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The eye of the needle: Is one of your purposes tax avoidance?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Tuesday, May 26th, 2020

We have all become familiar with the expression in the PPT set out in article 7(1) of the MLI and article 29(9) of the 2017 OECD Model where "obtaining that benefit was one of the principal purposes of any arrangement or transaction". Discerning which is a principal purpose is one of the main challenges in applying the PPT and other anti-abuse rules that turn on purpose.

This kind of language has appeared in UK domestic legislation for a very long time, and in UK double tax treaties for nearly 30 years. A string of recent UK decisions has considered the purpose of arrangements in the context of one of the oldest anti-avoidance rules designed to prevent UK residents structuring their affairs through offshore entities. The "Transfer of Assets Abroad" legislation was first introduced by Finance Act 1936, section 18 and is now in Income Tax Act 2007, Part 13, Chapter 2. The most important provision deems the income of a non-UK person to be the income of anyone who is UK resident and transferred assets directly or indirectly to the non-UK person, if that transferor has a broadly defined, "power to enjoy" the income of the non-UK person resulting from the transfer.

A so-called "motive defence" precludes this attribution of income. In its current form, there are two defences:

"…the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected."

"… the transfer and any associated operations(a)were genuine commercial transactions, and (b)were not designed for the purpose of avoiding liability to taxation."

The scope of the defence has been narrowed over time by legislation. As originally enacted, a main purpose that was not tax avoidance was sufficient to satisfy the defence.

What is a tax avoidance purpose?

To what extent does consideration of tax in deciding on a course of action constitute avoidance? In this context, the UK courts distinguish between "tax avoidance" and "tax mitigation". The House of Lords decided in *Willoughby v IRC [1997] UKHL;* 70 TC 57 that tax avoidance is a course of action designed to conflict with or defeat the evident intention of Parliament. Tax mitigation is taking advantage of a fiscally attractive option afforded by the tax legislation, and genuinely suffering the economic consequences that Parliament intended to be suffered by doing so. This approach is consistent with the PPT and statutory GAARs which permit tax benefits that are consistent with the purpose of the relevant tax rule and are thus not abusive. See http://kluwertaxblog.com/2020/02/27/alta-energy-treaty-shopping-is-no-abuse/

The UK tax tribunals have recently considered this issue in a series of cases where UK resident taxpayers have used offshore structures in UK-related activities.

Property development

Davies and Others v HMRC [2020] UKUT 67 (TCC) concerned three UK resident individuals who were involved in the development of UK land by a Mauritius resident company wholly owned by a Bermuda resident insurance company. The Mauritian company purchased and developed land in the UK. The three individuals each took out a life insurance policy with the Bermuda company under which their entitlements were linked to the Mauritian company.

The individuals argued that they did not enter into the arrangements to avoid tax, and did not, avoid tax. The life policy arrangements were subject to UK tax payable on a chargeable event in relation to the proceeds of the policies and the Mauritian company paid tax in Mauritius on the development profits. Their purpose was to find an alternative vehicle for the purchase to release another company in which they were interested that had contracted to purchase the land from its commitments without forfeiting the deposit and also to make pension plans for themselves. Deferral of tax (which might constitute avoidance) until payment under the policies must be considered in the context of pension provisions, otherwise all pension planning would constitute tax avoidance.

The Upper Tribunal upheld the FTT reasoning that consideration of tax is not necessarily avoidance of tax because of the distinction between tax mitigation and avoidance. While taking out of a life policy itself does not constitute tax avoidance, the policies in conjunction with the creation of a special purpose vehicle in Mauritius to complete the purchase in place of another company to benefit from the Mauritius-UK double tax treaty were for tax reasons. I will return to the treaty aspects of this case in a later blog.

IT services

In *Hoey v HMRC* [2019] UKFTT 489 (TC), an IT contractor was employed by offshore company in a scheme that had become common for such individuals who worked in circumstances where their customers would engage them on short term contracts for specific projects. The scheme involved multiple contractors being employed by a single non-UK resident company (an "umbrella company") which then provided their services to the end users. It also involved the establishment of a trust for each contractor which received payment from the umbrella company. The trust, in turn, which then made interest free loans to the contractors, with the expectation that those loans are never repaid.

Although the taxpayer did not fall within the provisions, the First-tier Tribunal considered, *obiter*, that the motive defence would have failed. It found that the taxpayer's motive was purely to avoid the complexities of running his own company or his own consultancy. He had no idea that the arrangements involved tax avoidance or anything untoward. He had been put in touch with the provider of the scheme by his advisor, whom he trusted implicitly. Consequently, his motivation did not relate to tax avoidance. However, the legislation requires the intentions of the designer or promoter of the scheme also to be considered. While the establishment of an umbrella company was found to be a perfectly reasonable commercial transaction the insertion of additional transactions, being the setting up of an umbrella company offshore, which makes payments to a trust, which then makes interest free loans to the contractors, with the expectation that those loans are never repaid, constituted tax avoidance. The motive defence accordingly would have failed.

Buy-out company and family trust

The motive defence also failed in *Rialas v HMRC* [2019] UKFTT 520 (TC) . A UK resident was sought to buy out his co-shareholder in a UK resident company. For this purpose, a non-UK resident company was set up, owned by a non-UK discretionary trust established for the benefit of the taxpayer's family. The non-UK resident company borrowed the purchase price for the shares from an unrelated third party which was repaid out of post-acquisition dividends paid by the UK company.

The taxpayer's motives in setting up this structure were:

(1) monetise the value of his holding in the UK company.

(2 to do so, he had to buy out his co-shareholder, who was not keen to sell, especially if he had to continue working in the business, but under the overall control of a larger organisation.

(3) to borrow, as he did not have the funds, but without personal liability if things went wrong and retain the upside if the UK company continued to grow.

(4) buy out his co-shareholder in a way which did not involve a new party in the ownership chain, who would require certain UK regulatory approval.

(5) The lender, who was prepared to lend on unusually favourable terms, would only lend to a non-UK based company, preferably in a jurisdiction which would preserve the privacy they sought.

(6) hold these new assets via an offshore trust to reduce exposure to UK Inheritance Tax. He was aware that an offshore trust was a "good thing" from a UK Inheritance Tax perspective but had no specific UK tax advice on this.

All these factors were found by the First-tier Tribunal to have a commercial purpose except the establishment of the trust to insulate the assets from Inheritance Tax which was ruled to go beyond mere tax mitigation and was unacceptable tax avoidance.

Transfer of business offshore

In contrast, the motive defence succeeded in *Fisher and others v HMRC* [2020] UKUT 62 (TCC). There, a telephone betting business was sold by a UK resident company to a Gibraltar company both owned by the same UK resident family members. The Upper Tribunal identified a qualitative difference between a taxpayer voluntarily entering into a tax avoidance arrangement in order to save tax and a situation in which a taxpayer is effectively forced to restructure in the same tax-efficient way as its competitors in order to secure the survival of the business. The introduction of betting duty in the UK resulted in all major telephone betting companies leaving the UK, which the taxpayers followed. This was because a UK based company, subject to the levy, would be uncompetitive in pricing bets and would go out of business. For this reason, the commercial transactions were not "designed for the purpose" of avoidance. It was implicit in this that avoidance of tax may result from the transactions without disqualifying the taxpayer from benefiting from the defence.

Proper application of such provisions is entirely dependent on a fair and accurate identification of the purpose of the relevant tax provision (or “intention of parliament”).

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