

Corporate Tax Risk and Tax Avoidance: New Approaches

JUDITH FREEDMAN, GEOFFREY LOOMER
AND JOHN VELLA*

Abstract

The relationship between tax authorities and large corporate taxpayers is a concern world-wide as can be seen from the 2008 OECD Study into the Role of Tax Intermediaries. In the United Kingdom, HMRC have been developing a risk rating approach to tax risk management as part of their Review of Links with Large Business. The approach is designed to promote an enhanced relationship between HMRC and the taxpayer, based on trust and transparency. The objectives include the improvement of resource allocation and the encouragement of companies to consider their position so as to achieve the benefits of low risk rating, which may involve altering their tax planning strategy. In addition, new approaches to tax avoidance legislation such as targeted anti-avoidance rules and principles-based legislation are being introduced or considered. This article discusses a survey of tax directors in which the authors used detailed tax planning scenarios to investigate the views of tax directors on the impact and success or otherwise of these new approaches. The views of tax directors are only one factor in judging the success of these developments, but given that one aim of current tax policy is an enhanced relationship with corporate taxpayers, directors' views are significant in assessing the progress being made.

Introduction

This article sets out and analyses the main findings and conclusions of a survey of tax directors undertaken by the authors in the first half of 2008. The survey examined attitudes regarding new approaches being developed by the revenue authorities in the United Kingdom to managing tax risk and regarding legislation to curb tax avoidance.

The context: review of links with large business, tax risk and the Organisation for Economic Co-operation and Development study

The management of tax risk by both corporate taxpayers and revenue authorities has received heightened attention in recent years. Revenue authorities are concerned to

* Judith Freedman is Professor of Tax Law, Oxford University, and Director of Legal Research at the Oxford University Centre for Business Taxation (OUCBT). Geoffrey Loomer is a Research Fellow at OUCBT. John Vella is Career Development Fellow in Company Law, Oxford University. The survey on which this article is based forms part of a larger project being undertaken at the OUCBT under an Economic and Social Research Council (ESRC) large grant (RES-060-25-0033). The authors gratefully acknowledge the support of OUCBT and ESRC. They also thank the anonymous participants in the survey and the practitioner advisers on the scenarios for their time and Jane O'Hare for administrative assistance.

CORPORATE TAX RISK AND TAX AVOIDANCE

manage the risk that corporate taxpayers will engage in what the authorities consider to be revenue reducing avoidance behaviour unforeseen by legislators and lacking in transparency.¹ Large corporate taxpayers generally want to ensure that their tax planning is legal, efficient and appropriate, that it does not create reputational risks and that reporting and compliance requirements are satisfied.² The two sets of objectives will not always overlap entirely and there may be differences of view as to the degree of risk relating to any given transaction and on the meaning of legislation. Not only will taxpayers and revenue authorities have different views of some of these behaviours but taxpayers will vary among themselves in their attitudes to what constitutes acceptable and unacceptable tax risk.

In January 2008 the Organisation for Economic Co-operation and Development (OECD) published a study into the role of tax intermediaries,³ a study which went considerably further than its title suggests in attempting to form the basis for an agreed approach to the management of tax risk by revenue authorities. The OECD study team considered the tripartite relationship between revenue bodies, taxpayers and tax advisers (the “intermediaries” of the title of the study) in the context of what it calls “aggressive” tax planning and the impact this has on tax administration.

The problem of drawing a boundary between tax planning and tax avoidance, or what is sometimes termed “acceptable” and “unacceptable” (or “aggressive”) taxpayer behaviour, is one that besets all tax jurisdictions. It raises fundamental questions about the nature of tax legislation and the relationships between taxpayers, intermediaries, the administration, the courts and government. The notion of “aggressive” tax planning has now been introduced formally into the international tax lexicon by the OECD Study, which defines aggressive tax planning in a distinctive way.

“Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences. Revenue bodies’ concerns relate to the risk that tax legislation can be misused to achieve results which were not foreseen by the legislators. This is exacerbated by the often lengthy period between the time schemes are created and sold and the time revenue bodies discover them and remedial legislation is enacted.

Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. Revenue bodies’ concerns relate to the risk that taxpayers will not disclose their view on the uncertainty or risk taken in relation to grey areas of law (sometimes, revenue bodies would not even agree that the law is in doubt).”

(Emphasis as in original document)

This aggressive tax planning concept generally, and this definition specifically, are, however, highly contentious. Other commentators would argue that the fact that the tax

¹ Definition taken from *OECD Study into the Role of Tax Intermediaries* (OECD, 2008) (OECD Study), available at: www.oecd.org/dataoecd/28/34/39882938.pdf (accessed January 4, 2009).

² See, for example, PwC’s description of tax risk management at: www.pwc.co.uk/eng/issues/tax_risk_management.html (accessed January 4, 2009).

³ OECD Study, fn.1.

BRITISH TAX REVIEW

revenue consequences of a transaction are not those that the revenue authorities expected does not mean that they are not those that the legislature acting as a body expected and, moreover, that the test of whether tax planning is “acceptable” should be what the legislation says as interpreted by the courts and not what the tax authorities suppose it was intended to say. This raises very difficult issues of parliamentary intention, the role of legislators, the courts and the administration, and also the rights and duties of taxpayers and their advisers. These issues cannot be fully explored in this article but the results of this survey will be used in future work as a basis for further examination of these questions.⁴

Enhanced co-operation and new approaches to legislation

The OECD study team recommended, among other things, that revenue bodies establish a tax environment in which trust and co-operation can develop so that *enhanced relationships* with large corporate taxpayers and tax advisers can exist. This is intended to lead to better resource allocation by revenue authorities so that they can respond to continuing risks. The study team suggested that revenue bodies should use a risk-based approach to direct attention to taxpayers and tax advisers who are unwilling to engage in mutually beneficial relationships with a view to making it apparent that there are consequences of this stance. A number of countries have experimented with some form of enhanced co-operation, including the USA, Ireland and the Netherlands.⁵

In the United Kingdom, even before the OECD Study was commenced, a similar approach had been adopted in HMRC’s links with large business programme (Varney Review).⁶ The core team working on the OECD Study was supplied by the United Kingdom so the coincidence in the approaches is no surprise. The UK authorities are now taking a two-pronged approach to the management of what they term “tax risk” in large corporates. HMRC define tax risk as:

“a risk that a customer will not pay the *right* amount of tax or duty at the right time. . .”

“A tax compliance risk may be an identified tax issue, where HMRC and the customer may not agree about a particular tax analysis set out in a return or declaration. Or it may be a less specific uncertainty about whether tax returns and declarations are

⁴ For references to some of this literature see J. Freedman, “Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament” (2007) 123 LQR 53; R. Avi-Yonah, “Corporate Social Responsibility and Strategic Tax Behaviour” in W. Schön (ed), *Tax and Corporate Governance* (Springer, 2008); R. Avi-Yonah, “Aggressive Tax Behaviour and Corporate Social Responsibility” in J. Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (OUCBT, 2008) (*Beyond Boundaries*); R. Fraser, “‘Aggressive Tax Behaviour’ and Corporate Social Responsibility: A Response” in *Beyond Boundaries*.

⁵ The experiences of these countries are set out in more detail at Annex 8.1 of the OECD Study, fn.1. On the Netherlands and Australia see R. Happé, “Multinationals, Enforcement Covenants and Fair Share” (2007) 35 *Intertax* 537, reprinted in *Beyond Boundaries*, fn.4.

⁶ For the HMRC publications setting out the details of this programme see *Review of Links with Large Business* (HMRC, November 2006) (*Varney Review*); *Making a Difference: Delivering the Review of Links with Large Business* (HMRC, March 2007) (*Varney Delivery Plan*); *HMRC Approach to Compliance Risk Management for Large Business* (HMRC, March 2007) (*Risk Management Report*).



CORPORATE TAX RISK AND TAX AVOIDANCE

correct which may lead to an issue being identified.”⁷

(Authors’ italics)

The first prong of this approach is to work towards an enhanced relationship based on trust and co-operation, enabling the revenue authorities to direct their limited resources to the areas where they are most needed. The revenue authorities appear to hope that this will encourage the corporate taxpayer to look beyond its legal obligations in assessing its behaviour.⁸ The words “right” and “correct” in the above quote may be problematic and this provides important background to this exercise. It is now widely agreed that companies will assess reputational risk, which arguably might in some cases take them beyond their legal taxpaying duties, but attitudes to reputational risk vary considerably as do the views of company directors and managers on the extent to which their taxpaying behaviour should be governed by considerations which extend wider than reputational risk.⁹ The survey discussed in this article examines the views of corporate tax managers on these issues through the medium of a discussion of risk rating. In addition to being a resource allocation mechanism, risk rating attempts to create an incentive to taxpayers to aim for a low risk rating by moderating their behaviour. This approach is explained further below. The survey investigated the value given to the benefits of being low risk and the extent to which company managers and directors were prepared to moderate behaviour in order to achieve the purported benefits, such as cost saving and reduced management time spent on tax affairs.

At the same time the UK revenue authorities are developing a second new approach to managing avoidance behaviour by attempting to improve the drafting of anti-avoidance legislation so that it is not necessary to rely on companies’ management going beyond their legal obligations. Targeted anti-avoidance rules are being used and principles-based legislation is being explored, as explained further below. Using specific examples, this survey investigates these legislative initiatives and considers their chances of success in improving the understanding of all parties of what is required by the law.

As will be seen, for the most part the survey results support this two-pronged approach. The two approaches are interlinked in a number of ways in part because the differences in views about what is “acceptable” tax planning feed into the risk rating. There is considerable support for exploration of the use of new methods of drafting within a context of enhanced co-operation and trust achieved by the first approach. Not only might this reduce the complexity and frequency of new legislation, but clearly if there is a stronger chance that some tax planning will be found to be ineffective by the courts, the case for

⁷ HMRC, *Tax compliance risk management: Guidance for LBS customers and staff* (December 2007) (December 2007 Guidance) at 5, available at: www.hmrc.gov.uk/large-business/risk-framework-guidance.pdf (accessed January 9, 2009).

⁸ For example, the December 2007 Guidance states that its assessment of a company’s risk rating will take account of whether innovative tax planning is undertaken that relies on a new analysis of legislation or an analysis of new legislation that is not clearly agreed in published policy objectives or HMRC guidance, or existing analysis of legislation, but in circumstances producing a more advantageous tax outcome than previously applied. Note that a taxpayer relying on high level advice on the meaning of the legislation might thus still be assessed as high risk under this definition if this advice does not concur with the HMRC view. In assessing a company’s risk rating HMRC will ask: “Are the customer’s judgments about the application of tax law generally consistent with HMRC’s views?”: December 2007 Guidance at 28. This is clearly contentious. See also L. Wise, “OECD Study into the Role of Tax Intermediaries” in *Beyond Boundaries*, fn.4.

⁹ See the literature cited in fn.4 above, and further discussion below.

BRITISH TAX REVIEW

pursuing that planning approach is lessened. The survey results also suggest limits on how far it can be expected that large corporations will go beyond their legal obligations and concerns about the power of the second approach to clarify the requirements of the law.

Details of survey

The survey on which this article is based collected the views of tax directors by way of face-to-face interviews conducted in the spring of 2008 with representatives of 30 corporate groups (comprising FTSE 100, FTSE 250 and unlisted companies) regarding alternative approaches to tax risk and tax avoidance. This survey will be referred to as the Main Survey. The article first describes the experiences and opinions of large business representatives with respect to the Risk Rating Approach (RRA), a key feature of the Varney Review, as well as the status of relationships between HMRC and large business more generally. The questions focus on the workings of the Large Business Service (LBS), which administers the taxation of the largest UK businesses.¹⁰ It next considers the respondents' views on the practical implications of two developing legislative approaches—targeted anti-avoidance rules and principles-based legislation—and how these approaches impact upon, and are influenced by, relationships between HMRC and large businesses. This work builds upon the authors' earlier pilot survey regarding the Varney Review, conducted in spring 2007 (the Pilot Survey).¹¹ The methodology employed in the Main Survey is described further in Appendix I.

Brief reference is also made to work commissioned by HMRC resulting in two pieces of research carried out in 2007 by independent firms on the experience of large business customers, including views on key aspects of the Varney Review. Summary results were published in January 2008,¹² and a full report on one of the two pieces of research was published after the Main Survey interviews had been completed.¹³

Risk rating and the relationship between HMRC and large businesses

Background to the risk rating approach (RRA)

This part of the article focuses on the RRA and the relationship between HMRC and large businesses. This was first explored in the Pilot Survey and the issue was probed further in the Main Survey.

One of the four desired outcomes of the Varney Review is “an efficient risk based approach to dealing with tax matters”.¹⁴ Under this RRA, each company within the

¹⁰ The LBS deals with the affairs of around 700 companies, based on factors including turnover, assets threshold, and sector. There is some flexibility as to inclusion depending on a variety of circumstances. (Source: interview with LBS senior official).

¹¹ For a summary see J. Freedman, G. Loomer and J. Vella, “Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC” in *Beyond Boundaries*, fn.4. For the full report see: www.sbs.ox.ac.uk/Tax/publications/reports/Reports.htm (Pilot Survey Full Report).

¹² HMRC, *Update on Review of Links with Large Business: research summary* (January 2008), available at: www.hmrc.gov.uk/large-business/lb-summary.pdf (accessed January 9, 2009).

¹³ HMRC Research Report 58, *Research to support the implementation of proposals in the Review of Links with Large Business* (December 2007) (HMRC Research Report 58), available at: www.hmrc.gov.uk/research/report58.pdf (accessed January 9, 2009).

¹⁴ *Varney Review*, fn.6 at para.1.7. See also para.1.6 and the Chairman's Foreword at 1. This approach is not entirely novel. The *Varney Review* in fact builds on the report *Working with Large Business*:

CORPORATE TAX RISK AND TAX AVOIDANCE

LBS is awarded a risk rating, which determines the volume of HMRC's interventions in the company's affairs and the nature of the working relationship between the two. In essence, a light touch is adopted for low risk companies, thus releasing resources that can be directed towards higher risk companies.¹⁵ Risk here is "compliance risk", defined by HMRC as "the likelihood of failure to pay the right tax at the right time, or of not understanding what the right position might be".¹⁶

Initial implementation of the RRA for companies within the LBS was all but complete at the time of the interviews. In fact, in the 2008 Budget, HMRC reported that 97 per cent of LBS customers had been risk reviewed using the new risk review template. The 13,000 or so large businesses that do not fall within the LBS, known as "Local Compliance customers", may also benefit from the RRA. A risk strategy and guidance based on the LBS model is currently being introduced.¹⁷

The stated aim of the RRA is achieving a "more cost effective use of resources and efficient resolution of issues".¹⁸ It is clear from the documentation, however, that HMRC also view this approach as a means of incentivising companies to alter their behaviour in terms of transparency, governance, and tax planning. It can thus also be characterised, in part, as being an administrative route to deal with the problem of avoidance. For example, HMRC's documentation speaks about having "encouraged businesses to consider their position by defining the benefits of being low risk".¹⁹ Whilst HMRC thus aim to support companies in having a low risk relationship, since it is assumed that this is what they want,²⁰ HMRC do not force their hands. The theory, at least, is that each company is free to behave in the way it chooses, which will result in a particular position on the risk rating spectrum. If it makes choices that result in it remaining at the higher end it will simply forfeit the benefits of being low risk.

The interviewees in the Pilot Survey agreed with the approach in principle, but a majority raised serious questions about its details and practical operation. The details of the approach, however, had not been fully developed at the time of that survey. In fact, detailed guidance was only published in December 2007.²¹ Furthermore, too little time had passed for the interviewees to fully appreciate the impact of the approach in practice. For the purposes of the Main Survey, therefore, the authors were interested in finding out whether the uncertainties on the details had been overcome and how the approach was translating into practice.

Providing High Quality Service—Improving Tax Compliance (HMRC, April 2006) which, amongst other things, provided for a risk assessment process. In fact, it appears that HMRC carried out risk assessments even earlier than this.

¹⁵ 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: *Risk Management Report*, fn.6 at para.1.6. See P. Hampton, *Reducing Administrative Burdens: Effective Inspection and Enforcement* (HM Treasury, March 2005).

¹⁶ *Risk Management Report*, fn.6 at para.3.2.

¹⁷ HMRC, *The framework for a better relationship* (Budget 2008) at 10 (2008 Framework), available at: www.hmrc.gov.uk/budget2008/supplementary.htm (accessed January 9, 2009).

¹⁸ *Varney Review*, fn.6 at 16.

¹⁹ 2008 Framework, fn.17 at 4. See also HMRC, *Making a difference: Certainty and clarity* (October 2007) at 11; *Risk Management Report*, fn.6 at para.1.4; *Varney Delivery Plan*, fn.6 at para.3.3 and at 16; 2008 Framework, fn.17 at 10; December 2007 Guidance, fn.7 at 8, 16 and 18.

²⁰ December 2007 Guidance, fn.7 at 8.

²¹ December 2007 Guidance, fn.7.

Companies' risk ratings

Under the RRA, companies are given a risk rating on a number of criteria,²² as well as an overall rating. A high ranking official from the LBS explained to the authors²³ that there are only two overall ratings a company can obtain—"low risk" and "higher risk". Some interviewees also spoke of different gradations within the overall "higher risk" category, such as "moderate risk" and "high risk". These different gradations within the overall "higher risk" category are not found in the December 2007 Guidance. The LBS official explained to the authors that this could be due to a misunderstanding on the part of the interviewees or a lack of clarity by the HMRC official in charge of the risk rating of the particular company.²⁴ Despite this, it seems that some gradation within the overall "higher risk" category is recognised by HMRC in as much as they have set up the "High Risk Corporates Programme".²⁵ Out of the nine companies interviewed in the Pilot Survey only one was deemed low to moderate risk. The remaining companies were either at the higher risk end of the scale or had not yet had their risk assessment. In the Main Survey, the companies' risk ratings were distributed more uniformly. A small number of the companies interviewed were, at the time, still to undergo a risk rating assessment. Out of those that have had a risk rating, some reported a single overall risk rating—and these were divided almost equally between low and higher risk. The rest merely said that they obtained different ratings on the different criteria. However, they again split quite evenly between those that seemed to lie closer to the lower end of the spectrum and those that lie closer to the higher end. Thus the interviewees were spread quite evenly along the risk spectrum.²⁶

²² The criteria will be discussed below.

²³ Interview, fn.10. See also December 2007 Guidance, fn.7.

²⁴ The minutes of HMRC's Large Corporates Forum of October 9, 2007, available at www.hmrc.gov.uk/lbo/minutes-091007.htm (accessed January 9, 2009), report as follows:

- "Members were confused by high risk and low risk and how low/high risks (as in enquiries into specific areas) equate to a customer being high/low risk. There was a suggestion that individual risks are renamed "issues" to prevent confusion with the term in relation to customers. It was agreed that this was an area that LBS needed to look at.
- Can you still be low risk and have lots of issues? While something may be quite high risk due to financial implications, it was felt that this shouldn't make a customer high risk if there was openness/discussions otherwise this could end up preventing effective working relationships. [HMRC] agreed that customers could indeed have some high risks within the business while still retaining low risk status; each case would be judged on its merits."

See further discussion on this point at text following fn.31.

²⁵ This programme is referred to in HMRC, *Measuring the Tax Gap—An Update* (HMRC, Working Paper 5), available at: www.hmrc.gov.uk/research/measuring-tax-gap.pdf (accessed January 9, 2009).

²⁶ The detailed responses were as follows:

- Four companies had not had a risk rating assessment yet—all FTSE 250;
- 16 gave a single overall risk rating: 7 of these said they are low risk (4 FTSE 100, 2 FTSE 250, 1 unlisted); 2 said they are moderate risk (FTSE 250); 7 said they are high risk (FTSE 100);
- 10 did not give an overall risk rating: of these 2 said they are on the lower end of the scale (1 FTSE 100, 1 FTSE 250); 8 said they are low on some criteria and moderate or high on others. Out of these 8, 3 are clearly on the lower end of the spectrum and could possibly be overall low risk or thereabouts (2 FTSE 100, 1 FTSE 250), whilst the remaining 5 seem to be situated somewhere on the mid-high end of the scale, possibly closer to the high end (FTSE 100).

CORPORATE TAX RISK AND TAX AVOIDANCE

These findings are in line with HMRC's expectation that by March 2008 nearly 40 per cent of risk rated companies would be low risk.²⁷ Interestingly, asked if they were surprised by this 40 per cent figure, 13 of the 21 interviewees who answered this question said that they were not surprised. The risk rating of the particular company does not seem to have had an impact on the interviewees' views on this figure. It is also interesting to note that all but one of the tax directors of FTSE 100 companies who were not surprised by the figure commented that many companies covered by the LBS are relatively "small". There appears to be a belief amongst some of the Main Survey interviewees that there is a correlation between high risk and large, complex companies. This is despite the fact that HMRC claim that large, complex companies may be low risk²⁸ and that even within the sample a number of large, complex companies are in fact low risk or on the lower end of the scale. It is the case that all those at the highest end of the risk scale in the sample²⁹ appear to the authors to be large and complex companies. The sample is too small to provide conclusive evidence in this regard, but in view of the apparent concern of some firms that there is a correlation between size and risk it would be useful if HMRC could provide a breakdown of risk ratings by size of company.

Risk rating criteria

All the interviewees for the Pilot Survey agreed with the basic ideas behind the RRA. Nevertheless, all but one had reservations about the detail and its translation into practice.³⁰ These reservations primarily concerned the risk rating criteria and the benefits of being low risk. The three main reservations on the risk rating criteria were the nature of the criteria, the different weight to be given to the criteria, and the use of tax avoidance as a criterion; these were explored further in the Main Survey.

The risk rating criteria and their weight

The risk rating criteria can be divided into two general groups: structural or inherent on the one hand and behavioural on the other.³¹ Inherent risks include change, complexity and "boundary issues" (by which HMRC mean issues arising from international relationships and transactions), while behavioural risks include corporate governance, delivery, tax strategy and contribution.³² The Pilot Survey revealed some uncertainty as to whether it was the existence of inherent risk itself or the management of that risk that would

²⁷ 2008 Framework, fn.17 at 10. By June 2008 the actual number of large businesses managed by the LBS that had a low risk rating was 238 (out of around 700 possible businesses): Hansard, HL, Vol.703, col.WA70 (July 7, 2008), available at: www.publications.parliament.uk/pa/ld200708/ldhansard/text/80707w0003.htm.

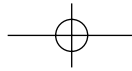
²⁸ December 2007 Guidance, fn.7, explained further below.

²⁹ These include: (i) companies that are high risk and (ii) companies which have different ratings on the different criteria, and, although the interviewees were not told their overall rating, they believe them to be closer to the high end of the scale.

³⁰ Pilot Survey Full Report, fn.11 at 9.

³¹ *Risk Management Report*, fn.6 at para.4.4 and Annex A.

³² December 2007 Guidance, fn.7 at 6–7 and Annex C. "Contribution" in this context is the tax paid in comparison with the amount HMRC might expect from the level of its economic activity and in comparison to its competitors. Obviously this comparison involves subjective judgments and could be contentious.



BRITISH TAX REVIEW

be relevant in the risk rating process. Most of the interviewees assumed that it was the former.³³ As their companies were large and complex they concluded that they could never be low risk thus making the risk rating process “irrelevant”.³⁴ Furthermore, the Pilot Survey also revealed that there was considerable uncertainty as to the weight to be given to the various criteria. In particular, most of these interviewees were uncertain as to whether a company that did not have a low score on structural criteria could bring its overall rating down to low risk by having a low score on behavioural criteria.³⁵ Thus the authors concluded 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”.³⁶

HMRC seem to have responded to these concerns, expressed by the authors and others. The December 2007 Guidance states:

“The ‘Inherent’ sources of compliance risk will not determine whether we have a low risk relationship with the customer. What matters is how those risks are being managed and how they translate into the assessment of ‘behavioural’ ratings for governance, delivery and tax strategy (Annex C). A business with major inherent sources of risk can be seen by HMRC as low risk if, by its actions, it is minimising those risks and willing to be open about tax compliance and issues.”³⁷

HMRC have thus shifted their emphasis onto behavioural factors or, at least, they have conveyed more clearly the message that behavioural factors carry more weight than inherent factors. A majority of the Main Survey interviewees seem to have recognised the change, and therefore that large complex companies could be low risk.³⁸ Some interviewees expressly noted the evolution of the approach in this sense.³⁹ Others were less clear in their answers on the risk rating criteria, simply noting that both structural and behavioural issues are important.⁴⁰ Six out of the 22 interviewees who answered the question, all from large and complex companies, and all high risk or on the higher end of the scale, acknowledged that HMRC are now asserting that large complex multinationals can be low risk, but these interviewees remain sceptical. One simply pointed to the fact that the membership of the recently created High Risk Corporates Programme seems highly correlated to the upper end of the FTSE 100.

Two further interviewees believe that large complex multinationals cannot be low risk because they were told so by HMRC staff. This brings to light a problem noted by other interviewees, namely that the change in attitude on the RRA has not fully filtered down from the top at HMRC. Apart from the need to ensure that everyone at HMRC is up to speed on the RRA, some interviewees also commented that, despite the welcome evolution of the approach, there is still room for further improvement and refinement. In

³³ Pilot Survey Full Report, fn.11 at 9.

³⁴ Pilot Survey Full Report, fn.11 at 11.

³⁵ Pilot Survey Full Report, fn.11 at 10.

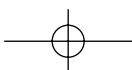
³⁶ Pilot Survey Full Report, fn.11 at 11. See also at 17.

³⁷ December 2007 Guidance, fn.7 at 7. See also at 11.

³⁸ 12 out of the 22 interviewees who answered the question.

³⁹ 7 out of the 22 interviewees who answered the question.

⁴⁰ 2 out of the 22 interviewees who answered the question.



CORPORATE TAX RISK AND TAX AVOIDANCE

particular, a few interviewees believe that the criteria and the guidance give less room for flexibility and judgement than is desirable.

Thus the shift in emphasis from structural to behavioural criteria was recognised by a majority of those interviewed. Some, however, have heard the rhetoric but remain unconvinced. It appears that large, complex multinationals can be low risk if they satisfy the behavioural criteria discussed below but it remains the case that companies at the highest end of the risk scale in our sample are large, complex multinationals.

Tax strategy and risk rating

Centrality of tax planning to risk rating As noted, one of HMRC's risk rating criteria is a company's tax strategy. An important aspect of this criterion is a company's attitude to tax planning and avoidance.⁴¹ If large, complex multinationals are to be low risk, as discussed above, then tax planning could be the most important risk rating criterion in a considerable number, if not a majority, of cases. These large companies can never be fully low risk on inherent factors, so they can only bring down their overall rating by becoming low risk on behavioural factors. None of the interviewees said that they want to be anything other than low risk on corporate governance and delivery. Indeed, becoming transparent and open and putting good systems in place are aspects of the Varney Review that most, if not all, the interviewees seem to agree with and aspire to.⁴² It follows that if companies manage to bring down their risk rating on the other behavioural factors, their overall risk rating will depend on their attitude to tax planning.

Several interviewees provided direct support for this view. They want to be open and transparent and have the advantages of real time disclosure, but they also want to be free to engage in tax planning that is legal and believed to be technically effective, but that HMRC may dislike. Thus transparency, disclosure, and robust compliance systems are seen to be reasonable requirements, but engaging in tax planning is seen by a number of the interviewees as something the company has a right to do and purely a matter of cost/benefit analysis. These interviewees made it clear that, even though they know that they could reduce the company's risk rating by altering its tax planning behaviour, they are unwilling to do this where HMRC's view that a piece of tax planning is "unacceptable" is based on an interpretation of the law which they feel they are entitled to disagree with, pending determination by the courts.⁴³ Two firms expressly stated that tax planning behaviour should not be a risk rating factor since provided there is full disclosure there is not a heightened risk. The December 2007 Guidance makes it quite clear though that such behaviour is a factor. The correlation between risk rating and tax planning behaviour is evident from the

⁴¹ December 2007 Guidance, fn.7, Annex C.

⁴² The authors note that the research carried out on behalf of HMRC reported:

"There were contrasting views among participants about whether an open and transparent relationship with HMRC was a realistic goal. Once again, those businesses professing an overtly risk averse approach to tax described the goal of improving transparency as 'commendable', particularly for supporting businesses trying to keep up to date with tax law changes. An opposing view highlighted the perceived 'naivety' of aiming for openness given the conflicting aims of businesses and HMRC, with one trying to minimise tax payments and the other trying to maximise tax revenue." HMRC Research Report 58, fn.13 at 20.

⁴³ Note that the research carried out on HMRC's behalf found concern amongst participants regarding the use of tax planning as a risk rating criterion: HMRC Research Report 58, fn.13 at 26.

BRITISH TAX REVIEW

Main Survey, in that most of the FTSE 100 respondents reporting a broadly low risk rating also appeared to eschew activity that they described as “aggressive tax planning”.

Tax policies/strategies and board involvement Other factors taken into account when assessing the risk rating of a company on the tax strategy criterion are whether the strategy is documented, the extent to which tax planning is articulated in it, and the board’s awareness of it.⁴⁴ Clearly, all this links with another of the seven risk rating criteria, namely, corporate governance.

HMRC view a board approved tax policy as a feature of good governance.⁴⁵ Paragraph 3.2 of the *Risk Management Report* states that a business that is successfully managing tax risk will have, among other things, “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”.⁴⁶

A great majority of the Main Survey interviewees’ companies have a tax policy or a tax strategy,⁴⁷ almost all approved by their board. Only a few, mostly low risk, companies have shared their policy or strategy with HMRC. The obvious benefit of drawing up a tax policy and not just a strategy is that it focuses the mind on how tax and tax risk is managed within a company. Some interviewees seemed to have a positive view of the impact of tax policies. On the other hand, as some interviewees noted, such stated policies can prove to be rather anodyne. Vague generalisations can make for a perfectly respectable tax policy in theory but they may be so broad as to be of very limited practical significance.

HMRC have also been clear in saying that they have and will engage at board level on tax issues.

“Where we believe that a customer’s behaviour poses a serious tax risk we will engage directly at Board level to try to persuade that customer to change the behaviours that are generating those risks. A Board needs to be aware that contentious tax investigations and disputes are expensive and resource intensive. We will generally seek dialogue and offer a Board an alternative approach and will always support our customers in moving towards a low risk relationship.”⁴⁸

A number of Main Survey interviewees discussed HMRC’s engagement with their board or board members.⁴⁹ Given that a majority of the interviewees’ policies or strategies were board approved, and that a majority also said their board (or a board committee) is involved at some stage in the decision-making or review processes,⁵⁰ it is unsurprising

⁴⁴ December 2007 Guidance, fn.7.

⁴⁵ See HMRC, *Tax in the Boardroom*, available at: www.hmrc.gov.uk/lbo/tax-in-the-boardroom.htm (accessed January 9, 2009).

⁴⁶ *Risk Management Report*, fn.6, at para.3.12. Schedule A includes these questions: “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?”

⁴⁷ 28 answered this question: 10 have a tax policy; 11 have a tax strategy; 2 said that tax falls within the ambit of a broader risk policy.

⁴⁸ December 2007 Guidance, fn.7 at 16. See also 2008 Framework, fn.17 at 10.

⁴⁹ This issue was discussed with 18 of the interviewees.

⁵⁰ All of the interviewees in the Pilot Survey already had board participation in the decision-making or review processes. In the Main Survey this matter was only mentioned fleetingly by the interviewees whilst discussing their tax policies/strategies.

CORPORATE TAX RISK AND TAX AVOIDANCE

to find that nearly all the interviewees who discussed HMRC engagement at board level were adamant that their boards or members thereof are at least broadly aware of the tax affairs of the company. Indeed, a few described the view that their board might not be aware of the tax planning undertaken by their tax department as “naïve”. It should be noted, however, that one or two interviewees’ comments suggested that, in their view, board engagement was not (or previously had not been) adequate in their companies.

While HMRC appear to view the board of directors as an organ that can keep tax planning in check, a few interviewees noted that board engagement can have the opposite effect as a result of the so-called “golf course syndrome”. Directors hear about the tax planning carried out in other companies while socialising with other directors, or indeed, whilst acting as non-executive directors on the boards of other companies, and thus become eager for their companies to enter into the same type of transactions. A cross-fertilisation of tax planning ideas can thus take place. Board directors will not want to take reputational risks but that does not necessarily mean that they do not want to engage in tax planning that has a good chance of increasing profits.

The findings support the view that tax planning could be the most important risk rating criterion in a considerable number of cases. Tax policies and strategies are common, but the former can often be too vague and general to have much practical significance. All but one of the high risk companies interviewed in the Main Survey have a tax policy/strategy.⁵¹ Also, all but one of these companies claimed to have formal or informal decision-making/review processes which involve the board or board members.⁵² Thus the Main Survey shows that companies engaging in non-conservative tax planning may nevertheless have corporate governance procedures in relation to tax matters.⁵³ The Main Survey, however, did not investigate the adequacy and robustness of such processes, in particular the ones of an informal nature.

Benefits of being low risk

HMRC set out the consequences of being low risk in the *Risk Management Report*, particularly in Chapter 5, and again in considerable detail in the December 2007 Guidance. In essence, low risk companies are to benefit from a light touch approach, whilst higher risk companies will be the subject of “more intensive scrutiny”.⁵⁴

A majority of the interviewees in the Pilot Survey could not see the benefits of being low as opposed to high risk. Some noted that low risk companies are meant to enjoy a light touch approach but were sceptical about that happening in practice. They thought that the size and complexity of certain companies necessitated constant audit reviews and regular interventions, whatever their risk rating may be. On the other hand, these interviewees had no difficulty identifying a particular negative consequence of being high risk: being “hassled” by HMRC, especially by being asked for a lot of information.

⁵¹ Tax planning falls within the ambit of a more general code of conduct/risk policy for this one company. Note that one of the companies said that its policy was unwritten and informal.

⁵² The decision-making and review processes were not discussed with this company, so it could, in fact, have such processes in place.

⁵³ On this point see HMRC Research Report 58, fn.13 at 26.

⁵⁴ *Risk Management Report*, fn.6 at para.1.10.

BRITISH TAX REVIEW

In contrast, 13 of the 25 interviewees who answered this question in the Main Survey could see the benefits of being low risk. These included being subject to fewer enquiries, obtaining formal and informal clearances with greater ease, being approached by HMRC with a less suspicious frame of mind, a real time working relationship, and a quicker resolution of disputes. Only two of the 25 who answered this question said that they were unclear as to what were the benefits of being low risk. The remaining 10 were aware of the benefits, but did not think they sufficed to induce them to alter their tax planning behaviour and thus become low risk. Some of these interviewees said that the benefits were “intangible”; others said that they could be tangible but still would not justify altering their behaviour. All of these 10 interviewees were higher risk rated apart from one, whose company is still to be risk rated. They believe that ultimately one has to weigh the costs against the benefits of becoming low risk. If the benefits do not outweigh the costs then they will not undertake the necessary changes to become low risk. Thus the results of the Main Survey suggest strongly that a minority, but a sizeable minority, of companies will never view the benefits of being low risk as sufficient to justify a change in tax planning behaviour, though they might be prepared to improve co-operation in other respects that would be helpful to both HMRC and the companies. This, as shall be discussed later in this article, has repercussions for the fulfilment of some of the goals of the RRA.

Relationship with HMRC

The RRA is, as mentioned, one of the desired outcomes of the Varney Review, the other three being certainty, speedy resolution of issues, and clarity through consultation. All four outcomes contribute to the ultimate aim of the Varney Review, which is that of improving the relationship between HMRC and large business.

One of the most positive findings of the Main Survey is that most of the interviewees said either that they enjoy a good relationship with HMRC or that their relationship with HMRC has improved recently.⁵⁵ Interviewees from both low and higher risk companies noted an improvement in the openness of the relationship, in the speed with which issues are resolved, and in the focus on the more important issues.⁵⁶

The focus on important issues, in particular, marks a clear difference from the past. Interviewees in the Pilot Survey had complained about the “hassle factor”, that is, that HMRC were often indiscriminate, demanding voluminous documentation in areas where the risk was low and perhaps the amount of tax in question was low too. In the Main Survey both low and higher risk companies commented on an improvement in this respect. This is, of course, to be expected for low risk companies; however, as noted, HMRC are committed to speedier resolution and to focusing their interventions on areas of significant risk even for higher risk companies.⁵⁷ In fact, speedy resolution of issues

⁵⁵ 13 companies noted that the relationship has improved recently. 7 enjoy a good relationship. Interviewees were not asked directly whether their relationship with HMRC has improved or if they enjoy a good relationship with HMRC, so the actual figures could have been higher.

⁵⁶ The last 2 noted improvements also relate to another of the 4 desired outcomes of the Varney Review, namely speedy resolution of issues: *Varney Review*, fn.6 at 18–19. The delivery of this desired outcome is detailed in 2008 Framework, fn.17.

⁵⁷ December 2007 Guidance, fn.7, Part 5 “Handling tax issues for all customers”. See also proposal 7 of the *Varney Delivery Plan*, fn.6.



CORPORATE TAX RISK AND TAX AVOIDANCE

is, as noted, one of the four desired outcomes of the Varney Review, and proposals have been put in place for its attainment. It is clearly linked to the RRA in as much as it is partly based on, and made possible by, an allocation of resource according to risk.

The relationship between HMRC and large businesses thus seems to be moving in the right direction, but there is a need for further work. Indeed, a few interviewees first noted the improvement then hastened to add that there is still some way to go. One interviewee commented that HMRC still tended to react aggressively when challenged. Another observed that, while HMRC have been very good at dealing with small, less significant issues, it remains to be seen how they act when dealing with the larger, more significant ones. A further comment was that, whilst the tone of engagement between HMRC and companies has improved greatly, some elements within HMRC are still wedded to the antagonistic and aggressive culture of the past. A few interviewees noted, in particular, that former HM Customs and Excise staff still tend to be more aggressive than former Inland Revenue personnel. The HMRC International Division was also singled out for criticism by a small number of interviewees. A few interviewees did this directly, complaining about their general mode of operation or their alleged lack of understanding of global business. Others criticised the International Division indirectly, complaining about their overzealous application of controlled foreign company rules. A few interviewees noted that, at times, the International Division can be out of line with their Customer Relationship Manager (CRM).⁵⁸

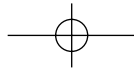
It is interesting to note that interviewees from two of the three companies interviewed that were outside the management of the LBS had a very negative view of their relationship with HMRC. There are too few interviewees in this category to draw any conclusions from this but it may suggest that there would be value in extending the Varney Review beyond the LBS, as indeed HMRC plan to do.

A CRM is assigned to every company in the LBS. The CRM acts as a first point of contact with HMRC.⁵⁹ A number of Main Survey interviewees expressly emphasised the importance of good quality CRMs if the relationship between HMRC and taxpayers is to improve and the Varney Review goals are to be obtained.⁶⁰ The message put forward was unequivocal: good CRMs make a difference. Most interviewees who commented on their CRMs were complimentary, finding them competent and enjoying a good relationship with them. A few, however, were less positive. Some complained that their CRM had been changed too often, thus making it difficult to nurture a good relationship. The interviews left no doubt whatsoever that a strong investment should be made in ensuring that the quality of CRMs and the resources available to them are high. This is essential if the whole project is to be a success. Consideration also needs to be given to the relationship developed between CRMs and taxpayers and the way in which this should be monitored and controlled. As with, for

⁵⁸ The research carried out on behalf of HMRC found a perception of adversarial approaches by HMRC amongst participants. Recent improvements were also noted: HMRC Research Report 58, fn.13 at 46–47. CRMs are discussed further below.

⁵⁹ See proposal 7 of the *Varney Delivery Plan*, fn.6.

⁶⁰ 5 interviewees. The research carried out on behalf of HMRC found, more generally, that “the personality of individual contacts within HMRC was felt to be crucial”: HMRC Research Report 58, fn.13 at 21.



BRITISH TAX REVIEW

example, audit partners, there are potential advantages and disadvantages of a strong relationship.

Evaluation of RRA: conclusions and observations

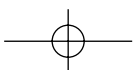
The goals of the RRA are a more cost effective use of resources, a more efficient resolution of issues, and incentivising companies to alter their behaviour in terms of transparency, governance, and tax planning. The results of the Main Survey support the conclusion of the report on the Pilot Survey that the RRA should lead to a better allocation of resources within HMRC and possibly a change in behaviour in terms of transparency and openness, but that it is unlikely to change the attitude of specific corporate taxpayers towards planning.⁶¹ This view has since also received broad support from research carried out on behalf of HMRC.⁶²

The Main Survey suggested that the relationship between HMRC and large businesses is moving in the right direction. Many of the interviewees appreciated the improvement brought about by cost effective use of resources and a more efficient resolution of issues. Many also professed to be truly committed to openness, transparency and good governance. Indeed, there were a few clear cases in which HMRC's efforts appeared to make a difference to these issues. In all these senses, at this stage in their development, the RRA and the related proposals implementing the Varney Review can be said to be a success.

As predicted, however, the RRA has been less successful in altering tax planning behaviour. Two features must be present for this to occur. Firstly, all types of company, whatever their size and complexity, must be able to move from higher to low risk. Whether this was possible was still uncertain at the time of the Pilot Survey, but HMRC have gone some way in clarifying the ability of large complex multinationals to be low risk, since it is the management of inherent risk and not the inherent risk per se which is taken into account. Secondly, the incentives to effect the necessary behavioural changes to become low risk must be in place. HMRC have clarified the benefits of being low risk, yet a number of interviewees from higher risk companies either said they that still cannot see what the benefits are, or that these benefits are not substantial enough to justify altering their tax planning behaviour. These interviewees all seemed to share the same view: they want to be open and transparent but they do not want to alter their tax planning behaviour (which they engage in only if it is legal and believed to be technically effective even though it may be "aggressive" in the view of HMRC). Company management ultimately applies a cost/benefit analysis to this question. If the benefit of being low risk (savings made through certainty and lighter engagement with HMRC) does not outweigh the costs (foregoing the savings made from tax planning) then companies will simply not have sufficient incentives to make the necessary changes to become low risk. This is particularly so when the question of where the boundary of the law lies is still, often, very indeterminate. Differences in opinion as to whether planning is acceptable or not are merely viewed as legitimate differences in the

⁶¹ Pilot Survey Full Report, fn.11 at 17–18.

⁶² "There were generally pessimistic views about whether the risk review would incentivise tax behaviour changes, other than by highlighting potential areas for improvement. This was explained as resulting both from conscious decisions about attitude towards tax risk, and the inherent risk status of businesses due to their size, structure and nature." HMRC Research Report 58, fn.13 at 27.



CORPORATE TAX RISK AND TAX AVOIDANCE

interpretation of a statute. Out of the 12 companies at the lower end of the scale (including seven low risk companies) interviewed for the Main Survey only three seem to be conservative in their tax planning *purely as a matter of general attitude to tax planning*; the vast majority seem to be conservative due to circumstances, whether these circumstances are the particular industry or line of business the companies are in, their particular legal structure which reduces the incentive for tax planning, or their low corporate tax bill. For example, companies relying on government contracts may feel the need to be conservative in their tax planning. For these reasons the authors believe that the RRA alone was unlikely to be the sole or major factor resulting in a curtailment of tax planning activities for most companies.

Another issue discussed with some interviewees was whether the influence of shareholders, investors or even the wider community makes a difference to tax planning behaviour. A number of reports and studies have in fact elaborated upon the way in which efforts by companies to understand and manage tax risk can enhance shareholder value.⁶³ Others have even suggested that a company's approach to taxpaying and tax planning are relevant to its broader corporate responsibility.⁶⁴ HMRC's effort to bring tax into the boardroom could thus be seen, in part, as an attempt to encourage directors to consider what their duties to shareholders and, perhaps, stakeholders at large, require of them in terms of tax and tax planning.⁶⁵

These issues were investigated in the Pilot Survey⁶⁶ and were revisited with a few of the interviewees in the Main Survey. As this was not a focus of the Main Survey, no conclusions can be drawn from these few responses, but they raise interesting issues for future consideration. The Pilot Survey found that companies do not see tax as a Corporate Social Responsibility (CSR) matter in the broad sense, that is, as defined by the European Commission: "enterprises deciding to go beyond minimum legal requirements and obligations stemming from collective agreements in order to address societal needs."⁶⁷ The Main Survey interviews did not contradict this.

Some discussions of CSR, however, construe it in a narrower, less controversial, sense. This merely requires directors to take into account the broader interests of stakeholders, including customers and the community in general, to the extent that that furthers the maximisation of shareholder value over time.⁶⁸ Tax could fall within the CSR agenda of

⁶³ D.F. Williams, KPMG's Tax Business School, *Developing the Concept of Tax Governance* (2007); Henderson Global Investors, *Tax, Risk and Corporate Governance* (February 2005); Henderson Global Investors, *Responsible Tax* (October 2005).

⁶⁴ SustainAbility, *Taxing Issues—Responsible Business and Tax* (2006), available at: www.sustainability.com/researchandadvocacy/reports_article.asp?id=450 (accessed February 8, 2009). For academic discussions see: Avi-Yonah, (Springer 2008), (OUCBT 2008) and Fraser, fn.4; 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* (CUP, 2007); J. Freedman, "The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility" in J. Holder and C. O'Connell (eds), *59 Current Legal Problems* (2006) 359. Also see the discussion in the Pilot Survey Full Report, fn.11 at 38.

⁶⁵ See the discussion of HMRC's engagement at board level beginning at text to fn.44.

⁶⁶ Pilot Survey Full Report, fn.11 at 38–41.

⁶⁷ European Commission Communication COM (2006) 01136. This issue was discussed with 6 interviewees. 5 argued that tax is not a CSR issue in the broad sense; 1 seemed ambivalent about the matter.

⁶⁸ This can be described as the Enlightened Shareholder Value approach. For a discussion of this approach see DTI, *The Strategic Framework* (London, February 1999, URN 99/654).

BRITISH TAX REVIEW

companies in this narrow sense if company directors believe that shareholders, analysts and the public might view corporate tax planning unfavourably, since this might lead to reputational damage leading to a fall in share prices, sales and profits. If this were the case, directors would have to consider whether the benefits of tax planning were outweighed by these costs.

In the Pilot Survey, tax directors were unanimous in their belief that shareholders and analysts do not pay much attention to tax matters. Views were more varied in the Main Survey, to the extent that this was discussed. Here a small number of tax directors stated that some shareholders do pay attention to tax matters, or that it is hard to establish whether or not they do so.⁶⁹

On the question of the impact of media coverage, in the Pilot Survey, the majority of the 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, they felt that the issues are not covered in the media or that they go unnoticed by the public and so most of the corporate respondents were not concerned about negative press coverage. In the Main Survey, where this was discussed with ten interviewees, one said that there were potential reputational risks associated with tax planning, but that these were often exaggerated, whilst another thought that these risks might be more of a concern for companies dealing directly with ordinary members of the public than they were for his company. One interviewee simply said that the public were not concerned with corporate tax issues. Another said that it was not realistic to believe that a company's tax affairs would affect its reputation. He took the view that few tax related stories made it to the main newspapers, and that even when they do, they do not affect share price or sales at all. The remaining six interviewees were concerned about negative press coverage because of the effect this could have on the company's reputation. Of these, one did not explain why this was so, and another went on to say that reporting on tax tends to be very superficial and, since the public ignores it, goes away rather quickly. One interviewee thought that negative publicity might affect a company's reputation with individual investors. Two interviewees worried that negative press coverage might affect their customer base. Finally, one interviewee argued that negative press coverage was very damaging but then said that it was hard to know if a company's share price or customer sales would actually be affected by this at all.

It is thus interesting to note that some of the interviewees who expressed concern about negative press coverage did not fully articulate how this could be damaging. There is a lack of knowledge and research on the effect of negative press coverage on share price, sales and profits. In addition, the Main Survey interviewees could have been influenced by the negative (and in fact incorrect) press coverage of some tax planning undertaken by Tesco and the subsequent libel action taken by Tesco which

⁶⁹ Of the 11 interviewees with whom this issue was discussed, 6 interviewees said that shareholders do not pay much attention to tax matters, 3 of these interviewees noting that shareholders seem quite happy for the companies they invest in to engage in tax planning. One interviewee simply noted that shareholders are happy to accept tax planning, but they might be less so if a company were to be susceptible to any reputational repercussions that might follow. Three interviewees said that some shareholders do care about tax. One said that it is hard to determine whether shareholders really care about tax.

CORPORATE TAX RISK AND TAX AVOIDANCE

was continuing at the time the interviews were carried out.⁷⁰ Given that the coverage was subsequently corrected, an apology issued and the libel action settled, this may have been a temporary effect. Indeed, the editor of the *Guardian* has expressed the view that the willingness of the company to litigate may have made it harder for the media now to investigate such issues.⁷¹ The extent to which reputational concerns will be strong enough to limit a company's legal tax planning behaviour will vary from company to company and will depend on the nature of the business and other factors. Such concerns are therefore often relevant, but the public reaction to engagement in legal, albeit artificial, tax planning is unlikely to be clear cut, given that attitudes to tax paying and tax planning cover a range of views and also given the problems most people will have in understanding the tax system. In addition this is such a complex and difficult area that, inevitably, the press will have difficulty in understanding and reporting the issues. All this makes the impact of reputational risk far from straightforward. Further research is needed on the question of the impact of negative press coverage on a company's tax planning, profits and share price, and on its reputation more generally.⁷²

Targeted anti-avoidance rules (TAARS)

The motivation for addressing TAARS and principles-based legislation (PBL)

As discussed above, a major part of each interview concerned tax risk and relationships between large businesses and the revenue administration. The authors believe that these issues are related to the nature and impact of TAARs and PBL, in that a crucial aspect of tax risk and tax relationships is how relevant anti-avoidance legislation is conceived, drafted and applied. This hypothesis was borne out in the Main Survey interviews.

The aim of the Main Survey was to investigate the large business perspective regarding TAARs and PBL by asking a number of broad questions about those topics but also by analysing detailed hypothetical scenarios in each interview. The scenarios, which were provided to each interviewee a few days in advance of their interview, are summarised here and are explained in full in Appendix II. Each example involved some element of tax planning the effectiveness of which could be affected by recent or proposed anti-avoidance legislation, specifically the loan relationships TAAR,⁷³ the draft legislation on financial products

⁷⁰ The first article was published in February 2008. Some of the articles and updates on the libel action commenced by Tesco against the *Guardian* can be found at www.guardian.co.uk, although the initial articles have now been removed since they were shown to be incorrect.

⁷¹ A. Rusbridger, "A Chill on 'The Guardian'" *The New York Review of Books* (January 15, 2009). It is to be noted, however, that in February 2009 the *Guardian* has published a series of articles on tax avoidance, which are the result of extensive investigations. The outcome remains to be seen.

⁷² For commentary on research in the US see M. Desai, "Corporate Governance and Taxation: The Implications for Financial Reporting" and M. Hanlon, "Analysing the Impact of Tax Avoidance" both in *Beyond Boundaries*, fn.4, but the US research is not conclusive.

⁷³ FA 1996, ss.91A–91G, as amended.

BRITISH TAX REVIEW

avoidance,⁷⁴ and the restrictions on allowable losses TAAR.⁷⁵ Each scenario was based on examples discussed in HMRC publications, with additional details provided in order to make the scenarios more realistic. The goal was to move beyond generalities in order to understand how businesses might assess and react to TAARs and PBL as a practical matter, and to compare such assessments and reactions to the academic and policy commentary on these developing legislative approaches. In addition, an overarching goal was to draw connections between these results and the conclusions regarding tax risk and relationships.

The nature and impact of TAARs

The targeted approach to curtailing unacceptable tax avoidance represents a middle route between the application of a general anti-avoidance rule (GAAR) (whether legislated or judicially created) and the use of detailed technical measures to counter every transaction that is considered unacceptable. The TAAR concept is not new but it appears that the terminology has only recently been adopted by HMRC and HM Treasury.⁷⁶ Unlike detailed prescriptive legislation, TAARs and GAARs usually place significance on a taxpayer's purposes in carrying out a transaction.

General comments on the impact of TAARs and other anti-avoidance provisions

The Main Survey questions asked tax directors which TAARs they had encountered in practice and whether they viewed the introduction of new TAARs positively. In this context the authors highlighted a statement made by HMRC in a recent policy document that "TAARs aim to strike a balance between generality and specificity",⁷⁷ asking interviewees if they felt this balance had been struck correctly.

While not every respondent had dealt with the actual application of TAARs to transactions carried out by his or her firm, all respondents agreed that existing TAARs potentially could affect a variety of transactions undertaken by them. The degree of concern regarding TAARs varied. A majority of interviewees (17) were emphatic that some TAARs are too general, too vague, or too opaque, such that they threaten to capture what these interviewees often described as "legitimate commercial transactions". A smaller group (three) complained about the generality of certain TAARs but tended to focus on the complexity and specificity of other rules, noting the effort required to plan around them. The final 10 respondents felt that there was always a risk of TAARs applying to transactions undertaken by them, yet they did not worry much about that risk because they were confident in the commerciality of their activities. It is notable that

⁷⁴ HM Treasury (HMT) and HMRC, *Principles-based approach to financial products avoidance: a consultation document* (December 2007) (PBL Consultation Document), available at: www.hmrc.gov.uk/legislation/disguised-interest-intro.htm (accessed January 9, 2009). The proposed legislation as it stood at the time of the interviews is discussed below. Revised clauses, taking on board some of the criticisms mentioned in the interviews, were published in a newer consultation document, HMT and HMRC, *Principles based approach to financial products avoidance* (November 2008), with a view to the possible introduction of legislation in the Finance Bill 2009.

⁷⁵ TCGA, s.16A.

⁷⁶ D.F. Williams, "Avoidance through the Creation and Use of Capital Losses by Companies" [2006] BTR 23, referring to the 2005 HMRC guidance on the predecessor to TCGA, s.16A.

⁷⁷ HMRC, *Simplifying anti-avoidance legislation* (March 12, 2008) (Simplification Progress Report) para.A.10, available at: www.hmrc.gov.uk/budget2008/supplementary.htm (accessed January 9, 2009).

most of the tax directors in the last group were from companies that have been rated by HMRC as low risk, were at the lower end of the risk spectrum, or were smaller companies not covered by the LBS and did not appear to have much knowledge about the scope of TAARs.

Some tax directors identified particular anti-avoidance provisions which they felt were too specific, including aspects of the loan relationships and repossessions rules, which in their view have led to the need for further detailed legislation to counteract innovative schemes. However, when addressing TAARs that take account of a taxpayer's purposes, the dominant theme of the responses was that these rules were too broad in scope, leading to a lack of clarity.⁷⁸ Anti-avoidance provisions that were most frequently highlighted as being too generally worded, and thus too vague, were the restrictions on allowable losses rules, arbitrage rules, and provisions of the CFC regime, although this list is not exhaustive.⁷⁹ A majority of the FTSE 250 respondents commented that TAARs which seem to be targeted at highly contrived tax schemes—in their view employed predominantly by large financial institutions—may nonetheless affect “commercial tax planning” carried out by medium-sized firms. They find themselves in a situation where they assume that this commercial tax planning is “onside” yet they harbour fears that it will be considered “offside” according to some rule or another.

The contribution of TAARs and other anti-avoidance provisions to legislative complexity and uncertainty

Beyond the question of generality and specificity, most tax directors interviewed addressed the complexity and uncertainty of UK tax legislation, with TAARs and detailed anti-avoidance rules being illustrations of such problems. Interviewees identified various causes of legislative complexity and instability, including a constant thirst for tax reform by HM Treasury and HMRC, often described by interviewees as legislative “tinkering”; an increasingly global and sophisticated business environment; and a keen desire for tax law to be detailed and precise. Most respondents seemed to place the greatest weight on the first of these factors. However, seven respondents expressly recognised in the interviews that the responsibility for legislative complexity and change may lie as much with business as it does with government; they conceded that the exploitation of tax minimisation opportunities and the demand for legal certainty by businesses have contributed to the current legislative framework. Some described the cycle of prescriptive legislation, loophole exploitation, and further prescriptive legislation as a “cat and mouse game”.

Opinions differed regarding whether legislative complexity or instability were significant problems and, if so, whether they diminished the attractiveness of the United Kingdom as a location for corporate activity. It is important to note that the Main Survey interviews were carried out at a time when corporate tax dominated the business section of the press.

⁷⁸ The interpretation of purpose-based TAARs is discussed below.

⁷⁹ TCGA, s.16A; FA 2005 ss.46–57, Sched.2; ICTA ss.747–756, Schedules 24–26, as amended. Some interviewees used the term “motive” rather than purpose and this is also found in the literature. In fact the legislation refers to purpose, object or reason rather than motive. The terminology has been the subject of extensive discussion and case law. See, for example, J. Avery Jones, “The mental element in anti-avoidance legislation” [1983] BTR 22; R. Shiers, “ABTA: the nature of ‘main purpose’” [2003] BTR 212; J. Kessler, “Tax Avoidance Purpose and Section 741 of the Taxes Act 1988” [2004] BTR 375 at 390–395. This topic cannot be explored further in this article but requires further work in relation to TAARs.

BRITISH TAX REVIEW

Corporate tax issues appeared on the front page of the *Financial Times* day after day and also surfaced in more general news programmes. This interest in tax matters, and particularly in the competitiveness of the United Kingdom's corporate tax regime, was ignited by the announcement that two prominent companies, Shire and United Business Media (UBM), were to relocate to Ireland.⁸⁰ The reason most frequently referred to in the press for these relocations, and for the reported consideration being given by other companies to follow suit, was the negative impact of the proposed rules on the taxation of foreign profits,⁸¹ but the overall complexity of the UK tax system was also cited. To some, the relocation of Shire and UBM had merely confirmed earlier predictions that a "radical overhaul" of the UK corporate tax system was needed in order to regain the country's international competitive position.⁸² While acknowledging the contribution of various factors to the competitiveness of the tax regime, the interviews focused on the contribution (if any) of anti-avoidance complexity and uncertainty.

A majority of Main Survey respondents (23) expressed exasperation with the complexity and unpredictability of current anti-avoidance rules, all but one asserting that this was a phenomenon hindering the competitiveness of the UK economy.⁸³ Some of these interviewees emphasised that they would much prefer a simple, stable system over a complex, unpredictable system, even if it meant that there were fewer tax planning opportunities available. Other respondents stressed that there is too much "layering" of anti-avoidance provisions on top of other provisions, some giving the example of the amendments to the loan relationships rules in FA 2007 and FA 2008. Four interviewees observed that the stream of anti-avoidance legislation makes it very difficult to discern what the government's long term tax policies are—other than stopping avoidance. It was often said that excessive compliance costs stem not so much from structuring or defending a firm's tax affairs, but from trying to comprehend all applicable legislation.

The remaining seven tax directors recognised that anti-avoidance provisions contribute to legislative complexity but did not criticise it, either because they felt the complexity was manageable or because they believed that such provisions have no relevance to someone operating a "commercial" business. These respondents insisted that complexity in itself has little effect on the competitiveness of the United Kingdom, arguing that legislative complexity follows from the complexity of modern international commerce. All of these interviewees stressed that the volatility of the UK tax system, including the instability of its anti-avoidance provisions, was more of a concern than complexity. It was said that in an environment of ceaseless change it is difficult or impossible to forecast after-tax profits.

⁸⁰ For some other examples and a discussion of other advantages of migrations see J. Cooklin, "Corporate exodus: when Irish eyes are smiling" [2008] BTR 613.

⁸¹ See HMT and HMRC, *Taxation of the foreign profits of companies: a discussion document* (June 2007), available at: www.hm-treasury.gov.uk/consult_foreign_profits.htm (accessed January 9, 2009). In December 2008, the government published modified proposals which take into account the objections of business to some extent. See HMT and HMRC, *Taxation of the Foreign Profits of Companies: Draft Provisions* (December 2008), available at: www.hmrc.gov.uk/cnr/tax-foreign-profits.pdf (accessed January 9, 2009), and P. Cussons at 1 of this issue.

⁸² See CBI Tax Task Force, *UK business tax: a compelling case for change* (March 2008) available at: www.cbi.org.uk.

⁸³ About half of these respondents added that, while they were concerned about the complexity and uncertainty of anti-avoidance provisions, the uncertainty surrounding the proposals for the taxation of foreign profits, fn.81, was more significant to them.

CORPORATE TAX RISK AND TAX AVOIDANCE

Interpretations of purpose rules used in TAARs

As mentioned above, most TAARs emphasise a taxpayer's purpose or purposes for carrying out a transaction. This is illustrated by two provisions that were under consideration in the hypothetical tax planning scenarios discussed in the interviews.⁸⁴

First, the application of the loan relationships rules in Finance Act 1996 (FA 1996) sections 91A to 91G depends on satisfying certain conditions, including a condition concerning the taxpayer's purpose or main purposes. Section 91D provides, in part:

“(9) For the purposes of this section, a share is acquired by the investing company for an unallowable purpose if *the purpose, or one of the main purposes*, for which the company holds the share is—

- (a) the purpose of circumventing section 95 of the Taxes Act 1988 . . . , or
- (b) any other purpose which is a tax avoidance purpose . . . [any purpose that consists in securing a tax advantage].”⁸⁵

(authors' italics)

Similarly, the restrictions on allowable losses rule in the Taxation of Chargeable Gains Act 1992 (TCGA) section 16A provides, in part:

“(1) For the purposes of this Act, “allowable loss” does not include a loss accruing to a person if—

- (a) it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and
- (b) *the main purpose, or one of the main purposes*, of the arrangements is to secure a tax advantage.”

(authors' italics)

It is important to note that these TAARs are concerned with *a taxpayer's* purpose or purposes in implementing a transaction. A few interviewees responded to the questions regarding the determination of main or primary purpose, at least initially, by addressing *statutory* purpose and speculating upon how purposive interpretation of TAARs might differ from purely textual interpretation. This confusion is understandable given that there has been so much debate recently about the scope of purposive statutory interpretation as a means of distinguishing acceptable tax avoidance from unacceptable tax avoidance.⁸⁶ When this confusion arose it was explained that the aim was to understand how large businesses construe their *own* purposes in implementing a transaction and how they distinguish among a multiplicity of such purposes.

Two key results emerged from the interviews with respect to TAAR purpose tests. First, there was a preference among the interviewees for the use of common language

⁸⁴ Interviewees' reactions to the scenarios are discussed beginning at text to fn.90 and the detailed scenarios are set out in Appendix II.

⁸⁵ It is important to note that avoidance schemes arise in this area due to differences in treatment between debt and equity for tax purposes. Many proposals for corporate tax reform are based on eliminating this difference which is, arguably, difficult to rationalise given the structure of modern corporations: see OECD Policy Brief, *Reforming Corporate Income Tax* (July 2008), available at: www.oecd.org/dataoecd/30/16/41069272.pdf (accessed January 9, 2008).

⁸⁶ See for example: Lord Hoffmann, “Tax Avoidance” [2005] BTR 197; Freedman (2007), fn.4.

across the various purpose tests. Some said that having different legal phraseology for the same concept “isn’t helpful”. No interviewee could identify the practical difference between a primary purpose and a main purpose, nor could any interviewee explain how he or she would distinguish among a purported multiplicity of “main purposes”.⁸⁷ One interviewee stated that there is little need to concern oneself with the different tests as one would expect judges to apply a single test anyway. Indeed, a number of the interviewees simply referred to the *Duke of Westminster* principle,⁸⁸ which they took to support the proposition that a taxpayer is entitled to arrange his commercial affairs in the most tax effective manner, and in doing so effectively ignored the nuances of the purpose tests.

Having said that, within the current framework, a large majority of respondents stated that they preferred a single legal test that focuses solely on a taxpayer’s “main”, “primary”, “underlying”, or “overwhelming” purpose behind a transaction, rather than a test that contemplates multiple “main purposes”. Sixteen interviewees expressed this preference clearly, often stating that such a test was essential in order to allow commercial transactions to be implemented in a tax-efficient manner. Eight others were less explicit but seemed to stress the importance of a taxpayer’s primary *motivation* for a transaction, sometimes referring back to the *Duke of Westminster* principle as described above. Of the remaining respondents, some said they were not unhappy with current TAAR purpose tests, some said they preferred alternative tests that depended on economic outcomes rather than subjective intentions, and some were unclear about their preference.

The following arguments were put forward by the 24 respondents who favoured a main or primary purpose test in TAARs.

First, some said that tests like that in FA 1996 section 91D or TCGA section 16A, which refer to multiple main purposes for a transaction, contemplate an unreasonable level of detail or “granularity” in a company’s reasons for acting as it does. One tax director expressed this view by stating that detailed purpose tests are not “meaningful” to boards: either they are comfortable with the overall commercial objective of an arrangement or they are not. Several respondents agreed that counsel’s opinions are sought regarding which of several purposes was dominant in an impugned transaction. It was commonly felt, however, that such opinions are of little value; perhaps, although this is speculation on the part of the authors, these directors’ companies use counsel’s opinions to provide a measure of insurance for their own position. This complaint was connected to the broader policy issue raised by a majority of the interviewees, namely, the need to preserve taxpayers’ ability to structure commercial transactions in a tax-efficient manner. Most respondents argued that virtually any commercial arrangement will be structured in a tax-advantaged manner, often stating that it would be “irrational” or “foolish” to ignore tax considerations. A few respondents asserted that a test based on “one of the main purposes” gives scope to HMRC to insist that taxpayers implement the highest-tax comparator transaction. It was frequently said that the focus of purpose-based TAARs should be where the particular transaction *began*: with a firm’s commercial officers/managers or with its tax department/advisers. There were, however, varying degrees of enthusiasm for basing

⁸⁷ This is an issue being addressed by the HMRC *Anti-Avoidance Simplification Review* announced in Budget 2007 (before our interviews) and still under discussion. See now the Simplification Progress Report, fn.77 and the July 2008 update at www.hmrc.gov.uk/avoidance/anti-avoid-cont.htm (accessed January 8, 2009), which specifically refers to the possibility of alignment of definitions in this area. See also fn.79 above.

⁸⁸ *IRC v Duke of Westminster* [1936] AC 1.

CORPORATE TAX RISK AND TAX AVOIDANCE

anti-avoidance rules solely on a taxpayer's primary or overwhelming purpose, even among those who were broadly supportive of such a threshold. This is best illustrated by interviewees' reactions to the hypothetical scenarios, discussed below.

It was noted that the freedom to structure transactions in a tax-efficient way depends not only on the text of relevant TAARs but also on HMRC's interpretation and application of those provisions. Half of the respondents indicated that they had disagreed with HMRC about the main purpose or purposes of a transaction, or expected imminently to have such a disagreement. Most said that the question whether the presence of some tax purpose takes a transaction onto the wrong side of a TAAR depends on whether HMRC personnel analysing the transaction apply the rule "sensibly".⁸⁹ They felt that appropriate application of TAARs by HMRC personnel requires a strong appreciation of the business perspective. Opinions regarding the level of commercial awareness and sophistication of HMRC personnel were more pronounced in respondents' answers about principles-based legislation, thus the issue is addressed in more detail in that part of the article, below.

Reactions to scenarios⁹⁰

Preferred share financing arrangement In this example a holding company in a UK group (ACo) has cash on hand in excess of its current requirements. It is considering various opportunities for investing these funds and identifies BCo, an unconnected private company, as an attractive investment. The reasons for this include that: BCo carries on a complementary business; BCo is expected to become profitable in the near future; and BCo has tax losses carried forward. Because of its loss position, BCo is indifferent as regards either paying dividends on equity financing or paying interest on debt financing—thus BCo is willing to offer a preferred share dividend which exceeds what might be offered by comparable companies and which approaches a commercial interest rate. ACo decides to invest in a block of BCo preference shares which are cumulative, redeemable, and carry a fixed rate dividend.

Interviewees were told that the taxpayer's advisers took the view that the loan relationships rules would not apply so as to treat the dividends received by ACo on the preference shares as taxable income, largely because ACo's purpose in acquiring the preference shares is not an "unallowable purpose" under FA 1996 section 91D. Interviewees were also told that, in contrast, the HMRC Corporate Finance Manual suggests that an investment in cumulative redeemable preferred shares, where the issuer is in a loss position and the dividend rate is broadly similar to the commercial interest rate, gives rise to a creditor loan relationship because the arrangement is motivated by tax avoidance.⁹¹ That is, the issuer does not lose by paying a dividend rather than interest because it cannot use a deduction anyway, while the return is not taxable as interest in the hands of the recipient.

A substantial majority of respondents stated that this transaction should be permitted as a policy matter. Specifically, 22 respondents said that the "main", "primary", "underlying",

⁸⁹ A range of respondents (8) highlighted the CFC "motive test" (as they called it) contained in ICTA, s.748(3), arguing that HMRC apply this provision overzealously in order to disregard the effectiveness of transactions involving foreign subsidiaries. There is a potential interaction here with the role of CRMs.

⁹⁰ The scenarios are described in full in Appendix II.

⁹¹ CFM 6320, available at: www.hmrc.gov.uk/manuals/cfmmanual/CFM6320.htm (accessed January 9, 2009).

BRITISH TAX REVIEW

or “overwhelming” commercial objective of this transaction was investment of surplus funds; they felt that the presence of such a commercial objective was sufficient to make this transaction legitimate. The eight remaining interviewees were ambivalent or equivocal, suggesting that this transaction was probably acceptable but depended on the relative weight of the various commercial and tax motivations. Notably, no respondents said unequivocally that this transaction should be considered unacceptable as a policy matter. Virtually all interviewees tended to apply a main or primary purpose test when assessing the transaction, consistent with the responses summarised above. Beyond the presence of a commercial motivation, some interviewees (11) also felt that this transaction should be considered acceptable because of the “symmetry” or “parity” between the payer of the dividend and the recipient of the dividend. These respondents argued that it was irrelevant that BCo has tax losses and queried what policy wrong is associated with the “use” or “arbitrage” of “tax attributes”. This last term as used by the interviewees refers to the availability of losses and allowances. It is interesting that respondents were generally in favour of this transaction regardless of whether their respective firms had been rated as low risk or higher risk by HMRC.

Most respondents, despite believing that this transaction should be permitted as a policy matter, said that they would be worried about HMRC challenging it under the loan relationships rules. Seventeen interviewees indicated that they would be uncomfortable going ahead with this transaction, often pointing to the negative HMRC guidance or referring to anecdotal evidence of HMRC’s approach to similar transactions. A further six respondents felt that the likelihood of HMRC challenging this transaction depended on the perceived balance of tax and non-tax motivations for the investment. Finally, five respondents said that they would in all likelihood go ahead with a transaction of this nature despite potential challenge. None of the respondents said that the loan relationship rules were inapplicable to this transaction, meaning that the different opinions were based on different views of how HMRC would apply the rules.

Share consolidation arrangement In this example the taxpayer is a UK plc and the ultimate parent of a global group of companies. The taxpayer owns three UK holding companies (XCo, YCo, and ZCo) which in turn hold various shares and assets. As part of a rationalisation of the group’s structure, the taxpayer wishes to sell certain shareholdings to third parties and to consolidate its remaining shareholdings within YCo and ZCo. This restructuring involves XCo selling off various shares and assets. Among other gains and losses, XCo realises a chargeable gain on a disposal of certain portfolio shares (in G plc) and realises a loss on a disposition of certain other portfolio shares (in L plc), all sold to an unconnected third party, P. An option negotiated by the parties specifies that ZCo has the right to acquire the L plc shares from P for their market value within 60 days, provided that the market value has not risen or fallen more than a nominal amount. After 40 days ZCo exercises this option and buys the L plc shares from P. (Interviewees were also asked to consider a modification of the above scenario where ZCo does not exercise its option to buy the L plc shares.)

Interviewees were told that the taxpayer’s advisers took the view that the loss arising on the disposal of the L plc shares by XCo is an “allowable loss” and, as such, can be set off against chargeable gains. In their view, the loss is not subject to the restrictions on allowable losses TAAR in section 16A of the TCGA because it was not the main purpose, or one of the main purposes, of the arrangement to secure a tax advantage. Interviewees

CORPORATE TAX RISK AND TAX AVOIDANCE

were also told that, in contrast, the HMRC guidance with respect to section 16A suggests that the loss on the L plc shares might be considered “artificial” and therefore restricted.⁹²

Most of the respondents had a more negative view of this transaction compared to the preferred share financing arrangement discussed above, although opinions were not unanimous. Specifically, 18 interviewees felt that this transaction should not be permitted as a policy matter, often describing it as “artificial” or “contrived”. This group invariably said that the main or primary purpose of the arrangement was loss crystallisation rather than commercial divestment. They focused on the option negotiated by the parties to allow the taxpayer’s group to acquire the L plc shares from P at approximately the same value as they had been sold to P. Some described this as a “repurchase” option and said that the presence of such an option meant there was no “real disposal” or no “genuine intention” to dispose. A minority of respondents (five) believed that this transaction should be considered acceptable. They emphasised that the latent/unrealised loss on the L plc shares was a real economic loss and thus should be available to set off against chargeable gains. Two of these interviewees added that the tax reduction brought about by recognising the loss was merely a deferral rather than an outright saving. The seven remaining interviewees were ambivalent or equivocal, suggesting that the legitimacy of the transaction depended on the relative weight of the various commercial and tax motivations. Interviewees who had a negative view of this transaction were from a mixture of low risk and higher risk firms, while four of the five who expressed favourable views were from higher risk firms.

All interviewees who addressed section 16A TCGA, whatever their policy views of this transaction, said that they would be worried about HMRC challenging it. Specifically, 28 respondents said that the TAAR would apply to this transaction and would almost certainly be invoked by HMRC to deny the capital loss on the sale of the L plc shares. The majority (18) thought this was a fair result because the transaction was primarily tax-driven. One of the five interviewees who took a positive view of this transaction said that it was “dead in the water” under section 16A; the remaining four appeared to agree with this assessment.

The modified scenario, wherein ZCo does not exercise the option to purchase, provoked some interesting discussion. The 10 interviewees who addressed this scenario speculated that HMRC’s application of the TAAR would change because of the different economic result. Two respondents suggested that this altered treatment was deserved, as the economic result (divestment of the L plc shares) would constitute evidence of the commercial motivation underlying the transaction. The other eight respondents believed that in principle the modified scenario was no different, as the taxpayer’s motivations remained the same, yet in practice the treatment would differ. One of these interviewees said that even though “a main purpose” of the arrangement was securing a tax advantage, HMRC would be unlikely to challenge the modified scenario. He described this as “untaxing by concession”.⁹³ He and others observed that this difference between principle and practice illustrates the problem with section 16A TCGA.

⁹² HMRC Guidance, *Capital Gains Tax—Avoidance through the creation and use of capital losses* (July 2007) paras 50–53 (Examples 9 and 10).

⁹³ Echoing the wording of Lord Wilberforce in *Vestey v IRC* [1980] STC 10. It was held in *R v IRC, Ex p. National Federation of Self-Employed and Small Businesses Ltd* [1981] STC 260 that HMRC have

Guidance and clearances

The Simplification Progress Report⁹⁴ suggests that HMRC guidance can assist taxpayers in understanding the intended scope of TAARs.⁹⁵ While that document does not refer to clearances, another rational course of action might be to seek a non-statutory clearance from HMRC under the recently expanded Clearances Service.⁹⁶ Interviewees were asked whether in areas potentially affected by a TAAR there should be an associated clearance process, whether they might seek a clearance under the current clearances regime and—short of seeking a clearance—whether they would rely upon the published guidance for assistance.

A majority of respondents (19) said that statutory and non-statutory clearances are, or could be, useful, although invariably these were general comments rather than comments about TAARs specifically. A further seven interviewees felt that clearances are not useful or that taxpayers should not have to depend on them; these interviewees insisted that a clearance only represents HMRC's opinion and has no legal effect. It is notable that, while the majority view was expressed by a mix of low and higher risk firms, all respondents who viewed clearances negatively were from firms that are at the higher end of the risk spectrum. A few interviewees questioned whether clearances would ever be given in situations potentially covered by TAARs (or any anti-avoidance provisions) given the stated position of HMRC that they will not issue clearances where “tax avoidance” activities are involved.⁹⁷ Another interviewee said that an “effective clearance mechanism” could help to provide a level of certainty about TAARs that business could live with. A frequently expressed view was that an “effective” clearance system would have to be fully informed, consistent, and legally binding. Even among the majority who viewed clearances positively, a few respondents remarked that having to rely on HMRC discretion to apply or disapply a TAAR is not an ideal system.

Views regarding HMRC guidance were less enthusiastic. Only eight respondents stated that the published guidance is or could be useful to them. Sixteen interviewees said that administrative guidance is either undesirable in principle or is not useful in practice. For example, three interviewees explained that businesses were uncomfortable with the guidance that was issued with TCGA section 16A because the legislation said one thing while the guidance said another—the guidance being more favourable to taxpayers. In

“a wide managerial discretion as to the best means of obtaining for the national exchequer from the taxes committed to their charge, the highest net return that is practicable having regard to the staff available to them and the cost of collection” (per Lord Diplock). This discretion is very wide but it must be exercised *intra vires* and lawfully. See also *R v IRC, Ex p. Wilkinson* [2005] UKHL 30; [2006] STC 270. The authors do not suggest that the current exercise is outside HMRC's powers. TAARs clearly do give very wide scope for discretion. The question here is to what extent, if any, this needs to be constrained for the future.

⁹⁴ Fnn. 77 and 87.

⁹⁵ Simplification Progress Report, fn.77 at para.A.11.

⁹⁶ Developing this service was a key feature of the Varney Review. The service ran as a pilot from January 2, 2008 and was made more widely available as of April 2008. For further details see 2008 Framework, fn.17 and the online guidance to statutory and non-statutory clearances, available at: www.hmrc.gov.uk/cap/links-dec07.htm (accessed January 9, 2009).

⁹⁷ HMRC, *Giving Certainty to Business through Clearances and Advance Agreements* (June 2007) para.3.27 and Annex C. There is, of course, a circularity here. One has to know what amounts to a tax avoidance activity before one knows whether the clearance could possibly be available.

their view this meant that there were flaws in the legislation. Three other respondents noted that, in any event, the published guidance tends to address simplistic examples and is thus of little value in real world situations.

Analysis and conclusions

As Avery Jones observed in 1996, there is nothing new in complaining about the complexity of tax legislation.⁹⁸ He identified several causes of this complexity, three of which were stressed repeatedly by the interviewees with particular reference to TAARs. Those causes are: tax reform and associated legislative amendments, often in response to avoidance activities, described by the interviewees as legislative tinkering; an increasingly global and sophisticated business environment; and a keen desire for tax law to be detailed and precise so that its application is certain.

Avery Jones and others have argued that massive increases in the volume and detail of tax legislation have not enhanced legal certainty; rather they have achieved the reverse. Most of the interviewees would be likely to agree with Vann's estimation that the United Kingdom (and other Anglo-Saxon countries) suffers from the disease of "tax rule madness",⁹⁹ the key symptom being an ever-increasing spiral of legislation, loophole exploitation, and further legislation. There is no doubt that some of the difficulty stems from the courts' traditional insistence on predominantly textual interpretation of taxing statutes, yet much of the responsibility lies with the legislative designers and draftsmen. In a lecture in 2004, published in this *Review*, Lord Hoffmann stated that "the Revenue appear to have no faith in the ability or willingness of the courts to recognise the economic effect beneath the varied forms and often prefer to legislate by reference to form rather than substance".¹⁰⁰

One way to ameliorate this problem may be to enact further purpose-based TAARs, as they depend less on the technical details of a transaction and more on a taxpayer's reasons for carrying it out. It is far from obvious, however, that the business community views such rules as enhancing commercial certainty. These interviews indicate that there is significant concern about the generality and potential vagueness of such rules.

The view expressed by many interviewees that HMRC and HM Treasury should seek to achieve common language across the various purpose tests used in TAARs, as the use of a variety of phrasing to express the same concept can only lead to confusion, is persuasive. Efforts at alignment are currently underway.¹⁰¹ The second suggestion arising from a majority of the interviews, namely, that purpose-based TAARs should focus solely on a taxpayer's *main* or *underlying* purpose for carrying out a transaction, is more problematic. Most would agree that transactions wholly driven by tax avoidance (some interviewees referred to creating deductions "out of the air") should be prohibited. There can be other transactions, however, where it is fairly clear that there is a prevalence of tax structuring despite some overall commercial goal, and there may be valid policy reasons for HM Treasury and HMRC to prevent or to limit such structuring. Indeed,

⁹⁸ J.F. Avery Jones, "Tax Law: Rules or Principles?" [1996] BTR 580.

⁹⁹ R. Vann "Improving Tax Law Improvement: An International Perspective" (1995) *Australian Tax Forum* 193, 222, cited in Avery Jones, fn.98.

¹⁰⁰ Lord Hoffmann, fn.86 at 205–206.

¹⁰¹ See fn.87 above.

the different opinions expressed regarding the hypothetical scenarios demonstrate that there are different levels of enthusiasm (or, perhaps, different interpretations) for “main” or “underlying” purpose tests. In the first example most interviewees stressed that “the main purpose” of the transaction was investment, not sharing of tax losses, yet their favourable views of the transaction were in some cases conditioned by the fact that they viewed sharing of tax attributes as unobjectionable. In the second example a majority of interviewees stated that “the main purpose” of the transaction was loss crystallisation, not restructuring or divestment, yet their negative views of the transaction were in some cases buttressed by the observation that the UK system for taxing capital gains and losses is based on realisation rather than accruals. Perhaps what is needed is not some innovation in the phrasing of purpose-based anti-avoidance rules, but rather a better policy expression in the legislation of what activities or economic outcomes are or are not condoned. It is this point, in part, which has led to another new approach to legislation, discussed in the next part of this article.

PBL

The nature and expected impact of PBL

Various commentators have argued that the ever-increasing spiral of detailed tax legislation, and its attendant lack of certainty, can only be resolved by shifting to an entirely new legislative approach, variously styled as “purposive drafting” or “principles-based drafting”.¹⁰² As Krever explains, there is a difference between purposive drafting and principles-based drafting. On his view purposive drafting attempts to make clear what the provisions are intended to achieve with an explanatory purpose statement in the legislation. Principles-based drafting starts with fundamental high level principles from which it carves out exceptions. What purposive legislation and PBL have in common is that they constitute a further step away from the traditional approach of detailed prescriptive legislation. There is an appetite for PBL among policy makers who have grown frustrated with the failures of prescriptive legislation and TAARs. This appetite is illustrated by various Australian efforts¹⁰³ and, more recently, by the PBL Consultation Document.¹⁰⁴

The PBL Consultation Document was issued in December 2007 along with draft legislation, which was revised in February 2008 in response to a series of open day discussions and written representations. However, the government decided not to include the revised draft legislation in the 2008 Finance Bill in order to allow further time for consultation.¹⁰⁵ At the time of the interviews the consultations were continuing. After the interviews had been concluded, in November 2008, HMRC published a further consultation document containing further amended draft clauses which take on board some of the points made by our interviewees and others.¹⁰⁶

¹⁰² E.g. Avery Jones, fn.98; B. Drummond, “A purposive approach to the drafting of tax legislation” [2006] BTR 669; B. Drummond and P. Marwood, “Purposive drafting in the Finance Bill 2007” [2007] BTR 350; R. Krever, “Plain English Drafting, Purposive Drafting, Principles-based Drafting: Does Any of it Matter?” in *Beyond Boundaries*, fn.4 at 189.

¹⁰³ Pinder and Berkeley, *Coherent Principles Approach* (Australian Treasury 2005).

¹⁰⁴ PBL Consultation Document, fn.74.

¹⁰⁵ Simplification Progress Report, fn.77 at para.2.10.

¹⁰⁶ See fn.74 above.



CORPORATE TAX RISK AND TAX AVOIDANCE

As the PBL Consultation Document and revised draft legislation on financial products avoidance represents the first express attempt by HMRC and HM Treasury to enact purposive or principles-based legislation, the survey questions were focused on those proposals. Comments were also welcomed from respondents regarding the merits and challenges of PBL more generally.

Seeking simplicity, certainty, and revenue protection

The PBL Consultation Document claimed that a principles-based approach would further the goals of simplicity, certainty, and revenue protection in the UK tax system.¹⁰⁷ It also stated that such an approach would promote fairness and consistency in tax treatment. The draft “principle” regarding disguised interest was expressed as a purpose statement in the February 2008 revised draft legislation. Section 1 of the draft Schedule provided:

“The purpose of this Schedule is to secure that (subject to exceptions, and except where double taxation would result) a return designed to be economically equivalent to interest is treated in the same way as interest for the purposes of corporation tax.”

The stated purpose is said to be achieved through the concept of a “tax-privileged investment return”, which is defined (in general terms) as a return which equates, in substance, to a return on an investment of money at interest yet is not wholly charged to tax as interest. The new legislation would allow simplification in that some existing provisions could be repealed.

Comments on PBL as a new legislative approach

The interviews suggest that there is some theoretical interest in a principles-based approach as a means of improving the simplicity of the UK tax system. A majority of the respondents (20) felt that PBL is a way forward and is worth exploring as an alternative to overly specific prescriptive legislation and overly broad TAARs. They generally agreed that a principles-based approach would further the objectives of simplicity and revenue protection. These respondents’ enthusiasm was tempered, however, by concerns about the need for certainty and appreciation of the business perspective. It was often said that any legislated principles should be “meaningful”, “focused”, and “clear”, and should only be enacted following extensive consultation with stakeholders. Only four of these 20 respondents were optimistic that a principles-based approach could enhance commercial certainty. It is notable that three of these four respondents were from firms that have been rated as low risk by HMRC. The remaining interviewees feared that a move towards PBL would reduce certainty, but they were nonetheless in favour of exploring the approach.

A further five interviewees expressed the opinion that a principles-based approach is, as a policy matter, undesirable. These respondents stated that they preferred explicit legislation and were wary of “legislation by guidance”. A few of those opposed to PBL stated that they simply did not trust HMRC personnel to apply broad principles with an appropriate focus or with a consistent view of which planning activities are and are not acceptable.¹⁰⁸ Interestingly, there was no obvious correlation between this view and a

¹⁰⁷ PBL Consultation Document, fn.74 at para.1.8. See also Simplification Progress Report, fn.77 at paras A.15–A.18.

¹⁰⁸ See further discussion at text to fn.112.

BRITISH TAX REVIEW

firm's risk rating. The remaining five tax directors were agnostic about the merits of PBL or did not express a clear opinion either way.

A recurring theme in the interviews was that there will be significant challenges in integrating PBL into current UK tax law, not only due to resistance from businesses but also because of incompatibility with UK legal norms. Nine interviewees, whether in favour of PBL or not, remarked that the British courts would struggle with a principles-based system initially, speculating that more time would be spent in litigation to clarify the scope of the relevant provisions. Others felt that counsel would have similar difficulties.

Comments on the draft PBL

In contrast to the broadly positive comments received about PBL as a new legislative approach, none of the tax directors interviewed were happy with the 2007 draft or February 2008 revised draft legislation on financial products avoidance. Twenty-two of the interviewees offered comments on the draft legislation; the remaining eight did not comment, usually because they had not analysed the legislation or been involved in the consultations. Most of the concerns from the 22 respondents fell into two categories: the lack of precision in the stated principle and the lack of effective consultation in the development of the principle.

First, aside from one respondent who felt that the draft legislation was not "ambitious" enough in its scope, most interviewees argued that the draft legislation suffered from a lack of clarity and was thus excessively broad and vague. Specifically, nine respondents believed that the way the provisions were drafted—or the way that the draft guidance indicated they would be interpreted—meant that the legislation threatened a variety of "commercial transactions" which in their view should not be so affected. The remaining interviewees seemed to agree with this view without saying so expressly. Some respondents described the principle governing disguised interest—namely, that a return "designed to be economically equivalent to interest" should be treated in the same way as interest—as "unprincipled" because it went beyond the "headline intention". By this they appeared to mean that the draft legislation as interpreted in the draft guidance was seeking to remedy various kinds of mischief other than the transformation of interest into an economically equivalent amount. For example, virtually all of the respondents queried why preferred share financing arrangements like that described in the first hypothetical scenario should fall within the draft provisions as a matter of policy.¹⁰⁹ It was suggested that HMRC's concern with such arrangements is not that the inter-corporate dividend is similar to interest; rather, it is that the benefit of tax losses is being shared among unconnected parties, what was sometimes referred to as "sharing of tax attributes". Others queried why the draft principle should be used to prevent "recognition of non-trading losses" within a corporate group.

The second and related concern expressed by some respondents (seven) was that there had been a lack of "real" or "effective" consultation regarding the draft legislation.¹¹⁰ There was a common feeling among these respondents that the push to implement

¹⁰⁹ See further discussion at text to fn.111.

¹¹⁰ It should be reiterated that these interviews were conducted in April and May 2008. This was prior to HMRC's announcement that they would revise the draft legislation in accordance with comments received in early 2008 and would conduct further consultations with stakeholders via invitational



CORPORATE TAX RISK AND TAX AVOIDANCE

the draft PBL in Budget 2008 was too rushed. Some felt that the consultations only happened after the substantial issues had been decided within HMRC and HM Treasury. It should be noted that, since the proposals have not been implemented and are still being consulted on, this is not in fact what has happened, largely because the responses to the consultation were taken seriously by HMRC and HM Treasury, showing that this was a genuine exercise. Some respondents suggested that more thorough consultation would result in greater refinement of the stated principle, perhaps to exclude further “commercial transactions” from its scope. The final outcome remains to be seen but there can be no doubt that the consultations have resulted in major changes to the proposals.

Reactions to scenario

The preferred share financing arrangement described above was a scenario regarding which interviewees were asked to consider both the current TAAR (section 91D of FA 1996) and the draft PBL on disguised interest. Consistent with the current guidance in the Corporate Finance Manual, the PBL Consultation Document suggests that an investment in cumulative redeemable preferred shares, where the issuer is in a loss position and the dividend rate is broadly similar to the commercial interest rate, gives rise to a “tax-privileged investment return” because the arrangement is motivated by tax avoidance.¹¹¹

As mentioned above, a substantial majority of respondents felt that this transaction should be permitted as a policy matter, yet most were worried about HMRC challenging it under the loan relationships rules. Similarly, most respondents who were familiar with the draft legislation and guidance stated that they would be worried about HMRC challenging this transaction under the proposed PBL. Thirteen interviewees said that they would be more uncomfortable about proceeding with this transaction under the draft PBL than under the current TAAR. This was generally because, as one interviewee put it, HMRC could make a reasonable argument that the dividend was “economically equivalent” to a loan at interest. A further nine interviewees felt it made no difference to the analysis whether one applied the draft PBL or the current TAAR. None of the interviewees said that they would be more comfortable proceeding with this transaction under the proposed legislation, which is perhaps not surprising. An interesting observation made by four respondents was that HMRC routinely used to allow transactions of this nature, one of them observing that freedom to share tax attributes was considered essential to the viability of the UK economy. They nevertheless conceded that the draft PBL on disguised interest (and, to a lesser extent, the loan relationships rules) led to a different result.

What are the characteristics of good PBL?

As explained above, a majority of respondents were at least cautiously optimistic about PBL as a new legislative approach, yet were dissatisfied with the 2007 and 2008 draft PBL on financial products avoidance. The survey therefore sought to identify the features which respondents would associate with well crafted principles-based provisions. The

workshops in August 2008. Following that there have been further workshops and considerable modifications to the proposals.

¹¹¹ PBL Consultation Document, fn.74 at paras 2.1, 2.26-2.29 (Example 7).

BRITISH TAX REVIEW

characteristics that were most commonly identified were: certainty/clarity of the principle; consistency in application of the principle; and appreciation of the business perspective in crafting and applying the principle.

Virtually all of those who were in favour of PBL stressed that any legislated principles should be “meaningful”, “focused”, and “clear”. A few respondents (five) observed that the desired level of certainty/clarity in legislated principles would require a greater “common understanding” between HMRC and business about what types of planning activity are acceptable.¹¹² Another aspect of certainty/clarity raised by six interviewees was the need to guard against the conflation of multiple policy goals under a single vague principle. As mentioned above, some respondents felt that the policy concern about “interest-like” investment returns going untaxed, which was the purported motivation for the draft PBL on disguised interest, should not be confused with other policy concerns.

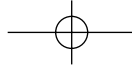
A virtue closely related to clarity is consistency. Various respondents emphasised that PBL will be welcomed by taxpayers only if they can trust HMRC to apply the relevant principles consistently. Six interviewees pointed to the frequent amendments in detailed anti-avoidance rules, as well as changes in the application of TAAR purpose tests, as evidence of fluctuating tax policies which detract from taxpayer trust. Indeed, as mentioned above, when addressing the first hypothetical scenario, four of the interviewees remarked that HMRC routinely used to allow such transactions, yet the draft PBL and associated guidance suggest that such transactions are contrary to the draft principle. Respondents also pointed to examples of reversals in HMRC’s acceptance of other specific transactions.

Finally, half of the interviewees stated that a functioning principles-based system cannot be achieved without HM Treasury and HMRC gaining a better understanding of the business perspective. It was felt that this understanding could be achieved partly through consultations on the relevant draft provisions, but more fundamentally by HMRC undergoing a “culture change”. Some of these respondents highlighted that there are not enough HMRC personnel with a strong understanding of the complexities of modern business, particularly international business, making it difficult for them to apply tax principles to business transactions in a focused and objective manner. Three such interviewees explicitly recognised that better relationships brought about by the Varney Review have improved commercial awareness within HMRC, although this understanding does not yet extend to full comprehension of their international businesses. The connections between the new forms of legislation and the new post Varney relationship are discussed further below.

Guidance and clearances

It is acknowledged in the PBL Consultation Document that principles-based provisions necessitate detailed guidance in order to achieve sufficient commercial certainty. It can be expected that a robust clearance regime would also assist taxpayers with their decision-making around principles-based provisions. Thus, as with the discussions regarding TAARs, interviewees were asked whether in areas potentially affected by PBL they would

¹¹² This issue is discussed in greater detail in the Pilot Survey Full Report, fn.11, and takes us back to the relationship of trust which might be created with the CRM.



CORPORATE TAX RISK AND TAX AVOIDANCE

find clearances and guidance to be of assistance. The answers to these questions mirrored the responses given in the context of TAARs.

As above, a majority of respondents (19) welcomed an improved clearance regime; most of these respondents felt that an effective clearance mechanism would be critical to the success of PBL. A further seven interviewees felt that clearances are not useful or that taxpayers should not have to depend on them. Several respondents, whether or not they were supportive of a clearances regime, cautioned that a functioning principles-based system would require a significant enhancement to HMRC resources.

Only eight of the respondents stated that the published guidance is, or can be, useful to them. Sixteen interviewees said that administrative guidance is either undesirable in principle or is not useful in practice. Several of these respondents argued that it is not satisfactory to have “vague rules” which are narrowed down by guidance when the guidance lacks legal force. A few interviewees said that the government has not achieved its aims of improving simplicity and clarity if it makes the legislation shorter but then issues “reams” of guidance to explain its meaning.

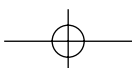
Analysis and conclusions

In different ways these interviews both disprove and confirm Bennion’s assertion that “the pragmatic British” do not welcome statements of principle in their legislation: “They distrust them because they almost invariably have to be qualified by exceptions and conditions to fit them for real life. What is the use of a principle that cannot stand on its own?”¹¹³ Contrary to that assertion, the interviews indicate that there is considerable interest in at least *exploring* a principles-based approach as a means of improving the simplicity of the UK tax system. Most respondents agreed that a principles-based approach would further the objectives of simplicity and revenue protection. Nevertheless, the interviews confirm Bennion’s assertion when applied to specific draft legislation. Most respondents’ enthusiasm for PBL was tempered by concerns about the need for certainty/clarity, consistency in application, and appreciation of the business perspective. The draft PBL on disguised interest, along with its expected application by HMRC, were considered to fail all three of these criteria.

The desire for certainty/clarity in commercial transactions is understandable, yet there may be a perhaps unfounded belief that such certainty is best obtained via a traditional system of detailed prescriptive legislation. As noted above, the questions regarding TAARs revealed that a large majority of the interviewees were exasperated with the complexity and unpredictability of current anti-avoidance rules, most asserting that this was a phenomenon hindering the competitiveness of the UK economy. The prevalence of this opinion strongly suggests that new approaches are needed, possibly including a principles-based approach. The authors reiterate that a principle is not merely a vague rule; it is “something external to the rules which helps one to construe the rules and, in consequence, enables the rules to be less detailed”.¹¹⁴

¹¹³ F. Bennion, *Bennion on Statute Law* (3rd edn, Longman Group, London, 1990) 25, cited in Avery Jones, fn.98. For further discussion of rules and principles in tax law see J. Braithwaite, “Making Tax Law More Certain: A Theory” (2003) 31 *Australian Business Law Rev* 72; D. Weisbach, “Formalism in the Tax Law” (1999) 66 *Univ of Chicago Law Rev* 860; J. Freedman, “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle” [2004] BTR 332.

¹¹⁴ Avery Jones, fn.98.



BRITISH TAX REVIEW

The desire for consistent application of legislated principles is also fully understandable. It is not surprising that changing policy views on the part of HM Treasury and HMRC, reflected in frequent amendments to legislation or in altered application of purpose-based TAARs, have led some businesses to lack trust in the tax administration. Without improving such trust it will be very difficult to gain acceptance of a principles-based system, which evidently relies on administrative discretion to a greater extent than a system of prescriptive rules. There was at least some indication in these interviews that better relationships brought about by the Varney Review have improved commercial awareness within HMRC. While this may have enhanced taxpayer trust on some level, the interviews suggest that it has not been enhanced to the point where all large businesses feel they can trust HMRC to apply TAARs and PBL with appropriate focus and restraint, as discussed below.

Appreciation of the business perspective by the tax authorities is also important, although one should be careful to distinguish between *appreciating* the business perspective and *agreeing with* the business perspective. It is the elected members of Parliament, on the advice of HM Treasury and HMRC, who decide what tax policies to pursue and what tax legislation to enact. A reasonably clear, consistently applied principle which has been refined through effective consultations, yet which is contrary to that which business desires, is not necessarily a poor principle. In this regard, two broad tax principles which some respondents suggested might be welcomed by the business community were: first, consistency of tax computations with consolidated accounts; and second, symmetry between payer deductions and recipient income inclusions. Of course, principles like this do not appear to be of the same kind as principles employed in PBL—they operate at a more fundamental level. A policy move towards enacting tax principles of a more fundamental nature within a framework that could give them operational value might assist in obviating the need for a great number of specific tax rules, although the difficulties involved in creating such a system are not to be underestimated.

Principles-based legislation of any kind is, however, possible and helpful only if the underlying policy of the tax system is coherent. This appears to be the real difficulty in the area of disguised interest in particular and more generally. It is difficult to find the true rationale for the difference in treatment of debt and equity for tax purposes which leads to avoidance schemes in this area.¹¹⁵ This makes it hard to draw up an appropriate principle and leads to suspicions amongst our respondents that in fact there are various different reasons for attacking these schemes, some of which they accept and some which they do not. Greater and more open discussion of the underlying mischief aimed at might be helpful in this respect.

HMRC/Taxpayer relationship and the form of legislation

The RRA and the other initiatives to improve the relationship between HMRC and large businesses require a common basis of trust to succeed. In fact, one of the main drives behind the Varney Review is that of developing such trust. As seen above, trust is also crucial for the acceptance and success of TAARs and PBL.

¹¹⁵ See fn.85 above.

CORPORATE TAX RISK AND TAX AVOIDANCE

Given the discretion afforded to HMRC by these two types of legislation, a number of interviewees pointed out that companies must trust HMRC to apply TAARs and PBL sensibly and with appropriate restraint. Some interviewees said that, whilst the relationship between the two has generally improved in recent times due to the initiatives undertaken through the Varney Review, it might not have reached the stage where companies trust HMRC to apply such legislation in this manner. This may help to explain some of the negative feedback on the proposed principles-based legislation.

Whilst a relationship based on trust is thus a necessary condition for the successful adoption of certain types of legislation, there could be potential difficulties and dangers in fostering it. One interviewee suggested that HMRC might be less likely to apply TAARs or PBL to low risk companies than to high risk ones. He commented that HMRC will only raise TAARs “if you are in that space”. This interviewee’s reasoning seems to be that HMRC might be more willing to believe, or even assume, that there is a valid commercial reason behind a transaction, thus bringing it outside the scope of a TAAR, if it is carried out by a low rather than a high risk company. This view was echoed in comments from other interviewees. HMRC’s December 2007 Guidance could be interpreted as supporting this belief since the list of benefits of being low risk includes the following:

“We will normally assume, unless it is clearly not so, that the customer’s judgment will match ours—although this may not be the case for transactions involving innovative tax planning or avoidance. We will assume that lower tax outcomes have been chosen from a range of outcomes for valid reasons.”¹¹⁶

Further the Guidance adds that where companies are low risk:

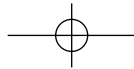
“We will assume that we will be told about significant new tax issues; we will not ask questions to test disclosure unless it is very clear that these have not been brought to our attention.”¹¹⁷

If these are listed as benefits of being low risk, it would seem to follow that HMRC will not make the same assumptions for higher risk taxpayers. It seems that they would also scrutinise the accounts less thoroughly for low risk taxpayers. This approach follows naturally from the risk rating process. A company will only be rated as low risk on the understanding that it will disclose any transaction on which there was any question of a TAAR applying and discuss it with its CRM. On the other hand, a company rated as low risk which genuinely believes that a transaction does not fall within a TAAR could end up being treated with more lenience than a higher risk company entering into a very similar transaction for very similar reasons but subjected to intensive scrutiny. There could be quite a thin line between sensible allocation of investigative resources and fairness in treatment. Whilst this is a matter clearly within HMRC’s powers of management,¹¹⁸ it is an area which will need to be monitored if it is not to give grounds for concern about fairness in application of legislation as between taxpayers. It should also be remembered that companies are dynamic and that there will be a rational behavioural response to risk

¹¹⁶ December 2007 Guidance, fn.7 at 14.

¹¹⁷ December 2007 Guidance, fn.7 at 14.

¹¹⁸ See fn.93 above.



BRITISH TAX REVIEW

rating, so that companies that have been given a low risk rating could be encouraged to take chances. Whilst this was not suggested by any of our respondents, it is no doubt a possibility of which HMRC are aware and accordingly a low risk rating will not mean that monitoring can be abandoned altogether.

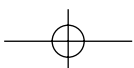
The importance of building a relationship based on trust is unquestionable, and the steps taken to achieve it thus far should be recognised. Yet, these small points serve as a reminder of the difficulties and dangers that might lie ahead.

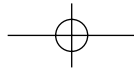
Conclusions

Recent migrations or threats of migrations of large, prominent companies out of the United Kingdom have shown how important it is that the government fosters a good relationship with corporate taxpayers and correctly calibrates its framework for dealing with tax risk and unacceptable tax planning. We have seen companies threatening to move, and in some cases actually moving, away from the United Kingdom because they are unhappy with the tax system. This alone should not determine tax policy. It is essential to raise revenue and it is the task of HMRC to manage tax risk and of Parliament to carry out changes it considers desirable to deal with tax risk and tax planning which reduce revenues in a way unacceptable to the government. Clearly, in forming a balanced tax policy they will be guided by many factors. The view of tax directors and their boards regarding the impact of these actions on corporate decision-making with respect to location and new investment is one important factor relevant to the formulation of a balanced, competitive but revenue raising tax policy.

The results of the Main Survey suggest that the implementation of the Varney Review is having a positive effect in improving the relationship between HMRC and large businesses and that the procedure is one that is worth rolling out beyond the taxpayers currently covered by the LBS. Valuable developments have taken place since completion of the Pilot Survey. Risk rating is more clearly seen to be related to behavioural rather than structural factors but there is still a fundamental belief amongst some companies that their size and level of inherent complexity are a barrier to a low rating. Although HMRC documentation already explains the relationship between behavioural and structural factors and most interviewees seemed to understand this, it may yet be worth elaborating further in the Guidance how a large and inherently complex business may nevertheless be low risk by satisfying the behavioural tests.

To the extent that behaviour relates to transparency and disclosure, it is widely considered by the interviewees that these are positive and attainable objectives. The sticking point for some comes with altering their tax planning behaviour. In their view, the potential benefits of a low risk rating do not outweigh the value of being able to use all legal methods at their disposal, including those which HMRC would consider aggressive, to attempt to minimise tax costs. Indeed, some consider it unreasonable that there should be any disadvantage in acting within the law, even if the result is one which HMRC dislike. It does not seem that the RRA alone will result in behavioural change in this group of companies. The disclosure regime seems to have had considerably more effect in modifying the behaviour of this group to the extent that it affects the economics of tax planning. One question for the future is whether the emphasis on tax planning behaviour in the risk rating process is in any way limiting the possibilities of opening up transparency and co-operation with this group of companies. There is





CORPORATE TAX RISK AND TAX AVOIDANCE

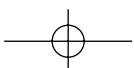
some evidence that the new approaches to resource allocation, speedier settlement and focus on major issues are operating in these cases anyway, regardless of risk rating, so possibly failure to achieve a low risk rating does not always undermine the objective of closer co-operation. Nevertheless a closer shared understanding of what behaviour is and is not “commercial” might help where there is transparency but lack of agreement about the judgments being made on tax strategy. Possibly the current review of anti-avoidance legislation should pay more attention to “commerciality” as a test since this seems to be the term most often used by the taxpayers in explaining their view of the position. The question of whether there is a commercial purpose or not is also referred to in the December 2007 Guidance when discussing what is meant by a “low risk” tax strategy.¹¹⁹

The CRM is crucial to the success of the Varney Review. Investment in recruitment, retention and training of good CRMs with the ability to understand the needs of large business without becoming “captured” (in the sense of identifying too strongly with their customers) is important. Attention needs to be paid to the length of time a CRM spends in each client relationship in order to attain a good balance.

New approaches to drafting legislation are seen to rely on a trust relationship. The ease with which complex anti-avoidance legislation is managed by HMRC and the corporate taxpayer alike will be dependent on that relationship, therefore, whatever form of anti-avoidance legislation is adopted. The belief that specific legislation will provide total certainty may be spurious, in the light of previous experience, and this was recognised by some of the interviewees. Despite support for the idea of PBL in theory, however, when it came to draft legislation and to actual TAARs, many interviewees perceived considerable problems. There was reluctance from many interviewees to move towards very broad forms of legislation or to embrace purpose-based tests. It was clear from the discussion of the scenarios that different interviewees interpreted behaviour in very different ways and had genuine and arguable rationales for their interpretations in many cases.

Interviewees were more likely to be comfortable with TAARs if they had a low risk rating but this did not seem to hold for PBL, though perhaps this was because interviewees were less sure what the new proposals would entail. Even though the new relationship with business is having some success and is well worth pursuing, it is not a substitute for getting the legislation right in the first place. The reservations expressed about clearances and, even more so, HMRC guidance, by many interviewees underline this conclusion. There is a dislike of the use of legislation which catches commercial transactions so that the taxpayer has to rely on “untaxing by concession”. The work that has been done on improving resource allocation, speed of settlement, and trust generally between HMRC and large taxpayers is to be applauded but the problem of drawing the line between tax planning and tax avoidance (in the pejorative sense) remains one to be solved by the legislators and the courts.

¹¹⁹ December 2007 Guidance, fn.7 at 12.



Appendix I

Sample and methodology

This article is based on a survey of tax directors from 30 companies carried out in April–June 2008. This survey follows and builds on a Pilot Survey carried out in April–May 2007. For the Pilot Survey, a letter was sent to the Hundred Group and interviews were carried out with tax directors from the nine companies which volunteered. For the current project, the authors interviewed tax directors from eight of those nine companies,¹²⁰ 21 other companies from a short list selected randomly from the FTSE 350 list, and one unlisted company. Companies short listed randomly received a letter. Seventeen companies responded and agreed to be interviewed. Others did not respond to the initial letter but were contacted by telephone and then agreed to be interviewed. In all 19 companies from the FTSE 100, 10 from the FTSE 250 and one unlisted company were interviewed. Twenty-seven of the companies interviewed are dealt with by the LBS. Out of the remaining three companies, two have been informed that they will be moved into the LBS soon. One of the 27 companies in the LBS at the time of the interview had been informed that it is being moved out. One high level LBS official was interviewed in order to check and clarify some points of fact and obtain a balancing view.

The survey was carried out by means of in–depth interviews of about one hour conducted by two of the present authors. There was an interview schedule, but the interviews were not highly structured, allowing the interviewees to focus on matters of importance to their companies. This flexibility allowed the interviewers to steer the interviews away from broad generalisations to a more meaningful and concrete exchange. It also facilitated the attainment of a satisfactory depth of discussion. On the other hand, it meant that not all issues were discussed for the same length of time and in the same amount of detail with all interviewees.

One further feature of the interviews was that the questions asked, and the issues discussed, often did not lend themselves to an easy “yes” or “no” answer. This again led to very engaging and profound discussions. On the other hand, it meant that some interviewees did not always provide direct answers to the questions asked. These interviewees, at times, responded by providing examples, recounting an anecdote, speculating on what the general view of tax directors was, or making a broad, generalised point. In the light of all this, the authors note the difficulty at times encountered in determining the exact view of an interviewee on a particular issue for the purposes of this article. The authors have erred on the side of caution, by, for example, not attributing any specific views to the interviewees unless this was clearly and incontrovertibly stated or implied in the answers given. If an interviewee’s answers only seem to provide vague support for a view, then that is what is stated in the article.

Therefore, whilst the authors attempted to put order to the answers given, to aggregate views, and to draw out some main and subsidiary themes, this research remains very much of a qualitative and not a quantitative nature.

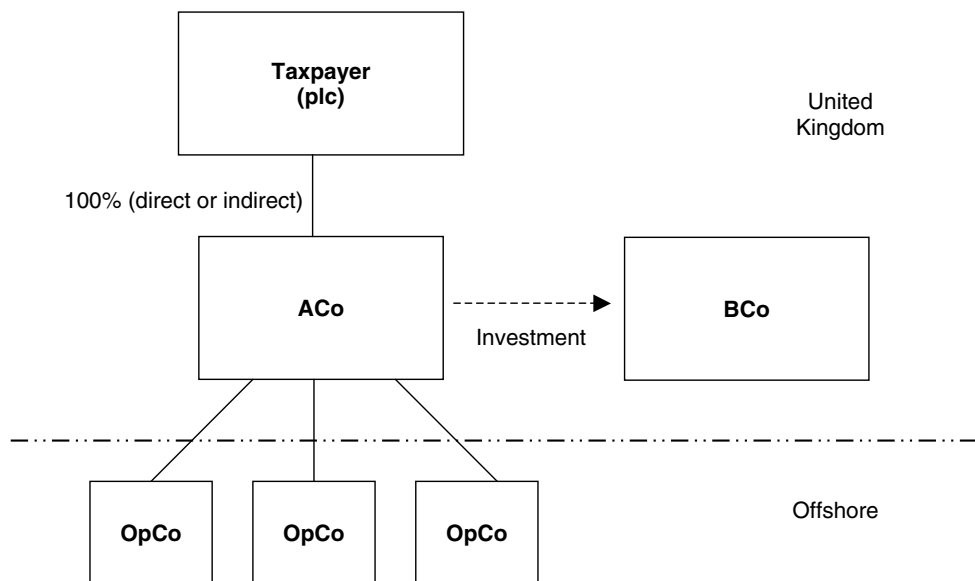
¹²⁰ One of the 9 companies was unable to participate this year.

Appendix II

Scenarios

Preferred share investment arrangement

The Taxpayer is a plc resident in the United Kingdom. It is the ultimate parent of a group of companies operating in several jurisdictions (the “Group”). The Taxpayer wholly owns, directly or indirectly, a holding company known as “ACo” which is resident in the United Kingdom. ACo owns shares in a number of operating companies (“OpCos”) that are resident in various jurisdictions where they carry on business. Some of the OpCos have recently distributed profits to ACo such that ACo has cash on hand in excess of its current requirements. ACo is **considering various opportunities for investing these funds**, either in other operating companies within the Group, or in some other company that is not a part of the Group. One candidate for investment is BCo, an unconnected private company which is resident in the United Kingdom. The relevant companies are shown in the following diagram:



The Taxpayer and ACo have identified BCo as an attractive investment **for a variety of reasons**. First, BCo carries on a business which is complementary to, but not in competition with, the Group’s businesses. Secondly, although BCo has sustained losses in the last few years it is expected to become profitable in the near future. Thirdly, as BCo has tax losses carried forward it is indifferent between paying dividends on equity financing and paying interest on debt financing—thus BCo is willing to offer a **preferred share dividend** which exceeds what comparable companies might offer and which approaches a commercial interest rate. The Taxpayer’s Group Treasurer has considered the credit

BRITISH TAX REVIEW

rating of BCo and has confirmed that an investment in BCo would be within the normal risk parameters approved by the board.

The specifics of the investment are that BCo will issue to ACo a block of preference shares which by their terms are cumulative, redeemable, and carry a fixed rate dividend of five per cent. The preference shares do not mandate redemption but are redeemable at BCo's option at least one year after issue. BCo may issue some of the preferred shares to other investors but the shares will not be widely held (ACo will own more than 10 per cent of the issue).

The Taxpayer's advisers take the view that neither **the current loan relationships rules** nor **the proposed "disguised interest" rules** would apply so as to treat the dividends received by ACo on the BCo preference shares as taxable income.

First, the Taxpayer's advisers are of the opinion that the BCo preference shares are not **"non-qualifying shares"** for the purposes of sections 91B through 91E of FA 1996 (as amended). They opine that, although the return on the preferred shares will be broadly equivalent to the return on a commercial loan, the shares are not **"designed to produce"** such a return and, in any event, the shares are "excepted shares" because ACo's purpose in acquiring the shares is not a **"tax avoidance purpose"** or other "unallowable purpose". Therefore section 91D should not apply so as to treat the BCo shares as a creditor loan relationship in the hands of ACo.

Secondly, the Taxpayer's advisers are similarly of the opinion that **the proposed principles-based rules regarding "disguised interest"** should not apply so as to require an income inclusion by ACo (or by the Taxpayer) as a result of the BCo investment. They believe that this arrangement falls outside the stated purpose of those rules, which is "to secure that . . . a return designed to be economically equivalent to interest is treated in the same way as interest for the purposes of corporation tax". Specifically, the Taxpayer's advisers take the view that the investment in BCo is not **"an arrangement designed to produce a tax privileged investment return"** because it is not reasonable to assume that it was **the main purpose, or one of the main purposes**, of the arrangement to obtain such a return.

The Taxpayer's advisers have noted, however, that **HMRC appear to disagree** with this view. Both the HMRC Corporate Finance Manual¹²¹ and the recent consultation document¹²² assert that an investment in cumulative redeemable preferred shares, where the issuer is in a loss position and the dividend rate is broadly similar to the commercial interest rate, is captured by the legislation because the arrangement is motivated by tax avoidance.

Share consolidation arrangement

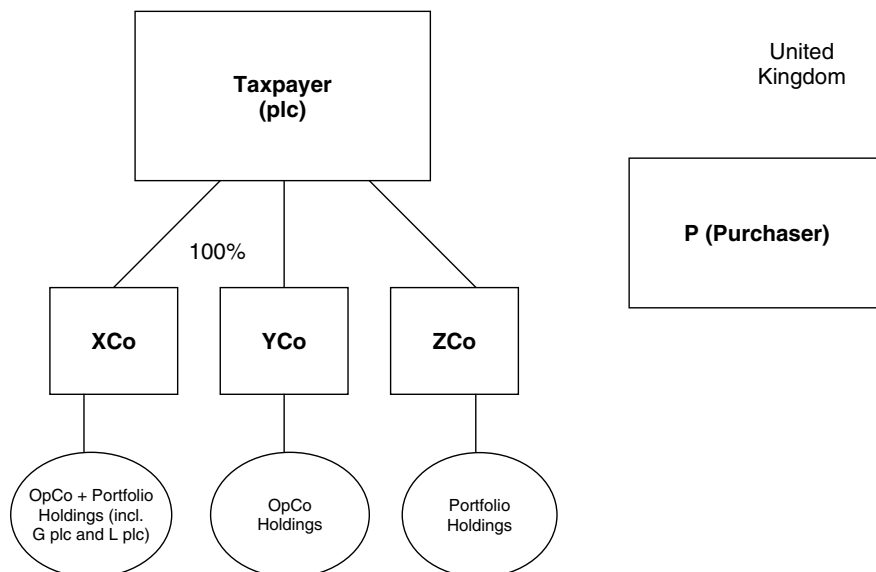
A. The Taxpayer is a plc resident in the United Kingdom. It is the ultimate parent of a group of companies operating in the United Kingdom and several other jurisdictions (the **"Group"**). Among other companies, the Taxpayer wholly owns three holding companies known as **"XCo"** **"YCo"** and **"ZCo"**, each of which is resident in

¹²¹ CFM 6320, available at: www.hmrc.gov.uk/manuals/cfmmanual/CFM6320.htm (accessed January 9, 2009).

¹²² HMT and HMRC, *Principles-based approach to financial products avoidance: a consultation document* (December 2007), available at: www.hmrc.gov.uk/legislation/disguised-interest-intro.htm (accessed January 9, 2009).

CORPORATE TAX RISK AND TAX AVOIDANCE

the United Kingdom. XCo holds shares in various operating companies within the Group and also holds a portfolio of shares in unconnected companies. YCo only holds shares in operating companies within the Group. ZCo only holds portfolio investments in unconnected companies. The relevant companies are shown in the following diagram:




As part of a rationalisation of the Group's structure, the Taxpayer wishes to sell certain shareholdings to third parties and to consolidate its remaining shareholdings within YCo and ZCo. One aspect of the planned reorganisation is to have YCo hold all shares in operating companies within the Group and to have ZCo hold any remaining portfolio investments in unconnected companies. Accordingly, the Taxpayer would like to transfer XCo's assets (primarily shares in other companies) such that: (1) YCo will acquire any shares in operating companies within the Group previously held by XCo; and (2) third party purchasers and ZCo will acquire any portfolio investments previously held by XCo. XCo may subsequently be wound up.


Among other gains and losses, XCo realises a chargeable gain on a disposal of certain portfolio shares (in G plc) to an unconnected third party "P". XCo also sells a block of shares (in L plc), which are standing at a loss, to P, expecting to realise a capital loss which can be set against the chargeable gain arising from the G plc shares. A contract negotiated between the Taxpayer, XCo, ZCo and P specifies that ZCo has the right to require P to sell the L plc shares to ZCo for their market value within 60 days, provided that the market value has not risen or fallen by more than three per cent. After 40 days ZCo exercises this right and buys the L plc shares from P.

The Taxpayer's advisers take the view that the loss arising on the disposal of the L plc shares by XCo is an "allowable loss" and as such can be set off against chargeable gains

BRITISH TAX REVIEW

to reduce XCo's liability to capital gains tax. In particular, they are of the opinion that the loss is not subject to the "restrictions on allowable losses" TAAR in section 16A of the TCGA. Although it is true that the loss accrues to XCo in consequence of, or in connection with, an "arrangement" broadly construed, the advisers believe that it was not **the main purpose, or one of the main purposes**, of the arrangement to secure a tax advantage. The Taxpayer's advisers have noted, however, that the HMRC guidance with respect to "contrived losses" suggests that the loss on the L plc shares may be restricted.

B. Please consider a modification of the above scenario where ZCo does *not* exercise its right to buy the L plc shares from P within 60 days, either because the market value of the L plc shares has varied by an additional five per cent or because ZCo simply decides it is not interested in acquiring those shares. 

 Compliance; Large businesses; Revenue and Customs; Risk assessment; Tax avoidance; Taxation Administration