for HMRC. It will be less so, of course, if companies of a certain size and complexity cannot be low risk. The utility of the risk rating approach as a tool to bring about a change in behaviour is more questionable. If the benefits are spelt out more carefully they could, perhaps, suffice to improve transparency, the management of structural risk and governance. Indeed, most of our interviewees appeared credibly committed to these issues as things stand. Perhaps such benefits can never be strong enough, however, for companies which are more reluctant to change, and the only way this can be obtained is by resorting to legislative intervention. This appeared to be the

[21] Ibid para 1.2.

view of one source from HMRC who said that statutory support is needed, compelling companies to provide information regularly and/or file their returns earlier, if HMRC are really to move to real time discussions. If not, non-compliant businesses will still give HMRC the least possible information at the latest time possible and HMRC will still only hear what they want them to hear.

Whether these benefits can ever be strong enough to alter tax planning behaviour is difficult to judge, but from our interviews one is led to believe that they cannot be. In fact, as explained in section 2 below, businesses seem to view their part of the bargain in improving the relationship between HMRC and themselves as being increased openness and transparency, not changing their tax planning behaviour. Also, control of 'unacceptable' tax planning or pushing at the boundary of the law, by whatever means, requires definition of these terms.

2. The Continuing Importance of the 'Boundary of the Law'

The companies interviewed generally welcomed HMRC's proposals to deliver greater certainty, enhanced clarity and consultation, speedier resolution, and improved resourcing to risk. Most of the scepticism and dissatisfaction related to the implementation of these proposals. One issue that emerged quite clearly from our discussions was the continuing practical importance, when actually allocating resources to risk, of the distinction between what most of our interviewees referred to as 'acceptable' and 'unacceptable' tax avoidance.[22] Indeed, as noted in section 1.5.3, whatever other factors may be identified in the *Varney Delivery Plan*, a company's 'behaviour' with respect to tax planning or tax avoidance seems to be critical to its risk profile. The *Varney Delivery Plan* eschews the word 'avoidance' and instead adopts the term 'boundary of the law', which seems to imply a boundary between acceptable and unacceptable avoidance, whatever that may mean. Thus we find ourselves in a situation where most business people and HMRC representatives want to move beyond the debate about what distinguishes acceptable tax avoidance (sometimes known as tax 'planning' or tax 'mitigation') from unacceptable tax avoidance; nonetheless, the distinction remains central to a company's risk rating and thus its future relationship with HMRC.

[22] In current parlance the term 'tax avoidance' is sometimes used to denote *unacceptable* or *ineffective* avoidance only, that is, arrangements which a court would ultimately hold to be inconsistent with the text, context and purpose of the relevant statutory provisions. Similarly, the term 'tax planning' is often used to describe *acceptable* or *effective* avoidance. However, as shown in the Introduction to this report , the terminology is used inconsistently. The difficulty with using words like 'acceptable' and 'unacceptable' is that one must ask: acceptable to whom? Lord Hoffmann states in *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6, [2001] STC 237, para 62: 'The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not.' Others, however, might take a wider view of what is unacceptable.

2.1 Structural Risk, Behavioural Risk and Tax Avoidance

As discussed in section 1 above, most companies we interviewed would welcome a shift away from structural factors, such as business complexity and international exposure, towards behavioural factors in assessing tax risk. HMRC representatives agreed that a risk assessment must give substantial consideration to behavioural factors. The difficulty lies in determining what behaviour comprises.

Several companies argued that low risk behaviour consists of strong corporate governance systems, transparency about tax risks, and openness with HMRC, not the particular transactions that a business does or does not undertake. It was felt that HMRC should assess behaviour by focusing on a firm's internal decision-making systems, compliance with information requests, speed of disclosure, and fullness of disclosure. This approach would be consistent with the 'governance' and 'delivery' components identified in Annexes A and B of the *Risk Management Report*. Accordingly, most companies believed that a lower risk rating is indicated if a business is very open regarding the transactions it undertakes – even if HMRC disagrees with the taxpayer's interpretation of the law as applied to those transactions.

The general opinion among the companies interviewed was that HMRC is unlikely to approach 'behaviour' in this way. It was felt that HMRC sees behaviour as comprising governance, transparency, openness *and* the actual tax planning decisions implemented by a company. One moderate to high risk company said that, from HMRC's perspective, responsible behaviour comprises transparency, openness, and 'not doing planning that HMRC don't like'. Another firm, who have been rated high risk, said that when they inquired about how they could reduce their risk level they were told to change their 'behaviour'; they understood this to mean that they should curtail or moderate their tax planning.

The above comments were consistent with what HMRC representatives told us about how they undertake, or expect to undertake, risk assessments under the Varney approach. Although we were not told so expressly, the impact of a firm's tax planning decisions on its risk profile might come through the 'governance' component identified in Annexes A and B of the *Risk Management Report*.[23] We were unable to determine from the answers given whether a firm's approach to tax planning would be a more or less important factor than its governance systems, compliance with information requests, speed of disclosure, and fullness of disclosure. HMRC representatives indicated that all of these factors should be considered in determining a taxpayer's risk profile. We observed that it was common for HMRC representatives (and some other respondents) to speak of businesses that are 'compliant' in contrast to those that are 'aggressive'. This language implies that being more aggressive in tax planning decisions is equivalent to non-compliant

[23] Governance is described as 'Customer's use of tax planning, management of risk and accountabilities, openness and cooperation'. The other components that might be affected by tax planning are 'delivery' ('Customer's ability to deliver right tax at right time through, processes, systems and skills') and the more general 'contribution' component ('To what extent are there unexplained tax performance or payment variations, trends or issues?').

behaviour. It would seem that many large businesses disagree that such a connection may be drawn.

2.2 Assessing Behavioural Risk Based on the 'Spirit of the Law'

The *Varney Delivery Plan* states that HMRC intend to reduce interventions with low risk customers and to investigate intensively those companies that repeatedly push at the 'boundary of the law'. As discussed above this could have a range of meanings but HMRC have suggested elsewhere that determining the acceptability of tax planning behaviour requires looking at the spirit rather than merely the letter of the law.[24] This clearly requires a non-literal reading of legislation but whether it is intended to go further than purposive interpretation as it would be applied by the Courts is not discussed in the *Varney Delivery Plan*. We asked a series of questions about the feasibility of this approach and, assuming the approach were feasible, how a firm should determine if a tax planning arrangement is within the 'boundary of the law' or consistent with the 'spirit of the law'. With few exceptions, the companies we interviewed denounced this approach as unworkable.

At the heart of the *Varney Delivery Plan* is the belief that the majority of large corporate taxpayers are broadly compliant. This view is captured in paragraph 3.2 of the *Delivery Plan*, repeated at paragraph 1.3 of the *Risk Management Report*:

> At the heart of our approach is the belief that the majority of our customers want to pay the right amount of tax at the right time. This means that our large business customers have the same core objective in managing tax risk as HMRC – to ensure compliance with the law. This is usually complex and requires considerable investment in systems and governance. Our aim is to work closely with our customers to understand better how they manage their tax risks within the wider commercial context in which they operate. Wherever possible, we want to rely on customers' own understanding of how the law applies to their business, and on their own systems and governance.

There was little disagreement from the businesses and HMRC representatives we interviewed that most companies want to pay the 'right amount' of tax and thereby 'comply with the law'. However, one could reasonably question whether these statements convey any meaning, as the 'right amount' of tax often depends, in the absence of judicial determination, on a person's own view of the text and purpose of legislation. Is the right amount of tax dependent upon what the *Varney Delivery Plan* calls the 'boundary of the law'? Is tax planning behaviour which goes beyond the boundary of the law synonymous with unacceptable tax avoidance? Is it synonymous with ineffective tax avoidance or can it apply to behaviour which has a chance of being

[24] See for example HMRC, *International Tax Handbook* ITH103, available at http://www.hmrc.gov.uk/manuals/ithmanual/html/1ithcont/01_0001_ITHCONT.htm (as at 22nd June 2007). For further discussion see J Freedman, 'The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility' in J Holder and C O'Cinneide (eds), 59 *Current Legal Problems* (2006) 359.

upheld in the courts? Would the behaviour of Barclays Mercantile in the *BMBF* case have been 'pushing the boundary of the law' despite the fact that the House of Lords upheld the efficacy of the behaviour for tax purposes? These questions are important because assessing a firm's behavioural risk depends on whether its tax planning decisions are seen by HMRC to be within the boundary of the law.

None of the respondents disagreed that tax laws have a boundary, but the majority felt that this boundary can only be what Parliament and the courts say it is. Some respondents felt that this requires a **predominantly textual/technical interpretation** of the law, perhaps with reference to purpose as expressed in Hansard or legislative notes.[25] One company stated that it was appropriate to apply an 'abuse of law' test to determine whether tax avoidance is acceptable or unacceptable, suggesting that judges implicitly use this test when deciding tax avoidance disputes. However, this was an isolated view. Most companies asserted that behaviour cannot be measured based on some undefined spirit of the law. One interviewee suggested that it is 'ridiculous' to expect firms to look beyond legislative text and purpose in order to decide what the spirit of the law is. Another suggested that this expectation is 'insane' and that judging behaviour on this basis is 'offensive'. Others were more moderate in their responses, saying that it is often 'unclear' where the boundary of the law lies or what the spirit of the law is. As such, most are willing to rely on a predominantly technical interpretation of the law and to use the law 'to their advantage', usually in the course of a **commercially motivated transaction**.[26] There was some consensus that it would be useful for businesses to know what the spirit of the law was, but that knowledge could only be derived from direct statements by Parliament or decisions of the courts. Several companies argued that the boundary of the law or the spirit of the law cannot simply be what HMRC personnel say they are.

These responses indicate to us that, in the view of many large businesses, it is troubling for HMRC to assess behaviour based on undefined concepts including 'boundary of the law' and 'spirit of the law'. They consider the nature of the inquiry to be such that it is not possible to identify with any precision which behaviour is acceptable or unacceptable. The distaste for these concepts is probably what motivates businesses to prefer a definition of 'behaviour' that depends solely on governance, transparency, and openness, as discussed above.

2.3 Operating within Areas of Uncertainty – Where is the Boundary of the Law?

One objective of this project was to move beyond the broad statements often made in the debate about 'responsible behaviour' and 'avoidance' by trying to establish more precisely where a common understanding exists and where it does not. A common understanding of unacceptable tax avoidance would, of course, lend legitimacy to any risk assessment based on HMRC's view of a firm's tax planning decisions.

[25] See section 2.3.2 for further discussion.
[26] See section 2.3.1 for further discussion.

Unfortunately, there are divergent attitudes about what kinds of tax avoidance are acceptable (within the boundary) or unacceptable (at or beyond the boundary).

It is perhaps not surprising that most of the disagreement in this area related to the importance of 'commercial purpose' in a transaction, the degree to which purposive interpretation of taxing statutes takes us beyond a literal interpretation thereof, and perhaps whether there is something beyond this called 'spirit of the law'. In order to elucidate these admittedly vague concepts, we asked a series of questions about the two hypothetical arrangements described in Appendix A.

The first example involved an intra-group reorganization whereby the parent company would cause one of its indirect holding companies (BCo) to acquire the shares of certain operating companies from a second indirect holding company (YCo). The shares of the second holding company would then be transferred to the first, such that the two subsidiaries (BCo and YCo) would become an 'associated' group within the overall group according to the statutory definition of 'associated'. The relevant acquisitions/disposals would be transfers of capital assets within a group and therefore no capital gain or loss would result. A key goal of this structure was to allow the shares in the operating companies to be transferred to a third party purchaser while deferring recognition of the latent capital gain on those shares. Specifically, the purported effect of this structure was that there would be no 'de-grouping' charge upon the sale of the operating companies and their former holding company (YCo) to a third party purchaser. The published HMRC guidance indicated that this type of arrangement did not achieve the desired tax effects, because the two holding companies were not an 'associated' group at the time of the first intra-group transfer. Arguably, the legislation could have been read either way. Many practitioners argued that the arrangement was effective.

The second example involved a multinational enterprise whose treasury functions were decentralized. In order to increase the overall efficiency and profitability of the group, the parent company planned to aggregate all of its main financing activities in a single financing company (FinCo) located in a convenient jurisdiction. Ireland was suggested as a location because it is an EU member state offering a familiar legal system, a strong financial system and a competitive corporate tax burden. Specifically, it was suggested that FinCo be established in the International Financial Services Centre in Dublin. The effectiveness of the arrangement relied on the 'motive test' exclusion from the CFC regime, as the various other exclusions would not seem to apply.

Full details of the hypothetical scenarios are provided in Appendix A. We also welcomed interviewees to draw on their own experiences with similar transactions or arrangements.

2.3.1 Comments on the Importance of Commercial Purpose

Opinions varied widely with respect to the importance (or relevance) of commercial purpose. Several commentators from both business and HMRC noted that the approach to tax avoidance articulated in *BMBF* does not incorporate any 'commercial purpose' or 'economic substance' requirement. Even the previous approach enunciated in *Ramsay* was not a true commercial purpose or economic substance test along the lines of the

American judicial doctrines;[27] although one business representative and one HMRC representative stated that commercial purpose was a more salient consideration prior to *BMBF*. The business person in question observed that opinions from tax advisors formerly went into 'colossal detail' about the commercial purpose of an arrangement; such opinions now tend to address commercial purpose in a single brief paragraph. He viewed this as evidence that the presence or absence of commercial motivations in a transaction is almost irrelevant under the *BMBF* approach.

It would nevertheless seem that, from a practical perspective, HMRC personnel and many large businesses see commercial purpose as a relevant consideration in assessing whether a transaction is within or beyond the boundary of the law. While it was generally accepted that a commercial objective is important, there was an assortment of views on what kinds of motivations qualify as 'commercial'.

Four of the companies we interviewed said that it is 'essential' or 'crucial' that any transaction they enter have a commercial purpose (with tax savings not being seen as a valid commercial goal). Two respondents said that their companies have a tax policy which expressly states that they will not enter 'tax-led' schemes. This observation is consistent with other survey work, where it has been found that some companies formally require their tax arrangements to be aligned with their underlying business.[28] However, all of these respondents agreed that it was acceptable for a taxpayer to implement a business-led transaction in the most tax effective manner. The remaining companies stated that it is always preferable to have a strong commercial purpose in any transaction, but suggested that many current transactions have a limited or even 'illusory' commercial purpose. One of these respondents said that is sufficient if there are real legal consequences to a transaction, such as a change of share rights or share ownership. He was in agreement with the other remaining business representatives that corporation tax is a significant cost against business profits; reducing that cost in order to maintain competitive position or enhance shareholder value is seen as a valid commercial objective *in itself*. Several respondents acknowledged that HMRC does not accept this view and that other jurisdictions including the USA, Australia and Canada enforce a more restricted view of commerciality.[29]

The *Varney Delivery Plan* suggests that an absence of commercial purpose is a key indicator of high-risk transactions or arrangements. Paragraph 5.12 of the *Risk Management Report* highlights transactions or arrangements:

- which have little or no economic substance or which have tax consequences not commensurate with a customer's economic position;

[27] For further discussion see J Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 LQR 53.
[28] *Henderson Report*, n 3 above.
[29] The American tax system incorporates a judicially created business purpose doctrine, while the Australian and Canadian systems include statutory GAARs.

- bearing little or no pre-tax profit which rely wholly or substantially on anticipated tax savings;

- that result in a mismatch such as between the legal form or accounting treatment and the economic substance; or between the tax treatment for different parties; or between the tax treatment in different jurisdictions;

- exhibiting little or no business driver;

- involving contrived, artificial, transitory, pre-ordained or commercially unnecessary steps or transactions;

- where the income, gains, expenditure or losses falling within the UK tax net are not proportionate to the economic activity taking place or the value added in the UK.

The HMRC representatives we met confirmed that the absence of a commercial motivation is indicative of unacceptable tax avoidance, stating that judges will have regard to this factor when interpreting and applying statutory provisions. It was suggested that this is precisely what happened when the House of Lords decided *Scottish Provident*. HMRC representatives conceded that it is often difficult to prove that an arrangement had no commercial motivations, as businesses will point to the commercial *effect* of an arrangement (such as a change of share rights or share ownership) as a commercial motivation. Others will point to the reduction of corporation tax itself as a commercial motivation, as mentioned above. It is perhaps not surprising that HMRC personnel questioned the legitimacy of such motivations.

2.3.2 Comments on Purposive Interpretation

Opinions also varied regarding what is involved in 'purposive' statutory interpretation. The approach from *BMBF*, which involves purposive statutory construction and an investigation into whether a transaction meets the statutory description, appears to mean different things to different people.

Some respondents believe that what the *BMBF* approach requires is a predominantly textual/technical interpretation of the law, perhaps with reference to purpose as expressed in Hansard or legislative notes. One respondent said that, unlike some jurisdictions, courts in the UK will not 'recharacterize' a transaction in order to determine whether it conflicts with the statutory intent. A few of the interviewees described the present (post *BMBF*) approach as 'form over substance' and they considered it to be favourable to business.[30] One respondent acknowledged that current attitudes to tax planning would have to change if the opinions of the judiciary were to 'swing back' in favour of the state.

[30] An alternative view is that the *BMBF* approach may be more likely to succeed against a taxpayer than the old-*Ramsay* approach in some cases. See, for example, P Miller, 'Furniss v Dawson, adieu' (2006) *Taxation* 553 and *EDI Services Ltd and Others v Commissioners* (No 2) [2006] STC (SCD) 392.

Another interviewee started from the premise that UK corporation tax is 'inherently unfair', such that it becomes acceptable to manipulate the law in order to get more commercially appropriate results. A number of respondents from both business and HMRC stated that the incredible detail and complexity of some statutory provisions leaves no room for any discernible spirit. The securities repurchase rules and the CFC regime were frequently identified in this regard.

As discussed in section 2.2, only one company appeared to think that purposive interpretation entailed applying an 'abuse of law' test to determine whether tax avoidance is unacceptable. No other companies or HMRC representatives adopted this view. The HMRC personnel we met seemed content to rely on purposive interpretation of legislation in order to discern the law's spirit, but the discussion was very general.

One noteworthy observation had to do with amended legislation. An HMRC representative said that a taxpayer clearly violates the spirit of the law where Parliament has amended the law, perhaps on successive occasions, to counteract a certain type of transaction, and the taxpayer immediately 'tweaks' the transaction in order to escape the amended legislation. One business respondent argued that this type of behaviour is perfectly acceptable under current jurisprudence, where only the text and purpose of the specific legislation are important.

2.3.3 Comments on the First Example Transaction

We first consider the four business respondents who believed that a commercial objective is a necessary feature of any transaction. Only one of these suggested that one could 'find' a good commercial reason for the first example. Two of these firms felt that the transaction was technically ineffective for the reasons identified in HMRC's guidance; they indicated that they had undertaken comparable but technically correct transactions in the course of commercially motivated disposals or reorganizations. The fourth respondent said that the transaction was unacceptable because it was totally driven by a desire to avoid tax.

Opinions among the remaining firms were substantially in favour of this transaction. Respondents said that this transaction had a 'solid' commercial purpose, that it was neither 'aggressive' nor 'controversial', and that it was 'relatively mainstream'. Factors leading to this opinion included: (a) that the arrangement involved a legally effective change of share ownership within the group; (b) that there was an eventual disposal of shares to a third party; and (c) that the validity of deferring capital gains tax in such situations was subsequently affirmed by the introduction of the substantial shareholdings exemption (SSE). Most of the interviewees did not appear to evaluate the transaction by reference to the purpose of the relevant statutory provisions, but tended to focus on its commercial trappings. Several firms noted that, as this type of tax planning was based on the assumption that HMRC's published guidance was incorrect, they would not have implemented the transaction without notifying their CRM and disclosing the relevant information.

HMRC representatives tended to agree with the former group of firms, stating that this transaction was technically ineffective for the reasons given in HMRC's guidance or that the entire arrangement was tax-motivated and thus unacceptable. One representative, however, stated that the transaction was not 'offensive'; he described it as 'common planning' based on the view that the HMRC guidance was incorrect.

2.3.4 Comments on the Second Example Transaction

Opinions regarding the second example were generally more positive. Only one firm suggested that there was no obvious commercial reason for moving the treasury functions to Ireland (this was not the same firm that considered the first example to be totally tax driven). The remaining business respondents each said that there could be a variety of good commercial reasons for doing so. These commercial reasons might include better access to funds, more efficient means of distributing funds, reduced regulatory fees, and, in some respondents' opinions, reducing the group's overseas tax burden.

HMRC representatives expressed a balance of views with respect to this arrangement. One said that relocating to Ireland would be acceptable if there were 'good commercial reasons' for doing so, notably better access to funds for the group's financings. Other representatives said that there were no good business reasons for the relocation. It was suggested that the use of CFCs, including financing companies and captive insurance companies, inevitably raises suspicion about unacceptable tax avoidance.

Several of the business representatives expressed concerns about what they see as the HMRC perspective on foreign operations. At least four respondents said that in implementing an arrangement like this one they would want to rely on the 'exempt activities' test rather than the 'motive' test to avoid attribution of CFC income. It was felt that the motive test is too arbitrary and that HMRC too often sees the tax motive as being primary. One respondent, whose views on tax planning were generally quite conservative, stressed that it is legitimate for a multinational enterprise to set up 'bona fide' operations with 'real human beings' in whatever country it chooses. Two other companies complained that HMRC sees itself as a 'world tax policeman' and therefore adopts a 'scorched earth policy' with respect to international tax issues. They argued that HMRC attacks CFCs in a host of ways, including asserting that the entity bears no risk or that it has no real employees in the foreign country. It was suggested that this aggressive approach drives multinational enterprises to move even more of their business to other jurisdictions, depriving the UK of employment and tax revenue. One respondent also said that the breadth and complexity of the CFC regime drives them to engage in more aggressive domestic planning so as to reduce their worldwide tax burden. This was one area where business respondents applauded the Varney commitment to raising HMRC awareness of the commercial perspective.

2.4 Moderating Behaviour in Exchange for HMRC Commitments

The *Varney Delivery Plan* commits HMRC to building a relationship of trust with large businesses, which is to come from open dialogue about risk assessment, enhanced clarity and consultation, and speedier resolution of disputed issues. HMRC expects a form of *quid pro quo* from business, expressed both in terms of 'partnership' and 'bargain'. It appears that businesses are willing to accede to this partnership or bargain if what it demands of them is transparency, openness and professionalism in their dealings with HMRC. They are, however, not willing to commit to a more conservative stance on tax planning.

The idea of a partnership between HMRC and large business is expressed in paragraph 3.3 of the *Delivery Plan*, repeated at paragraph 1.4 of the *Risk Management Report*:

> Where we believe that a customer is not managing tax risks adequately, or is repeatedly pushing at the boundary of the law, we will intervene quickly and intensively. We will aim to work in partnership with our customers to help them manage and reduce their tax risks.

Elsewhere in the *Varney Delivery Plan* this relationship is characterized more as a bargain between HMRC and large business. Paragraph 3.7 of the *Delivery Plan*, repeated at paragraph 1.8 of the *Risk Management Report*, states the following after observing that HMRC's commitments represent a significant change in the way HMRC operates:

> In return we will expect transparency from our business customers about their approach to tax risk management and disclosure of any areas of legal uncertainty.

In other forums HMRC officials have referred expressly to a 'bargain' between HMRC and business: HMRC commits to delivering greater certainty, enhanced clarity and consultation, speedier resolution, and improved resourcing to risk, while business commits to enhanced tax governance, transparency about tax risks, and openness with HMRC. But these commitments are said to carry a further obligation regarding a firm's actual tax planning strategy. It appears that HMRC believes there is a strong association between tax planning and a company's governance systems and transparency, as indicated by the fact that 'tax planning' is included in the 'governance' component identified in Annexes A and B of the *Risk Management Report*. According to this view, a business that is more creative or aggressive in its tax planning will tend to have deficiencies in its decision-making systems and tend to be less transparent in its dealings with HMRC. This view was consistent with what several business respondents told us about how HMRC sees behavioural risk. As mentioned in section 2.1, some companies feel that HMRC makes an association between tax planning behaviour and the quality of a firm's 'compliance'. The business view was that it is unreasonable to draw this connection.

The businesses we interviewed welcomed HMRC's plans for greater certainty, clarity, consultation and resolution. In particular, most of the respondents praised HMRC's commitment to streamline the process for resolving contentious issues, including unsettled historic issues. A number of companies highlighted HMRC's commitment to resolve international transfer pricing enquiries within an 18 month timeframe. Yet they did not feel that these commitments compelled any change in their approach to tax planning. As stated in the *Risk Management Report*, 'higher risk businesses will also benefit' because the process of getting to the heart of issues and reaching conclusions will be quicker. It seems that this improved process may have an unintended effect on tax planning behaviour. The implementation of a more efficient dispute resolution process may result in more – not less – legal disputes around the boundary of the law. Most companies agreed that HMRC should be devoting resources to investigating, and perhaps challenging, transactions which it feels are near the boundary of the law. Those companies said that they would be open and candid with HMRC about such transactions, hoping to resolve any disputes in a professional manner. Two of the companies we spoke with suggested that, under the new risk regime, a company will have incentive to be *more* aggressive with its tax planning because there will be more HMRC resources devoted to resolving the contentious issues. In other words, having a higher risk rating is seen by some to imply speedier resolutions and improved certainty, while potentially achieving a lower effective tax rate.

2.5 Analysis and Conclusions

We can identify a number of related issues concerning the uncertainty that surrounds the 'boundary of the law' which arise from our survey.

First, while the general opinion of the businesses interviewed was that there should be greater emphasis on behavioural risk as opposed to structural risk in assigning risk ratings, it was questioned whether 'behaviour' should incorporate a company's tax planning decisions. It is not surprising to find that most businesses would prefer a definition of 'behaviour' that depends solely on governance, transparency, and openness, leaving them to engage in whatever tax planning they deem appropriate without affecting their relationships with HMRC.

Next, there is a strongly held view that it is unhelpful to assess behaviour based on undefined and vague concepts including 'boundary of the law' and 'spirit of the law'. Using such criteria for assessing risk detracts from the ability to build up common ground about what behaviour is 'unacceptable', the objective expressed in the *Varney Report* quoted in the Introduction to this survey. First, the uncertainty may lie in deciding how a statute would apply to a given situation, which is ultimately a question of how the courts would interpret that statute. Given the current state of the case law, there may be considerable doubt about the likely outcome and so the boundary is unclear. This is problematic enough. Even more troubling is the idea that 'unacceptable avoidance' might mean behaviour that is not acceptable to HMRC, even where there is a strong likelihood, supported by legal opinion, that the scheme would be effective and not outside the purpose of the legislation as construed by the courts.

The decision to allocate resources to areas of high risk cannot be faulted. It follows that if HMRC believe that engaging in tax planning is conducive to companies being high risk, it may be reasonable to allocate more resources to companies that engage in such planning. However, this simply takes us back to the acceptable/unacceptable tax planning debate. If there is not common ground as to where the line should be drawn between acceptable and unacceptable tax planning, companies can legitimately have a different opinion to that of HMRC. The reliance on this criterion by HMRC, without further discussion as to what it meant, could thus be taken as veiled warning that companies will be deemed high risk unless they forego their interpretations and follow those of HMRC. This is why many interviewees considered it would be fairer and more efficient if HMRC were to focus on governance and transparency in reaching their risk rating.

Large businesses do not seem intent on altering their approach to tax planning as a *quid pro quo* for HMRC providing greater certainty, enhanced consultation, or speedier resolution of disputes. Whilst it is sometimes implied that being more 'aggressive' in tax planning decisions is equivalent to 'non-compliant' behaviour, large businesses may disagree that such a connection can fairly be drawn. If the *Varney Delivery Plan* represents a partnership or bargain between HMRC and large business, the businesses we interviewed see their side of that relationship as a commitment to be open, transparent and professional, not a commitment to curtail tax planning.

3. Formal and Informal Disclosure

A key theme of the *Varney Delivery Plan* is the expectation that large businesses will endeavour to provide full and contemporaneous disclosure of their tax affairs. As discussed above, the proposed relationship of trust between HMRC and large business includes a commitment to transparency about a firm's 'approach to tax risk management' and 'disclosure of any areas of legal uncertainty'. Several of our respondents described this approach as 'real-time interaction' or 'real-time disclosure', which is consistent with the terminology used in the *Risk Management Report*.

We asked interviewees to comment on how their practices have evolved in light of the amendments to the formal (obligatory) disclosure regime and the renewed attention on informal (voluntary) disclosure.

3.1 Formal Disclosure of Tax Arrangements

When the disclosure regime was introduced in 2004, disclosure was limited in scope to tax arrangements concerning employment or certain financial products.[31] This was broadened with effect from August 2006 to potentially any arrangement involving

[31] Finance Act 2004, Part 7 (ss 306-319); The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2004 (SI 2004 No 1863).

income tax, corporation tax or capital gains tax.[32] One significant aspect of the disclosure regime is that it does not purport to define tax avoidance. Instead it lists certain 'hallmarks' which the Government perceives are common to unacceptable tax avoidance arrangements, including confidentiality and payment of premium fees.[33] Under the current rules, a tax arrangement needs to be disclosed to HMRC where: (a) the arrangement will or might enable any person to obtain a tax advantage; (b) the tax advantage is the main benefit or one of the main benefits of the arrangement; and (c) the arrangement falls within any of the prescribed 'hallmarks' of avoidance. It is usually the 'promoter' of a discloseable scheme who makes the disclosure, but in certain cases the scheme user may be required to do so.

We first asked companies and HMRC representatives whether they felt that the enhanced disclosure regime has led to a change in attitudes to tax planning among companies, tax advisors and merchant banks. Further to that question, we asked whether companies continue to be approached with tax avoidance schemes, continue to use such schemes, or have a policy against using such schemes.

Most respondents agreed that the disclosure regime is working as intended, because the Government is now getting early notice of the more aggressive tax arrangements. Parliament can and will amend legislation, perhaps retrospectively, to 'shut down' schemes that are seen as unacceptable. One HMRC representative said that recognition of this legal risk has led to a 'big shift' in attitudes among businesses. Another HMRC representative was more equivocal, suggesting that the disclosure regime has changed attitudes only for the most conservative firms. This respondent speculated that the introduction of the disclosure rules gave conservative firms a reason to resist the commercial pressure to use avoidance schemes; it did not affect the attitudes of more aggressive taxpayers. Among business representatives, only one stated unequivocally that the disclosure regime had changed attitudes about marketed tax arrangements. Two others, both of whom have a practice or policy of not using tax-led schemes, said that they saw no change of attitude in the marketplace. The remaining business respondents each said that the disclosure regime has prompted a change in 'approach' or 'emphasis' rather than a change of attitude. The most commonly identified change was a shift from what were described as 'long term' or 'slow burn' schemes to arrangements that operate quickly. One respondent noted that this approach minimizes the 'change of law risk' with respect to tax arrangements. Beyond this change, several respondents observed that marketed schemes now tend to be more complex and more tailored to particular businesses or sectors.

Virtually all of the businesses interviewed stated that they have used and will continue to use discloseable schemes. Only two stated that they have a practice or policy of not using such schemes. These two respondents observed that the large professional firms (the 'Big 4') and merchant banks do not approach them with tax arrangements because of their demonstrated lack of interest. The remaining companies stated that they continue to

[32] The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 (SI 2006 No 1543).

[33] For further discussion see R Bland, 'Hallmarks and the Direct Tax Disclosure Regime' [2006] BTR 653.

be approached with bespoke arrangements, in some cases with 'monotonous regularity'. Three of these respondents said that the decision to accept any of these offers depends on a cost-benefit analysis, taking into account a variety of factors including legal risk. Others stated that they would consider a marketed arrangement only where it could be implemented in the context of a commercial transaction and would bring sustainable benefits.

A common perception was that there is less mass-marketing of schemes, which has had a greater effect on the high net worth individual sector than it has on large corporates. Several respondents said that the marketing is now more 'targeted' but could not say whether the overall quantity of schemes on offer has decreased. One respondent indicated that the quantity has indeed decreased. Another said that the frequency with which his firm is approached is about the same in 2007 as it was in 2002, after experiencing a dip in the interim. Five companies observed that, whether or not the overall quantity of marketed arrangements has changed, the recent activity tends to come more from the Big 4 and less from merchant banks and other promoters.

3.2 Informal Disclosure of Tax Planning

The real-time disclosure envisioned in the *Varney Delivery Plan* obviously goes beyond statutorily mandated disclosure of marketed schemes. We therefore asked interviewees whether it is appropriate for large businesses regularly to disclose the tax planning elements of their commercial arrangements. We also asked whether firms disclose the relevant transactions (a) before implementation, (b) after completion but before filing the return, (c) upon filing the return, or (d) only when HMRC inquires about the transactions.

There was general agreement that it is appropriate for businesses to disclose their tax affairs to HMRC, but opinions about the timing and quantity of disclosure varied. The usual practice of most of the firms we interviewed is to disclose transactions only upon filing the tax return. They are happy to provide the supporting information and documents if requested by HMRC. The HMRC representatives we interviewed agreed that this is the most common practice. One complained that the 'disclosure' in question sometimes consists of a footnote in the tax computation with a reference to a statutory section number. Some of the companies that usually disclose on filing said that they might alert HMRC to major issues, such as a change of corporate structure, after the end of the fiscal year but before filing their returns. Three other companies stated that they have a practice of disclosing all significant tax planning issues to HMRC immediately after the end of the fiscal year, either in writing or at a meeting with their CRM. One respondent said that this was his firm's practice even before the formal disclosure regime was introduced; he said that it made no sense to 'play audit roulette' by ignoring contentious issues. Another respondent indicated that the 'spirit of openness' in these year-end meetings has led to a reduction in HMRC's subsequent requests for information and documents. Only one company stated that their practice is to disclose their tax affairs in real time.

These responses lend credence to the views expressed by some businesses and HMRC representatives regarding statutory support and resource needs. Some respondents suggested that real time discussions will not happen by consensus. Without additional legal requirements, some taxpayers will continue to provide the minimum amount of information at the latest time possible. We were also told that HMRC will need greater resources if it is to deal with information in real time. One company which usually discloses its tax affairs on filing complained that when it did disclose information earlier, HMRC took an inordinate amount of time to address the issues. Others questioned whether there was any use in providing new information to HMRC when there was a backlog of disputed issues. Therefore, while it appears that many large businesses are keen to move to real time interaction with HMRC, there is work to be done to make that goal legally and practically feasible.

3.3 Analysis and Conclusions

These responses indicate that the formal disclosure regime has affected specific approaches, but not general attitudes, to tax avoidance schemes. The schemes that are marketed currently tend to be tailored for specific sectors or companies and are designed to operate more quickly, thus minimizing the risk that Parliament will overrule the arrangements by legislation.

While a movement to greater disclosure and interaction is welcomed, it seems that any change in the level of voluntary disclosure will be gradual. There was some indication from both business and HMRC that complete real-time disclosure will not be achievable without statutory support and additional resources.

4. Clearances and Rulings

4.1 Background

Part of the business case for moving to early and full disclosure of a firm's tax affairs is the ability to obtain commercial certainty in advance of filing tax returns. Related to this goal is the *Varney Delivery Plan*'s commitment to enhance commercial certainty by extending the current system of clearances and rulings. Details regarding how such a system might operate have been proposed in a recent HMRC Consultation Document, where it is stated that the ability to obtain binding clearances 'as a matter of normal business practice has the potential to make a real difference to the competitiveness of the UK in relation to tax administration'.[34] We asked interviewees in what situations they would find an expanded system of clearances most useful.

[34] HMRC Consultation Document, n 7 above. See also House of Lords, Select Committee on Economic Affairs, *4th Report of Session 2006-07* (June 2007) paras 23-32, 284-85, available at

4.2 The Utility of Clearances in General

The general view of business respondents was that clearances can be useful in some contexts, and thus an expanded system of clearances is obviously welcome. Some respondents said that they did not grasp the distinction between clearances and rulings, but speculated that rulings are pertinent to 'inbound investment' rather than existing UK businesses.[35] Most respondents added the important caveat that they would apply for HMRC approval only in respect of 'highly commercial' transactions, perhaps involving an acquisition to or disposition from an unrelated third party. In such situations a clearance or ruling might be sought in order to provide an **additional level of certainty**, after obtaining comfort from internal or external opinions. One business respondent said that his practice is to apply for a clearance only where he 'knows' he is going to get it. Others asserted that the transactions relevant to their businesses are so complex that they 'never' seek clearances.

Consistent with this theme, some business respondents and one HMRC representative suggested that clearance procedures would be more useful to small and medium sized businesses, which are unlikely to have internal tax departments or the resources for external tax opinions.

4.3 Clearances and Tax Planning

There was a consensus that clearances and rulings will not be sought or given in respect of arrangements which push at the 'boundary of the law'. HMRC representatives stated quite clearly that, while clearances and rulings will be available for a wider range of transactions than is currently the case, they have no intention to vet tax planning arrangements.

One representative highlighted that this approach is consistent with existing *Code of Practice 10*, which states that HMRC 'will not help with tax planning, or advise on transactions designed to avoid or reduce the tax charge which might otherwise be expected to arise'.[36] This stance is reiterated in the recent Consultation Document: HMRC will not grant clearances 'where [HMRC] believe that the arrangement seems to be included primarily in order to obtain a tax advantage'.[37]

Similarly, the companies interviewed were almost unanimous in saying that they would not apply for a statutory clearance or ruling in any case involving 'pure' or 'out-and-out' tax planning. Two companies suggested that they might apply for HMRC clearance with respect to the second example transaction; none said that they would for the first

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http://www.publications.parliament.uk/pa/ld200607/ldselect/ldeconaf/121/12102.htm (placing a high priorty on the development of the clearances system).

[35] See HMRC Consultation Document, n 34 above, ch 4.

[36] HMRC, *Code of Practice 10*, available at <http://www.hmrc.gov.uk/pdfs/cop10.htm>.

[37] HMRC Consultation Document, n 34 above, para 3.27, appendix B and appendix C.

example. Accordingly, these procedures will remain relevant to business only insofar as the transaction being considered is 'highly commercial'.

4.4 Analysis and Conclusions

Our interviews suggest that clearances and rulings will be useful in a limited range of circumstances but not in the areas of most uncertainty. The distinction between 'acceptable' and 'unacceptable' behaviour is central to the new clearances regime since clearances will not be available where HMRC believe that the arrangement seems to be included primarily in order to obtain a tax advantage. If this is left simply to HMRC belief this could give rise to difficulty and the clearance regime might not be seen to be as useful as some are now suggesting.

5. Tax, Corporate Governance and Relationships with HMRC

5.1 Introduction

As seen above, corporate governance in tax matters is one of the issues HMRC will consider when assessing compliance risk. HMRC's views on what constitutes good corporate governance in tax matters have been expounded in its guidance *Tax in the Boardroom*[38] and they are repeated in the *Risk Management Report*. Paragraph 3.2 of this report provides that a business that is successfully managing tax risk will have, *inter alia*, 'strong governance, with a clear tax strategy and principles set by its Board, and well-defined accountabilities, roles and responsibilities that are understood throughout the business.'[39] In this section we shall deal with tax policies, decision-making, and review processes.

HMRC clearly favour bringing tax into the boardroom, although one interviewee fears that HMRC have adopted all the 'management speak' about governance without knowing what to do with it in operational terms. Be that as it may, this policy appears sensible in that the control of a company is vested in the board, and, as one of our interviewees pointed out, only a very foolish Head of Tax would engage in behaviour not approved by the board. Clearly, however, this policy will have the greatest practical impact on companies in which the board currently is unaware or not fully aware of the behaviour of their tax department, for in such cases the board could rein them in. One interviewee opined that HMRC believe this to be true of a number of companies. He appeared to disagree, believing instead that boards are generally aware of the behaviour of their respective tax departments. He said, in fact, that 'Varney was peddling nonsense' when

[38] See n 3 above.
[39] Schedule A includes this question: 'What are the reporting structures – what reports are required and made to the Board by the customer's tax team? What are the relevant accountabilities?'

suggesting that boards would be 'horrified' if they knew what tax departments were doing.

5.2 Tax Policies

In its guidance, HMRC recommends 'that companies put in place a formal tax policy that sets out their high level tax strategy, operating principles and guidelines and that this policy is approved by the board of directors.' Five out of our nine interviewees have formal tax policies, all approved by their Board. Only one has shared it with HMRC, another was asked but declined to do so. None have shared it with their shareholders.

We did not have access to these tax policies but we were left with the impression that they are formulated in general terms. Interviewees told us that they include policies such as those of not entering into tax-driven schemes, not entering into transactions without a commercial purpose, being transparent with HMRC and complying with the law.

The remaining four interviewees do not have formal tax policies. One interviewee said that tax planning falls under the general code of conduct / risk policy. Another interviewee, being a financial services institution, has a very sophisticated 'risk policy' which deals with various risks, including tax risk. This policy, which mandates the amount of tax risk they can take, is reviewed by the risk and audit committee, not the full board. The last two interviewees do not have a formal tax policy. One, however, has a 'tax strategy', which is to maximize after-tax profit, although that does not always entail minimizing tax nor does it entail doing anything that breaches the law. Interestingly, high ranking HMRC officials approached the board of both companies asking them to sign letters which would, it seems, act as proxy tax policies.

The first interviewee said that the board received a letter from HMRC implying they were high risk and 'threatening' to make life awkward if they did not agree to change their ways. They declined to do so, however, because the letter was 'nebulous' in the behaviour it was requesting them to adopt. They felt they were being asked to agree not to engage in 'unacceptable' tax planning, with the determination of acceptability being made by HMRC. Our interviewee opined that in no other area of business would one agree to sign up to a concept that is 'nebulous' and depends on the 'vagaries' of what someone else thinks. As they thought it was not 'ethical' to sign a commitment about tax planning behaviour that is poorly defined and that they probably would not comply with, they decided not to sign it in the first place.

The second interviewee explained that whilst in the process of settling a large number of issues that were in dispute, their finance director was asked by HMRC to provide a tax policy 'conduct letter', and although it was not a formal condition of settlement they felt they could not refuse. Settlement was reached with both sides conceding some issues and the CFO providing a conduct letter, which essentially set out their tax policy for the future. Our interviewee opined that as a result of this letter there is some planning they would have done in the past which they will no longer do, and that their Finance Director

might be uncomfortable with a high risk rating. He suggested, however, that HMRC and the company might interpret the letter differently.

5.3 Decision-Making and Review Processes

All our interviewees were happy to discuss their corporate governance structures in tax matters, and whilst different, the majority did include board participation at some stage in the decision-making or review process.

5.3.1 Decision-Making Processes

All but one interviewee spoke of board, board committee or CFO participation during the decision making process, this, however, usually came about when 'structural issues', 'large issues', 'the most important issues', 'major tax planning issues', 'material transactions' or 'large transactions' were involved. Participation came in different forms. Two of our interviewees intimated that the process by which this is done is not completely formalised. Both thus said that the head of tax would have an informal word with the CFO if he was concerned about any such transaction. Board level participation is more formalized in the remaining six companies, but varies in nature and degree. One said that a transaction 'might' go before the operating committee or the full board, and another said that if legal advice is deemed necessary and involves considerable fees he will first ask the CFO for approval, then the transaction would go back to the CFO who will normally refer it to the chairman of the audit committee or the audit committee as a whole and possibly one or two other directors. Another two companies said that such transactions go before a sub-committee of the board, and one said that in extraordinary cases, it would go to the full board. The final two companies said that such transactions would have to be signed off. One said that they would have to be signed off by the Group Treasurer, Head of Legal, Head of Accounting and the CFO. The other said that they would have to be signed off the 'head of execution team', the CFO and the risk director. Eventually it would be presented to the CEO but his approval would amount to a 'rubber stamp'.

Apart from difference in board level participation, the companies differed in the rest of the decision making process, although it always involved a mixture of internal processes within the tax group and the participation of outside counsel, solicitors or auditors when deemed necessary. At times it involved other departments, such as legal and accounting, or purposely set-up committees such as a 'corporate and legal integrity team'. The most formalised decision making processes appeared to be those of companies that are subject to additional regulation, such as the Sarbanes-Oxley regime or banking regulation.

5.3.2 Review Processes

A majority of our interviewees also spoke of review processes. One head of tax said that he reports directly to the board once a year. Two have reviews by board sub-committees: the tax planning of one is presented to the risk committee every quarter, the other has semi-annual reviews carried out by a board sub-committee, but these do not look at tax

planning in detail, merely verifying whether the guidelines for risk are being adhered to. Compliance with the board-approved tax policy of one interviewee is usually 'self-assessed' by units within the tax group. Finally, one interview spoke of internal and external audit controls.

5.4 Analysis and Conclusions

Our survey could not, of its nature, reveal the extent to which boards are aware of the tax departments' behaviour, although some of our interviewees were adamant that their boards are fully aware. If boards are fully aware, the impact of bringing tax into the boardroom, whilst meaningful, will not be very great. Furthermore, whilst boards can be approached directly by HMRC, they can, and perhaps always will, turn to their tax departments which can explain concerns away. One interviewee thus told us that when the board was informed that the company is high risk, it was not really shocked once matters were explained and it was told that most companies are high risk.

Tax policies can obviously differ greatly, some being more effective than others, but the general nature of the language usually employed in these policies seems to undermine their value. One certainly would not be able to tell whether a company is aggressive in its tax planning on the basis of these tax policies alone. Take a company which adopts the policy of not entering into transactions without a commercial purpose. One could think that such a policy would mean that the company would not engage in certain types of tax planning, but that would depend on the interpretation given to the term 'commercial', which, as seen in section 2 above, can vary greatly. In fact, an interviewee who admitted to being very aggressive has a formal tax policy which includes being transparent with HMRC and enhancing shareholder value *within the law*. This interviewee said that they enter into aggressive tax planning in order to keep their Effective Tax Rate ('*ETR*') down. This perhaps shows that a board approved tax policy drafted in general terms might do little to curb or reduce aggressive tax planning. One also suspects that boards will probably be unwilling to adopt more detailed and specific tax policies, and that is perhaps understandable.

Our survey gave us a glimpse into their decision-making and review processes of companies. They seem to vary in detail, formality and even rigour, but usually include board or board member participation at some level, even if only minimally. Interestingly, four interviewees who confessed to being aggressive in tax planning, and another, whose company is reputed to be so, seem to have very rigorous decision-making and review processes. This seems to indicate that good governance does not inevitably lead to less, or less aggressive, tax planning. Or, as these interviewees would undoubtedly aver, a considerable amount of tax planning, even aggressive tax planning, does not necessarily equate with bad governance.

6. Tax, Corporate Governance and Relationships with Other Stakeholders

The themes of the *Varney Delivery Plan* are consistent with recent efforts to highlight the role of business taxation in corporate governance and corporate social responsibility (CSR). We therefore asked interviewees for their opinions on the relevance of a firm's tax planning strategy in the minds of shareholders, analysts, and the wider community. The predominant view was that shareholders and analysts do not understand or care about corporation tax – they are concerned only with stability and consistency of pre-tax returns. Moreover, the overwhelming response was that corporation tax is currently not a factor in firms' CSR agendas.

6.1 Work on Tax Governance, Corporate Governance and Corporate Social Responsibility ('CSR')

A number of recent studies and reports have elaborated the way in which efforts by companies to understand and manage tax risk can enhance shareholder value, although directors and investors may not realize this. These include reports by KMPG,[40] Henderson Global Investors,[41] and Citigroup.[42] The central argument made in these reports is that directors cannot ignore the impact of taxes and tax planning as they can significantly affect a company's profits. The *Citigroup Report* observes that 'the market generally struggles with or ignores tax risk' and goes on to demonstrate that tax risk, which is said to comprise reputational risk, audit risk and regime risk, should be taken more seriously by investors and analysts.

Looking beyond the investment community to other stakeholders, there have also been suggestions that a company's approach to taxpaying and tax planning are relevant to its broader corporate responsibility. The *Henderson Report* asserts that debates about corporate responsibility are now extending to tax matters. Organisations such as the Tax Justice Network and SustainAbility are also active in promoting CSR in relation to taxation.[43] However, much may depend upon how CSR is defined and this is sometimes unclear in the debates. If CSR is merely an aspect of risk management, then its demands are very different from those imposed if it involves companies doing more than having regard for legal duties and reputational risk in assessing their social responsibilities as taxpayers.

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[40].Williams, n 3 above.

[41] *Henderson Report*, n 3 above.

[42] K Lee and N Antill (Citigroup), *Generation (Ta)X – An Investors' Guide To Analysing Tax Risk* (Citigroup Global Markets, London, September 2005) ('*Citigroup Report'*). This report is proprietary and is referred to herein with the authors' permission.

[43] SustainAbility, n 3 above. For academic discussions see R Avi-Yonah, 'Corporate Social Responsibility and Strategic Tax Behavior' http://papers.ssrn.com/sol3/papers.cfm?abstract_id=944793; D McBarnet, 'Corporate Social Responsibility Beyond Law, Through Law, For Law: The New Corporate Accountability' in D McBarnet, A Voiculescu and T Campbell (eds), *The New Corporate Accountability:* (2007 forthcoming); J Freedman, n 24 above.

6.2 Relationship with Investors and Analysts

Corporation tax, and planning around corporation tax, can obviously affect a company's profits and thus may affect its share value.[44] However, interviewees were unanimous in observing that shareholders and analysts do not seem to pay attention to corporation tax, whether due to a lack of comprehension or a lack of concern.

All of the companies interviewed stated that the investment community rarely raise concerns about a firm's tax policies or planning decisions. Many respondents said that shareholders simply want their investments to have 'stable returns', 'consistency', or 'longevity', leading analysts to focus on such criteria as well. Others said that shareholders and analysts do not want to see 'shocks' or 'volatility' in share value. We were told that the investment community places a 'huge' and perhaps inordinate value on stability. Several respondents pointed out that analysts tend to focus on pre-tax returns and to use a corporation tax figure of 30% in their valuation models, even if the company has achieved a lower ETR.[45] Indeed, some respondents bemoaned the fact that analysts fail to recognize the hard work required to obtain tax savings. It would seem that analysts use a lower ETR only where a company has consistently maintained that rate for several years. Two respondents suggested that, if the investment community did become interested in corporation tax, they would probably expect firms to minimize tax to the extent permitted by law.

A few interviewees noted that shareholders and analysts might ask questions about widely publicized tax disputes that carry a huge financial risk for the company. HMRC representatives agreed that shareholders seem indifferent about tax, although one respondent noted that shareholders could become concerned if a firm was aggressive *and* unsuccessful in its tax planning. One business respondent agreed that investors might take notice if the company were to suffer a series of tax setbacks. Aside from these situations, it was felt that most investors and analysts do not have the knowledge or the desire to understand the complexities of corporation tax.

6.3 Relationship with the Wider Community

While most companies are mindful of their reputation in the wider community, few of our respondents were apprehensive about the public's perception of their tax policies and planning decisions. None believed that the obligation to pay corporation tax was an element of CSR.

[44] The effect of tax planning on share price requires empirical research in the UK but on the USA see M Desai and D Dharmapala, 'Corporate Tax Avoidance and Firm Value' NBER Working Paper No 11241; M Hanlon and J Slemrod 'What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News about Tax Aggressiveness' http://ssrn.com/abstract=975252. The evidence seems to be somewhat equivocal.

[45] Presumably this will change to 28% to reflect the reduction in the corporation tax rate.

About half of the interviewees observed that it was important to avoid damage to their public reputation or 'brand'. We assume that the remaining respondents would agree with this as a general principle. However, only three business respondents said that they would be concerned about negative press coverage regarding avoidance of corporation tax. The remaining respondents, including HMRC representatives, believed that corporation tax issues seem to be too complex or obscure for the media and the public to understand. Accordingly, the issues are not covered in the media or they go unnoticed by the public. Respondents from both business and HMRC gave the example of the press coverage surrounding the *BMBF* litigation, which seemed to have no lasting reputational effect (although, of course, the House of Lords found in favour of the taxpayer in that case). Several respondents noted that there is more public concern with respect to 'visible' tax avoidance, specifically wealthy executives receiving fringe benefits and domestic companies 'going offshore'.

Consistent with the above views, interviewees were unanimous in saying that the payment of corporation tax is not as yet a 'social' issue relevant to CSR. Even the companies with the most conservative approaches to tax planning within our sample agreed with this view. All of the businesses we met have developed or are in the process of developing a CSR policy. Only two companies said that their board has considered including corporation tax as an aspect of their CSR policy – both rejected it. Among the remaining firms, a recurring observation was that paying corporation tax is not a 'moral' or 'social' issue and thus is not a factor in the CSR agenda. One respondent said that his firm's CSR policy does not extend to paying more tax than is due under the law; they are not interested in 'making donations to Government'. Others echoed this view, arguing that they could spend their tax savings more wisely than the Government could. At least two firms suggested that there would be a greater social aspect to taxpaying if the amounts collected were earmarked for particular public services, rather than going into general revenue.

As one business respondent aptly stated, CSR is a reflection of the issues that shareholders and the public are concerned about. It is therefore not surprising that most respondents cited issues including environmental protection, employees' human rights, customers' human rights, and investment in developing countries as the issues on the CSR agenda. One HMRC representative and two business respondents acknowledged that it is *possible* tax will become important to CSR in the future. They thought this would happen only if the media and the public begin to focus on taxpaying and tax planning as important social issues.

6.4 Analysis and Conclusions

A major problem in deciding the relevance of CSR to tax is that this label is used in different ways. Sometimes it refers to the making of a sensible business case within the enlightened shareholder value model confirmed to be the law by the Companies Act

2006.[46] Sometimes it appears to go beyond this to a broader, perhaps purer, view of CSR, which has been defined by the European Commission as 'enterprises deciding to go beyond minimum legal requirements and obligations stemming from collective agreements in order to address societal needs.'[47] Whilst the former would be widely accepted and would include having regard to reputational risk in assessing tax risk, the latter is more contentious. Even where our interviewees thought CSR might become significant in the future, this appeared to be linked to the reputational risk issue rather than a 'purer' form of corporate responsibility.

It is sometimes unclear in the reports we have cited, which suggest that CSR is important to business, which type of CSR they have in mind. For example, the Henderson report gives as its example of following the 'spirit of the law' the fact that FTSE 100 companies exercise pragmatic, professional judgement by considering, as a matter of risk assessment, how the courts would view a particular tax scheme. Arguably this is something all tax directors would agree they should do as matter of assessing tax risk, but it may have been thought by some of our interviewees not to require justification as CSR.

7. Conclusions

7.1 Scope of Survey

This report summarizes and considers the responses of our interviewees regarding **six topics** that are broadly relevant to the *Varney Delivery Plan*, namely:

(1) the risk rating approach;

(2) the continuing importance of the 'boundary of the law';

(3) formal and informal disclosure;

(4) clearances and rulings;

(5) tax, corporate governance and relationships with HMRC; and

(6) tax, corporate governance and relationships with other stakeholders.

[46] See in particular section 172, 'Duty to promote the success of the company'. McBarnet's definition could fall into this category: 'CSR essentially involves a shift in the focus of corporate responsibility from profit maximisation for shareholders within the obligations of law to responsibility to a broader range of *stake*holders, including communal concerns such as protection of the environment, and accountability on ethical as well as legal obligations. …These broader concerns are not necessarily seen as in conflict with shareholder interests but as protecting them long-term. CSR is not philanthropy, contributing gifts from profits, but involves the exercise of social responsibility in how profits are made.' See n 43 above.

[47] European Commission Communication COM (2006) 01136.

This survey was small in scale, engaging with nine very large businesses. These are not held out to be representative, although they do spread across sectors and revealed a spectrum of opinion and approaches. Discussions were also held with HMRC representatives. Any further work would need to extend the range of companies being interviewed to some smaller companies which we believe might respond differently on some aspects. Nevertheless, there are some useful indicators here of how the objectives of the Varney Review, which were broadly agreed by business and Government, might be progressed.

Whilst each section of this report contains its own analysis and conclusions we shall highlight here some key preliminary conclusions and suggestions for further research.

7.2 Risk Rating

For the goals of risk rating to work, it must be possible for companies to become low risk. If large complex companies are to have an incentive to try to become low risk the focus needs to be on method of management (such as governance, systems and transparency) rather than structural issues such as size and complexity which they cannot change, and this needs to be made clear. However it can be argued that planning levels should figure in the risk assessment; the real problem is to know how and when it will be taken into account. It may be that there is a need for a more sophisticated form of risk rating to reflect different criteria, since some of them are not within the power of the taxpayer to alter.

The benefits of a low risk rating need to be made clearer to large companies if they are to find it attractive. HMRC should address the question of the extent to which a light touch approach can be adopted with large complex companies and light touch companies should nevertheless be able to obtain timely resolution of problems which might arise.

It seems doubtful that the benefits of a low risk rating would be sufficient to alter a company's tax planning strategy by virtue of including tax planning behaviour in the rating matrix, especially if there is no common ground on what amounts to 'unacceptable tax planning' for the purpose of risk rating. If companies perceive 'unacceptable' tax planning to be 'what HMRC think it is', they will not be prepared to alter their behaviour.

7.3 The Boundary of the Law

The distinction between 'acceptable' and 'unacceptable' behaviour thus continues to be significant, despite the new approach to risk and relationships in the *Varney Report* and other developments such as the disclosure regime. The distinction is also central to the new clearances regime since it will not apply where HMRC believe that the arrangement seems to be included primarily in order to obtain a tax advantage. If this is left simply to HMRC belief this could give rise to difficulty and the clearance regime might not be as useful as some are now suggesting.

There is some evidence that company tax directors do accept commercial purpose as a test which they use to self-regulate, despite the fact that its basis in case law is now

thought by some to be weakened by the direction in which the House of Lords went in *BMBF.* Commercial purpose or business driver, which is arguably not the same as economic substance, are also criteria important to HMRC as reflected in the *Risk Management Report* at paragraph 5.12.[48]

There was a difference of opinion over the presence of commercial purpose in relation to our scenarios, but it does at least seem to be a starting point in that both tax directors and HMRC representatives used it as a rule of thumb. It might be a way of reaching towards the common ground referred to by the *Varney Report.* Since it is not based firmly in the case law, however, it is of dubious authority. Unless the courts are able to provide some clarification, and nothing about the past twenty years suggests that they will, legislative backing for this as a starting point could be helpful. Commercial purpose or motive is already referred to in many specific anti-avoidance provisions. It could figure as part of a GAAR although experience in other jurisdictions suggests it would need some elaboration to be of real value.

In the absence of judicial or statutory clarification, there is doubt about where the boundary of the law lies and the extent to which the courts will construe legislation purposively. If it is to be construed purposively there is doubt about how that purpose is to be ascertained in cases where it is not spelt out clearly in the legislation. Improvements here would require a new approach to statutory drafting.[49] One useful clarification that HMRC could make would be to state expressly that its criteria in 5.12 are intended to give the same result as the courts would reach. In this connection it is interesting to note that the Australian Tax Office, in its document *Large Business and Tax Compliance*,[50] lists characteristics of risk but then states:

> While features of the kind outlined in this chapter will attract our attention, a business's tax position must be determined on the basis of the proper application of tax law to the facts of the case. In this regard, we understand that Australian tax law does not recognize the concept of economic equivalence for tax purposes.

It would seem helpful to state something along these lines in risk assessment documentation in order to allay some concerns that HMRC has a broader notion of unacceptability than the courts, thereby obtaining a greater chance of co-operation, trust and reaching the common ground on defining acceptability which is sought.

7.4 Corporate Governance and CSR

Decision-making and review processes of companies vary in detail, formality and even rigour, but usually include board or board member participation at some level, even if only minimally. Some of those associated with the most aggressive tax planners seem to have very rigorous decision-making and review processes. This seems to indicate that good governance in terms of processes does not inevitably lead to less, or less aggressive, tax planning.

[48] See section 2.3.1 above.
[49] Discussed further Freedman n 27 above . See now Finance Bill 2007, Schedule 13.
[50] ATO (2006).

Our survey could not, of its nature, reveal the extent to which boards are aware of the tax departments' behaviour, although some of our interviewees were adamant that their boards are fully aware. If boards are fully aware, the impact of bringing tax into the boardroom, whilst meaningful, will not be very great. Furthermore, whilst boards can be approached directly by HMRC, they are likely to turn to their tax departments which can explain concerns away. Where the Board is asked by HMRC to sign a letter about its conduct, the language of the letter may be so general or use undefined terms so that this simply transfers the debate about acceptability of behaviour to a debate about what was meant by the letter.

Proponents of CSR in the tax context often seem to be making a business case requiring corporate directors to consider the risk that a tax scheme will not be effective and/or cause reputational damage, in which case this does not go beyond normal tax risk management. More work is needed to assess the actual reputational impact of companies entering into tax planning schemes but care needs to be taken not to overstate this case without evidence if its proponents wish their arguments to be taken seriously, since there is scepticism about the impact on share price. It is also important to define the scope of CSR. Whilst our interviewees would consider the business case if they thought tax planning might be relevant to risk and reputation, they rejected any wider notion of CSR. If, as the SustainAbility report suggests, 'Considering tax as a CR issue does not mean that more tax must be paid that the law requires…this is not possible: all tax is paid because law requires its settlement'[51] then it is important that those arguing for this responsibility make clear its scope.

It is interesting to note that two proponents of CSR, Reuven Avi-Yonah[52], and R Murphy, intuitively gravitate towards a commercial purpose test in their formulations when discussing CSR.[53] Working on the agreement of some extended, principle based but contained legal test might be more successful in attaining this than arguing for unconstrained CSR in view of the uncertainty about its scope.

There is still more that can and should be done to reach the commendable aim of the Varney *Report,* that is to establish more common ground in what constitutes unacceptable tax planning and behaviours and to use risk rating to improve efficiency and relations between HMRC and large business.

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[51] See n 3 above p.14

[52] 'What is the appropriate response for a corporate executive confronted with a plan that may pass legal muster in a court of law, but that the executive knows is purely tax motivated and has no business purpose other than tax reduction', Avi-Yonah, n 43 above.

[53] SustainAbility Report n 3 above at p. 20.

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Appendix – Scenarios Discussed in Interviews

The example arrangements, which are explained in detail below, are:

1. Group Asset Transfer Arrangement;

2. Offshore Financing Arrangement.

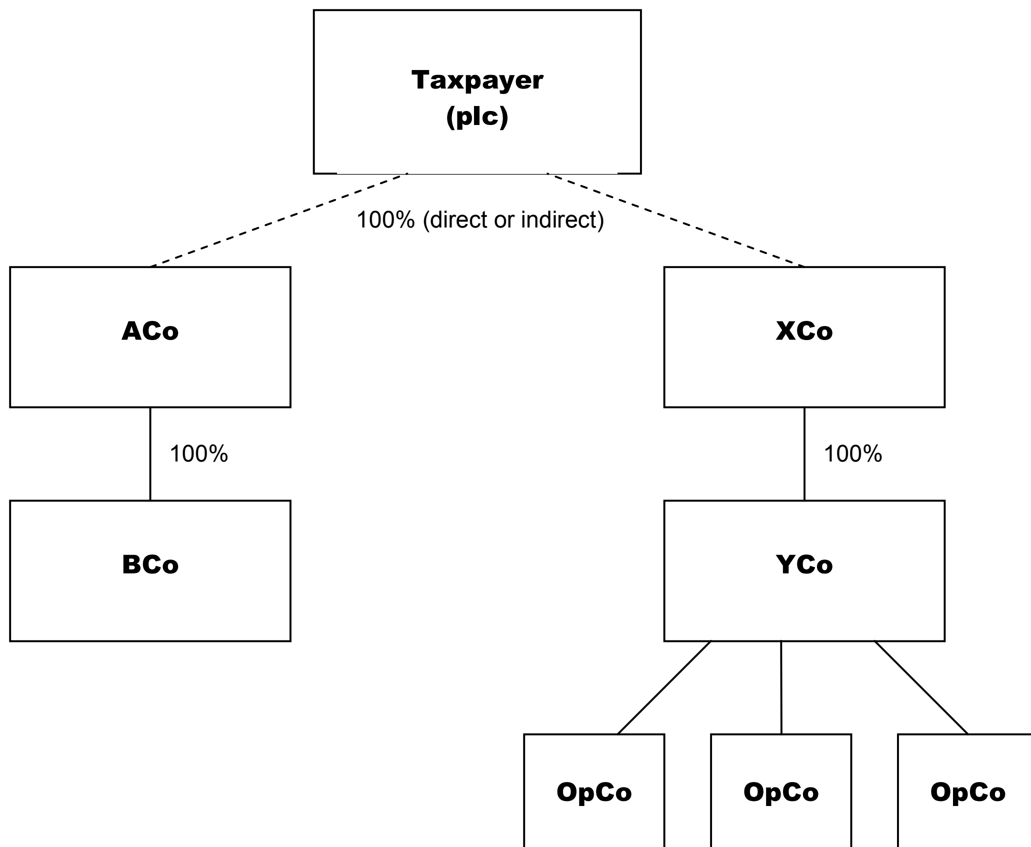
While these arrangements are of course hypothetical, we are interested to hear about the relevant decision-making process and recommendations you might make regarding the implementation of such transactions. We are particularly interested in learning if and how concerns about corporate governance and your relationship with HMRC would factor into your decision-making process.

1. Group Asset Transfer Arrangement

* Note: This example is based on the facts in *Johnston Publishing (North) Ltd v HMRC*. Although the High Court has now endorsed the Revenue view of the 179(2) exemption, the matter was not free from doubt before this decision (and it may yet be appealed). We would like to explore how you might have approached this arrangement before the decisions by the Special Commissioners and the High Court. As such, please assume that this arrangement has not yet been considered by the courts and that the taxpayer's advisers give the opinion described below.

We are also aware that the substantial shareholdings relief makes this kind of planning less significant. Please assume that you are considering it before that relief was available.

The taxpayer is a plc and the ultimate parent of a group of companies (the 'Group'), each of which is resident in the UK. The taxpayer wholly owns, directly or indirectly, a holding company known as 'ACo', which in turn owns a subsidiary known as 'BCo'. BCo has nominal capital and assets and does not carry on any business. The taxpayer also wholly owns, directly or indirectly, a holding company known as 'XCo', which in turn owns a subsidiary known as 'YCo'. YCo owns shares in a number of operating companies ('OpCos'), each of which carries on business in the UK. YCo holds its OpCo shares as capital property. The relevant companies in the Group are shown in the following diagram:



The OpCos have been profitable and thus there is a significant latent capital gain on the OpCo shares held by YCo. The taxpayer believes that, at some point, an unrelated entity or group might be interested in acquiring the taxpayer's interest in the OpCos. The taxpayer consults its advisers regarding how it might plan for this possibility. It is suggested that, rather than waiting for a potential purchaser to acquire the OpCo shares from YCo or to acquire the YCo shares from XCo (either of which would result in a significant chargeable gain), the taxpayer should arrange for the following series of transactions to take place in advance of any third-party sale:

- On Day 1 ACo uses existing funds to subscribe for newly issued shares in BCo, capitalising BCo with precisely enough funds to acquire the OpCo shares held by YCo and to acquire any residual value in YCo. For illustration purposes, let this amount be £102m.

- Later on Day 1 BCo acquires the OpCo shares from YCo for fair market value consideration of £100m. This acquisition/disposal is a transfer of capital assets within a group and therefore the consideration paid by BCo is deemed to be such that no gain or loss results (section 171 of the TCGA 1992).

- On Day 2 YCo pays a dividend to XCo out of its distributable profits, which are roughly equivalent to the £100m YCo received upon transferring its OpCo shares less YCo's historic cost of the OpCo shares. No charge to corporation tax arises on this dividend (section 208 of the ICTA 1988). Following this dividend, the value of the YCo shares is reduced to approximately £2m.

- Later on Day 2 BCo acquires the YCo shares from XCo for £2m. Again, this acquisition/disposal is a transfer of capital assets within a group and therefore the consideration paid by BCo is deemed to be such that no gain or loss results (section 171 of the TCGA 1992).

- Following these transactions, BCo owns the OpCo shares formerly held by YCo and wholly owns the YCo shares formerly held by XCo.

Sometime in the next year, the taxpayer is approached by an unrelated company ('PurchaseCo'). An agreement in principle is reached between the taxpayer and PurchaseCo under which the taxpayer agrees to transfer its interest in the OpCos to PurchaseCo for fair market value consideration of, say, £103m. This agreement is implemented by PurchaseCo acquiring all of the BCo shares from ACo. Thus PurchaseCo becomes the indirect owner of the OpCo shares.

The effect of this arrangement is that the taxpayer's (indirect) interest in the OpCo shares is transferred to PurchaseCo in a manner that defers recognition of the latent capital gain on the OpCo shares. We presume that this arrangement is acceptable to PurchaseCo. More specifically, as ACo, BCo, XCo and YCo are all members of the Group until the end of Day 2, the transfer of the OpCo shares from YCo to BCo on Day 1 is an 'intra-group' transfer giving rise to no chargeable gain or loss. The transfer of the YCo shares from XCo to BCo on Day 2 similarly gives rise to no gain or loss. The subsequent transfer of the BCo shares from ACo to PurchaseCo will give rise to a small chargeable gain in the hands of ACo, but the latent capital gain on the OpCo shares which accrued up to the time of the intra-group transfer on Day 1 is preserved. In other words, the transfer of the BCo shares from ACo to PurchaseCo will result in a tax charge at the shareholder tier but no tax charge at the asset tier.

It is the opinion of the taxpayer's tax advisers that there should not be a 'de-grouping' charge under section 179 of the TCGA 1992 upon BCo and YCo leaving the Group. In the advisers' view, the exception for sub-groups of 'associated companies' which leave a group at the same time and between which there have been intra-group asset transfers (subsection 179(2)) should apply to this arrangement. Here, there is an intra-group asset transfer between BCo and YCo on Day 1, BCo and YCo become associated companies on Day 2, and BCo and YCo leave the Group upon the subsequent transfer to PurchaseCo. Thus there should be no de-grouping charge and the inherent capital gain on the OpCo shares should not be recognised until such time as PurchaseCo causes BCo to dispose of the OpCo shares.

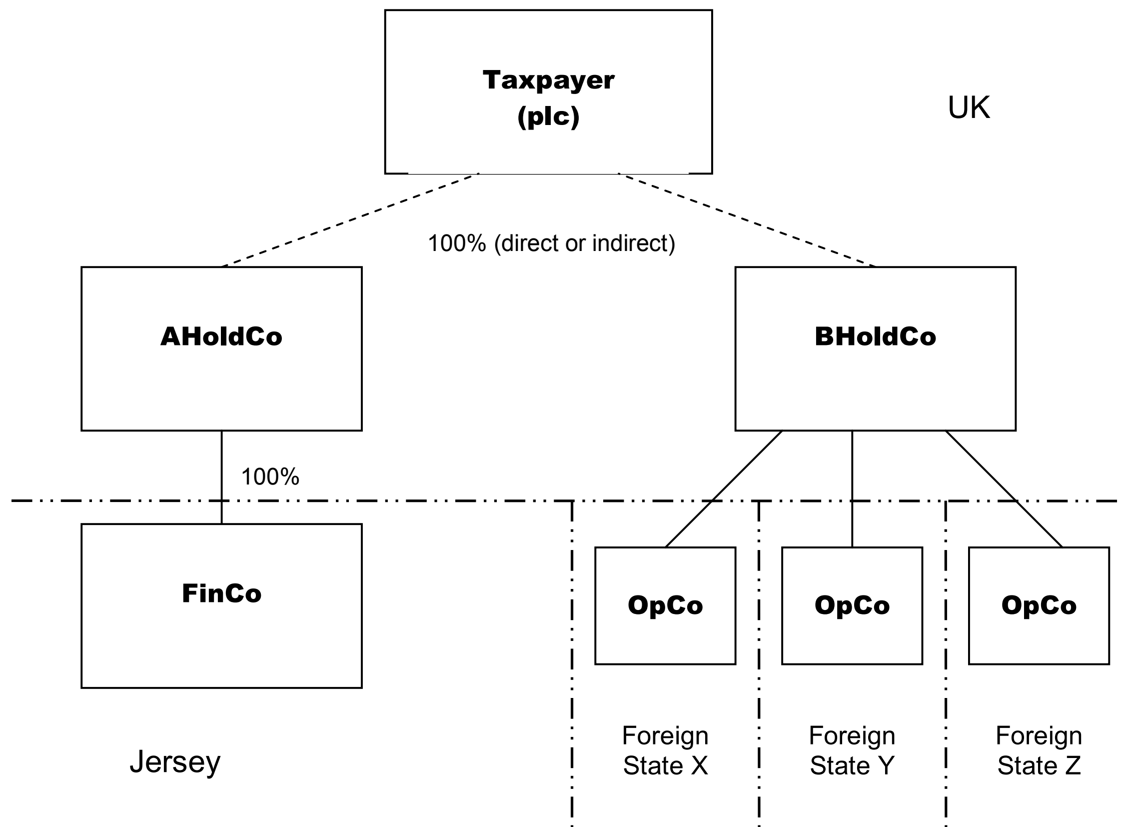
However, the tax advisers have indicated that HMRC may not agree with this opinion. The view of HMRC, as expressed in Capital Gains Manual 45400, is that the 179(2)

exemption from the de-grouping charge presupposes 'a shareholder tier charge reflecting the increase in value of the underlying asset while held by the group'. HMRC therefore states that the exclusion requires the companies to be associated at the time of the intra-group asset transfer as well as the time that the companies leave the group. The advisers are uncertain whether HMRC would assert that, in any event, the arrangement is ineffective because it involves impermissible tax avoidance.

2. Offshore Financing Arrangement

* Note: You will be aware that there is a debate about the validity of the United Kingdom CFC legislation following the decision of the European Court of Justice in *Cadbury Schweppes v CIR*. Please assume for the purposes of this discussion that the legislation (now or as amended) complies with EU law.

The taxpayer is a plc resident in the UK. It is the ultimate parent of a large group of companies operating worldwide (the 'Group'). The taxpayer wholly owns, directly or indirectly, holding companies known as 'AHoldCo' and 'BHoldCo', each resident in the UK. AHoldCo owns a financing subsidiary ('FinCo'), which at present is resident in Jersey. BHoldCo owns shares in a number of operating companies ('OpCos') that are resident in various jurisdictions where they carry on business. The relevant companies in the Group are shown in the following diagram:



The principal activity of FinCo is to raise finance from various sources and to provide that finance to the OpCos for use in their businesses. However, at present the Group's financing activities are not centralized – the OpCos and certain other entities in the Group also carry out financing activities. In order to increase the overall efficiency and profitability of the Group, the taxpayer is considering aggregating all of its main financing activities in a single financing company located in a convenient jurisdiction.

The taxpayer's advisers have suggested that it consolidate its main financing activities in FinCo and that FinCo be continued into (or re-established in) Ireland. They have suggested Ireland as a location because it is an EU member state offering a familiar legal system, a strong financial system and a competitive corporate tax burden. Specifically, it has been suggested that FinCo be established in the International Financial Services Centre in Dublin.

FinCo's activities will consist of raising finance from various sources and on-lending to connected persons in the Group for use in their businesses. FinCo will earn an arm's length rate of return from these activities. All of FinCo's shares will be held, directly or indirectly, by AHoldCo. FinCo will have a flexible distribution policy under which dividends will be paid at the discretion of the board. FinCo's premises in Dublin will likely consist of one office containing the necessary computer equipment and

communications equipment. FinCo will employ two or three qualified staff working on site, possibly seconded from the taxpayer's head office in the UK.

The opinion of the taxpayer's advisers is that FinCo should not be subject to the existing CFC regime (or the proposed modified regime). It is admitted that FinCo will be a 'controlled foreign company' because it will be resident outside the UK, controlled by a person resident in the UK, and subject to a 'lower level of taxation' than in the UK. It is also admitted that FinCo will not satisfy the majority of exclusions from the CFC regime:

- FinCo's distribution policy will not meet the 'acceptable distribution policy' standard (90% of net profits distributed as dividends within 18 mos of year-end).

- FinCo will not carry on trading activities that satisfy the 'exempt activities test' (either because its activities will constitute an 'investment business' or because its activities will be a 'financial business' where 50 per cent or more of the gross trading receipts are derived from associated or connected persons).

- The annual profits of FinCo will exceed the *de minimis* threshold of £50,000.

- FinCo will not be located in an 'excluded country'.

However, it is the advisers' opinion that FinCo will satisfy the 'motive test', resulting in FinCo not being subject to the CFC regime. The advisers take the view that the taxpayer's main purpose in establishing FinCo in Ireland is to consolidate the Group's financing activities in a single entity so as to increase the Group's overall efficiency. Reducing UK tax is not the taxpayer's main reason or purpose, or one of the taxpayer's main reasons or purposes, for establishing FinCo in Ireland, although it is admitted that the choice of FinCo's location is influenced in part by the favourable corporate tax rate in Ireland. The taxpayer's advisers have noted that HMRC may take a different view, as expressed in International Manual 208000 regarding the 'motive test'.