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# BRITISH TAX REVIEW

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## Current Note

### **Locating the source principle in the Income Tax (Earning and Pensions) Act 2003**

It is a fundamental tenet of our income tax law that for payments to be chargeable as earnings of the employment they must have “the employment” as their source. This principle was formerly expressed in section 19(1) (Schedule E) of the Income and Corporation Taxes Act 1988 (ICTA 1988), in the following way:

“Tax under this Schedule shall be charged in respect of any office or employment on emoluments *therefrom* which fall under one or more than one of the following Cases. . .”

Schedule E was replaced in April 2003 by the Income Tax (Earning and Pensions) Act 2003 (ITEPA 2003), the second Act produced by the Tax Law Rewrite Project. Of course, that Act was intended to rewrite, and not reform, the law; accordingly, the source principle ought still to be a part of the framework. Yet, while it is clear that the principle remains a part of the intendment of ITEPA, pinpointing exactly where in the Act it is expressed is a far more difficult task than it was under Schedule E.

#### *The obvious candidate*

Since, under the old law, the source requirement was expressed in the relevant charging provision, section 19 of ICTA, the most obvious place to start is with the new charging provision, section 6 of ITEPA. That section reads as follows:

#### **“6 Nature of charge to tax on employment income**

(1) The charge to tax on employment income under this Part is a charge to tax on—

- (a) general earnings, and
- (b) specific employment income

The meaning of ‘employment income’, ‘general earnings’ and ‘specific employment income’ is given in section 7.

(2) The amount of general earnings or specific employment income which is charged to tax in a particular tax year is set out in section 9.

(3) The rules in Chapters 4 and 5 of this Part, which are concerned with—

- (a) the residence and domicile of an employee in a tax year, and
- b) the tax year in which amounts are received or remitted to the United Kingdom,

apply for the purposes of the charge to tax on general earnings but not that on specific employment income.

(4) the person who is liable for any tax charged on employment income is set out in section 13.

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(5) Employment income is not charged to tax under this part if it is within the charge to tax under [Part 2 of ITTOIA 2005 (trading income) by virtue of section 15 of that Act] (divers and diving supervisors).”

Although one of the paragraphs dealing with section 6 in the Explanatory Notes to the Act states that the basic rule is that employment income is charged to tax on income from employments,<sup>1</sup> nowhere in section 6 is this actually expressed, and this is so notwithstanding that section 6(1) is said to be derived from section 19(1) of ICTA, and paragraphs 1 and 5 of Schedule E.<sup>2</sup> So, whilst, under the old law, the requirement was an express part of the charging section, that position is not replicated under the new Act.

### *The Revenue approach*

HMRC, in their Employment Income Manual,<sup>3</sup> assert that it remains a requirement that earnings must be from the employment in order for them to be taxable, and state, without further comment, that section 7(3) and section 62 of ITEPA supply this restriction. An examination of those provisions, however, reveals that the position is not quite so straightforward.

Section 7 provides the meaning of “employment income”, “general earnings” and “specific employment income”.

Under section 7(2), “employment income” means:

- (a) earnings within Chapter 1 of Part 3,
- (b) any amount treated as earnings, or
- (c) any amount which counts as employment income.

Under section 7(3), “general earnings” means:

- (a) earnings within Chapter 1 of Part 3, or
- (b) any amount treated as earnings,  
excluding in each case any exempt income.

By section 7(4) “specific employment income” means any amount which counts as employment income, excluding any exempt income.

Again, there is nothing on the face of section 7 which amounts to an expression of the source principle.

Chapter 1 of Part 3 consists of only one section: section 62, “Earnings”. It reads as follows:

#### **“62 Earnings**

- (1) This section explains what is meant by ‘earnings’ in the employment income Parts.
- (2) In those Parts ‘earnings’, in relation to an employment, means—

<sup>1</sup> Explanatory Notes to ITEPA 2003, para.45, available at: [www.opsi.gov.uk/ACTS/acts2003/en/ukpgaen\\_20030001\\_en\\_1](http://www.opsi.gov.uk/ACTS/acts2003/en/ukpgaen_20030001_en_1)

<sup>2</sup> See ITEPA Table of Origins, p.2, available at: [www.opsi.gov.uk/acts/acts2003/related/ukpgatoo\\_20030001\\_en.pdf](http://www.opsi.gov.uk/acts/acts2003/related/ukpgatoo_20030001_en.pdf)

<sup>3</sup> See EIM00600, available at: [www.hmrc.gov.uk/manuals/eimanual/EIM00600.htm](http://www.hmrc.gov.uk/manuals/eimanual/EIM00600.htm)

- (a) any salary, wages or fee,
  - (b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or
  - (c) anything else that constitutes an emolument of the employment.
- (3) For the purposes of subsection (2) 'money's worth' means something that is—
- (a) of direct monetary value to the employee, or
  - (b) capable of being converted into money or something of direct monetary value to the employee.
- (4) Subsection (1) does not affect the operation of statutory provisions that provide for amounts to be treated as earnings (and see section 721(7)).”

It is said in the Table of Origins that accompanies ITEPA that section 62 derives in part from section 131 of ICTA which contained an inclusive definition of “emolument”. Note 13 of Annex 2 to the Explanatory Notes explains that while, as a concept, “emoluments” was integral to the workings of the employment income Parts, as a word it had a “distinctly antiquated flavour”. As a result a decision was taken to replace the concept with that of “earnings”. But “earnings” is not a synonym for “emoluments”. The latter has an extra dimension that the former does not. The dictionary definition of “emolument” is “profit or gain arising from office or employment”.<sup>4</sup> It is, therefore, not strictly necessary to add the words “from the employment” because that qualification is inherent within the term. The same is not quite true of “earnings”,<sup>5</sup> nor can it be said that “earnings” in this context can assume such a meaning, because the term is exhaustively defined by section 62.

Turning to section 62 itself, while subsection(2)(c), which speaks of “anything else that constitutes an emolument of the employment”, appears to import the source requirement into the residuary category of “earnings”, such a limitation is not found, in express form at least, within either subsection (2)(a) or subsection (2)(b); and although the words “in relation to an employment” are used, they act only to frame the definition of “earnings”, they do not themselves add a further requirement. So, on the face of it, there is no need for either of the payment types listed in section 62(2)(a) or (b) to be sourced from the employment in order to count as “earnings”.

Accordingly, it appears that the Revenue's assertion that the principle can be found within section 7(3) and section 62 requires further explanation.

#### *An alternative view*

A different approach is to focus on section 9 of ITEPA. That section determines the amount of general earnings or specific employment income which is charged to tax in a particular tax year, and it reads as follows:

#### **“9 Amount of employment income charged to tax**

- (1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows.

<sup>4</sup> *Shorter Oxford English Dictionary* (6th ed., Oxford, 2007).

<sup>5</sup> Defined in the *Shorter Oxford English Dictionary* (6th ed., Oxford, 2007) as, “gain or profit” or “the amount of money earned; income from work etc”.

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- (2) In the case of general earnings, the amount charged is the net taxable earnings from an employment in the year.
- (3) That amount is calculated under section 11 by reference to any taxable earnings from the employment in the year (see section 10(2)).
- (4) In the case of specific employment income, the amount charged is the net taxable specific income from an employment for the year.
- (5) That amount is calculated under section 12 by reference to any taxable specific income from the employment for the year (see section 10(3)).
- (6) Accordingly, no amount of employment income is charged to tax under this Part for a particular tax year unless—
  - (a) in the case of general earnings, they are taxable earnings from an employment in that year, or
  - (b) in the case of specific employment income, it is taxable specific income from an employment for that year.”

Here is a reference to earnings “from an employment”, but it appears in a section concerned with quantum. Interestingly, the Explanatory Notes suggest that the “amount” of earnings chargeable to tax is the “net taxable amount”<sup>6</sup>; they do not appear to contemplate that the words “from an employment” further qualify the amount of earnings charged to tax. It could be argued, however, subject to one point made below, that section 9 actually imports three requirements before income for a particular year can be taxed. The first is that the income must be either “taxable earnings” or “taxable specific income” (both as defined); secondly, it must be “from an employment”; thirdly, it must be “for that year”. In this way, the source principle would be preserved, although the way in which the charge to tax operates would have been altered. Instead of the tax charge being limited to earnings from the employment, the charge would, *prima facie*, cover all salaries, wages or fees, gratuities or profits or incidental benefits, etc. received by the employee, irrespective of whether or not those receipts can be said to be “from the employment”. Section 9 would then operate so as to remove from the scope of the charge earnings not sourced from the employment. While the effect is the same as under Schedule E, the structure is very different.

The qualification to this argument on section 9 involves a consideration of the effect of section 15. This section determines what amounts to “taxable earnings” from an employment in a tax year” where the employee is resident, ordinarily resident and domiciled in the United Kingdom.<sup>7</sup> It reads:

**“15 Earnings for a year when employee resident, ordinarily resident and domiciled in UK**

- (1) This section applies to general earnings for a tax year in which the employee is resident, ordinarily resident and domiciled in the United Kingdom.

<sup>6</sup> See Explanatory Notes to ITEPA 2003, paras 55–60.

<sup>7</sup> Section 15 defines “taxable earnings” in relation to Chapter 4 ITEPA (employee resident, ordinarily resident and domiciled in the United Kingdom). Similar provisions exist for the purposes of Chapter 5 (employee resident, ordinarily resident or domiciled outside the United Kingdom): see ss.22, 25, 26 and 27.

(2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of “taxable earnings” from the employment in that year.

(3) Subsection (2) applies—

- (a) whether the earnings are for that year or for some other tax year, and
- (b) whether or not the employment is held at the time when the earnings are received.”

We have already seen that the term “general earnings” includes the section 62 definition of “earnings”, a concept apparently not limited by a requirement that sums must be from an employment. The literal effect of this section is, therefore, to deem any “earnings” received in a tax year to be “taxable earnings from the employment in that year” for the purposes of section 9, regardless of whether or not they actually arose from an employment.

But it is plain that ITEPA contemplates that the “earnings” must have as their source the employment; the contrary is unthinkable. The difficulty, as has been discussed, is that while the intentment is present its expression is not. A consideration of sections 9 and 15 reveals that the source condition was most probably intended to have entered the scheme of the Act at the point where the term “earnings” is defined (s.62), but the words of the Act on their own are not enough to supply it. Instead some tweaking is required to make the scheme work as intended.

#### *Importing the principle*


There are two ways of squaring the circle. The first is to return to the definition of “earnings” in section 62 and to imply into each of the first two categories that which is explicit in the third: namely that any salary, etc. or gratuity, etc. must also be “of the employment”. As mentioned, the words “in relation to an employment” are not enough to do the job, but they do support this implication.<sup>8</sup> Although such a solution is not reflective of the Schedule E structure, which had the requirement in the charging provision, it does fit with the remainder of ITEPA.

The second solution is to maintain that section 9 supplies the requirement, and that it has gone from being a limit on the scope of the tax charge to a curb on the amount of “earnings” that fall within it. One then has to deal with section 15, which, on a literal interpretation, undermines this view of the Act. One approach to this is simply to read section 15 as being concerned only with the definition of “taxable earnings” and not with the term “from the employment”, thus allowing section 9 to operate as described. Such a reading is consistent with the apparent scheme of ITEPA and with the relevant part of the Explanatory Notes, but again does not reflect the position under Schedule E. Indeed, as suggested above, this interpretation reveals a change in the nature, albeit probably not the effect, of the charge to tax on employment income.

Ultimately, despite the absence of an explicit provision, there is enough in ITEPA to read the source requirement into the law, but it is nonetheless both disappointing and disconcerting to find that such a key principle has not been expressly dealt with in the new Act. Perhaps more worrying still for those who have to advise on the basis of


<sup>8</sup> As does s.13 (Person liable for tax), which provides that “the taxable person” is the person to whose employment the earnings relate.

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the new legislation is the potential for once-familiar concepts and principles to become transformed, apparently inadvertently, during the process of rewriting. Whether, and if so how, this affects the application of a particular aspect of the system will, of course, depend on the facts and circumstances of each case, but it seems that one cannot take for granted that the Rewrite has altered the law only in form. 

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 Drafting; Employment income; Income tax; Tax reform



## Case Notes

### ***Columbus Container Services B.V.B.A. & Co v Finanzamt Bielefeld-Innenstadt: the ECJ fails to grasp the tax competition nettle in relation to foreign income rules***

The European Court of Justice (ECJ) held in *Columbus Containers*<sup>1</sup> that Germany could lawfully override the exemption provided for in its tax treaty with Belgium in order to tax the profits of a Belgian partnership in circumstances where it applied similar treatment to a German partnership. This apparently straightforward ruling however disguises the fact that the Court failed to address the more fundamental issue raised by the national court's reference, namely whether a Member State can switch from exemption to credit in order to combat low tax and preferential regimes in other Member States.

Columbus was a Belgian limited partnership whose partners were German residents. Its main purpose was the co-ordination of the business activities of an international group. Under Belgian law, Columbus had separate legal personality and was subject to corporation tax under the preferential arrangements applicable to coordination centres. Under German law, Columbus was a partnership and was treated as a permanent establishment (PE) of the German-resident partners. According to the double taxation convention between Germany and Belgium, Columbus' business income was exempt from German income tax and net wealth tax. However, the German tax authorities, applying the treaty-override provision in the German Foreign Tax Law, imposed income tax on Columbus' business income (with credit for the Belgian tax) and assessed the value of Columbus' business assets for net wealth tax purposes.

The German rules provided that, where designated passive income arose from the foreign establishment of a taxpayer subject to unlimited German tax liability and where such income would be liable to tax as controlled foreign corporation income if the establishment were a foreign corporation, double taxation relief was to be given by the credit method rather than by way of exemption. Thus, in other words, a switch from exemption to credit occurred under the German foreign income rules in circumstances where the German CFC rules would have applied if the taxpayer had been a company.

Columbus challenged the German authorities' decision, and the German court sought a ruling from the ECJ on whether the provisions of the Foreign Tax Law were contrary to the freedom of establishment under Article 43 of the EC Treaty and to the free movement of capital under Articles 56–58 of the EC Treaty.

The ECJ held that Germany was free under Community law to override its tax treaty with Belgium and switch from exemption to credit in order to tax a Belgian partnership subject to the preferential Belgian co-ordination centre regime.

#### *The Advocate General's opinion*

In understanding the scope of the judgment it is helpful to read it against the background of the Advocate General's (AG's) opinion. The AG begins by explaining that the German court's question does not relate directly to the German CFC rules but to the rules giving

<sup>1</sup> C-298/05 *Columbus Container Services B.V.B.A. & Co v Finanzamt Bielefeld-Innenstadt*.

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relief for double taxation. The first part of the opinion therefore focuses on whether Germany can lawfully give double tax relief for income from a Belgian partnership using the tax credit method. He concludes that it can. Given that Germany also taxes German partnerships there is no difference of treatment between the domestic and cross-border situations. The AG notes further that the question whether the German switch-over provision is compatible with the provisions of the double taxation convention goes beyond the scope of Community law.

The AG then moves on to consider the further issue raised by the case, namely the link between the double tax relief rules and the CFC rules. Here the AG follows AG Leger's view in *Cadbury Schweppes*<sup>2</sup> that, even if the legislation at issue were tax neutral compared to a purely domestic situation, in order to identify whether there is a restriction on the exercise of a freedom protected by the Treaty, a comparison between two cross-border situations should be made. Accordingly, the relevant comparison is between the tax treatment accorded to German residents deriving profits from a PE located in Belgium under the coordination centres regime and the treatment accorded to German residents with PEs located in other member states. There is a restriction of the freedom of establishment because the German rules dissuade German taxpayers from establishing themselves in low tax jurisdictions because the switch to credit is linked to the level of taxation in the foreign State, and more specifically with its CFC rules.

Turning to whether the restriction is justified the AG again follows the reasoning of AG Leger in *Cadbury Schweppes*. He notes that in the absence of Community harmonisation it must be accepted that there is competition between the tax regimes of the various Member States. The AG regrets that such competition operates between the Member States without restriction but notes that this is a political matter which cannot restrict rights conferred by the EC Treaty.

Likewise, the AG considers that, although the national measure may be justified by reasons to combat wholly artificial arrangements, it fails the proportionality requirement. The German legislation does not enable taxpayers to demonstrate on a case-by-case basis whether the permanent establishment is genuinely established in the host State and carries on its activities in that State.

In short, applying the principles in *Cadbury Schweppes*, the AG concludes that the German rules are unlawful unless required to combat wholly artificial situations.

The AG's opinion provided a comprehensive and thoughtful discussion of the issues raised by the case and a sound basis for the Court's deliberations. In the event, however, the judgment itself is disappointing. In particular it seems to have avoided completely the tax competition issue and the question of the link with the German CFC rules.

### *The decision of the ECJ*

The first clue in examining the scope of the judgment is to consider the question the Court thought it was answering (or, perhaps, wanted to answer). The Court's practice, after tracing out the background to a case, is to paraphrase the national court's question in its own words. Significantly, the ECJ's summary, which is to be found at [26] of the judgment, limits itself to the question whether a Member State can lawfully override the

<sup>2</sup> C-196/04 *Cadbury Schweppes plc v Commissioners of Inland Revenue* [2006] STC 1908; [2006] ECR I-7995.

exemption under its tax treaty and tax foreign income. The Court's ruling is directed at answering that question and, in this, the Court largely follows the AG's Opinion. It concludes that there is no discrimination. Columbus does not suffer any tax disadvantage by comparison with partnerships established in Germany since both are taxed.

The ECJ adds that Germany is not required to adapt its system to that of other Member States in order to prevent a distortion of the choice made by companies and partnerships in establishing themselves in other Member States. This appears to be an endorsement of the AG's view that, as Community law stands at present, Member States are not obliged to recognize the legal and fiscal status accorded by the domestic law of other States. Thus, it is immaterial that Belgium taxes Columbus as a corporation.

As far as the overriding by Germany of its tax treaty is concerned, the Court holds that it has no jurisdiction to rule on the compatibility of the German rules with Germany's tax treaties.

Finally, the Court notes that Article 43 does not prohibit different treatment of different types of foreign establishment where the domestic and cross-border situations receive the same treatment.

#### *Comment*

None of the above seems surprising or offensive. In particular, on the difference in treatment of foreign companies and branches the Court had previously held in *Marks & Spencer*<sup>3</sup> that Community law does not require a Member State to apply the same tax rules to foreign subsidiaries and branches. There is little reason why it should: providing the same treatment is applied domestically to each category of establishment, such a difference in treatment does not act as a barrier to cross-border establishment.

Nor is the conclusion that Community law has nothing to say about the overriding by Germany of its tax treaty surprising. The Court sees Article 293 of the EC Treaty merely as an encouragement for Member States to enter into double taxation agreements in accordance with international practice to remove or mitigate double taxation: see, e.g. *Kerckhaert-Morres*.<sup>4</sup> The conclusion and scope of such agreements is a matter for Member States.

The problem with the judgment is not what the Court says but what it does not say. Unlike the AG, the Court does not address the more fundamental issue in the case, namely whether a Member State can switch from exemption to credit to combat low tax regimes and the relevance or otherwise of the principles set out in the *Cadbury Schweppes* judgment. This issue was simply not dealt with.

One can only speculate about why the Court failed to address a key issue in the case. Given the AG's opinion it can hardly have been inadvertent. One suspects that, as sometimes happens, the interest in providing a complete answer for the national court was sacrificed in an attempt to reach a common line among the judges. It is wholly conceivable that the nature of the restriction in this case prompted considerable debate. The restriction under the German rules did not consist in the more normal deterrent to establish abroad but in a deterrent to establish in a Member State with a low tax regime targeted by the

<sup>3</sup> Case C-446/03 *Marks & Spencer Plc v Halsey (Inspector of Taxes)* [2006] STC 237; [2005] ECR I-10837.

<sup>4</sup> Case C-513/04 *Kerckhaert-Morres v Belgium* [2007] STC 1349; [2006] ECR I-10967.

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German CFC rules (as against another higher tax Member State). Although, as the AG rightly commented, *Cadbury-Schweppes* provides a precedent for this type of restriction it may be that some of the judges had difficulties with it.

Ultimately, however, judgments such as this do little to enhance the Court's reputation. Given that referrals to the Court add between two and three years to the length of proceedings it is unhelpful when the Court—whether deliberately or inadvertently—fails to provide adequate guidance. <sup>LT</sup>

PAUL FARMER\*

### *Fleming and Condé Nast Publications Ltd v HMRC: time for Parliament to step in?*

THE cases of *Fleming (t/a Bodycraft) v HMRC (Fleming)* and *Condé Nast Publications Ltd v HMRC (Condé Nast)*<sup>1</sup> are the latest House of Lords pronouncements in a long and drawn out saga relating to the recovery of overpaid VAT. The story began on July 18, 1996, when the Paymaster General announced that the time limit to recover overpaid output tax was to be changed. The previous time limit was six years from the overpayment or from reasonable discoverability of the overpayment.<sup>2</sup> The problem with this time limit from the perspective of HMRC was that recovery could be sought many years after a payment was made, for example after a declaration by the European Court of Justice (ECJ) that a tax law in the United Kingdom was incompatible with Community law. HMRC contended that the time limit meant they had little security of receipt and, as a result, it was changed in 1997 to a three year flat time limit, commencing from the time of making the VAT payment.<sup>3</sup> This change was to apply from the date of the announcement by the Paymaster General and it applied even where VAT had already been paid and so was retroactive in its effect. A similar step was taken in relation to input tax. Regulation 29(1A) of the VAT Regulations 1995 (Regulation 29(1A)), until 1997, contained no time limit at all to recover under-claimed input tax.<sup>4</sup> In March 1997, the current time limit of three years was introduced to be effective from May 1, 1997.<sup>5</sup>

The problem with these steps taken was brought out in the case of *Marks and Spencer v Customs and Excise Commissioners (Marks and Spencer (ECJ))*,<sup>6</sup> where the taxpayer brought two claims for the recovery of overpaid VAT totalling £6 million.<sup>7</sup> The claims were

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<sup>LT</sup> EC law; Controlled foreign companies; Double taxation treaties; Freedom of establishment; Free movement of capital; Partnerships; Tax competition

<sup>1</sup> *Fleming (t/a Bodycraft) and Condé Nast Publications Ltd v HMRC (Fleming)* [2008] UKHL 2; [2008] STC 324.

<sup>2</sup> VATA 1994 s.80(4) and (5).

<sup>3</sup> Finance Act 1997 s.47, amending VATA 1994 s.80.

<sup>4</sup> For some time there was a controversy as to whether both input and output claims came under VATA s.80. This was clarified in *University of Sussex v Commissioners of Customs and Excise* [2003] EWCA Civ 1448; [2004] STC 1 where it was definitively held that VATA 1994 s.80 deals with output tax and Regulation 29(1A) deals with input tax.

<sup>5</sup> Value Added Tax (Amendment) Regulations 1997, reg.4.

<sup>6</sup> Case C-62/00 *Marks and Spencer plc v Customs and Excise Commissioners* [2003] QB 866; [2002] STC 1036.

<sup>7</sup> For more detail see M. Chowdry "How long can section 80 last? *Marks & Spencer Plc v Commissioners of Customs and Excise (No.5)*" [2004] BTR 106.

refused in part on the basis that they were time barred and recovery could only be sought of sums paid in the three years immediately preceding the claim. Marks and Spencer argued that the retroactive effect of the time limit, which meant that their claim which was valid under the old time limit had suddenly disappeared when the new time limit was introduced, was incompatible with Community law principles of effectiveness and legal certainty, therefore the cap should not apply to their claim. Both the VAT tribunal<sup>8</sup> and High Court<sup>9</sup> agreed with HMRC that the claim was time barred, however the Court of Appeal made a reference to the ECJ. The point referred was whether or not the retroactive effect of the three year limitation period was compatible with the Community law principles of effectiveness and legal certainty.

The ECJ<sup>10</sup> held that Member States could legitimately impose time limits on the recovery of overpaid VAT and such time limits could be shortened.<sup>11</sup> However, such time limits and any shortening had to be compatible with Community law and for this to be so, not only did the time limit have to be reasonable<sup>12</sup> but any shortening of the time limit had to accord with the principles of effectiveness and legal certainty.<sup>13</sup> In order to do so, the legislation should have introduced an adequate transitional period so that those who had claims under the old law could continue to bring claims for some period. The case returned from the ECJ to the Court of Appeal<sup>14</sup> (hereinafter referred to as *Marks and Spencer* (CA2)) where it was confirmed that the time limit could not bar any part of the claim.<sup>15</sup>

For some time, HMRC maintained that the *Marks and Spencer* (ECJ) judgment did not apply to Regulation 29(1A). However, in both *Fleming (t/a Bodycraft) v HMRC*<sup>16</sup> and *Condé Nast Publications Ltd v HMRC*<sup>17</sup> it was accepted that Community law principles also required a transitional period in this situation. The overarching question faced by the House of Lords in these two cases was then, what happens now? How does the court deal with cases that arise where input tax was under-claimed before the introduction of the new time limit and the right to claim was removed overnight due to the lack of a transitional period? In order to deal with this question, the House of Lords considered what was done in relation to output tax and so it is convenient to discuss this issue before considering the judgments.

<sup>8</sup> *Marks & Spencer plc v Customs and Excise Commissioners (No.1) (Teacakes)* [1997] V&DR 85.

<sup>9</sup> *Marks & Spencer plc v Customs and Excise Commissioners* [1999] STC 205 (QB).

<sup>10</sup> Case C-62/00 [2003] QB 866; [2002] STC 1036.

<sup>11</sup> Case C-62/00; [2002] STC 1036 at [36]. See further Case C-228/96 *Aprile Srl v Amministrazione delle Finanze dello Stato* [1998] ECR I-7141, [28]; C-343/96 *Dilexport Srl v Amministrazione delle Finanze dello Stato* [1999] ECR I-579 [41]–[42].

<sup>12</sup> Case C-62/00 [2003] QB 866; [2002] STC 1036, [35] and [38].

<sup>13</sup> Case C-62/00 [2003] QB 866; [2002] STC 1036, [33] and [47].

<sup>14</sup> *Marks and Spencer v Customs and Excise Commissioners* [2003] EWCA Civ 1448; [2004] STC 1.

<sup>15</sup> In relation to one of the cases, concerning overpaid VAT on teacakes, the case continues. Auld L.J. held that the principle laid down by the ECJ was not applicable to the teacakes. The case has been referred by the House of Lords to the ECJ. For more detail on this part of the claim see M. Chowdry, “Unjust Enrichment and Section 80(3) of the Value Added Tax Act 1994” [2004] BTR 620.

<sup>16</sup> *Fleming (t/a Bodycraft) v HMRC* [2006] EWCA Civ 70; [2006] STC 864.

<sup>17</sup> *Condé Nast Publications Ltd v HMRC* [2006] EWCA Civ 976; [2006] STC 1721; see also *Abercromby Motor Group Ltd v HMRC* [2005] UKVAT V19015; *National Galleries of Scotland v HMRC* [2005] UKVAT 19372; *London Institute (Now known as the University of the Arts, London) v HMRC* [2005] UKVAT 19362.

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### *HMRC's approach to overpaid output tax claims affected by the lack of a transitional period*

HMRC attempted to rectify the situation in relation to overpaid output tax through the introduction of two Business Briefs, which sought to put in place a transitional period so as to render the legislation compatible with Community law. Business Brief 22/02 was issued on August 5, 2002<sup>18</sup> and put in place a transitional period of three months. A period of three months was chosen further to the Advocate General's opinion in *Grundig Italiana SpA v Ministero delle Finanze*.<sup>19</sup> This was not a VAT case, but it provided useful guidance on the compatibility of retroactive time limits with EC law. The Advocate General considered the three month period allowed by the Italian legislation to be adequate, however the ECJ held that an "adequate" period must allow taxpayers who had a claim under the old law, and who would lose their claim under the new law, sufficient time to lodge their claim.<sup>20</sup> The minimum adequate transitional period when reducing a time limit from ten/five years to three years was said to be six months.<sup>21</sup> Therefore, Business Brief 27/02<sup>22</sup> was issued on October 7, 2002. This extended the transitional period to six months. The Briefs retrospectively put into place a transitional period during which certain claims could be brought under the old legislation. The period ran from December 4, 1996, the date on which the resolution introducing the three year limit was passed, until June 30, 1997, just over six months later. HMRC set out that taxpayers could only bring a claim under the Brief if they fell into one of three categories: (i) a claim had been made before June 30, 1997 but had been refused on the basis that it was outside the new three-year limitation period; (ii) a refund had been given for a claim brought before June 30, 1997, but sums refunded relating to tax paid more than three years before the claim had been clawed back by HMRC; (iii) it could be proved that, although no claim had been brought, an error was discovered before June 30, 1997. In all cases, the claim had to relate to VAT overpaid before December 4, 1996. Claims could be made from the date of the first Business Brief (August 2002) until June 30, 2003, in respect of this transitional period. Whether or not this is an acceptable approach or should be used in relation to Regulation 29(1A) will be discussed in more detail below.

### *Facts and discussions in the lower courts*

*Fleming* concerned a taxpayer who dealt in specialist cars, in particular Aston Martins. He brought a claim for the recovery of under-claimed input tax in October 2000 in relation to cars he had purchased in 1989–1990 but the claim was refused by HMRC as it was out of time according to Regulation 29(1A). *Condé Nast*<sup>23</sup> also concerned under-claimed input tax which HMRC refused to pay due to the claim being time barred. In this case the claim related to staff entertainment expenditure. A claim was brought in June 2003 for recovery of the input tax relating to periods from April 1973 to December 1996.

With regard to *Fleming*, at first HMRC contended that the claim was simply out of time as the three year cap should apply. As discussed, they eventually gave up this claim

<sup>18</sup> [2002] 33 STI 1148.

<sup>19</sup> Case C-255/00 *Grundig Italiana SpA v Ministero delle Finanze* Case C-255/00 [2002] ECR I-8003.

<sup>20</sup> Case C-255/00 *Grundig Italiana SpA* at [38].

<sup>21</sup> Case C-255/00 *Grundig Italiana SpA* at [40].

<sup>22</sup> [2002] 42 STI 1356.

<sup>23</sup> *Condé Nast Publications Ltd v HMRC* [2005] EWHC 1167; [2005] STC 1327 (Ch) (June 10, 2005).

but continued to refuse the claim on the basis that, even if a fictional transitional period should be read into the legislation to render it compatible with Community law, the claim had been made after this fictional reasonable transitional period. In relation to *Condé Nast* HMRC made a similar argument, but also claimed that, even if a transitional period were put into place, then the taxpayer would have to show both that he could have made a claim and he would have made a claim within this fictional transitional period.

*Earlier courts in Fleming and Condé Nast*

Fleming's case<sup>24</sup> began in the tribunal,<sup>25</sup> which confirmed that the three year cap could not be relied upon due to the principle laid down in *Marks and Spencer* (ECJ) that a transitional period should have been put in place.<sup>26</sup> However, the tribunal went on to consider whether or not HMRC was able to refuse the claim on other grounds. First, it held that it was reasonable to refuse a claim brought more than 10 years after the period to which the claim related. This ground is clearly not based in principle, and was not mentioned again in the higher courts. Second, even if a transitional period *had* been given from May 1, 1997, its view was that the claim was made after any such transitional period would have expired. It was said that legal certainty requires that finality should be achieved after a reasonable period of time.<sup>27</sup> The claim should have been brought within a reasonable time and could be refused because it was not brought in a timely manner.

In the High Court<sup>28</sup> Evans-Lombe J. also decided against the taxpayer, broadly on the tribunal's second ground, and that for the purposes of legal certainty there had to be a time when the privileged position of taxpayers in this category came to an end.<sup>29</sup> Therefore, where taxpayers had such claims, they had to be brought within a reasonable time of the new time limit being introduced. Three years and five months after the new limitation period was brought in was, in his view, too long a period.

The Court of Appeal overturned the decision of the High Court and allowed the taxpayer's appeal. On the facts, the appeal was allowed by all three judges, although they disagreed on the point of whether or not to read a transitional period into the legislation in order to render it compatible with Community law.

Arden L.J., in the minority, argued that a transitional period can be read in. She stated that it is the duty of the court to read something into the legislation if this is required for the purpose of giving effect to Community law.<sup>30</sup> However, on the facts, in her view the claim was brought within such a fictional transitional period.

In contrast, Ward and Hallett L.JJ. held that the legislation could not be saved by reading a transitional period in. Therefore, there should be no three year limitation on claims until Parliament steps in and introduces a transitional rule and, in the meantime, under-claimed input tax for periods dating from the conception of VAT in 1973 may be reclaimed. Ward L.J. simply stated that it is not possible to read in something which does

<sup>24</sup> For a full discussion of the case through the earlier courts see M. Chowdry, "Coulda Woulda Shoulda: Shortening Time Limits for the Recovery of Overpaid VAT" [2006] *EC Tax Review* 226.

<sup>25</sup> *Fleming (t/a Bodycraft) v HMRC* [2004] UK V18579 (April 23, 2004).

<sup>26</sup> [2004] UK V18579 at [12].

<sup>27</sup> [2004] UK V18579 at [14].

<sup>28</sup> *Fleming (t/a Bodycraft) v HMRC* [2005] EWHC 232 (Ch); [2005] STC 707 (Ch).

<sup>29</sup> *Fleming* [2005] EWHC 232; [2005] STC 707 (Ch) at [24].

<sup>30</sup> *Fleming (t/a Bodycraft) v HMRC* [2006] EWCA Civ 70; [2006] STC 864 at [42]–[44].

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not exist at all<sup>31</sup> and so the legislation could not be relied upon by the Commissioners. He made the forceful argument that if it were possible to read in a transitional period, *Marks and Spencer* (CA2)<sup>32</sup> would have been decided differently. The Court of Appeal in that case could have read in a transitional period further to the ECJ's pronouncement that such a period was necessary.<sup>33</sup> The fact that no transitional period was read in with regard to the restriction on output tax claims also means that no transitional period can be read in with regard to input tax claims, as the two situations are indistinguishable.<sup>34</sup> Hallett L.J. agreed with this argument.

Following the judgment, HMRC issued Business Brief 13/06 which allowed taxpayers to bring claims further to the Court of Appeal's decision in *Fleming*, subject to the condition that if the House of Lords overturned the decision, they would have to repay the money.<sup>35</sup>

Condé Nast's case came through the courts behind *Fleming*, so much of the discussion involved an analysis of the judgments mentioned above—it was only in the House of Lords that the cases were heard together. The additional issue involved in this case, however, was whether HMRC are entitled to require a taxpayer bringing a claim to show that he both could and would have brought a claim if a transitional period had been in place at the time. This is the approach that HMRC have taken in the Business Briefs referred to earlier.<sup>36</sup> Warren J. discussed this issue in some detail in *Condé Nast*<sup>37</sup> although the point was obiter as the case had been decided on another basis. He stated that such a requirement could not be imposed on taxpayers—it was necessary to protect the right to claim if it existed before the new law was put into place. There was nothing to show that the ECJ would permit an extra requirement to show that the taxpayer would have brought a claim. Not only does the requirement have practical problems but it does not accord with Community law. Chadwick L.J.<sup>38</sup> in the Court of Appeal<sup>39</sup> approved of this reasoning. However, again the case was decided on a different basis. It was held by Chadwick L.J. in a judgment with which Arden and Smith L.JJ. agreed, that the court was bound to follow the Court of Appeal decision in *Fleming* and thus the three year cap could not be applied. However, it was added obiter that the reasoning of Arden L.J. in *Fleming* was preferred so that, had they been able to follow it, they also would have held that a transitional period could be read into the legislation.

<sup>31</sup> *Fleming* [2006] EWCA Civ 70; [2006] STC 864 at [80]. In fact, Ward L.J. also doubted if a longer transitional period could be read in where a shorter one was provided for in the legislation.

<sup>32</sup> *Marks and Spencer* [2003] EWCA Civ 1448; [2004] STC 1.

<sup>33</sup> *Fleming* [2006] EWCA Civ 70; [2006] STC 864 at [80].

<sup>34</sup> *Fleming* [2006] EWCA Civ 70; [2006] STC 864 at [75].

<sup>35</sup> Business Brief 13/06: 25 August 2006

<sup>36</sup> A decision to refer a question on this issue was taken in *EMI Group Plc v Revenue and Customs* [2006] UKVAT 19417 (Jan 8, 2006). However, the tribunal has reversed its decision to refer questions on this issue in *EMI Group plc v Revenue & Customs* [2007] UKVAT V20211 (June 27, 2007) on the basis that timing questions have been adequately resolved by *Marks and Spencer* (CA2) and *Fleming* (CA). The tribunal also mentioned that the issue was likely to be further clarified by the House of Lords in *Fleming*. Unfortunately, the issue in relation to whether or not the Business Briefs are an adequate remedy has certainly not been resolved and the issue will now have to come through the courts again.

<sup>37</sup> *Condé Nast Publications Ltd v HMRC* [2005] EWHC 1167; [2005] STC 1327.

<sup>38</sup> *Condé Nast Publications Ltd v HMRC* [2006] EWCA Civ 976; [2006] STC 1721 at [49]–[50].

<sup>39</sup> *Condé Nast* [2006] EWCA Civ 976; [2006] STC 1721.



*Issues before the House of Lords*

By the time the cases reached the House of Lords it was clear that they dealt with similar issues and so the decision was taken to consider them together. The issues before the House of Lords were:

1. Given that Regulation 29(1A) is not compatible with Community law, what steps should the courts take in relation to claims brought where Community rights have been affected?
  - (a) Can the courts disapply the legislation?
  - (b) If so, for how long can they disapply the legislation?
  - (c) If the courts cannot set an end to the period for disapplication, then should Parliament set such a period or can HMRC set such a period through a mechanism such as the Business Briefs?
2. If HMRC have to allow claims for some period to those whose Community law rights were affected, can they limit claims by requiring taxpayers to show that they could and would have brought a claim?

On a first reading of the judgments, their Lordships seem, basically, to be in agreement. However, on closer inspection a number of different views appear and the judgment as a whole is far from clear. What *is* clear is that all of their Lordships found for Fleming so the appeal by HMRC was dismissed. In relation to *Condé Nast*, by a majority their Lordships found for the taxpayer whilst also dismissing the appeal of HMRC. Lord Walker in the minority would have allowed HMRC's appeal.

*Issue 2—can HMRC require a taxpayer to show he could and would have made a claim?*

The easiest point to deal with is in fact the second issue before their Lordships. Only Lord Walker and Lord Neuberger touched on this point, giving the longest and most comprehensive judgments. Lord Hope, Lord Scott and Lord Carswell all agreed with either Lord Walker or Lord Neuberger. On the issue of whether or not HMRC can impose the requirement that a taxpayer must show that he could and would have brought a claim had a transitional period been put into place at the time, their Lordships spoke with one voice. Lord Walker stated that such a requirement is both administratively unworkable and contrary to legal certainty.<sup>40</sup> Lord Neuberger explained a little more fully that the requirement that the taxpayer could have claimed is unnecessary since it is already a requirement that the taxpayer have an accrued right, which was affected by the shortening of the time limit. Therefore, only those who could have brought a claim before the new limitation period was introduced are at issue in any case. He also agreed that the requirement that the taxpayer would have brought a claim cannot be used by HMRC. Not only is it administratively unworkable, but it also ignores the Community requirement that all those whose rights have been affected must be given a remedy.<sup>41</sup> This is a welcome confirmation of the fact that having breached Community law by putting the time limit in place, HMRC should not be able to go against the principle of effectiveness and make it excessively difficult for taxpayers to bring claims by adding further requirements to such a claim.

<sup>40</sup> *Fleming (t/a Bodycraft) v HMRC* [2008] UKHL 2; [2008] STC 324 at [64].

<sup>41</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [97].

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### *Issue 1a—can the courts disapply the legislation?*

All of their Lordships agreed that it was the responsibility of the courts to disapply legislation that was incompatible with Community law. However, they were not united as to how this should be implemented, and as will be seen, issues 1(b) and 1(c) caused more difficulty.

### *Issue 1b—for how long can the courts disapply offending legislation?*

Various options were put before the court relating to the period of disapplication.<sup>42</sup> The court must disapply the offending legislation in order to comply with the Community law principle of effectiveness. To reiterate, this is the principle that Member States must “not render virtually impossible or excessively difficult the exercise of rights conferred by Community law.”<sup>43</sup> Therefore, HMRC contended that the disapplication should only take place for the period necessary for the principle of effectiveness to be protected.

HMRC, on the basis of *Grundig* discussed below, contended as their primary argument (Analysis A) that the period of disapplication should run only from the date of the change in the law (in this case May 1, 1997) for six months.<sup>44</sup> Analysis B was that the period should run for six months after the date that the reasonable taxpayer should have appreciated that a transitional period should have been provided in the legislation (and thus the taxpayer’s claim was not barred by the fact legislation was in place).<sup>45</sup> Three alternatives were given for the date from which this period could commence: the date of the ECJ’s judgment in *Marks and Spencer*, the first Business Brief, or the second Business Brief. A final alternative (analysis C) was that the period of disapplication should continue until primary or secondary legislation or a formal announcement introduced an adequate claim period.<sup>46</sup>

The majority of their Lordships refused to read a transitional period into the legislation in this case, with only Lord Walker supporting such a possibility. Much of the discussion on this issue turned on the interpretation of the ECJ case of *Grundig*, [41].<sup>47</sup> Here, the ECJ observed that the principle of effectiveness meant that a retroactive limitation period need only be disappplied to the extent that the period was in breach of the principle of effectiveness. Their Lordships discussed at length whether or not this meant that a transitional period could be read into the legislation so that the retrospective limitation period could apply after the period of an adequate transitional period had passed.

Lord Walker accepted that the court was able to disapply the offending legislation, but only for the period during which the principle of effectiveness was offended. He also accepted the view that it was the responsibility of the domestic court to decide on the length of this period. He suggested that there was a need to find a balance between the rights of the taxpayer and the need of the state to plan its expenditure and protect against

<sup>42</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 per Lord Walker at [49]–[52].

<sup>43</sup> Case C-228/96 *Aprile Srl v Amministrazione delle Finanze dello Stato* [1998] ECR I-7141 at [18]; *Dilexport Srl v Amministrazione delle Finanze dello Stato* [1999] ECR I-579 at [25]; Joined Cases C-397/98 and C-410/98 *Metallgesellschaft v IR Comrs* [2001] STC 452 at [85].

<sup>44</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [50]–[51].

<sup>45</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [51].

<sup>46</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [52].

<sup>47</sup> Case C-255/00 *Grundig Italiana SpA v Ministero delle Finanze* [2002] ECR I-8003.

disruption of finances.<sup>48</sup> Thus, where there was a minor or inadvertent infringement by a Member State, there was every reason to consider the importance of security of public receipts. Accordingly, he decided that the House of Lords should imply a period of disapplication for Regulation 29(1A). He rejected the notion that this should be ongoing as per analysis C, as this would be to go beyond the requirement of effectiveness.<sup>49</sup> He also rejected analysis A (disapplication for six months from the date of the introduction of the limitation) on the basis that taxpayers could not have known their rights until the judgment of *Marks and Spencer* (ECJ) as it was only after this time that it was confirmed that a transitional period should have been introduced when making the retrospective change in the law. However, Lord Walker found analysis B to be persuasive. Whilst well-informed taxpayers would have known by the end of 1999 that Marks and Spencer were questioning the validity of the limitation period, not all taxpayers fell into this category and thus it was necessary to give taxpayers six months from the date of the judgment in *Marks and Spencer* (ECJ) to bring their claims. This gave a final date of January 11, 2003.<sup>50</sup> Hence, as Mr Fleming made his claim before this (October 2000) his claim should be successful, but because Condé Nast's claim was made after this date (June 2003) the claim should be time barred.

This analysis essentially reads a transitional period into the legislation. This is problematic for a number of reasons, which are to some extent drawn out in the other judgments, none of which are entirely on all fours with the conclusions of Lord Walker even though they agree with the result in relation to *Fleming*.<sup>51</sup>

The other substantial judgment was given by Lord Neuberger. He agreed with Lord Walker that the principle of effectiveness implied that the court could *potentially* set a period for disapplication of the legislation<sup>52</sup> but decided that this was not such a case. Here, the principle of legal certainty would not be protected by an implied transitional period because the transitional period could not begin from the date the legislation was brought into force: taxpayers would not have any way of knowing at the time that they could still have brought a claim.<sup>53</sup> The legislation expressly stated that they could not.

<sup>48</sup> His reasons for this were, in part, based on the comments of Advocate General Jacobs in Case C-188/95 *Fantask A/S v Industriministeriet (Erhvervsministeriet)* [1997] ECR I-6783. Note however that Lord Neuberger disagreed with his analysis: see [92].

<sup>49</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [66].

<sup>50</sup> Lord Neuberger did not decide the case on this point, but indicated that six months may not be enough. He stated that the six-month period set out in *Grundig* was merely guidance and this case concerned an unlimited period being shortened (meaning that claims relating to VAT paid from its inception 24 years previous could be brought), which may necessitate a longer transitional period. *Fleming* [2008] UKHL 2; [2008] STC 324 at [87].

<sup>51</sup> This is subject to one possible exception. Lord Carswell states clearly at [74] that he agrees with the reasoning and conclusions of Lord Walker in relation to *Fleming*. However, he goes on to agree in relation to *Condé Nast* with Lord Hope and Lord Neuberger and he states at [77] that he would apply their reasoning to both appeals. The reasoning of Lord Hope and Lord Neuberger are quite different to Lord Walker's, as will be discussed below, and the result he comes to for the *Condé Nast* appeal is a logical progression of his decision on *Fleming*. Thus it is difficult to see how it is possible for Lord Carswell to agree with both and so it is unclear whether or not, or to what extent, Lord Carswell's judgment should be given weight.

<sup>52</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [80] making reference to Case C-255/00 *Grundig Italiana SpA v Ministero delle Finanze* [2002] ECR I-8003.

<sup>53</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [85] and [86].

Lord Neuberger decided that a transitional period had to be fixed in advance,<sup>54</sup> because this is the logical progression of the fact that a time limit itself must be fixed in advance, as stated in *Marks and Spencer* (ECJ).<sup>55</sup>

Lord Neuberger's view that in *some* circumstances a court may imply a transitional period is difficult to justify. First, if a transitional period must be fixed in advance, how can it ever be implied by the court? Is this not actually another argument in favour of saying that the court should never read one in. Secondly, the overriding principle of importance is that of effectiveness of protection of the rights of taxpayers. It is difficult to see when the rights of taxpayers would be protected by the court reading in a transitional period. If there is legislation in place which specifically prevents the taxpayer from bringing a claim, then a taxpayer cannot know that he is entitled to bring such a claim. Thus, as long as the legislation is in place, the principle of effectiveness is offended. The mere decision of a court that, after a certain period,<sup>56</sup> it is acceptable to apply rules against the interests of those with accrued rights at the date of the change in law does not protect the principle of effectiveness. Those who had a claim (but did not bring it) are still not able to bring a fresh claim as they would be out of time. This also offends the principle of legal certainty.

The issue as to whether the courts may *ever* introduce a transitional period, or whether they should have done so in the circumstances of this case makes no difference to the decision under consideration, but the difference is important. The lower courts should have clear guidance on how to protect the rights of taxpayers where legislation is clearly in breach of their rights. To leave the possibility of reading in a transitional period by the courts, as suggested by Lord Neuberger, is dangerous as it has a large impact on the rights of taxpayers and yet it does not comply with the principles of effectiveness and legal certainty. In the view of the writer, Lord Neuberger should have made it clearer that the courts are not at liberty to take such a bold step. The writer is more inclined to agree with the judgments of both Lord Hope and Lord Scott,<sup>57</sup> although these are somewhat clouded by the statements of each that they agree with Lord Neuberger.

Further comment may be made on Lord Neuberger's judgment, and this is on his view of the Court of Appeal's decision. He considered that the Court of Appeal wrongly decided that the court could not put in place a transitional period because they had incorrectly assumed that the situation in this case (where no transitional period was put in place by the legislature) was different to the situation in *Grundig* (where a transitional period had been put in place but which was inadequate to protect rights).

In response to Lord Neuberger's views on this aspect of the Court of Appeal's decision, two points can be made. First, with respect, the Court of Appeal in *Fleming* did not hinge its decision *only* on this issue but had also relied on the *Marks and Spencer* (CA2) point, referred to earlier.<sup>58</sup> Secondly, it is not entirely clear that the Court of Appeal considered a difference between the situation with Regulation 29(1A) and *Grundig* as critical to their

<sup>54</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [88].

<sup>55</sup> Case C-62/00 *Marks and Spencer plc v Customs and Excise Commissioners* [2003] QB 866; [2002] STC 1036 at [39].

<sup>56</sup> Which must have expired before the decision of the court, otherwise the claim would be allowed.

<sup>57</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [10]–[12] and [22].

<sup>58</sup> The fact that *Marks and Spencer* (CA2) did not make mention of the possibility of reading in a transitional period was also relevant. This point is unassailable—if the Court of Appeal in *Marks and Spencer* did not see the possibility of reading in a transitional period, then the Court of Appeal in *Fleming*, rightly, did not see fit to do so.

analysis: Ward LJ, giving the leading judgment, only mentions this possibility as a final dismissal of HMRC's argument.<sup>59</sup> A more important component to his decision was that he considered it difficult to read paragraph 41 as enabling a court to imply a transitional period because it is difficult to construe something out of nothing. It might possibly be easier to construe something out of an inadequate transitional period, but that was not at issue in the case.

*Issue 1c—Should the Commissioners be able to set an end to the period of disapplication or is this a matter for Parliament?*

The final question is, how should the period of disapplication be brought to an end? As discussed above, the majority held that it was not for the courts to set a date for this, but there was some controversy over the appropriate method of bringing the period to an end. Lord Neuberger, with the agreement of Lord Hope,<sup>60</sup> supported the possibility of HMRC making a statement which could put in place a prospective transitional period, as long as the statement was clear and adequately distributed amongst taxpayers.<sup>61</sup> He considered such a statement to be a viable alternative to legislation because all that Community law demands is that there is a proper transitional period and that it is properly communicated. In this vein he contended that it was doubtful that the two Business Briefs issued to put in place a transitional period for VATA 1994 s.80(4) were sufficiently distributed amongst taxpayers.<sup>62</sup> He found support for this proposition in *Stichting Goed Wonen v Staatssecretaris von Financiën*<sup>63</sup> where it was stated that in a case involving legitimate expectations, procedures for dissemination of information normally used by the Member State must be taken into consideration.

Lord Scott clearly and succinctly rejected the possibility of HMRC dealing with this issue on the basis that only Parliament could put in place a prospective transitional period in order to accord with Community law. He contended that the Commissioners have powers to issue Business Briefs under their management powers, but these powers did not extend to amending legislation.<sup>64</sup> Furthermore, he relied on the statement in *EC Commission v United Kingdom*<sup>65</sup> that, where national legislation is incompatible with Community law provisions, the situation can only be rectified through national provisions of a binding nature which have the same legal force as those being amended.<sup>66</sup> Here the legislation is contrary to Community law and thus legislation must be put in place to remedy the situation. It is interesting to note the comments of Lord Neuberger on this case. He contended that *EC Commission v United Kingdom* was not applicable here<sup>67</sup> as it involved the situation in which a Member State had failed to give effect to a Directive, whereas the present case involved a lack of compliance with procedural requirements of

<sup>59</sup> *Fleming* [2006] EWCA Civ 70; [2006] STC 864 at [78].

<sup>60</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [12].

<sup>61</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [104]–[107].

<sup>62</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [107].

<sup>63</sup> Case C-376/02 *Stichting Goed Wonen v Staatssecretaris von Financiën* [2006] STC 833 where it was stated that in a case involving legitimate expectations, procedures for dissemination of information normally used by the member state must be taken into consideration.

<sup>64</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [20].

<sup>65</sup> Case C-33/03 *EC Commission v United Kingdom* [2005] STC 582.

<sup>66</sup> *EC Commission v United Kingdom* [2005] STC 582 at [25].

<sup>67</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [105].

Community law. With respect, it is not clear that the distinction between the cases is relevant. The ECJ in *EC Commission* stated that legislation was necessary because this was the only way to protect rights which would otherwise be infringed by the action of the Member State. It is the only equivalent remedy to the original flawed legislation. To hold otherwise would be to undermine the rights of taxpayers and whether those rights stem from a Directive or from the general principles of Community law is irrelevant.

Further, the principle relied upon by Lord Neuberger from *Stichting Goed Wonen*, that national practice be taken into account, is not relevant in this case. The issue in *Stichting* was quite different—it concerned the question of whether legislation could have retroactive effect from the time at which a communication was made to taxpayers. The ECJ confirmed that it could, as long as legitimate expectations were protected. In *Stichting*, there was no offending legislation in place. In the present case, there is offending legislation in place. Where there is legislation in place expressly preventing a claim, the concept of legal certainty cannot be protected by just a statement from the executive to say a claim can actually be allowed despite the legislation. It is for this reason that *EC Commission v United Kingdom* held that equivalent measures are needed. New legislation is the only way to protect legal certainty.

So, in summary, how did the judges in the House of Lords line up on the question of whether the introduction of a transitional period should be the job of HMRC or the legislature? Lord Neuberger and Lord Hope support the view that this may be competently seen to by HMRC. Lord Scott thinks legislation is necessary. Lord Walker did not express an opinion on this as he decided that the courts should be able to decide upon the transitional period. The only indication we have is that he did not look favourably upon the Business Briefs due to his statement that they were “ill advised”.<sup>68</sup> Finally, we have Lord Carswell, who seems to give Lords Hope and Neuberger a majority on this, but his judgment does not seem adequately considered.<sup>69</sup> Thus it is difficult to find a definitive answer on whether or not HMRC can rectify the situation. In any case, the discussion on the point is *obiter* in the House of Lords, as the case was decided on the basis that the courts, at least in this case, were not able to read in a transitional period.

The safest and most legally sound route for HMRC would be for them to seek the introduction of prospective legislation. The existing Business Briefs suffer from many more problems than those given by Lord Neuberger<sup>70</sup> and the arguments in favour of legislation are forceful, as explored above. Therefore, legislation is clearly needed to rectify Regulation 29(1A).


It also suggests that something must be done about VATA section 80(4), which continues to rely on Business Briefs, criticised by Lord Neuberger. As mentioned above, Lord Walker also indicated that they were ill advised. Furthermore, the Business Brief put in place further to the Court of Appeal’s judgment in this case merely stated that claims would be allowed subject to the House of Lords’ decision and gave an administrative method of doing this. No time limit was set out, presumably because HMRC intended to wait and see what would happen in the House of Lords. Whilst this statement is an aid to

<sup>68</sup> *Fleming* [2008] UKHL 2; [2008] STC 324 at [69].

<sup>69</sup> See n.51.

<sup>70</sup> For more detail see M. Chowdry “How long can section 80 last? *Marks & Spencer Plc v Commissioners of Customs and Excise (No.5)*” [2004] BTR 106; M. Chowdry, “Coulda Woulda Shoulda: Shortening Time Limits for the Recovery of Overpaid VAT” [2006] *EC Tax Review* 226.

taxpayers, it cannot be seen as an alternative to legislation which would allow claims to be brought during a prospective transitional period.

As a final point, Parliament has also introduced other time limits retrospectively<sup>71</sup> without a transitional period. Whilst these deal with direct taxes, the same general Community law principles of effectiveness and legal certainty apply to them and so these provisions are also in breach of Community law.<sup>72</sup> The legislature needs to take urgent action by putting in place comprehensive and clear prospective legislation in relation to all these provisions. This will not only protect the rights of taxpayers, but will also protect HMRC from further attack from taxpayers through the courts and, hence, will ultimately protect revenues for the Government. 

MONICA BHANDARI \*

***JD Wetherspoon Plc v HMRC: machinery and plant capital allowances under review***

THE decision in *JD Wetherspoon Plc v HMRC*,<sup>1</sup> published in December 2007, relates to an appeal in connection with the tax return for the company's accounting year to July 31, 1999. It is surprising that such a fundamental issue as the scope of the term "plant" should be so unclear as to engender an uncertainty which was not resolved eight or nine years after the expenditure concerned was incurred. Nor, one suspects, is it yet resolved, for key aspects of the decision are questionable and may be subject to appeal.

Any perceived imperfection in the decision may in large part be due to the fact that the time set aside for the hearing, as agreed between the parties, proved to be wholly inadequate. In dispute was the tax treatment of more than 120 items of expenditure, and the Commissioners acknowledged that "the case involved a mass of detail most of which was not covered in the time which the parties had agreed for the hearing."


The decision focused on example pub premises in Cardiff (converted from a theatre) and Cosham (converted from two high street shops). In the inadequate time available the Commissioners decided to address points of principle, using only a limited number of disputed items as examples to illustrate their reasoning, and giving the parties a year to sort out the rest. In this case, they addressed three issues:

- (1) whether certain fixtures were plant and machinery;
- (2) the meaning and scope of section 66 Capital Allowances Act (CAA) 1990<sup>2</sup> dealing with expenditure on alterations to an existing building incidental to the installation of plant and machinery; and
- (3) whether and how the project "on costs" of preliminaries and professional fees could be allocated to the cost of plant and machinery.

<sup>71</sup> Finance Act 2004, ss.320 and 321; Finance Act 2007 s.107.

<sup>72</sup> For more detail relating to Finance Act 2004 s.320 see M. Chowdry, "The Revenue's Response: A Time Bar on Claims" (2005) 121 L.Q.R. 546; for more detail relating to Finance Act 2007 s.107 see M. Chowdry, "Limitation period in old actions for mistake of law relating to direct tax—section 107" [2007] B.T.R. 577.

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 EC law; Input tax; Repayments; Time limits; VAT

<sup>1</sup> *JD Wetherspoon Plc v HMRC* SpC 657; [2008] SWTI 139.

<sup>2</sup> Now Capital Allowances Act 2001 s.25.

## BRITISH TAX REVIEW

### *Plant or premises?*

The first issue was in essence a reconsideration of the so-called “premises test”, that is to say, whether an asset can properly be regarded as part of the “premises” and, if so, whether that precludes the asset from qualifying as plant for capital allowances purposes. The basic principle is that if an asset is part of the “premises” *in which* the trade is carried on it generally cannot be plant (except in some exceptional circumstances, as outlined below). However, if it is not premises it may function as “apparatus” *with which* the trade is carried on, which is plant.

The Commissioners took just one asset of the many in dispute, and sought to use it to illustrate the impact of applying general principles. In the circumstances, this was the only practical approach. The asset chosen was timber panelling fixed to the walls and used by the taxpayer to create a richer and more inviting atmosphere than traditional painted or papered walls, or to put it in terms of the well-known case *IRC v Scottish & Newcastle Breweries Ltd*,<sup>3</sup> to create an “ambience”. In that case, it was claimed successfully that one element of the company’s trade was the provision of a certain type of atmosphere, or ambience, conducive to providing comfort and attracting custom. Consequently allowances were given in respect of certain fixtures used to create this “ambience”, such as decor, murals and sculptures. This treatment is only permissible, however, where part of the trade is the creation of “ambience”—the same assets in an office, rather than a bar or restaurant, would not be plant. This is now made clear by the exemption from the term “building” of “decorative assets provided for the enjoyment of the public in hotel, restaurant or similar trades”.<sup>4</sup>

The Commissioners in *Wetherspoon* referred to *Scottish & Newcastle*, and accepted “that the panelling was an embellishment to create ambience”,<sup>5</sup> but then appear to have failed to consider fully how the courts have interpreted the term “premises”.

In *Scottish and Newcastle*, Lord Lowry expressed the following view:

“something which becomes part of the premises, instead of merely embellishing them, is not plant, except in the rare case where the premises are themselves plant, like the dry dock in *Barclay Curle* or the grain silo in *Schofield v. Hall*.”<sup>6</sup>

Subsequently, this was interpreted by Glidewell L.J. in *Wimpy International v Warland*<sup>7</sup> as follows:

“when Lord Lowry [in *Scottish & Newcastle*] referred to ‘something which becomes part of the premises’, he cannot have meant simply something which is affixed to the premises. He must have been expressing in other words the point made by Oliver L.J. in *Cole Brothers v Phillips* about something which ‘performs’... *simply and solely* the function of housing the business’.” (Emphasis added.)

So, having clearly accepted that the panelling did *not* “*simply and solely*” perform the function of housing the business (because they had already acknowledged that it created ambience), the Commissioners should have been bound to accept the decision of the

<sup>3</sup> *IRC v Scottish & Newcastle Breweries Ltd* [1982] STC 296.

<sup>4</sup> CAA 2001, s.23, list C, item 14.

<sup>5</sup> At [59].

<sup>6</sup> *IRC v Scottish & Newcastle Breweries Ltd* [1982] STC 296.

<sup>7</sup> *Wimpy International v Warland* [1989] STC 273.



higher courts, and find that the panelling was *not* premises, and therefore *not* barred from being plant. This they did not do, and thus appear to have erred in point of law.

Furthermore, whilst acknowledging that an asset could be both plant and premises in rare cases, (following Lord Lowry's statement, above), the Commissioners merely concluded that "This, of course, is not one of those rare cases."<sup>8</sup> It would have been helpful for them to have been explicit in their reasons for this, and to have identified what they regarded the rare cases to be. Were they simply cases in their "active premises" category, such as the dry dock, or are they perhaps wider?

The Commissioners did recognise, following Hoffmann J. in *Wimpy*, that the key issue was whether it was "more appropriate" to regard the panels as part of the premises, rather than having retained a separate identity. However, their decision was flawed at the outset by their failure to adequately consider what was meant by the term "premises", as discussed above.

They then ran through the four "considerations" (not to be regarded as separate tests) set out by Hoffmann J. in *Wimpy* as follows:

- (1) whether the disputed item appears visually to retain a separate identity;
- (2) the degree of permanence with which it has been attached;
- (3) the incompleteness of the structure without it; and
- (4) the extent to which it was intended to be permanent or whether it was likely to be replaced within a relatively short period.

The Commissioners' conclusion on each of these considerations was as follows:

- (1) The panelling "did appear visually to retain a separate identity";
- (2) The panelling was:  

"clearly capable of being removed; indeed similar panelling had been removed . . . and reused. There is no reason to believe that removal . . . would cause more than surface damage to the plaster";
- (3) "The structure of the rooms was clearly not incomplete without the paneling" (that is, the structure was complete without the panelling); and
- (4) "The panelling was not likely to be removed after only a short period".

The first three of these conclusions point to the panelling not being premises. So at that point it would seem "more appropriate" on balance to regard the panelling as having retained a separate identity, rather than as being part of the premises, following Hoffmann J.'s principles. The fourth finding seems to be based on surmisal rather than evidence (at least, none is referred to in the published decision). It is in any case probably a misunderstanding of what Hoffmann J.'s fourth consideration intended. It has never been considered that an asset failed to be regarded as plant simply because it had a relatively lengthy period of use. Case law has always been clear on the point. Indeed the *locus classicus* for plant, *Yarmouth v France*,<sup>9</sup> established that plant included "whatever apparatus is used by a businessman for carrying on his business . . . which he keeps for *permanent* employment in his business." (emphasis added)

<sup>8</sup> At [67].

<sup>9</sup> *Yarmouth v France* (1887) 19 QBD 647.

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By way of illustration, a dry dock in *IRC v Barclay Curle & Co Ltd*<sup>10</sup> was held to be plant despite the fact that it was agreed it might last for 80 to 100 years. Against this background, the most logical interpretation of Hoffmann J.'s fourth consideration is that it aimed simply to suggest that a relatively short period of use would indicate that an asset has *prima facie* not become part of the premises. A longer period of use would not, of itself, necessarily indicate the contrary.

The Hoffmann "tests" clearly point to the panelling having retained a separate identity, and therefore *not* being part of the premises. And although the Commissioners correctly recognised that Hoffmann J. did not intend his "considerations" to be exclusive of any others, they nonetheless appear to have erred in law by ignoring this result and inventing a new test of their own. This test was whether the panels were "an unexceptional component which would not be an unusual feature of premises of [this] type".<sup>11</sup> In other words, if it is not unusual to find wall panelling in pubs, they must be part of the premises. This test appears only in the Commissioners' published decision. It was not put forward by the taxpayer or HMRC and was therefore not debated.

Quite apart from what is meant by the terms "unexceptional" and "not unusual", this "test" would appear to be wholly inappropriate. It is intended to set forth a general principle which may be applied to any fixture in order to determine whether or not it may be regarded as plant. However, among the fixed assets which are "unexceptional component[s] which would not be an unusual feature of premises of [this] type" would be heating systems and sanitary ware, not to mention bar counters, and carpets—by this test, they would all be part of the premises and would not qualify as plant. The same would apply to a lift in an office building. And yet all these assets are accepted as plant; indeed proposed changes to the capital allowances legislation from April 2008 will put this on a statutory basis for assets such as electrics, central heating and lifts. Put another way, when applied to many common assets, the test gives results which are unequivocally wrong. One assumes the taxpayer will appeal.

### *Alterations incidental to the installation of plant and machinery*

The second matter under consideration related to the meaning of section 66 CAA 1990 (now s.25 CAA 2001), which deals with building alterations to an existing building incidental to the installation of plant and machinery. Both in its present form and under earlier Acts, this phrase has been open to differing interpretations. The narrow definition (generally argued by HMRC) is that the word "incidental" should be interpreted as relating to the actual physical act of installation; the wider definition is that the alterations must merely be consequential, or related to that installation.

This provision was introduced in the Income Tax Act 1945 and statements made by Ministers at the time in Parliament make clear that it was aimed at works such as modernising hotels, which required the installation of hot and cold water, bathrooms, lifts, and air conditioning, etc. The provision was intended to allow incidental works to qualify, such as partitioning larger rooms to install bathrooms, or fitting double glazed windows to make air conditioning effective. The intention was therefore for the legislation to apply extremely widely. However, Hansard was not considered by the Commissioners. There is

<sup>10</sup> *IRC v Barclay Curle & Co Ltd* [1969] 1 All ER 732.

<sup>11</sup> At [64].

of course an issue of whether recourse should be made to Hansard under *Pepper v Hart*<sup>12</sup> when the matter is one of open-endedness of a concept rather than actual ambiguity (in the sense of two opposing meanings).

In *Barclay Curle* Lord Reid said in the House of Lords when considering section 300 ICTA 1952 (the predecessor to the legislation under consideration):

“‘Incidental’ is a wider word than necessary . . . it may be that the exigencies of the trade require that, when new machinery or plant is installed in existing buildings, more shall be done than mere installation in order that the new machinery or plant may serve its proper purpose. Where that is the case this section enables the cost of the additional alterations to be included.”

The Commissioners in *Wetherspoon* considered the example of wipe-clean wall tiling in a kitchen, which the taxpayer argued was required due to hygiene requirements arising from the volume of grease laden steam, etc. produced by cookers, but which the Commissioners held did not have a sufficient *nexus* with the installation of those cookers. A cooker could be used perfectly well (that is, “serve its proper purpose”, in the words of Lord Reid) without the tiling.

The other assets looked at were foul drainage (which was held to be obviously plant due to the substantial capacity required—just like the cold water tanks and pipework that were held to qualify in *Wimpy*) and toilet cubicles. It has long been a source of disbelief and some humour that HMRC believed surrounding partitions or cubicles were not required for toilets to serve their proper purpose. The Commissioners on this occasion found that the erection of cubicles was incidental to the installation of plant. It is perhaps a matter of degree—without tiles in the kitchen, the cookers might still have been used, whereas without cubicles, the toilets would probably have been unusable. It is not wholly clear, however, that the precepts of *Barclay Curle* regarding the “exigencies of the trade” were considered by the Commissioners and this remains a grey area.

#### *Preliminaries and professional fees*

HMRC’s Valuation Office Agency has for many years sought arbitrarily to disallow a significant proportion (typically 50 per cent) of building contractor’s preliminaries (e.g. site management and accommodation, security or plant hire, etc.) and professional consultants’ fees (e.g. architect or quantity surveyor), before any allocation to the constituent parts of a project, including plant—the so-called “Newstead formula”. Such an approach has no basis in law. Consequently, where the taxpayer took specialist advice, HMRC’s approach was generally disputed and a compromise reached. However, there was, of course, always a risk that smaller taxpayers in particular would not have access to specialist advice and would simply accept the disallowance.

The Commissioners here recommended an eminently sensible approach. Where items claimed as preliminaries or fees may be properly apportioned or attributed to a qualifying or non-qualifying asset, they are part of the cost of that item. Any allocation should be as accurate as possible, but where, as in this case, there are many preliminary costs, a pro-rata apportionment between building and plant is reasonable in principle.

<sup>12</sup> *Pepper v Hart* 65 TC 421; [1992] STC 898, HL.

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### *Summary*

The question of expenditure “incidental to the installation of plant” was decided largely, but not entirely, in favour of HMRC. Although to allow the expenditure only where the relationship between the expenditure and the installation of plant is sufficiently close is not an unreasonable approach, the problem is that this is a question of degree and consequently a large area of uncertainty remains. Furthermore, given the clear ambiguity involved (which it is understood HMRC was keen to deny to avoid *Pepper v Hart* applying to allow *Hansard* to be used as an aid to the construction of the legislation) it is to be hoped that any appeal would consider more fully the original intention and scope of the legislation, as shown by *Hansard*. That would seem to offer a much more liberal interpretation of the term “incidental”.

On preliminaries, although the decision will be a blow to HMRC, it appears reasonable and one would hope mark the end of HMRC routinely seeking arbitrarily to disallow a substantial proportion of such costs.

Whilst the Commissioners are to be applauded for the way they dealt with the alterations and preliminaries, in contrast, on the “premises test”, it is difficult to conclude other than that they reached the wrong decision as a result of erring in law. This was largely due to not attaching sufficient importance to a key comment in *Wimpy* that “when Lord Lowry referred to ‘something which becomes part of the premises’, he . . . must have been expressing in other words the point made by Oliver L.J. in *Cole Brothers v Phillips* about something which ‘performs *simply and solely* the function of housing the business’.”

The resultant misunderstanding of the term “premises” meant that the Commissioners’ deliberations were inherently flawed. Furthermore, having answered the appropriate questions from case law (which in this case, clearly suggested that timber panelling was not premises), they ignored those answers and substituted instead a wholly inappropriate test of their own design, one which when applied to other assets, gives answers which are not only unexpected, but which are at variance with statute. One has every sympathy for the Commissioners, who appear to have been given wholly inadequate time for dealing with such complex issues. Nonetheless, this part of the decision, fails to apply House of Lords and Court of Appeal decisions. Presumably neither party will be wholly satisfied with the decision, and one suspects an appeal (or two) is inevitable. <sup>(LT)</sup>

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<sup>(LT)</sup> Capital allowances; Fixtures; Plants and Machinery; Pubs and bars

# A GAAR for the United Kingdom? The Australian Experience

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## Abstract

*This article contains an examination of the experience which Australia has had with its general anti-avoidance rule (GAAR) with a view to providing a more informed view in the United Kingdom about the impact which the introduction of such a rule might have in the United Kingdom. The Australian experience has shown that a purposive interpretation of the substantive (or specific) provisions of the income tax legislation has not been successful in controlling tax avoidance. It has also shown that success in controlling tax avoidance is dependent both on the content of such a rule and the interpretative approach which the courts adopt to such a rule. To be successful the GAAR should be targeted in its focus and not drawn in language which is too broad or generalised. The effectiveness of the signposting which emanates from a consideration of the content is largely dependent on the philosophical approach of the judiciary to tax avoidance generally.*

## Introduction

AT the dawn of the post-*Barclays Mercantile*<sup>1</sup> era Lord Hoffmann, in an article which appeared earlier in this *Review*, sought to provide assurance that under the new purposive approach to the interpretation of tax statutes, tax avoidance<sup>2</sup> should be a thing of the past. If Parliament intends a tax to be imposed, Lord Hoffmann considers that “the courts should be trusted to give effect to its intentions. Any other approach will lead us into dangerous and unpredictable territory.”<sup>3</sup> But a purposive approach to the interpretation of tax statutes is not an approach that sits comfortably with the literal approach which has prevailed in the United Kingdom for so long. If regard is had to the development of the law, which has been undertaken in order to deal with contrived tax avoidance transactions since the House of Lords decided *WT Ramsay Ltd v IRC*<sup>4</sup> over 25 years ago, it is readily apparent that the task has been difficult and there is no reason to suppose that a new, untried approach will be any easier. Furthermore, it will take time for any significant guidance to emerge regarding the application of the new regime.

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<sup>1</sup> *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51; [2005] 1 AC 684.

<sup>2</sup> In the context in which Lord Hoffmann used that expression and in this article, tax avoidance should be taken to include the structuring of transactions to attract tax deductions, as well as to avoid tax.

<sup>3</sup> L. Hoffmann, “Tax Avoidance” [2005] BTR 197 at 206.

<sup>4</sup> *WT Ramsay Ltd v IRC* [1982] AC 300.

Since a new interpretative approach is to be adopted, it may be timely to reconsider the possibility of adopting a GAAR as a means of achieving the clarity and predictability which taxpayers need more quickly. Professor Judith Freedman has argued for such a rule,<sup>5</sup> not because it would provide certainty—recognising that certainty is probably not achievable, or necessarily always desirable—but because a GAAR would provide a definitive statutory overlay to the provisions of the tax legislation: this would provide an identifiable framework for developing the principles by which the provision would be applied. This argument is nonetheless valid now, than it was under the former interpretative regime. But there is an additional reason: purposive interpretation, left to its own devices, may not prove to be capable of controlling tax avoidance.

A number of jurisdictions<sup>6</sup> have had experience with a GAAR and have utilised it to control tax avoidance, which even a legislatively mandated purposive approach to the interpretation of income tax statutes has failed to do. Australia is one of these and it is proposed to outline the experience that Australia has had with its purposive approach and GAAR, with a view to illuminating how that experience might inform the UK debate on the desirability, or otherwise, of adopting a GAAR. The Australian experience in relation to its GAAR may also be of assistance in informing the current debate on the UK's disclosure provisions and its targeted anti-avoidance rules (effectively miniature GAARs).

### Interpreting purposively

The Australian courts are required to apply a purposive approach to the interpretation of all Commonwealth government statutes and income tax statutes are Commonwealth statutes.<sup>7</sup> This has been a statutory requirement since 1981. To assist in this approach Australian courts may have regard to extrinsic aids to the interpretation of statutes.<sup>8</sup> This material includes speeches made to Parliament by the Minister introducing a Bill for the second time, Explanatory Memoranda relating to the Bill and Law Reform Commission Reports laid before Parliament prior to the enactment of the Bill. Such material may be considered wherever it would assist in ascertaining the meaning of a statutory provision and the purpose of the enactment, where the meaning is not clear. Notwithstanding this statutory directive, there is little evidence of a sufficiently robust substantive approach to undertake a consideration of the underlying objectives of the legislation. The approach is still closely allied with a literal, rather than a substantive approach, even in the face of legislation which specifically provides for a substantive approach to be adopted, or requires a result based on economic equivalence.<sup>9</sup> Likewise, extrinsic material is rarely referred to overtly. In keeping with tradition, the assessment of what taxpayers have done is form-based, since this is understandably seen by the courts as providing the best approach in ascertaining what they did, or purported to do. Sometimes an assessment is made about whether the legal obligations so revealed are consistent with what is perceived to be the

<sup>5</sup> J. Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] BTR 332.

<sup>6</sup> These include Canada, New Zealand, Australia and South Africa.

<sup>7</sup> Acts Interpretation Act 1901 (Cth), s.15AA; approach adopted in *Cooper Brookes (Wollongong) Pty Ltd v FCT* (1981) 147 CLR 297 at 320 & 323; confirmed in *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408.

<sup>8</sup> Acts Interpretation Act 1901 (Cth), s.15AB.

<sup>9</sup> *FCT v Radilo Enterprises Pty Ltd* (1997) 34 ATR 635.

substance of the transaction.<sup>10</sup> The concept of a sham has little place in Australian tax law, because it is confined to transactions where the parties never intended the agreement in question “to be operative according to its tenor at all, but was meant to cloak another and different transaction.”<sup>11</sup> It is rare for taxpayers in Australia to attempt to create a fiction to camouflage another transaction. So, overall, legal form prevails. As a consequence, even though it may theoretically be possible to control tax avoidance through a statutorily mandated purposive interpretative approach, it has not been achieved, largely because the courts have been reluctant to do so. This has meant that more and more reliance has been placed on the GAAR by the Commissioner of Taxation (Commissioner) to ensure that taxpayers shoulder what he considers their fair share of the tax burden to be.

The shortcomings of the purposive approach adopted in Australia in dealing with transactions structured to capture deductions, and, the importance of the GAAR in shoring up the Income Tax Assessment Act 1936 (ITAA 1936) and the Income Tax Assessment Act 1997 (ITAA 1997) against such arrangements are illustrated by *Federal Commissioner of Taxation (FCT) v Hart*,<sup>12</sup> the latest income tax deduction case to go to the High Court of Australia.<sup>13</sup> *Hart*’s case involved a claim to deduct an unpaid interest expense as an allowance in the calculation of the taxpayer’s assessable income.

In Australia, expenses are deductible if they are:

- incurred in deriving assessable income; or
- necessarily incurred in carrying on a business for the purpose of deriving assessable income.

It is not possible to deduct expenses of a capital, private or domestic nature.<sup>14</sup>

<sup>10</sup> *FCT v Firth* (2002) 192 ALR 542.

<sup>11</sup> Jordan C.J., *Perpetual Trustee Co Ltd v Bligh* [1941] 41 SR (NSW) 33, 39; for a similar view in a tax avoidance context see Dawson J., *FCT v Gulland* (1985) 160 CLR 55, 105.

<sup>12</sup> *FCT v Hart* (2004) 55 ATR 712.

<sup>13</sup> Appeals by taxpayers who pay income tax in Australia against an assessment for tax made by the Commissioner are heard in the Administrative Appeals Tribunal. Appeals from decisions of the Tribunal are heard by way of rehearing by a single judge of the Federal Court. The Federal Court has jurisdiction to determine matters concerning Commonwealth Law and tax on income is now a matter solely for the Commonwealth of Australia. Appeals lie from there to the Full Court of the Federal Court by way of rehearing, but on the same evidence which was before the first instance Federal Court. The Full Federal Court consists of three federal court judges. An appeal may be taken from a decision of the Full Federal Court to the High Court of Australia only on a matter of law and only with the leave of the High Court. The High Court is the court of ultimate appeal—akin to the House of Lords. There is no longer any entitlement to appeal to the Privy Council against a decision of the High Court. The Full Court of the High Court on tax matters consists of five justices. On constitutional matters it is seven justices. Prior to the Second World War, when the states had jurisdiction in tax matters, it was possible to appeal from the State Supreme Court on tax matters to a single judge of the High Court and then to a Full Court of three or possibly five justices, but the states no longer exercise the constitutional right to levy income taxes.

<sup>14</sup> ITAA 1997, s.8(1). This legislation both supplements and amends the ITAA 1936, which is the principal income tax act. In Australia, income tax is levied on a taxpayer’s taxable income, which is the total income from all sources, less expenses and allowances. Expenses may be deducted from the taxpayer’s income generally, not just the income in respect of which the expenses were incurred, or activities of a similar class or category. This system applies to both corporate and unincorporated taxpayers, other than taxpayers exempt from tax.

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Expenses satisfy this test if they are used for producing assessable income, or if none is produced, are used in what would have been expected to produce assessable income.<sup>15</sup> Deductibility is determined through a characterisation test based on the use to which the funds are put, or the function of the expenditure.<sup>16</sup>

In *Hart's* case the taxpayer had entered into a loan to assist in the acquisition of a residence and an investment property. The loan provided for the complete repayment of the principal amount during its term. The loan documentation contained two facilities—one which related to the residential loan—the other which related to the investment loan. Interest was payable rateably in respect of both facilities, unless the taxpayer elected to utilise an option conferred by the loan, called a wealth optimiser option, which enabled the taxpayer to elect to apply all payments due under the loan to repaying the home loan first. In that event interest payments due on the investment loan were capitalised. In Australia, no part of the interest on a loan raised to purchase a residence, in which the taxpayer lives, is deductible for tax purposes. The taxpayer elected to utilise this option and as a result unpaid interest on that part of the loan utilised to acquire the investment property was capitalised, together with compound interest on that capitalised interest. A claim was made to deduct this capitalised and compound interest, but the Commissioner disallowed it. In other words the Commissioner disallowed what would ordinarily have been a deductible expense and for the reason that the capitalised and compound interest expense was, in substance, of a private nature and therefore not deductible for tax purposes. In Australia, the fact that interest has not been paid is irrelevant to the issue of deductibility. Interest is deductible so long as it is payable, which it was in relation to the investment property. A single judge of the Federal Court, decided that the capitalised and compound interest was payable pursuant to legally binding contractual arrangements and arose in respect of funds that were utilised in the production of an income earning activity. As a consequence the expense had the character of an expense which was deductible for tax purposes.<sup>17</sup> This decision on deductibility was upheld by the Full Federal Court on appeal.<sup>18</sup> It was specifically argued by the Commissioner that the compound interest was just a device utilised by the taxpayer for the purpose of obtaining a larger tax deduction. This argument was rejected by the Full Federal Court on the basis that subjective purpose was generally irrelevant to the question of deductibility. Even if the dominant purpose of the taxpayer was to obtain the deduction, the test to deal with such situations was whether the outgoing was reasonably capable of being seen as desirable, or appropriate, from the point of view of the pursuit of business ends.<sup>19</sup> Here it was. Only if no other purpose could be identified would the deduction be denied. The issue of deductibility was not considered when the case went to the High Court.

The wealth optimiser product was so successful in Australia that the Commissioner took the view that it represented a threat to the revenue. Accordingly, he had also argued—as is customary in deduction cases—that if the expense were held to be deductible under the rules relating to deductibility, then it was denied by the GAAR. The single judge of the

<sup>15</sup> *Ronpibon Tin NL & Tongkah Compound NL v FCT* (1949) 78 CLR 47 at 56.

<sup>16</sup> *Hart v FCT* (2002) 50 ATR 369 at 376 (Hill J.); M. Cashmere, *Tax and Corporate Finance into the new Millennium* (CCH, Sydney, 1999) at 8–33.

<sup>17</sup> *Hart v FCT* (2001) 48 ATR 317.

<sup>18</sup> *Hart v FCT* (2002) 50 ATR 369.

<sup>19</sup> *Magna Alloys & Research Pty Ltd v FCT* (1980) 11 ATR 276 at 297.



Federal Court held that the GAAR did apply. This decision was reversed on appeal by the Full Federal Court, but reinstated by the High Court.

This case illustrates how a purposive approach to the deductibility of expenses may be incapable of denying deductibility for expenses incurred in transactions specifically structured to gain the deduction and how the GAAR effectively redresses that shortcoming. The reason is that the interpretative rules which have been developed make it difficult to deny interest deductions where the funds are used to produce assessable income.

### Legislative history

Australia's first Commonwealth income tax legislation was the Income Tax Assessment Act 1915: section 53 of that legislation contained a GAAR (adopted from a similar provision which applied in New Zealand). In substantially the same form it became section 260 of ITAA 1936. In 1981, section 260 was replaced by a division of the same Act, which is known throughout Australia as Part IVA and is found in sections 177A–177F of the ITAA 1936. Recent research has traced that development.<sup>20</sup>

Content is critically important to the application of a GAAR and it is proposed to examine the content of both section 260 and Part IVA, and, the interpretative approach which has been taken in relation to that content, with a view to exposing the difficulties which have been encountered in dealing with what the legislation has provided.

### Content of section 260

Section 260 of the ITAA 1936 provided that every contract or arrangement which had, or purported to have, the purpose or effect of directly or indirectly:

- altering the incidence of tax;
- relieving any person from liability to pay tax; or
- defeating, evading or avoiding any liability imposed on any person by the ITAA 1936, was absolutely void as against the Commissioner.<sup>21</sup>

It can be seen that while this provision provided a statutory overlay to the ITAA 1936, it was drawn in very broad and comprehensive terms: so broad, in fact, that it had the potential to annihilate any transaction which had any tax consequences. For transactions to fall within its purview, it was not necessary for any purpose to avoid tax to exist. A transaction only had to have the effect of relieving a person of a liability to pay tax, or altering the incidence of tax. However, from the outset, the courts did not regard the

<sup>20</sup> P.A. Harris, "The English origins of the Australian Anti-avoidance Rule—Parts 1 and 11" (2007) 61 *Bulletin for International Taxation* 65 and 109.

<sup>21</sup> This could be seen as an early example of principles-based drafting. The proposal for such a drafting style in tax legislation appears to have been abandoned in Australia. The exposure draft of the second and third tranches of the Taxation of Financial Arrangements legislation was originally drafted in this way. Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006 was intended to be the trailblazer for the new approach. The final version, introduced to parliament as Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007, just before the general election in November 2007, was drafted in normal legal style.

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content of this provision as having the all-encompassing impact which it purported to have.<sup>22</sup>

The first case involving the Australian Commonwealth GAAR reached the High Court of Australia in 1921. The case, *DCT v Purcell*,<sup>23</sup> considered section 53 of ITAA 1915, the similarly worded predecessor of section 260. What emerged from this case was a recognition that the GAAR did not apply to all transactions which had tax consequences. In this case a taxpayer, who owned property, had declared himself to be a trustee of it for others and in referring to the impact of the GAAR on that transaction, the Chief Justice of the High Court, Sir Adrian Knox said:

“The section if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer; but in my opinion its provisions are intended to and do extend to cover cases in which the transactions in question, if recognized as valid, would enable the taxpayer to avoid payment of income tax on what is really and in truth his income. It does not extend to the case of a bona fide disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other taxpayer.”<sup>24</sup>

That view was endorsed by the Full High Court.<sup>25</sup> So, the declaration of trust was not held to have altered the incidence of tax. Instead, it was held that the tax liability fell on the new owner as trustee, just as the statutory provision intended it to do.

Following this case it was assumed that the GAAR did not affect transfers of income-producing property. That remained perceived wisdom for 40 years until *Hancock v FCT*<sup>26</sup> came before the High Court. There the High Court was also faced with a transfer of income-producing property—in this case cum-dividend shares. To assist a major shareholder to acquire the balance of the shares which it did not own in a company, a share-trader acquired all of the shares in the company and then transferred them to the major shareholder at a significant discount, having in the interim received a large dividend, which effectively paid out all of the company’s accumulated profit. On this arrangement the share-trader paid virtually no tax, since the assessable dividend was offset by the loss suffered on the sale of the shares. As a consequence the Commissioner had effectively financed the take-over. It was accepted that the motive of the major shareholder in this transaction was to acquire all the shares in the company, not to avoid tax. The issue was whether the assessment for tax against the major shareholder, on the dividend declared on the shares it originally held, was sustainable. That assessment was upheld on the basis that section 260 applied wherever an arrangement had not only the effect, but also the purpose

<sup>22</sup> I.C.F. Spry, *Section 260 of the Income Tax Assessment Act* (2nd ed., LBC, Sydney, 1977); N. Orow, *General Anti-Avoidance Rules—a comparative international analysis* (Jordan Publishing, UK, 2000); Sir Ivor Richardson, “Reducing Tax Avoidance by Changing Structures, Processes and Drafting” and J. Waincymer, “The Australian Tax Avoidance Experience and Responses” in G.S. Cooper (ed.), *Tax Avoidance and the Rule of Law* (IBFD Publications BV, Amsterdam in co-operation with the Australian Tax Research Foundation, 1997) at 327 and 247 respectively; P. Harris, “Australia’s General Anti-Avoidance Rule” [1998] BTR 124.

<sup>23</sup> *DCT v Purcell* (1921) 29 CLR 464.

<sup>24</sup> *DCT v Purcell* (1921) 29 CLR 464 at 466.

<sup>25</sup> *DCT v Purcell* (1921) 29 CLR 464 at 470.

<sup>26</sup> *Hancock v FCT* (1961) 108 CLR 258.

of achieving any of the results enumerated in the section and, here, the requisite purpose was manifest. The purpose which was relevant to section 260 was not the taxpayer's motivation, but an objective purpose, discerned from the terms of the arrangement, or from the acts by which it was implemented. In effect, the statutory purpose was the result which was aimed at, determined from an objective assessment of the facts: its effect was the result achieved.

Once purpose became a relevant consideration, the test for differentiating between those arrangements which had the requisite purpose and effect of contravening section 260 and those which did not, came to be expressed by the predication test. This emerged from the Privy Council decision in *Newton v FCT*<sup>27</sup>—on appeal from Australia—where Lord Denning, delivering the opinion of the Privy Council, said:

“In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.”<sup>28</sup>

The question for this test was whether the arrangement must necessarily be labelled as a means of avoiding tax. The avoidance of tax did not need to be the sole purpose of the arrangement, or even the principal reason. But, it had to be more than an incidental reason, or inessential purpose.

The predication test was often applied, but it did not prove to be universally applicable. Arrangements which were not capable of explanation by reference to ordinary business or family dealing, but which were obviously designed to reduce tax, were still held not to contravene section 260. This resulted from the dilemma presented by the framework of the substantive provisions of the ITAA 1936 itself.

It was obvious that the ITAA 1936 contained many provisions which affected what was brought within the taxpayer's assessable income, or increased allowable deductions. These provisions could not be ignored without destroying the benefits which they conferred. It therefore became necessary for an approach to be adopted to allow such specific or particular provisions to prevail over section 260, which was of a general nature. So what came to be known as the choice principle emerged. This recognised that a taxpayer may choose to take alternatives available to him under the ITAA 1936, because section 260 had no application in such circumstances.

The rationale behind the principle was explained by Mason J. in *Cridland v FCT*,<sup>29</sup> in the following terms:

“...it proceeds on the footing that the taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes specific provision and the validity of the transaction is not affected by s260 merely because the tax consequences which it attracts are advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage.”<sup>30</sup>

<sup>27</sup> *Newton v FCT* (1958) 98 CLR 1.

<sup>28</sup> *Newton v FCT* (1958) 98 CLR 1 at 8.

<sup>29</sup> *Cridland v FCT* (1977) 140 CLR 330.

<sup>30</sup> *Cridland v FCT* (1977) 140 CLR 330 at 339.

But as this explanation recognises, the choice principle operated only so as to enable specific provisions, or concessions of the ITAA 1936, to have what was regarded as their intended effect.

The choice principle emerged at much the same time as the predication test and was founded on the rule of interpretation—*generalia specialibus non derogant* (general powers do not derogate from specific powers). But later—particularly during the period 1964–81, when Sir Garfield Barwick was the Chief Justice of the High Court—it developed into an over-riding principle, whereby a taxpayer could adopt almost any course of action to attract an advantageous tax position and have that accepted as falling outside the scope of section 260, notwithstanding that the course of action was contrived and deliberately undertaken to obtain the perceived advantage. This extension of the original principle is apparent in the judgment of Barwick C.J. in *Slutzkin v FCT*,<sup>31</sup> a case which was before the High Court in 1977, where the Chief Justice formulated the new approach in the following way:

“...the choice of the form of transaction by which a taxpayer obtains the benefit of his assets is a matter for him: he is quite entitled to choose that form of transaction which will not subject him to tax, or subject him only to less tax than some other form of transaction might do. *IRC v Duke of Westminster* [1936] AC 1, too easily forgotten, is still basic in this area of the law. There is no room in that area for any doctrine of economic equivalence. To the legal form and consequence of the taxpayer's transaction, which in fact has taken place, effect must be given: see *IRC(NZ) v Europa Oil (NZ) Ltd.* (1976) 1 All ER 503.”<sup>32</sup>

These words were carefully chosen to express the new approach: that steps taken to bring about any legal state of affairs, in order to attract a benefit afforded by the ITAA 1936, could not attract section 260, regardless of whether any legislative intent could be discerned in the ITAA 1936 to give the taxpayer a specific choice between alternatives. It was a general choice of form to which effect had to be given. The adoption of any form, however contrived or artificial, to achieve a tax advantage, did not establish any purpose or effect described in section 260. Instead, any assessment on that contrived state of affairs would reflect the proper incidence of tax which the legislature intended. *Slutzkin* was not a decision of the Full High Court, but the approach manifest in this case was confirmed immediately afterwards in *Cridland*, by a Full High Court.

The adoption of a choice principle expressed in such terms did not sit easily with the predication test. This was recognised in *Cridland*.<sup>33</sup> There, it was acknowledged, that in the face of the extended choice principle, *Newton's* case had little authority. *Newton's* case was to be explained on the basis of a finding of fact. Nor did it sit comfortably with section 260 itself. If adopting a contrived or artificial course of action, which produced a result which lay outside the scope of the ITAA 1936 did not alter the incidence of tax, or defeat a liability to tax, or indeed, prevent the operation of the ITAA 1936, this effectively deprived section 260 of most of its effect. This was even conceded by an acknowledgment on the part of the High Court in *Cridland* that as a consequence of the

<sup>31</sup> *Slutzkin v FCT* (1977) 140 CLR 314.

<sup>32</sup> *Slutzkin v FCT* (1977) 140 CLR 314 at 319.

<sup>33</sup> *Cridland v FCT* (1977) 140 CLR 330 at 334 (Mason J. (Barwick C.J., Stephen, Jacobs and Aickin JJ. agreeing)).

adoption of the extended choice principle, section 260 was effectively confined to cases where the impugned transaction was to be seen as merely “cloaking” some antecedent or actual transaction, or state of affairs, between the parties, for which the transaction under attack was substituted, in order to obtain the benefit of the particular provision in the ITAA 1936.<sup>34</sup>

There was a further problem with section 260: the provision simply made the impugned transaction void against the Commissioner. It did not permit the Commissioner to substitute a new and hypothetical set of facts in its place on which tax could be levied, and so taxpayers often escaped liability to tax on contrived transactions which contravened section 260, because of this difficulty. In *Europa Oil (NZ) Ltd v IRC* Lord Diplock observed:

“...it is not a charging provision; all it does is to enable the Commissioner when assessing the liability of the taxpayer to income tax to treat any conduct, agreement or arrangement which falls within the description in the section as if it had never been made. Any liability of the taxpayer to pay income tax must be found elsewhere in the Act. There must be some identifiable income of the taxpayer which would have been liable to tax if none of the contracts, agreements or arrangements avoided by the section had been made.”<sup>35</sup>

So when section 260 annihilated a transaction, the taxpayer would be liable to tax only if the actual facts then left exposed were such as to render the taxpayer liable. Determining the situation which was left after section 260 had done its work was notoriously difficult, since it had no existence in law or fact. However, if a taxpayer had been in receipt of assessable income from a particular source and he would have continued to receive it, but for the effect of the impugned arrangement, the taxpayer would have been assessed to tax on the basis that he would have continued to receive the income from that source. But section 260 did not strike at new sources of income, or restrict a taxpayer from parting with a source of income, whatever these concepts were regarded as being.

The extension of the choice principle, championed by Sir Garfield Barwick, ushered in a regime of optional tax for those who were able to exploit the system. But as tax avoidance schemes proliferated, so did public criticism. Questions were raised as to why recommendations on redrafting section 260 made in 1975 by the Asprey Committee, established by the Federal Government to report on reforming the Australian taxation system, had not been adopted. The press began to rail against the conservative government of the day for its inaction in dealing with a gross abuse of the tax system. Strident criticism—indeed scorn—was openly directed at the High Court and that reached fever pitch when it was revealed in the press that documentation relating to fashionable dividend stripping schemes, which had served their purpose, was being dumped at the bottom of Sydney Harbour, to ensure that the Commissioner would be frustrated in any later action taken against those involved in them. A scandalised nation was only placated when, in 1981, the government finally announced it would introduce new anti-avoidance measures to close the existing loopholes. The new measure was what has become known as Part IVA of the ITAA 1936.

<sup>34</sup> *Cridland v FCT* (1977) 140 CLR 330 at 339.

<sup>35</sup> *Europa Oil (NZ) Ltd v IRC* (1976) 1 All ER 503 at 511.

## Reform

What the government set out to do with the new measure was remedy the structural problems which had been exposed in section 260 and restore the interpretative approach to the GAAR to something akin to what it had been understood to be, when Lord Denning expounded the predication test.<sup>36</sup>

The main structural problem with the content of section 260 was seen as being that it contained too many broad and uncertain terms such as “altering the incidence of tax” and “defeating, evading or avoiding any liability imposed on any person by the Act.” These broad general terms were replaced with a clear definition of what tax advantages were to be targeted by the new measure. They were deductions made against assessable income, which might reasonably have been expected not to be allowable in the absence of the new measure, and income items, which might reasonably have been expected to have been included in assessable income, but were not.

The absence of power vested in the Commissioner, or the courts, to reconstruct the factual position after the transaction had been avoided was overcome by giving authority to the Commissioner to disallow a disputed deduction, thereby increasing the taxpayer’s assessable income, and, to include any omitted income in the taxpayer’s assessable income, thereby increasing that income.

The government was also concerned about ascertaining the purpose of the taxpayer’s actions more accurately. Under section 260 purpose had to be determined only from an examination of the effect of the arrangement. But the new measure contemplated that purpose would be ascertained objectively, not just from an examination of the transaction itself, but also its surrounding circumstances and practical results.

But the government was even more specific about its intentions in relation to the new measure. In the second reading speech to the Bill, which introduced Part IVA and in the Explanatory Memorandum which accompanied the Bill, it was said that the new measure was aimed at transactions which, in the language of political or social debate, were artificial, blatant and contrived or of a paper nature. Normal business or family arrangements were expressed to be beyond its scope. The second reading speech also indicated that the government had considered enacting the *Newton* predication test and specifically providing that the new provision was inapplicable to ordinary business and family dealings. It was, however, decided to adopt the new measure as a better way of controlling blatant, contrived or artificial transactions and on the basis that, in any event, it best encapsulated the view of the Privy Council in *Newton*. Strangely, there was no specific mention in either place of the position which the choice principle was to have under the new measure. It was simply stated that the new measure was to have paramount force in income tax law.

In view of the fact that the extrinsic aids, which courts may take into account when interpreting statutes purposively, state it was Parliament’s intention to re-instate Lord Denning’s predication test as the approach for applying Part IVA, it might have been anticipated that this would have become the interpretative cornerstone of dealing with the new measure. To the contrary: the approach taken by the High Court in relation to the new measure is untrammelled by any imprint of the approach which was taken in relation to its predecessor.

<sup>36</sup> Explanatory Memorandum to the Income Tax Laws Amendment Bill (No.2) 1981 and the second reading speech of the then Federal Treasurer, Mr John Howard MP.

This first became apparent in *FCT v Spotless Services Ltd*.<sup>37</sup> In this case counsel had argued, in line with the dictum of Lord Tomlin in *IRC v Duke of Westminster*,<sup>38</sup> that every taxpayer was entitled to order his affairs so that the applicable tax was less than it would otherwise have been.<sup>39</sup> That approach was rejected by the High Court as having no application to the new regime. The Court rejected the *Newton* predication test in the following way:

“... reference[...] . . . on the one hand to a “rational commercial decision” and on the other hand to the obtaining of a tax benefit as ‘the dominant purpose of the taxpayer in making the investment’ suggest the acceptance of a false dichotomy. . . . A particular course of action may be . . . both ‘tax driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a ‘scheme’ for the ‘dominant purpose’ of enabling the taxpayer to obtain a ‘tax benefit’.”<sup>40</sup>

This statement makes it clear that the new measure is not another incarnation of the old rule. The fact that there is a sound commercial reason for the transaction will no longer justify the transaction and ensure that the tax advantage is seen as incidental to the commercial objective. In taking this approach the court effectively ignored the statement of objective which Parliament had expressed in the Explanatory Memorandum and what had been said during the second reading speech when Part IVA was first introduced to Parliament. Parliament intended that the new measure would return the interpretative approach to something akin to the position as it was understood to be when Lord Denning propounded the predication test and before the disastrous extension of the choice principle. Those sources also make it clear that arrangements of a normal business or family kind, including those of a tax planning nature, were beyond the scope of Part IVA. In propounding an approach which took no account of Parliament’s express intention, the court sidelined the concept of purposive interpretation for Part IVA.

What appears to have happened is that the courts have perceived the content of the new measure as having some independent coherence which can be applied to all commercial transactions, without the need to resort to secondary evidence regarding Parliament’s intention. Furthermore, there seems to be an assumption that the new measure can be applied in some manner which enables the courts to distinguish between those transactions which they regard as inappropriate and those which are not. To date the High Court, in particular, has not provided clear principles by which this task may be undertaken. As a consequence Part IVA is applied on a case-by-case basis, on what appear to be policy grounds. But what has emerged is clear evidence that Part IVA is not confined to avoiding transactions which are artificial, blatant or contrived. Instead, with the new power that Part IVA has provided, the Commissioner is attacking transactions which are not straightforward, and even transactions which have been regarded as commonplace in the commercial world for decades.<sup>41</sup>

<sup>37</sup> *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

<sup>38</sup> *IRC v Duke of Westminster* [1936] AC 1.

<sup>39</sup> *IRC v Duke of Westminster* [1936] AC 1 at 19.

<sup>40</sup> *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at 415.

<sup>41</sup> Finance leases provide an example. *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497.

**Content of Part IVA<sup>42</sup>**

The structure of Part IVA is straightforward. It provides the Commissioner with a discretion to cancel any tax benefit which arises out of a scheme which he has identified, where there has been a dominant purpose on the part of someone connected with the scheme (who may or may not be the taxpayer) to obtain the tax benefit, and to assess the relevant taxpayer for tax on the basis of the situation which would have existed, had there been no tax benefit obtained. Significant penalties apply if Part IVA is contravened. The content of this provision, while broad, is more targeted in its aim than its predecessor.

There are four component elements: a scheme, a tax benefit, the purpose of obtaining the tax benefit and the discretion which the Commissioner has to cancel the tax benefit.

A scheme is any course of action, whether consensual, or unilateral and includes inaction.<sup>43</sup>

A tax benefit is:

- an amount not included in the assessable income of the taxpayer where the amount would have been included, or might reasonably have been expected to be included, if the scheme had not been entered into; or
- a deduction claimed where the whole, or part of it, would not have been allowable, or might reasonably be expected not to have been allowable, if the scheme had not been entered into.<sup>44</sup>

The requisite purpose is that of someone connected with the scheme, who need not be the taxpayer, not the purpose of the scheme itself. So the purpose of the relevant taxpayer may be imputed. The dominant purpose is to be ascertained from a list of eight criteria specified in section 177D(b) of ITAA 1936. These are the manner in which the scheme was carried out, the form and substance of the scheme, the timing of the scheme, the result in relation to the operation of ITAA 1936 that would have prevailed had it not been for the scheme, any change in the taxpayer's financial position, or that of any other person connected with the scheme, any other consequences and the connection of the parties.

Part IVA is not self-activating. It does not come into play until the Commissioner makes a determination to take action to disregard the tax benefit, which he may or may not do. But where he does, there must be a scheme that captures a tax benefit and the requisite purpose must be manifest. While the component elements are inter-related, for clarity they will be examined separately.

*Scheme definition*

Notwithstanding that a scheme is defined so broadly as to encompass anything, the definition of the scheme by the Commissioner has become a key to the application of the new measure. It can be seen quite readily that as a scheme can be anything, the Commissioner could identify the scheme just as those facts by which the tax benefit is captured, because then it would be easy to show that the requisite purpose to obtain the identified tax benefit was satisfied. This is just what the Commissioner has done.

<sup>42</sup> ITAA 1936, ss.177A–177H.

<sup>43</sup> ITAA 1936, ss.177D and 177A(1).

<sup>44</sup> ITAA 1936, s.177C.



However, the High Court said in *FCT v Peabody*,<sup>45</sup> the first Part IVA case to go to the High Court, that while a scheme can be identified by the Commissioner broadly or narrowly, it cannot be defined so narrowly as to be incapable of standing on its own feet without “being robbed of all practical meaning.”<sup>46</sup> This approach has the ability to restrict the application of Part IVA, since it can constrain attempts by the Commissioner to define a scheme as just those facts which constitute the identified tax benefit. But the concept of a scheme which is capable of standing on its own feet without “being robbed of all practical meaning” has caused difficulty, because of its uncertainty.

However, this uncertainty was clarified recently by two justices of the High Court, Gleeson C.J. and McHugh J. in *Hart*’s case. In disallowing the claim to deduct the capitalised and compound interest, the Commissioner had identified the scheme as that part of the loan documentation which enabled the taxpayer to utilise the wealth optimiser option and his election to do so. Faced with this situation Gleeson C.J. and McHugh J. in a joint judgment made the point—which is correct as a matter of tax law—that a taxpayer is not entitled to a deduction for interest on a loan just for agreeing to a term in a loan, or giving a direction about the allocation of interest payments, or taking some steps to exercise rights conferred under the contract of loan. The judges then went on to pinpoint what the essential character of a scheme under Part IVA must be:

“The definition of ‘scheme’ in s177A is wide, but it must be related to the tax benefit obtained. The deduction here was for the incurring of a liability to pay interest on borrowed money. The tax benefit in connection with the relevant scheme was part of an allowable deduction for interest. This, it seems to us, is what was meant by references in the judgments in the [court below] to the scheme being capable of standing on its own feet. The judges were making the point, which is undoubtedly correct, that, where the tax benefit in question is part of an allowable deduction for interest, a search for the purpose of the scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation. In a given case, a wider or narrower approach may be taken to the identification of the scheme, but it cannot be an approach which divorces the scheme from the tax benefit.”<sup>47</sup>

Thus the scheme was seen as being the borrowing for the two purposes, one private one income producing, and having the wealth optimiser feature. In other words it was seen as being the loan in its commercial context.

What this establishes is the importance of the scheme definition to the tax benefit and the inter-connection between the two. In *Hart* the identified tax benefit was part of a deductible expense and it was said that in such a case the scheme must be identified by reference to the facts that give the whole expense the character of deductibility for tax purposes. But this raises the question of what facts give the character of deductibility to an expense? In Australia, deductibility is determined by reference to the use of the funds for the derivation of assessable income. Normally that connection can be made without difficulty because it is obvious. But sometimes (as with loan funds) the connection is

<sup>45</sup> *FCT v Peabody* (1994) 181 CLR 359.

<sup>46</sup> *FCT v Peabody* (1994) 181 CLR 359 at 384.

<sup>47</sup> *FCT v Hart* (2004) 55 ATR 712 at 716. Gleeson C.J. is understood to be one of those involved in drafting Pt IVA.

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less obvious and the courts then consider whether the outgoing was reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the enterprise and the derivation of assessable income. That inquiry does not require a tracing of funds. But it does require an assessment to be made of the various aspects of the circumstances, including the direct and indirect advantages which the taxpayer sought in making the outgoing. If the inquiry disclosed that there was never any likelihood of assessable income being derived, then the necessary connection would be absent and the deduction would be denied.<sup>48</sup>

It would follow that in relation to the drawing of Part IVA schemes, the scheme would need to be drawn by reference to sufficient facts to enable the connection to be made between the expense and the assessable income. That might require an inquiry into the application of the funds received, or the likelihood of the derivation of assessable income. Where this was perceived to be necessary the scheme would need to be drawn with sufficient breadth to encompass that factual matrix.

In *Hart* the judges also confirmed the view that the correct identification of the scheme is pivotal to the operation of Part IVA, since if it is not correctly identified, the Commissioner would not have exercised his statutory discretion to cancel the tax benefit legitimately.

The reason for this is that the scheme must properly identify the tax benefit. It cannot be identified in isolation. If the tax benefit is an expense, it cannot be divorced from those facts that give the expense the character of deductibility. Similarly, if the tax benefit is part of an expense, it cannot be divorced from the facts that give the whole expense the character of deductibility.

### *The tax benefit*

The next element is the tax benefit itself. In order to determine whether a tax benefit exists, a prediction needs to be made about whether, in the case of income amounts, the amount which was not included in the taxpayer's income would have been included (or might reasonably have been expected to have been included), if the scheme had not been entered into. Where deductions are claimed, a prediction needs to be made about whether the deduction would not have been allowable (or might reasonably have been expected not to have been allowable), if the scheme had not been entered into. This exercise requires a comparison between the tax advantage claimed pursuant to the scheme which the Commissioner has identified and the hypothetical position which would otherwise have pertained.

But to reach a conclusion about the existence of a tax benefit, there must be a reasonable expectation about what the situation would have been, if the relevant scheme had not been entered into. Furthermore, the prediction must be sufficiently reliable for it to be regarded as reasonable. The Commissioner cannot create a hypothetical situation based on speculation. The hypothetical position needs to be supported by the facts as established by the evidence.

The importance of the existence of a factual basis on which to make the prediction is illustrated by *Hart*. In that case, the Commissioner had determined that if the borrower had

<sup>48</sup> *Fletcher v FCT* (1991) 173 CLR 1; *Magna Alloys and Research Pty Ltd v FCT* (1960) 11 ATR 276; Hill J., *Hart v FCT* (2002) 50 ATR 369.

not utilised the wealth optimiser option available to him under the loan documentation, he would have made payments of principal and interest rateably in respect of both the residential and investment properties, as provided in the loan documentation. On the other hand, the taxpayer maintained that he would have funded the acquisition of the investment property with an interest only loan. The difference between the two views was that, on the view propounded by the taxpayer, the tax benefit would have been limited to the interest on the compounded interest—a relatively modest amount—whereas the tax benefit, on the view propounded by the Commissioner, was the whole of the capitalised interest and the compound interest on it. The taxpayer had led little, or no evidence on this issue, since once he had decided the wealth optimiser option suited his needs, other alternatives had little interest for him. This told against him. The Full Federal Court, on appeal, specifically addressed this difficulty and took the view that as there was insufficient evidence to enable a reasonable prediction on either alternative to be made with certainty, and as the first instance judge had accepted the Commissioner's view, which it was open to him to do, the tax benefit was what had been identified by the Commissioner. In other words, in the absence of evidence to the contrary, it was reasonable to expect that the taxpayer would have paid the interest in the manner provided for in the loan documentation, in default of utilising the wealth optimiser option.

Once the scheme has been identified and the tax benefit which it provided has been ascertained, then the inquiry must be made to ascertain whether the taxpayer's dominant purpose in entering into the scheme was to obtain the identified tax benefit. The way in which the scheme has been defined then effectively circumscribes the inquiry which needs to be made to determine the issue of purpose.

#### *The relevant purpose*

The fact that a tax benefit has been identified does not lead to a conclusion that a dominant tax purpose exists. This is apparent from the decision of the Full Federal Court in *FCT v Eastern Nitrogen Ltd.*<sup>49</sup> This case involved a finance lease. A company involved in manufacturing fertiliser had entered into a sale and lease-back arrangement with a bank in respect of its ammonia plant. The effect was to provide the taxpayer with greater deductions for the rent of the leased plant than there would have been, if the taxpayer had continued to pay interest on the short term finance it had used to finance its business, prior to entering into this arrangement. The arrangement also had the effect of providing the taxpayer with secure long term finance, so that it no longer had to rely on the vagaries of short term financing. The Commissioner identified part of the rent payment under this arrangement as being the tax benefit and cancelled it on the basis that the taxpayer's dominant purpose in entering into the scheme to sell the plant and lease it back was to obtain the additional tax deduction. In doing so he argued that the rent deductions were higher than interest on a loan for a similar principal amount, because they contained an amount representing the amortisation of the capital cost of the plant to the bank. It was accepted that the rental payments were higher, but the court held that the taxpayer's dominant purpose was to obtain access to longer term stable finance, not to obtain a tax benefit. Leave to appeal to the High Court was refused.

<sup>49</sup> *FCT v Eastern Nitrogen Ltd* (2001) 46 ATR 474.

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The pursuit of a better after-tax return may contravene Part IVA. This emerges from *Spotless*. In this case a company had taken money off deposit in Australia and deposited the funds at interest in the tax haven of the Cook Islands. The interest derived in the Cook Islands was less than the interest derived on the Australian deposit, but because the interest was taxed at a low rate there, and because at that time income which had been taxed overseas was exempt from tax in Australia, the net income available to the taxpayer was higher than if the funds had remained invested in Australia. In the Full Federal Court the taxpayer had been held to be entitled to make that choice in the pursuit of a better after-tax return, because of the specific provision in the ITAA 1936 which provided for it. The High Court reversed that decision on the basis that the dominant purpose in making that choice was to obtain the identified tax benefit. In other words there was no explanation for the action taken by the taxpayer, other than to secure the tax benefit.

The real issue is what more is required, than the identified tax benefit, before a dominant purpose to obtain the tax benefit is located. The statutory provision itself is not much assistance in this regard, as it just provides that a determination must be made from a consideration of the eight listed factors. In other words the result is achieved through the application of a formula.

The predication test used to be the litmus test for distinguishing between transactions which fell outside the GAAR and those which did not. But as indicated above, the High Court has made it clear that the presence of a rational commercial decision:

“does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out the scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit.”<sup>50</sup>

A particular course of action may be both tax driven and bear the character of a rational commercial decision or dealing.

But the predication test can no longer serve this function. The purpose must be determined by the application of the formula. The formula comprises eight factors and they alone must provide the outcome. Not one of those criteria concerns the intention of Parliament. Nor do the criteria refer to the concepts of artificiality, blatancy or contrivance. So the test in Australia is not about ascertaining what transactions Parliament intended to permit. Nor is it about artificiality or its related concepts. It may have been possible to read into the factors some consideration of artificiality from the secondary parliamentary sources, but since the High Court has effectively rejected that possibility, resort to the extrinsic aids is difficult to achieve legitimately, even if useful and desirable. Indeed, if the extrinsic aids had been admitted, the guidelines which are necessary may have emerged more readily.

Notwithstanding that the eight factors cannot by themselves provide an answer about whether tax is the dominant purpose, the High Court has provided no definitive guidance about how to determine whether a tax purpose in a rational commercial decision or dealing is, or is not, objectionable, although its decisions have been unanimous.

What have emerged, however, are some general observations. One of these is the acceptance of the truism stated by Harlan J. in *Commissioner of Internal Revenue v Brown* that:

<sup>50</sup> *FCT v Spotless Services Ltd* (1996) 186 CLR 404 at 416.

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“tax laws exist as an economic reality in the businessman’s world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.”<sup>51</sup>

Another is the Delphic statement of McHugh J. in *Spotless*, to the effect that a conclusion that Part IVA applies “will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayer.”<sup>52</sup> Yet another is the acceptance of an observation made in *Frank Lyon Co v United States*, that it is not possible to “ignore the reality that the tax laws affect the shape of nearly every business transaction”<sup>53</sup> and an acknowledgement that the adoption of one particular form over another, may legitimately be influenced by tax considerations.<sup>54</sup> These observations do not, however, provide any guidance about when the identified tax advantage in a commercial context is objectionable.

The reluctance of the High Court to come to grips with this issue is causing tension between it and the Full Federal Court. What is more, it is leading to diametrically opposed applications of Part IVA. On occasions the Full Federal Court has pointed to the extrinsic aids available in relation to Part IVA in order to give some focus to the inquiry which the court is required to undertake. But apart from referring to Parliament’s intention to counteract “artificial, blatant and contrived” transactions, there has been no overt attempt to make any connection between the eight statutory factors and the concepts of artificiality. To date the Full Federal Court has gone no further than trying to undertake the inquiry required by the eight statutory factors in the context of the commercial framework in which the transaction was undertaken. The point at issue is the extent to which the commercial objective of the taxpayer is relevant to a determination of the taxpayer’s dominant purpose. The Federal Court has applied the GAAR against the whole of the factual matrix, which includes the commercial objectives of the taxpayer. That enables the court to make an assessment of the importance of tax in the context of the commercial transaction and in that way make an assessment of whether tax was the prime driver in what the taxpayer did. The problem with this is that the commerciality of the transaction is not one of the eight statutory factors. While paying homage to that approach, the High Court has adopted a much narrower focus. The form and manner in which transactions have been carried out have become determinative of the outcome and this effectively denies the application of the general observations made by the High Court regarding the impact of tax on commercial transactions, which are referred to in the immediately preceding paragraph.

Under the statutory provision the purpose which is relevant to the inquiry is the dominant purpose of someone connected with the scheme. Once that has been ascertained, then it can be attributed to the relevant taxpayer, regardless of whether the relevant taxpayer had any intention to obtain a tax benefit.

<sup>51</sup> *Commissioner of Internal Revenue v Brown* (1965) US 563 at 579; approved in *Spotless* (1996) 186 CLR 404 at 415.

<sup>52</sup> *Spotless* (1996) 186 CLR 404 at 425.

<sup>53</sup> *Frank Lyon Co v United States* (1978) 435 US 561 at 580; approved in *Spotless* (1996) 186 CLR 404 at 416.

<sup>54</sup> *Spotless* (1996) 186 CLR 404 at 416.

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The High Court in *Spotless* confirmed that dominant purpose means “that purpose which [is] the ruling, prevailing or most influential purpose.”<sup>55</sup> In the same case the High Court also accepted that since it is necessary to determine the ruling, prevailing or most influential purpose, there will be other purposes apparent. The court did not mention what these might be, but they can only be commercial or family purposes. It would follow that what is required is a consideration of the weight of the various purposes of those associated with the transaction, including their commercial purpose. It is axiomatic that a dominant purpose cannot be determined if some purposes are ignored. Such an approach may have overtones of the *Newton* predication test, which has been rejected as appropriate, but the court cannot ignore what ITAA 1936 actually requires. Furthermore, making the predication which ITAA 1936 contemplates does not compromise the High Court’s directive that the existence of a rational commercial decision does not necessarily save the transaction. What it does is focus the inquiry on what needs to be addressed and the context in which that inquiry is to be undertaken.

When *Hart* was before the Full Federal Court it was held that the dominant purpose of the taxpayer was the acquisition of the residential property and the retention of the investment property, not securing tax deductions for interest payments. Yet the High Court was of the view that securing the tax advantage was the taxpayer’s dominant purpose. This has left considerable doubt over the place of the taxpayer’s commercial objective as a valid consideration under the purpose test.

When *Hart* was before the High Court Gleeson C.J. and McHugh J., in a joint judgment, conceded that the commercial context needs to be taken into consideration, but then went on to say that the taxpayer’s purpose can be determined just from the form which the tax benefit takes. This appears from the following passage of the judgment of Gleeson C.J. and McHugh J.:

“Let it be assumed that. . . even if the “wealth optimiser structure” had not been available [the taxpayers] would have borrowed money to buy their new home and also borrowed money in order to retain their former home as an income-earning investment. The “wealth optimiser structure” depended entirely for its efficacy upon tax benefits generated by arrangements between the taxpayers and the lender that had no explanation other than their fiscal consequences. What optimised the [taxpayers] “wealth” was the tax benefit [..]: not the deductibility of interest as such; but the deductibility of additional interest [..] contrived by the particular form of the borrowing transaction.”<sup>56</sup>

There are several problems with this approach. If a conclusion can be drawn from the form by which the tax benefit was obtained, then there is a certain inevitability about the determination which is likely to be made regarding the taxpayer’s purpose. It is clear that if the inquiry is to determine what purposes there may be to explain the identified tax benefit and that inquiry is confined to a consideration of the form of the identified tax benefit, then the test is effectively self-determining.<sup>57</sup> In addition, this approach does not sit comfortably with the judges’ insistence that the scheme must be identified by reference

<sup>55</sup> *Spotless* (1996) 186 CLR 404 at 416.

<sup>56</sup> *FCT v Hart* (2004) 55 ATR 712 at 719.

<sup>57</sup> M. Cashmere, “Part IVA after Hart” (2004) 33 AT Rev 131 at 138; Hely J., *Macquarie Finance Ltd v FCT* 2005 ATC 4829 at 4878.

to the facts which gave the expense the character of deductibility. If the commercial context is essential to the identification of the scheme and the tax benefit, then logically the issue of purpose should be ascertained by reference to all those facts which must be taken into account in determining whether the interest was deductible in the first place.

While the High Court has been reluctant to weigh the commercial objectives against the other objectives in making a determination about the application of Part IVA, the Full Federal Court has not. This is seen most clearly in *Macquarie Finance Ltd v FCT*,<sup>58</sup> the only Part IVA case to go before a Full Federal Court since *Hart's* case was decided. In this case a subsidiary of Macquarie Bank issued a complex stapled security consisting of a redeemable preference share in Macquarie Bank and an interest bearing note in the finance subsidiary, in order to strengthen the Bank's Tier 1 capital. Ultimately the security holder could only be repaid by selling the redeemable preference shares. The issue was whether the interest on the notes was deductible and if it were, whether Part IVA applied to deny that deductibility. The most detailed consideration of Part IVA was given by Hely J., who, in addressing the test to be applied, observed:

"In applying Part IVA, it is necessary to determine whether a reasonable person would conclude, having regard to the eight factors listed in s177D(b) that the relevant parties in entering into and carrying out *the particular scheme*, had as their most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining of a tax benefit in connection with the scheme."<sup>59</sup>

From what Hely J. said a little later in his judgment the reference to "the particular scheme" meant not just the form of the scheme, or the particular details of the documentation. The phrase encompassed the commercial objectives of the taxpayer.<sup>60</sup>

This approach is based on the terms of the ITAA 1936, which provide that the purpose of the taxpayer is to be determined from a consideration of the listed statutory criteria. In making that determination each of the eight statutory criteria must be considered and no single criterion is to be given any more weight than any other. The approach is holistic. That view was first established by the Full Federal Court<sup>61</sup> and it has not been disapproved by the High Court. The overall difficulty in considering the commercial purpose of the taxpayer is that commerciality does not feature as one of the eight statutory criteria, or anywhere else in Part IVA. Commerciality does, however, go to the question of substance and substance is certainly one of the eight factors. Hely J. in *Macquarie Finance* considered that commercial considerations could be considered in relation to the consequences for the taxpayer, and that is also one of the eight listed factors.<sup>62</sup>

The High Court has been somewhat narrower in its approach. In *Spotless*, while acknowledging that the Commissioner's determination has to be made from a consideration of the eight statutory factors, the Court went on to state that the critical element in making such a determination was the manner in which the transaction was carried out. In *Hart*, Gleeson C.J. and McHugh J. said that the form of the transaction was critical to a determination about purpose. But if a form and manner approach is emerging from

<sup>58</sup> *Macquarie Finance Ltd v FCT* 2005 ATC 4829, leave to appeal to the High Court refused.

<sup>59</sup> *Macquarie Finance Ltd* 2005 ATC 4829 at 4872.

<sup>60</sup> *Macquarie Finance Ltd v* 2005 ATC 4829 at 4873.

<sup>61</sup> This principle was first established by Hill J. in the Full Federal Court in *Peabody v FCT* (1993) 25 ATR 32 at 42.

<sup>62</sup> *Macquarie Finance Ltd* 2005 ATC 4829, Hely J. at 4873.

the High Court, it denies the holistic approach which would appear to be required by the criteria set out in the statutory provision. It is also contrary to what was said by a unanimous High Court in *Peabody*, which was the first Part IVA case to go to the High Court. In that case it was said that a scheme could not be part of a scheme, unless that part of the scheme was capable of standing on its own.<sup>63</sup> Even though the requisite purpose can be satisfied by anyone who is associated with the sub-scheme, that purpose must relate to the whole scheme and not just to the purpose associated with the sub-scheme.<sup>64</sup> In *Hart* the requisite purpose would appear to have been determined by Gleeson C.J. and McHugh J. by reference to the purpose associated with a sub-scheme, that was not a whole scheme, and was therefore determined by reference to something that was not a Part IVA scheme at all.

The approach advocated by Hely J. in *Macquarie Finance* does not deny the form which the transaction took, but it poses the question about purpose in relation to the commercial context of the transaction, or to put the issue in a slightly different way, by reference to the facts which gave the expense the character of deductibility. The form cannot be determinative by itself. It is simply one of the things which is assessed in considering what the most influential purpose was, that drove the taxpayer to do what was done.

The impact of the two approaches is manifestly clear. By applying the statutory test in the context of what the taxpayer did, the Full Federal Court in *Hart* concluded that the dominant purpose of the taxpayer was not to obtain a tax benefit, but to acquire an investment property. By focusing on a particular provision in the documentation, which evidenced the loan, the High Court came—not surprisingly—to the opposite conclusion.

It may be that the true distinction between those facts which constitute a tax-driven purpose within a rational commercial decision and those which do not could be reached by asking whether the commercial benefit was available only if the tax benefit was achieved. This was suggested by Hill J., at first instance in the Federal Court, in *Macquarie Finance*.<sup>65</sup> In this case the taxpayer's purpose of obtaining Tier 1 capital was not dependent on the identified tax benefit, although the achievement of its commercial purpose was assisted by it. That may be a rationale of why the Full Federal Court, held that Part IVA did not apply in *Macquarie Finance*.

There is also the issue of whose purpose is relevant. The statutory rule dictates that the relevant purpose need not be that of the taxpayer. It can be attributed to the taxpayer by anyone connected with the scheme. That degree of attribution is perceived by some as inappropriate.<sup>66</sup>

### An emerging test?

Twenty-five years have elapsed since Part IVA was enacted and it has taken all this time for this jurisprudence to emerge. Yet even so, there is no broad consensus regarding

<sup>63</sup> *FCT v Peabody* (1994) 181 CLR 359 at 384.

<sup>64</sup> *FCT v Peabody* (1994) 181 CLR 359 at 383; Hill J., *Peabody v FCT* 93 ATC 4104 at 4117.

<sup>65</sup> (2004) 57 ATR 115 at 145. Hill J. is another understood to be involved in drafting Pt IVA.

<sup>66</sup> This view was expressed particularly in the aftermath of *Hart* and cases recently before the courts involving schemes designed to attract large up-front deductions for expenses, that had been mass-marketed to the general public. *Vincent v FTC* (2002) 51 ATR 18 is an example of such a case. G.S. Cooper, "Part IVA—a Post-Hart Report Card", paper delivered to the 20th National Convention, Taxation Institute of Australia, 2005.



the manner in which Part IVA should be applied. There may be some consensus on the way in which a scheme should be identified and its pivotal importance in establishing a foundation for the exercise of the Commissioner's discretion. There may be consensus regarding the identification of the tax benefit, but there is none regarding the manner in which the requisite dominant purpose should be identified.

The problems which have emerged in relation to the application of Part IVA have been exacerbated by the High Court in *Hart*. A joint judgment was given there by Gummow and Hayne JJ. which denied there was any validity in the interpretative approach expounded by Gleeson C.J. and McHugh J. or in the whole of the Part IVA jurisprudence which has emerged to date. Notwithstanding that both justices had participated in the development of much of the previous High Court jurisprudence on Part IVA, the judges said that the previous law was wrong, because it relies on the introduction of interpretative glosses which are not found in the ITAA 1936 itself. Part IVA has its own cohesion and as such can be interpreted by reference to its own syntactical logic. This, of necessity, carries with it an implicit rejection of any notion of purposive interpretation that might be informed by having regard to extrinsic aids to interpretation. The perception of some internal logic is founded on the definition of a tax benefit. The identification of a tax benefit requires an inquiry to be made to determine if the identified tax benefit would have been available, if the scheme had not been entered into. This requires an hypothesis to be made about what the tax position would have been in the absence of the scheme. Since an hypothesis needs to be made on this issue, the judges maintained that to ascertain the taxpayer's purpose an inquiry has to be undertaken to find if there was another way of carrying out the transaction. The drawing of a conclusion about purpose cannot be done except by making the comparison. This has become known as the alternate postulate.<sup>67</sup> Implicit in this is the view that the only purpose which is relevant to the inquiry is an inquiry about tax. This approach was supported by Callinan J., but with greater clarity about the objective of this inquiry. The emphasis is on whether it can be established that the transaction could have been carried out "more conveniently, commercially or frugally"<sup>68</sup> by some hypothetical counter-factual situation.

What this does is deflect the inquiry about the purpose of the taxpayer in entering into the scheme into speculation about what other kinds of schemes the taxpayer might have entered into, or carried out. The alternate postulate test has been rejected subsequently as an appropriate test by the Full Federal Court in *Macquarie Finance*, on the basis that it contains a fallacy. It confines attention to the tax consequences of the actual and counterfactual transactions and ignores the commercial advantage and consequences which would follow from what was actually done. So, if the counter-factual approach is adopted, there could be no inquiry about what purposes there might have been, apart from tax.<sup>69</sup>

Following the logic of inner cohesion, Gummow and Hayne JJ. went on to deny the importance of the scheme. In their view the definition of the scheme is not pivotal to the exercise of the Commissioner's discretion since the statutory definition is so wide it can encompass a whole transaction, or just one step in the transaction. They then proceeded to deny what was said by the High Court in *Peabody*, when it first considered Part IVA,

<sup>67</sup> *FCT v Hart* (2004) 55 ATR 712 at 730.

<sup>68</sup> *FCT v Hart* (2004) 55 ATR 712 at 743.

<sup>69</sup> *Macquarie Finance Ltd* 2005 ATC 4829, Hely J. at 4878.

that a scheme must be capable of standing on its own without being robbed of all practical meaning, because there is no justification to be found in the content of Part IVA for maintaining that the scheme must have some commercial or other coherence.

On that basis the question then becomes whether the taxpayer entered the transaction, or any part of it, for the dominant purpose of obtaining a tax benefit. Since the judges took the view that the exercise of the wealth optimiser option was, by itself, a scheme, it was inevitable that a dominant tax purpose was found to be manifest. By applying the counterfactual approach it was clear that if the taxpayer had not utilised the wealth optimiser facility he would have paid interest rateably over both the residential and investment loans, thereby proving that the transaction could have been carried out more “frugally”.

Gleeson C.J. and McHugh J. did not comment on the new counter-factual approach, other than to say that the fact a particular commercial transaction is chosen from a number of different alternative courses of action, because of the tax benefits associated with them, does not by itself mean that a dominant purpose of obtaining a tax benefit is thereby satisfied. The judges did, however, specifically reject the view that the definition of the scheme was not pivotal to the application of Part IVA. They also rejected the view that a scheme could be defined without reference to the facts which gave the expense the character of a deduction for tax purposes.

In the light of this divergence of opinion, it is difficult to determine what principles emerge from *Hart*. Likewise, it is difficult to determine which of the two joint judgments contains the *ratio decidendi*, as Callinan J., who gave a separate judgment, appears to support critical elements of both.<sup>70</sup>

What emerges from *Hart* is that there is no settled jurisprudence for interpreting Part IVA. The Full Federal Court has taken a consistent approach which enables the statutory GAAR to provide a balance between ordinary commercial transactions and those which might be regarded as blatant attempts to obtain a tax advantage. The High Court, even before *Hart*, had been much more zealous in striking down transactions which manifest tax advantages, even though they may not be seen generally as blatant or contrived. *Spotless* is an example. The High Court decision in *Hart* has simply confirmed the resolution with which tax avoidance is being dealt in Australia at the High Court level. The problem is, however, that the High Court is failing to provide principles for interpreting Part IVA which establish guidelines regarding its practical application. The joint decision of Gummow and Hayne JJ. in *Hart* simply compounds the problem.<sup>71</sup>

<sup>70</sup> The difficulties presented by the High Court decision in *Hart* were canvassed at length by Hill J. in *Macquarie Finance* when that case went before the Federal Court for the first time (see fn.65). At the conclusion of his judgment, Hill J. observed that the High Court decision in *Hart* would give rise to results which, in his view, were not within the intendment of ITAA 1936.

<sup>71</sup> G.S. Cooper, “The Emerging High Court Jurisprudence on Part IVA” [2006] 9 (no 5) *The Tax Specialist* 234. Expressions of disquiet at the present lack of clarity regarding the application of Part IVA are beginning to emerge with calls for statutory amendment to oblige the courts to give effect to the policy of the ITAA 1936; J. Dabner, “The Spin of the Coin—in Search of a Workable GAAR” (2000) *Journal of Australian Taxation* 232; J. Dabner, “Why We Must Replace Pt IVA: a Suggestion for Reform” (2004) *Tax Week Archive* Issue 41, section 875. Interestingly, more recent targeted anti-avoidance provisions which have used a similar formula have extended the criteria to which regard may be had to ascertain purpose. Div. 165 A New Tax System (Goods & Services Tax) Act 1999 which introduced a mini-GAAR for the goods and services tax regime incorporates reference to the legal rights and obligations involved in the scheme and its economic and commercial

### Factual reconstruction

One of the problems with section 260 was that it provided the Commissioner with no explicit authority to determine tax on the basis of a hypothetical alternative situation, once the actual transaction entered into by the parties had been declared void for tax purposes. This shortcoming has been addressed under Part IVA: the Commissioner has power to identify the contravening tax benefit and cancel it. The tax assessment is then raised against the hypothetical factual position, so long as the Commissioner can satisfy the court that the hypothetical facts represent a reliable prediction about what the taxpayer would have done, if the scheme had not been entered into.

Only the Commissioner has the power to make a determination to cancel a tax benefit: The court cannot do so. The court's power is limited to deciding whether the discretion was properly exercised. In other words, the court reviews whether the scheme and tax benefit were properly identified and whether there was the requisite tax purpose to enter into the scheme. If the Commissioner has not identified the scheme properly, then there can be no proper exercise of the discretion.

But the scheme, however it is drawn, must relate to a tax benefit which satisfies the statutory definition. The identification of the tax benefit is likely to cause more difficulty than it has to date, since if it is cancelled, tax is raised on a hypothetical situation and courts are reluctant to make decisions on the basis of a set of hypothetical facts. This issue has only been considered at any length by the High Court in two cases; *Peabody* and, more particularly, in *Spotless*. In the *Spotless* case, the taxpayer argued that the amount which might reasonably have been expected to be included in its assessable income did not exist, because once the amount of income actually earned had been cancelled, there was nothing earned to include in its assessable income. As a consequence there could be no amount that was not included in the taxpayer's assessable income. The court rejected this on the basis that Part IVA identifies the amount to be included in a more general way.<sup>72</sup> It is an amount which would have emerged from a particular source or activity. In this case the amount was said to be the return that might have been generated by the investment of the funds in Australia, in the absence of the Cook Islands scheme. The evidence disclosed the amount of interest which would have been earned in Australia, but the court did not quantify the amount by reference to the interest that would have been so earned. It simply said that the amount would not have been less than that actually earned in the Cook Islands, less withholding tax, i.e. a significantly smaller amount. That is unlikely to represent a reliable guideline for future taxpayers.

Furthermore, in raising a tax assessment the Commissioner must identify the correct taxpayer. The identification of the correct taxpayer is dependent on the accuracy of the prediction which can be made about the hypothetical facts which would have existed, had the scheme not been entered into. If those facts do not disclose a situation which is accepted as a reasonable expectation, then it is likely that the assessment could be raised against the wrong taxpayer. This is what happened in *Peabody*. In *Peabody* the

substance and the purposes of the legislation and other specified legislation. Some redrafting of Part IVA was recommended by the Review of Business in a Tax System Redesigned. Some of these recommendations were accepted by the Treasurer with indications of a commencement date. In 2001 it was announced that any commencement date had been postponed until legislation was introduced and to date no legislation has been introduced.

<sup>72</sup> *Spotless* (1996) 186 CLR 404 at 423.

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Commissioner sought to assess a beneficiary under a discretionary trust to income tax on the proceeds arising from the sale of property, notwithstanding that the trustee did not own the property and did not receive any distribution from the sale of that property. A taxpayer cannot be assessed to tax simply because the Commissioner decides to re-write the facts.

### The choice principle

The extrinsic aids to the interpretation of Part IVA, which accompanied its introduction, were silent about the place of the choice principle under the new measure. They simply stated that the new provision was paramount in tax law. On the other hand, Part IVA itself is subject to certain exclusions. Excluded from the operation of Part IVA are agreements, choices, declarations, elections or selections which are specifically provided for by the ITAA 1936, so long as the scheme has not been entered into or carried out for the purpose of creating the circumstances necessary to obtain that concession.<sup>73</sup> This applies both in relation to income amounts and deductions. That appears to encapsulate the choice principle as it was understood to be, prior to the Barwick extension of the principle.

The only case where the choice principle has arisen for consideration under the new regime is *Spotless*. It will be recalled that in this case a deposit had been made in the Cook Islands so that the taxpayer could claim, under a specific exemption provided in ITAA 1936, that the taxed income derived from the Cook Islands was exempt from tax in Australia. The consequence of electing to utilise this election, or choice, specifically provided by ITAA 1936, was to increase the taxpayer's after-tax income. What the taxpayer did would appear to have fallen squarely within the four corners of the statutory exclusion. But the High Court was of the view that the dominant purpose in making that election or choice was to achieve the tax benefit. Without that benefit the proposal would have "made no sense."<sup>74</sup> Interestingly, there was no mention of the rule of construction referred to above (*generalia specialibus non derogant*—general powers do not derogate from specific powers) or its importance in preserving the framework of the ITAA 1936 itself, which were tenets which had supported the choice principle in its original manifestation. The transaction would not appear to have been contrived: it simply took advantage of a benefit specifically provided for under the ITAA 1936. So, if this decision is correct, and it has been accepted as correct by the Federal Court,<sup>75</sup> then the choice principle in Australia now has very limited application—unless it is revisited. The principle is subordinate to the dominant purpose test.

### Administrative perceptions

In recent years the Commissioner has utilised Part IVA as a major platform in ensuring tax compliance. The High Court decision in *Hart* has been particularly helpful to him, since it provides no consensus regarding the interpretative approach to be adopted, but much that supports an extensive approach to the application of the Commissioner's discretion. In the post-*Hart* environment the Commissioner has issued an administrative practice

<sup>73</sup> ITAA 1936, s.177C(2) and (2A).

<sup>74</sup> *Spotless* (1996) 186 CLR 404 at 422.

<sup>75</sup> *Macquarie Finance Ltd v FCT*, fn.65 at 140 (Hill J.).

statement setting out the departmental approach which must be followed by tax officers when applying the statutory GAAR.<sup>76</sup> The core provisions of this release are based on the key platforms which underpin the joint judgment of Gummow and Hayne JJ. in *Hart*, since they are favourable to an easy identification of a dominant purpose to obtain a tax benefit.

The practice statement downplays the importance of identifying the scheme on the basis that the breadth of the statutory definition enables anything to be a scheme, regardless of how broad or narrow it may be. Instead, the identification of the tax benefit is what is seen as being critical. The identification of the tax benefit is seen as necessarily requiring a consideration of the income tax consequences of a counterfactual postulate. This clearly represents the adoption of the approach propounded by Gummow and Hayne JJ. and endorsed by Callinan J. in *Hart*. The counterfactual requires a reconstruction of events of what would have happened, or where there is no evidence about this, what might reasonably be expected to have happened, based on some reasonable hypothesis. Furthermore, officers are free to use any number of hypothetical situations to find a counterfactual which is more convenient, commercial or frugal. The considerations which are likely to be important to this inquiry include:

- the most straightforward and usual way of achieving the commercial and practical outcome of the scheme, disregarding the tax benefit;
- commercial norms and standard industry behaviour;
- the behaviour of the relevant parties before and after the scheme compared with the period of operation of the scheme; and
- the actual cash flows.

If the scheme had no effect or outcome, other than achieving the tax benefit, then it would be reasonable to assume that the pre-existing state of affairs would have continued, if the scheme had not been entered into.

The breadth of what may constitute a scheme under the GAAR is seen as reflecting Parliament's intention to focus the inquiry which needs to be made on the objective purpose of the taxpayer. To this end officers are directed not to have regard to the subjective intention of any person connected with the scheme, or the motivation of the taxpayer. While the Commissioner acknowledges that each of the eight criteria is equally important in ascertaining the purpose, he adopts the observations made by Callinan J. in *Hart* to the effect that "the presence or overwhelming weight of one factor alone may of itself in an appropriate case be of such significance as to expose a relevant dominant purpose."<sup>77</sup> Furthermore, the Commissioner sees the eight criteria as focusing attention on three elements; the way in which the scheme was implemented; its effect; and the connection between the taxpayer and any other person whose financial position is likely to change as a result of the scheme. There is, of course, support for this emanating from what was said and done by a unanimous High Court in *Spotless* and by a discordant High Court in *Hart*.

<sup>76</sup> Practice Statement Law Administration PS LA 2005/24. For a critique of the law and the Commissioner's position see J. Cassidy, "Part IVA is to be construed and applied according to its terms, not under the influence of muffled echoes of old arguments concerning other legislation" (2006) 1 *Commercial Law Journal* 30.

<sup>77</sup> *FCT v Hart* (2004) 55 ATR 712 at 743.

## BRITISH TAX REVIEW

The Commissioner is concerned about artificiality and the counter-factual approach enables him to identify this by comparing the manner in which the identified scheme was carried out, with the manner in which a simpler scheme might have been carried out. So, the presence of a step or steps in a transaction, which would not be found in a more straightforward hypothetical transaction postulated by the Commissioner, would establish artificiality. The presence of material steps in a scheme which are consistent with no explanation, other than that of obtaining the identified tax benefit, is regarded as critical to the identification of the requisite purpose. *Hart* is cited as an example.

Also relevant to this issue is the timing of the scheme's implementation. The Commissioner regards it as relevant that a scheme may be carried out just before the end of the financial year, or some other tax sensitive date (such as the date on which a tax rate is to change) or only for a brief period. These issues are relevant not only to the delivery of the tax benefit, but the purpose of the advantage obtained.

In relation to the second set of factors, which relate to the effect of the scheme, the absence of any practical change in the overall financial, legal or economic position of the taxpayer and connected parties, other than a more advantageous tax position, is likely to lead to a conclusion about the dominance of the tax purpose. These changes do not have to be changes that have resulted or will result; merely changes that might be reasonably expected to result. *Pridecraft Pty Ltd v FCT*,<sup>78</sup> a decision of the Full Federal Court, was cited as an example. Here a company paid AUS\$15 million on the last day of the financial year to a trust that was involved in paying bonuses to its employees. On the same day the trust lent the company back most of the money it had received. Contributions to employee incentive remuneration schemes are deductible. Bonuses were actually paid by the company, not the trust, with payments reducing the amount owing by the company to the trust under the loan. The amount actually paid out to employees in the year in which the AUS\$15 million contribution was made to the trust was AUS\$200,000. The court decided that although there were commercial reasons for the company making the contribution to the trust, the arrangement with the features it had, indicated that the dominant purpose was to obtain a very large and immediate tax benefit.

The third set of factors is concerned with the nature of the connection between the taxpayer and any other person whose financial position is expected to change as a result of the scheme, or for whom there are other consequences arising. This is seen as particularly relevant in non-arm's-length transactions. For instance, a loss-making transaction for the taxpayer, when only the taxpayer's position is regarded, may not produce a loss in substance, if an associate of the taxpayer makes a corresponding non-taxable gain. So an income transfer scheme, which would inject income into a loss making entity within the same group, would constitute a scheme having the requisite purpose.<sup>79</sup>

A number of features are listed as being indicative of a tax driven purpose:

- (1) an arrangement, or part of an arrangement, is out of step with arrangements ordinarily used to achieve the relevant commercial objective;
- (2) an arrangement is more complex than is necessary to achieve the commercial objective, or includes a step, or a series of steps that appear to serve no real purpose other than to gain a tax advantage. Among such transactions are those which interpose an entity to access a tax benefit, or an intra-group or related

<sup>78</sup> *Pridecraft Pty Ltd v FCT* (2004) 213 ALR 450.

<sup>79</sup> *CC (NSW) Pty Ltd (In Liq) v FCT* (1997) 34 ATR 604.

- party dealing that merely produces a tax result and arrangements which involve a circularity of funds or no real money;
- (3) the tax result is at odds with its commercial result, such as a loss being claimed for what was a profitable business;
  - (4) the arrangement results in little risk, where significant risks would normally be expected. Such situations would include the use of non-recourse loans, or put options which minimise or eliminate risk;
  - (5) the parties are operating on non-commercial terms, or in a non-arm's-length manner. Identified targets include interest rates charged at rates above or below market, insufficient security, or loan repayment deferred until the end of a lengthy period; and
  - (6) arrangements where there is a discrepancy between the substance of what is being achieved and the legal form. Targeted here are arrangements in a series which taken together produce no economic gain or loss and are in effect self-cancelling.

What this makes clear is that the Commissioner is firmly of the view that a scheme can be drawn so narrowly as to encapsulate just the identified tax benefit, since once the scheme is limited to the tax benefit, it is readily apparent that a dominant purpose of obtaining that advantage will be manifest. What is also manifest is the importance to the Commissioner of the ability to find some hypothetical counterfactual situation by which the transaction could have been carried out more simply, as that goes a long way to establishing the requisite purpose. The Full Federal Court in *Macquarie Finance* rejected both of these contentions. Likewise, the Full Federal Court has said that non-recourse loans are not inherently objectionable.<sup>80</sup> Nor are strategies which reduce or eliminate risk,<sup>81</sup> or arrangements which disclose round robin money flows.<sup>82</sup> Notwithstanding this, the practice statement still stands unamended.

What also emerges from the practice statement is that the Commissioner will endeavour to limit the choices available to taxpayers to ordinary, straightforward dealings of which he will be the arbiter. As a consequence complex, innovative or unusual transactions are at risk and, the more complex, innovative or unusual they are, the more at risk they are likely to be where some tax advantage can be identified. It will not be difficult to postulate some hypothetical set of facts by which the transaction could have been carried out without the tax advantage. But once that point is reached, Part IVA is likely to be invoked. For years the Commissioner has maintained that Part IVA is all about smell and the conflicting judgments in *Hart*—particularly the approach adopted by Gummow and Hayne JJ.—have now given some support to that approach. The challenge to sale and lease-back finance in *Eastern Nitrogen* may be seen as indicative of the kind of transactions which are regarded as being tainted, or out-of-the-ordinary.

The Inspector General of Taxation<sup>83</sup> has been particularly critical of the Commissioner's tendency to "prop up" deficient tax law which does not deliver on the Commissioner's perceived interpretation of the policy intent of the legislation, instead of attending to the administration of the tax law as it stands. He has also criticised the Commissioner's repeated delay in implementing court decisions which are not favourable to him. Those

<sup>80</sup> *FCT v Firth* (2002) 192 ALR 542 at 547 (Hill J.).

<sup>81</sup> *FCT v Cooke* [2004] FCAFC 75 at [96]–[97] (Lee, Sundberg and Conti JJ.).

<sup>82</sup> *Lenzo v FCT* [2007] FCA 1402 at [124] (French J.); *FCT v Sleight* [2004] FCAFC 94 at [77] (Hill J.).

<sup>83</sup> D.R. Vos, Annual Report of the Inspector General of Taxation 2005–2006 (October 2006) at 4.

concerns may well be increased by a speech delivered by the Commissioner to the Law Council of Australia in 2007, where he indicated that his department did not necessarily regard itself as being bound by single judge decisions of the Federal Court which his department considers are incorrect, so long as measures will be taken to test the issue again with some expedition. As the Administrative Appeals Tribunal is the first forum for aggrieved taxpayers before any appeal can be made to the Federal Court, this statement must presumably refer as well, to decisions of the Administrative Appeals Tribunal.<sup>84</sup>

### Application of Part IVA to the United Kingdom

The question which subsequently arises concerns the impact which a similarly-worded GAAR might have in the United Kingdom, if it were interpreted in a similar way. That could be tested by applying Part IVA to two high profile cases: *Barclays Mercantile* and *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd*.<sup>85</sup>

*Barclays Mercantile* concerned a claim by a financier for capital (depreciation) allowances in respect of plant it acquired to undertake a long term finance lease. The arrangement which had been entered into was unusual in a particular respect. The money which the financier provided to the lessee was not used as working capital in the lessee's business. It was deposited with another company within the financier's group and used to satisfy the lessee's obligations under the lease. The benefit to the lessee over the term of the lease was access to part of the depreciation allowance which was passed on to it by the financier. That was the only monetary benefit which it received from the transaction. On the termination of the lease a company within the lessee's group had the option to acquire the plant from the financier.

There are two finance lease cases in Australia where Part IVA has been argued: *Eastern Nitrogen* and *Metal Manufacturers*.<sup>86</sup> In both cases the issue was whether the lessee was entitled to a deduction for the lease payments, not whether the financier was entitled to depreciation on the plant. A lessee is ordinarily entitled to a deduction for lease payments in Australia, so long as it does not have any right to buy the plant on the termination of the lease. The lessee had no such right in either case, although it was anticipated by both parties that the lessee would re-acquire the plant on the termination of the lease. In addition, in Australia at least some part of the benefit of the Australian capital allowance is passed on to the lessee, usually in the form of lower rental payments. Interestingly, the Commissioner had not identified that as a relevant tax benefit. Observations made by Carr J.<sup>87</sup> indicate that this advantage was clearly one that could have been identified as a relevant tax benefit. Because it was anticipated that at the end of the lease the lessee would buy back the plant at its residual value, or repurchase price, the Commissioner maintained that so much of the lease payments as was used to reduce the value of the plant to its ultimate residual value was not deductible, but on capital account. In both cases the Full Federal Court held that no part of the rent payments was on capital account and the whole rent was fully deductible for tax purposes. The court also held in both cases that

<sup>84</sup> For an earlier indication of the Commissioner's view of the application of Part IVA see M. D'Ascenzo, "Part IVA—the Steward's Inquiry", paper delivered to the 37th Western Australian Convention Taxation Institute of Australia 2003 (unpublished).

<sup>85</sup> *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6; [2001] 1 All ER 865.

<sup>86</sup> *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474; *FCT v Metal Manufacturers Ltd* (2001) 46 ATR 497.

<sup>87</sup> *Eastern Nitrogen Ltd v FCT* (2001) 46 ATR 474 at 491.



Part IVA did not apply. In concluding that Part IVA did not apply, the court considered it material that the funds provided by the financier were utilised by the lessee as working capital. An application for leave to appeal to the High Court was refused in both cases.

In terms of the analysis for Part IVA purposes the scheme was held to be constituted by the making and implementing of the sale and lease back of the plant. The details were not identified. It emerges from the way in which the case was dealt with that the scheme included facts regarding the use of the funds. The tax benefit was held to be the capital component of the lease payments, it having been accepted by the parties that the taxpayer was entitled to a deduction for the interest component of the lease payments.

In relation to the application of the eight factors the court considered that the form and substance of the transaction were the same, but pointed to obtaining a tax benefit. The timing of the transaction was not seen as having any relevance in the circumstances. The result which would have been achieved in relation to the operation of ITAA 1936, which would have applied but for Part IVA, was that the rental payments would have been deducted in full and this pointed to a tax benefit. Insofar as the financial position of the taxpayer was concerned, the scheme resulted in substantial cash being available to the taxpayer for the purposes of its business and instead of being reliant on short-term finance, the taxpayer received a finance facility for five years. This reduced the taxpayer's exposure to interest rate fluctuations and provided financial certainty, which it had not previously enjoyed. The other factors were regarded as neutral or irrelevant. As a result of an evaluation of these factors the Full Federal Court, in both cases, held that Part IVA did not apply. In reaching this conclusion the court considered that it could not be said that the dominant purpose of the taxpayer was to obtain a tax benefit. Although that factor was important, the prevailing purpose was to obtain a very large financial facility on the best available terms as working capital. An application for leave to appeal to the High Court was refused in both cases.

If Part IVA is applied to *Barclays Mercantile* it is clear that the transaction is capable of providing a scheme. The difficulty lies in determining what the scheme is. This depends on whether it is defined broadly to encompass the whole transaction in its commercial context, or whether it is identified more narrowly as just that part of the transaction which captured the depreciation allowance. For the purpose of the exercise an assumption is made that the scheme is to be defined by reference to the definition propounded by Gleeson C.J. and McHugh J. in *Hart*, i.e. by reference to the facts by which it would be necessary to test deductibility of the expenditure on the acquisition of the plant. This means that the scheme would include reference to the application of the funds made available to the lessee as a result of the acquisition of the plant by the financier and their connection to the derivation of assessable income by the financier.

*Barclays Mercantile* concerned a deduction. Under Part IVA a tax benefit is a deduction which would not have been allowable, or which might reasonably be expected not to have been allowable, if the scheme had not been entered into. It is reasonably clear that the financier obtained the benefit of the capital allowance by entering into the finance lease and would not have done so, if the lease had not been entered into. So the capital allowance is the requisite tax benefit. But the identification of a tax benefit alone does not activate Part IVA. It is only where it can be said that the taxpayer entered into the scheme for the dominant purpose of obtaining the tax benefit that Part IVA applies. But it has been accepted repeatedly in Australia that a dominant purpose of obtaining a tax benefit can arise even in a normal commercial transaction. In this day and age a finance

lease could be regarded as a normal commercial transaction. The dominant purpose is to be determined by considering the eight statutory criteria. It is not proposed to deal with each in turn, but to examine them by reference to the three broad categories identified by the Commissioner in his recent practice statement: (1) the manner, form, substance and timing of the scheme; (2) its effect; and (3) the connection between the parties. These categories contain the main factors.

The first group of factors relates to the way in which the transaction was implemented: in particular, the form and substance of the scheme and the manner in which it was carried out. In relation to form and substance, the transaction was not dressed up as something it was not. It was a sale and lease-back in form and substance. In *Eastern Nitrogen* this factor was regarded as indicative of an objective purpose of obtaining a tax-benefit for the full value of the rental payments. While the tax-benefit transfer aspect was not argued or considered in *Eastern Nitrogen*, it is obvious that this would point to an objective purpose of taking advantage of that benefit.

But there are two particular aspects of the *Barclays Mercantile* transaction which weigh heavily on the factors of form and substance, as well as its effect. The first is that the lessee obtained no monetary benefit from the transaction, apart from the tax benefit transfer arrangements. The second is that the financier did not provide finance to the lessee in the form of working capital, or to retire the debt incurred in constructing the plant, because the money paid to the lessee for the acquisition of the plant was immediately returned to the financier by way of a security deposit. The security deposit was to be used to pay the rent. The substance and effect from the point of view of the lessee is that no commercial benefit arose from the transaction. Indeed, it had adverse consequences in that the lessee's only asset had been transferred to the financier and its ability to provide security to other financiers had been restricted by the additional collateral security which had been provided. From the point of view of the financier it was in the same monetary position it was prior to the transaction, except that it owned plant on which it could claim a capital allowance. The end result for both parties was that they were able to share the benefit of the capital allowance. The third group of factors which relates to the connection between the parties does not appear to call for any relevant consideration in this situation.

Consequently a decision needs to be made, having regard to the statutory factors, whether a reasonable person would conclude that the financier entered into or carried out the scheme for the dominant purpose of enabling it to obtain the tax benefit. Balancing the eight factors, a court would be likely to conclude that a reasonable person would say that the most influential purpose was to obtain the tax benefit. In fact, it would probably be concluded that this was the only purpose. As a consequence the transaction would be seen as contravening Part IVA. In the absence of the particular security deposit arrangement which characterised this case, the tax benefit would probably have been seen as an advantage which assisted the achievement of a commercial outcome, not one which was dependent on it. As a consequence, in that situation, Part IVA would not have applied.

The question then arises as to whether the conclusion would be different if the scheme were defined more narrowly, as suggested by Gummow and Hayne JJ. in *Hart* and their alternate postulate were applied. If a scheme can be anything, as the judges maintained, then it could be identified by reference just to the access which the finance lease gave to the capital allowance. If the alternate postulate is applied, then the provision of finance could have been provided by way of loan without accessing the capital allowance and the

associated tax-benefit transfer advantages. In fact, in *Eastern Nitrogen* the Commissioner had argued that the finance lease was nothing other than a camouflaged loan. A loan would enable the finance to be provided more frugally. It would follow that the requisite dominant purpose was present and Part IVA would apply. However, as leave to appeal to the High Court was refused in *Eastern Nitrogen* it is unlikely that the High Court would entertain an appeal on this ground. Therefore, it is likely that the Commissioner would define the scheme more broadly to incorporate the security deposit arrangements. Here it can be seen that whether the scheme is defined broadly or narrowly, the result is the same.

In *MacNiven* a taxpayer claimed a deduction for interest paid on a loan. The taxpayer was a subsidiary of the creditor. The taxpayer had paid the interest owed to the creditor with funds advanced by the creditor. The taxpayer was a loss company and was no longer trading. The interest needed to be paid so that it became deductible for tax purposes. In making the interest payments the taxpayer was required to account to the Inland Revenue for the appropriate amount of tax. Furthermore, the creditor was a tax-exempt entity. As such it was able to obtain a refund of the withholding tax paid on the interest received. The taxpayer had value as a company with crystallised tax losses and was ultimately sold at a profit. The Revenue sought to disallow the payment of interest.

This situation could not have arisen in Australia. Deductions are available in Australia for expenses which are payable: they do not have to be paid. There is no withholding tax payable on interest payable, or paid, by residents of Australia to residents of Australia. But, if the taxpayer were not trading, and there was no likelihood of it trading, then no deduction would be allowed for interest payable, or paid, in any event. The situation is covered by *Spassked v FCT*.<sup>88</sup> In that case, a taxpayer company, which was a member of the well-known IEL Group of companies, claimed interest payable on a loan as a deduction for tax purposes. The loan had been used to acquire shares in another company in the group. Those shares were its only asset. No dividends were derived from those shares and no dividend was intended to be paid on those shares for an indefinite period. The taxpayer incurred huge losses which it transferred to other members of the group. The Commissioner disallowed the deduction for interest and the deductions claimed by other members of the IEL Group for the losses which had been transferred to them.

The Full Federal Court upheld the Commissioner's assessment against the taxpayer on the basis it could not be said that the interest had been incurred in the gaining or producing of assessable income, or income which would have been expected to have been derived, which is the essential requirement for a successful deduction claim under section 8-1 of the ITAA 1936. In the event that the claim had been allowed, the Commissioner had argued that Part IVA would apply to disallow the deduction. As the court concluded that the interest expense was not deductible, it became unnecessary to consider Part IVA.

This means that any attempt to apply Part IVA to the factual situation in *MacNiven* must be done without the assistance of any direct authority. In order for Part IVA to apply a scheme must be identified. The scheme could be defined by reference to the facts of the transaction which enabled the interest to qualify for deductibility and by reference to the source of the funds and the specific outcome which arose from the payment. But that does not encapsulate the commercial objective of the wider transaction which was to prepare the taxpayer company for sale. So an assumption is made that the scheme would be drawn broadly to incorporate that objective. The scheme must identify the relevant

<sup>88</sup> *Spassked v FCT* [2003] FCAFC 282.

tax benefit which has been obtained. In this case the tax benefit would be a deduction for interest which would not have been allowable, or might reasonably have been expected not to be allowable in the absence of the scheme. It might also have encompassed the tax loss crystallisation which enabled the taxpayer company to be sold. Then the eight factors would need to be considered in order to ascertain whether the scheme was entered into for the dominant purpose of obtaining the tax benefit. The same grouping of factors is used. The first relates to the manner in which the scheme was carried out, its form, substance and timing. The second relates to the effect of the scheme and the third relates to the connection between the parties.

The form of the transaction was a loan with interest payable at a commercial rate. The form of the loan did not contain terms which were dictated by tax considerations that made the commercial end achievable, but the deduction available for interest paid would point to a tax benefit that would not have been available if some other form of financing—such as a share issue—had been undertaken. The manner in which the loan was made is consistent with its form. Neither of these factors would be seen as having a significant weighting in favour of a tax outcome.

Of greater relevance is the substance of the transaction and its effect. The substance of the transaction was that sufficient funds were injected by the creditor, which was also the holding entity of the taxpayer, to enable it to pay interest payable to the holding entity. Without that injection of funds the taxpayer could not have paid the interest. But, the payment had the significant effect of generating an allowable deduction, which would not have been possible without the injection of funds. Without the crystallised tax loss, the taxpayer would not have been saleable and in the absence of this, the creditor would not have been able to find a purchaser to buy the taxpayer company. The third factor is the connection between the parties. The creditor was the holding entity of the taxpayer. It was acknowledged that the funds would not have been available if there had not been that connection between the parties. The fact that the creditor was a tax exempt entity which was able to obtain a refund of the withholding tax paid by the taxpayer is probably not decisive by itself, because this would be the result in respect of every interest payment received. But in the context of the transaction it is another factor which weighs towards a predominant tax purpose. But the context of the transaction is that the company was being prepared for sale. That is a commercial objective. Can it be said that in that context the interest payment was dominant in achieving the commercial outcome? That is a matter on which different minds may well reach different conclusions. But the payment of interest flows inexorably from the loan made to achieve that purpose and that may (but only may) tip the scales in favour of a dominant tax purpose.

If a counter-factual analysis, as proposed by Gummow and Hayne JJ. in *Hart*, were utilised, the scheme would undoubtedly be identified narrowly as the interest expense and the crystallisation of the losses that payment of the interest achieved. That would also identify the tax benefit. The transaction could have been undertaken more frugally by injecting share capital and if that had been done, there would have been no interest paid which would have crystallised the tax loss. Then it could be concluded that the dominant purpose of carrying out the narrowly identified scheme was to obtain the tax benefit.

It is clear that the counterfactual approach which has been applied to both *Barclays Mercantile* and *MacNiven* deflects the inquiry about purpose away from ascertaining the purpose for entering into the transaction, towards pure speculation about what else the taxpayer might have done from a tax point of view, had significant thought been given

to the tax consequences. If the transaction could have been done differently without capturing the identified tax advantage, the predominant statutory purpose is found: that effectively recasts the statutory inquiry. The result of that inquiry is more than likely to produce a result quite different from an approach which casts the inquiry in the commercial context of what the taxpayer was doing, because it is targeted to circumscribe the result.

From a British perspective two significant issues emerge from this analysis. The first is that the inquiry undertaken pursuant to Part IVA is not directed at ascertaining the purpose either of the specific legislation which provides the tax advantage, nor at Parliament's intention in relation to Part IVA itself. It is directed at locating the tax advantage which the taxpayer has captured and then ascertaining whether the dominant purpose of the taxpayer was to obtain that tax advantage.

The second is that the outcome under Part IVA is very dependent on the definition of the scheme. The dominant purpose of the taxpayer has to be found within the context of the defined scheme. The definition of the scheme effectively circumscribes the outcome of the inquiry which has to be undertaken. The purpose to which the inquiry is directed is that of obtaining the tax advantage, not whether Parliament intended the taxpayer to have the tax advantage in the circumstances under consideration.

## Conclusion

Australia has had a GAAR for the best part of 100 years and it has achieved varying degrees of success in controlling tax avoidance. The statutory overlay provided by the GAAR shows that its effectiveness is dependent on the content of the rule and on the interpretative approach which is adopted in relation to that content. If the content is drawn in very broad and generalised terms, as was the case with section 260, the courts tend to find ways of reading the provision down. This has been the Australian experience, even in the face of a literal interpretative approach to tax statutes on the part of the judiciary. The Australian experience also indicates that the more the application of the GAAR is read down, the greater the propensity for attempts to be made to circumvent the broad ambit of the GAAR. On the other hand, if the content of the rule is more targeted, there seems to be more likelihood that the GAAR will be applied. Section 260 effectively made tax optional for those who were able to exploit the system. Part IVA is much more targeted than its predecessor. The defects which led to section 260 becoming unworkable have been addressed and the courts are giving effect to Part IVA in a manner which makes its impact a significant force in controlling tax avoidance.

Professor Freedman was optimistic that if a legislative GAAR were introduced it would enable signposts or principles to be developed. That is a legitimate expectation. But clear, consistent principles which enable the GAAR to be applied in a manner which keeps a reasonable balance between the revenue authorities and taxpayers may not emerge, and, perceptions may vary about the meaning and significance of those which do emerge, whether they are clear or not.

It is apparent that in applying Part IVA the courts in Australia have not followed a purposive approach in the way envisaged by Parliament. Parliament set out to rein in "artificial blatant and contrived" transactions. But the courts have extended the reach of Part IVA well beyond such transactions. Part IVA is being effectively applied to transactions which could be regarded as normal commercial transactions, simply because

they disclose what the courts regard as significant tax saving features. But the principles which are being used to achieve that result are far from clear, notwithstanding 25 years of judicial law-making on the subject. Until *Hart's* case there was some evidence of consistent signposting becoming apparent, although it would be too optimistic to regard these signposts as clear principles.

There was agreement at both the Full Federal Court level and High Court on the necessity for the transaction which encompassed the avoidance scheme to be correctly identified. There was also agreement that the scheme must capture the identified tax benefit. There was the beginning of a principle in relation to expenses, that the scheme which identifies that tax benefit must encompass the same facts which are assessed to determine whether the expense was deductible for tax purposes. But there is no consensus on the identification of the dominant purpose of the taxpayer to achieve the tax benefit. The Full Federal Court has adopted an approach that endeavours to determine this against the background of the commercial reality of the transaction, because this is the way in which the court can attempt to counteract objectionable transactions more transparently, appropriately and fairly. This approach would appear to be in accordance with Parliament's express intentions. But this is not the way in which the High Court appears to be approaching the interpretation of Part IVA. The High Court seems to have set its hat at adopting a more restricted interpretative approach to Part IVA. This has meant that Part IVA applies to a broader range of transactions than its predecessor. The problem with this is that there is little transparency about decision-making at the High Court level and decisions are fact-specific, rather than principle-based.

To date the High Court decisions have been influenced strongly by the form in which the transaction was carried out. So that if the form of the transaction indicates something unusual which carries some tax advantage, that is likely to be seen as contravening Part IVA. That approach is again apparent in *Hart*, but the approach of Gummow and Hayne JJ. which is manifest in *Hart*, extends the ambit of Part IVA well beyond that. This approach effectively rewrites Part IVA. If a tax benefit can be just the step in the transaction which captures the tax advantage and the question is asked about the dominant purpose behind that step, it is clear that the test is self-determining. A dominant purpose of obtaining that tax benefit will inevitably be satisfied. It does not enable the tax advantage to be ignored: it enables the tax advantage to be segregated and annihilated, regardless of the consequences or importance in the overall commercial context. What *Hart's* case confirms is that clear principles, which enable a reasonable balance to be maintained between the revenue authorities and taxpayers, need not necessarily emerge from a statutory framework, or indeed prevail. Similarly, even identifiable signposts need not necessarily emerge, let alone a coherent or consistent interpretative approach, or set of guiding principles.

Overall, what the current situation in Australia has revealed is that the interpretative approach to Part IVA (particularly at the High Court level) is disclosing deficiencies both in the legislation and the interpretative approach to that legislation. The inquiry which has to be undertaken is in large measure artificial and is constrained by the eight reference criteria. Those criteria omit specific reference to the commercial context in which the taxpayer was acting and they make no reference to the artificiality, blatancy or contrived nature of the transaction, that is something with which Parliament was primarily concerned. While there is evidence that the High Court has given some acknowledgement

to the importance of the commercial aspects of the transaction, the emphasis is on the micro details of documentary form. Form has become critical to outcome.

In the light of this it is reasonably clear that if the United Kingdom were to re-consider the introduction of a statutory GAAR, the rule should be targeted. The Australian provision provides a useful precedent. But steps should be taken to address the problems with which the courts in Australia have been grappling. An attempt should be made to ensure that the identified tax advantage cannot, by itself, be the target of attack. In other words, it should be clear that the purpose of the transaction should be assessed against the factual matrix of the commercial context of the transaction, not just by reference to the identified tax benefit. This means that it is essential for the tax purpose to be assessed against, and in the context of, the commercial purpose. Where the tax benefit is a deduction for expenses, it should be identified by reference to the whole of the facts which give the expense the character of a deduction for tax purposes. Where the tax benefit is excluded income, what is sought to be included must be done by reference to realistic hypothesis. The purpose should be an objective purpose: it probably does not matter whether that is the purpose of the relevant taxpayer or the transaction. Whether the purpose should be capable of being attributed from anyone involved in the transaction and not just the taxpayer, is open to doubt. Such attributed purpose widens the anti-avoidance net considerably and causes taxpayer alienation. The transaction against which the purpose is assessed needs to equate with commercial substance and this is particularly so in relation to parts of transactions. The inquiry about purpose should be directed primarily to what the taxpayer did and not what the taxpayer might have done. Likewise, the inquiry regarding purpose should not be an inquiry about whether the taxpayer would have entered into the transaction, but for the tax advantage, as that test would be self determining. It would also need to be accepted that this test is a formula with its own criteria and outcome. It is not an inquiry about Parliament's intention.

A statutory test would, as Professor Freedman has pointed out, provide a framework for dealing with tax avoidance, but considerable care would be required in providing an appropriate framework. In the absence of that, accurate maps to assist in traversing "the dangerous and unpredictable territory" may not be forthcoming. <sup>LT</sup>

<sup>LT</sup> Australia; General anti-avoidance rule; Legal history; Purposive interpretation; Tax avoidance; Taxation administration

# Tax Avoidance, Treaty Shopping and the Economic Substance Doctrine in the United States

KAREN B. BROWN\*

## Abstract

*This article surveys a line of cases involving treaty shopping to demonstrate a lack of uniformity in the application of anti-avoidance law. Unpredictability inheres in any legal system in which the courts possess authority to decide cases after application of judicial doctrine. It also examines the ways in which the United States has moved beyond the common law legacy to adopt non-judicial strategies to combat treaty shopping. Anti-treaty shopping cases are placed in the broader context of the substance-over-form debate that permeates US tax law. US anti-avoidance doctrine is contrasted with the UK approach.*

## Introduction

INTERPRETATION of federal tax statutes in the United States, a common law country, is relegated to the courts.<sup>1</sup> Given the separation of powers among the legislative, executive, and judicial branches of government, in determining the success or failure of a tax-avoidance scheme, a judge must be careful not to venture into either law-making or usurping the prerogatives of the executive. Since the inaugural 1913 income tax statute, the power and obligation of the judge to prescribe the contours of a concept as fundamental as the term “income” has been axiomatic.<sup>2</sup> Additionally, the authority of the courts to scrutinise attempts by taxpayers either to minimise tax by availing themselves of an unforeseen loophole in a statute, to manipulate loopholes to gain a tax advantage, or to engage in circuitous transactions to obtain tax benefits has been unassailable.

The US courts have gauged these plans by reference to familiar templates, including the substance over form and economic substance doctrines. These judge-made prisms have furnished a convincing analytical framework in some areas. In others, however, they have not supplied uniform results in cases involving similar facts. Consequently, neither the taxpayer nor the government may confidently predict the parameters of acceptable tax planning.

This has led Congress to propose various forms of legislation targeting an overwhelming deluge of tax-avoidance schemes. A recent proposal to codify the economic substance doctrine was aimed at, what Congress perceived to be, an unacceptable level of self-help

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<sup>1</sup> US Constitution, Art.1, s.8, cl.1 (according Congress “the Power to lay and collect Taxes”) and Art.3, s.2, cl.1 (extending judicial power to all cases “arising under this Constitution, the Laws of the United States, and Treaties. . . made under their Authority”).

<sup>2</sup> *Eisner v Macomber* (1920) 252 US 189.



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tax relief. It formed part of a bill (which was not enacted) entitled the Tax Reduction and Reform Act of 2007 and provided detailed clarification of the economic substance doctrine.<sup>3</sup> In particular, it would have allowed taxpayers to obtain tax benefits in a transaction only if: (1) the transaction changes in a meaningful way the taxpayer's economic position; and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. The bill also would have provided penalties for transactions which did not meet the standard and for the taxpayer failing to disclose the entry into these schemes to the Internal Revenue Service (IRS).

Tax practitioners and, surprisingly, the Chief Counsel of the IRS opposed this codification of the doctrine. IRS Chief Counsel, Donald Korb, preferred the "flexible judicial rule" objecting to adoption of an "inflexible statutory rule".<sup>4</sup> He also believed that codification would unnecessarily complicate tax trials, requiring a three-phase inquiry into: (1) whether the economic substance doctrine is applicable; (2) whether the taxpayer fails the test; and (3) whether penalties apply. Finally, Korb expressed concern that codification would "chill[] some otherwise significant, legitimate transactions."<sup>5</sup>

Tax practitioners were sceptical that codification would provide any clarity in the application of the doctrine. They also believed that enactment of a statutory rule would overrule a significant US Supreme Court precedent<sup>6</sup>: *United States v Centennial Savings Bank FSB* allowed loss deductions for tax purposes on the ground that properties exchanged by the taxpayers were materially different in a situation in which the taxpayer treated the properties as essentially the same for bank regulatory purposes.<sup>7</sup>

As in the United Kingdom, US jurisprudence regarding limitations upon judicial authority to prevent circumvention of tax laws remains dynamic, depending in some cases upon the fact pattern of a particular controversy. While standards are employed in both jurisdictions, application to future transactions is hard to predict.<sup>8</sup>

Most recently, the government has had limited success in convincing US courts to readily void tax avoidance schemes involving treaty shopping. Dissatisfaction with the development of anti-avoidance law appears to be chief among the reasons Congress and the IRS have adopted non-judicial tools to fight tax avoidance involving these types of transactions. Faced with US court decisions, similar to decisions in the United Kingdom, where a statute has been read more rigidly so that it does not proscribe aggressive tax planning, Congress has enacted legislation permitting the IRS to issue detailed regulations to prevent the use of treaty shopping by using intermediaries. In addition the IRS has issued a series of administrative pronouncements aimed at proscribed transactions.

<sup>3</sup> House of Representatives (H.R.) 3970, ss 3501, 3502, 110th Cong (2007) (relevant parts are reproduced in the Appendix). A separate bill emerged from the Senate Finance Committee. See s.2242, ss. 511, 512, 110th Cong (2007). These proposals were motivated by a need to raise a substantial amount of revenue to offset a plan to eliminate an inadvertent tax increase on the middle class. H.R. 3970 was estimated to raise revenue of \$10 billion.

<sup>4</sup> J. Coder, "Korb Continues PR Battle Against Economic Substance Codification" 117 *Tax Notes* 578 (Nov 5, 2007).

<sup>5</sup> Coder, fn.4 at 578.

<sup>6</sup> Coder, fn.4 at 578.

<sup>7</sup> *US v Centennial Savings Bank FSB* (1991) 499 US 573.

<sup>8</sup> Survey of anti-avoidance case law reveals that both the UK and the US courts have accepted three roles—interpreter of statute, arbiter of legislative intention, and protector of taxpayer expectation.

### Treaty shopping decisions

The treaty shopping cases involve the use of a treaty-resident intermediary to obtain tax benefits not otherwise available. In the typical scenario, a party who is not eligible for a reduced rate of tax on investment income, typically interest, from US sources will insert a related treaty resident who benefits from a lower treaty rate of tax and passes the payment on to the taxpayer. A reviewing court may either affirm the transaction, allowing enjoyment of treaty benefits, or it may find the treaty inapplicable by ignoring or disregarding the intermediary or by concluding that the treaty provision does not apply to a conduit entity because the payments are destined for another non-treaty resident taxpayer.

*Aiken Industries v Commissioner*, the leading early case involving treaty shopping, held that a treaty exemption did not apply to interest payments from a related US corporation because the recipient did not qualify for the treaty benefit.<sup>9</sup> In this case an Ecuadorian parent company, ECL, seeking to avoid tax on interest payments, loaned funds to a US subsidiary through a Honduran intermediary. The transaction involved back-to-back loans of identical amounts and interest rates between the Ecuadorian parent, its US subsidiary and its Honduran subsidiary.

Although it declined the government's invitation to disregard the intermediary, the court nonetheless held that the treaty did not exempt the interest payments because the purported recipient had an obligation to transmit the payment to its parent.<sup>10</sup> Concluding that the Honduran subsidiary was a mere conduit for the passage of interest payments, it found that the transaction had no valid economic or business purpose.<sup>11</sup>

The tax court reached a different result in *Northern Indiana Public Service Co v Commissioner (NIPSC)*, sanctioning the use of a treaty to support borrowing in the Eurobond market.<sup>12</sup> In *NIPSC*, a US parent used a Netherlands Antilles subsidiary to borrow funds abroad in order to avoid US withholding taxes applicable at that time. Finding "actual, non-tax-related changes in economic position", the Court of Appeal affirmed the lower court's decision. It concluded that application of the step transaction doctrine was not appropriate because the subsidiary derived significant income from its borrowing and lending activities.<sup>13</sup>

<sup>9</sup> *Aiken Industries v Commr* (1971) 56 TC 925.

<sup>10</sup> In a recent decision, the Court reached a similar result, but, using a different rationale, it denied treaty benefits by applying the step transaction doctrine to disregard the treaty-eligible intermediary. See *Del Commercial Properties Inc v Commr* (DC Cir 2001) 251 F3d 210, cert. denied, (2002) 534 US 1104.

<sup>11</sup> *Aiken Industries v Commr* 56 TC 925 at 933

<sup>12</sup> *Northern Indiana Public Service Co v Commr*, (1995) 105 TC 341, aff'd, (7th Cir 1997) 115 F 3d 506.

<sup>13</sup> The Appeals Court contrasted the financially strategic transaction in *NIPSC* with those in cases like *Gregory v Helvering*, (1935) 293 US 465 and *Kneisch v US*, (1960) 364 US 361, where the taxpayers engaged in transactions lacking economic substance, manipulating the tax code to create "artificial deductions." *Northern Indiana Public Service Co v Commr* 115 F 3d at 512. The step transaction doctrine permits a court to treat purportedly separate steps as a single transaction. By refusing to give legal effect to intermediate steps, a court applying the step transaction doctrine determines whether the desired tax benefits are achieved by looking at the substance of the transaction. See, e.g. *HJ Heinz Co v US* (2007) 76 Fed Cl 570, 588 (noting that "a purchase by one person cannot be transformed into a purchase by another by using the latter as a mere conduit through which to pass title"); *Furnis v Dawson* [1984] AC 474 (HL) (transfer of stock to an intermediary company and tax-free sale by intermediary to pre-determined purchaser ignored and treated as a taxable sale by original transferor).

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In *SDI Netherlands BV v Commissioner*, the tax court again refused to find a conduit arrangement in a situation in which a Bermudan parent company licensed computer software rights to its Netherlands Antilles subsidiary in order to avoid US tax on royalties.<sup>14</sup> It concluded that the royalties paid by the subsidiary to the parent were not subject to US tax.<sup>15</sup> As in *NIPSC*, this decision rested upon the economic viability of the subsidiary which engaged in a business activity from which it derived considerable earnings consisting of the spread between royalties received and those paid to the parent.

The dilemma facing courts in the treaty shopping cases arises out of the need to determine carefully the legislative intention as reflected in the terms of the treaty as well as protect a taxpayer's ability to engage in legitimate business activity. As demonstrated above, the balance struck by the courts may pay too much attention to the importance of the taxpayer's interest in effecting business transactions that bear the lowest possible tax. For this reason, the US government has resorted to extra-judicial devices in order to restrict taxpayer efforts to secure treaty benefits for transactions not envisioned by the Contracting States.

### Government response to treaty shopping cases

Unacceptable results in the treaty shopping cases led the government to take action on four fronts. The IRS issued administrative rulings regarding conduit arrangements designed to circumvent treaties. Congress amended the tax code to permit promulgation of administrative regulations restricting treaty shopping and it began to renegotiate recent treaties in order to restrict treaty benefits to entities treated as resident under enhanced limitation of benefits clauses. It strengthened rules requiring disclosure of tax shelters, including those involving treaty shopping.

Anticipating litigation, but before its defeat in *SDI Netherlands*, the IRS issued Revenue Ruling 80-362, which, based on an identical scenario, denied the treaty benefits by disregarding the treaty-resident intermediary.<sup>16</sup> It also issued Revenue Rulings 84-152 and 84-153, both of which denied treaty benefits in cases in which treaty-resident subsidiaries were used to reduce the costs of borrowing.<sup>17</sup> While these rulings appear designed to provide an interpretive framework, i.e. demonstrate the government's view that treaty benefits do not extend to ineligible third parties, the courts have rejected them as not authoritative.<sup>18</sup>

For recent discussion of the step transaction doctrine in US law, see Ethan Yale, "Was Heinz's Two-Step Redemption a Sham?" 117 *Tax Notes* 345, 356 (Oct 22, 2007).

<sup>14</sup> *SDI Netherlands BV v Commr* (1996) 107 TC 161.

<sup>15</sup> The Court held that payments from the US licensee were US royalties eligible for tax-exemption under the US-Netherlands treaty. It declined to ignore the Netherlands Antilles intermediary and treat the payments from the US licensee as made directly to the Bermudan parent (and hence ineligible for a treaty exemption).

<sup>16</sup> Rev Rul 80-362, 1980-2 CB 208.

<sup>17</sup> Rev Rul 84-152, 1984-2 CB 381; Rev Rul 84-153, 1984-2 CB 383.

<sup>18</sup> *SDI Netherlands BV v Commr* (1996) 107 TC 161. See also *National Westminster Bank v US* (1999) 44 Fed Cl 120, 131, aff'd, 2008-1 US Tax Cas (CCH) para.50, 140. (In determining whether Treas. Regs. para.1.882-5 superseded US-UK treaty language allowing allocation of interest deductions by a US branch on a separate entity basis, the Court of Federal Claims found that Rev Rul 89-115, promulgated in anticipation of litigation, was not binding because it erred in concluding that the treaty lacked a specific and determinative rule for allocating interest expense.)

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After the decision in *Aiken Industries* and before the decisions in *NIPSC* and *SDI Netherlands*, Congress enacted in 1993 a new tax code provision prescribing the Treasury Department (IRS) authority to combat the use of intermediary financing schemes for tax avoidance. That statute provides as follows:

“The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.”<sup>19</sup>

Pursuant to that authority, the IRS has issued detailed regulations setting forth the rules permitting disregard of the participation of one or more intermediaries in a financing arrangement where such entities are acting as conduit entities.<sup>20</sup>

The new rules apply where a financing arrangement (including lending of money or the licensing of intellectual property) between related parties (or unrelated parties in some circumstances) is effected through an intermediary pursuant to a tax avoidance plan.<sup>21</sup> These regulations are designed to reverse the result in future arrangements similar to those in *NIPSC* and *SDI Netherlands*.

Congress has also addressed unacceptable tax avoidance by renegotiating existing tax treaties. In particular, the 2006 US Model Treaty, the prototype for modern agreements, narrows the definition of those entitled to treaty benefits to include only those entities meeting more stringent requirements. Accordingly, a company may rely upon treaty benefits only if there is, among other things, public trading of stock in the treaty country, ownership by bona fide residents of the treaty country (and no stripping of earnings out to non-residents), or conduct of an active business within the treaty country.<sup>22</sup>

In addition to prescribing standards for scrutinising treaty shopping transactions, Congress has resorted to requiring notice of entry into tax avoidance schemes. Several code provisions place the onus upon the taxpayer to alert the IRS of the existence of a controversial transaction.<sup>23</sup> Significant penalties for failure to disclose provide the impetus to advise the IRS of these arrangements.<sup>24</sup>

The above discussion examines steps taken by the government to provide rulings and regulations, to buttress treaty limitation of benefits clauses, and to require taxpayer self-reporting in the battle to stem tax avoidance. Despite these measures, the treaty-shopping cases that reach the courts are reviewed anew, free of the obligation to accept the government's view regarding characterisation of the arrangement. A court will undertake the task of determining whether there is sufficient economic substance to allow the transaction to proceed with the tax advantages which the organisers sought. A genre of the economic substance test has been employed by both the UK and US courts in examining taxpayer tax-avoidance techniques.

<sup>19</sup> 26 United States Code (USC), s.7701(l).

<sup>20</sup> Treas. Regs. s.1.881-3, T.D. 8611 (1995). The rules do not apply to interest payments with respect to debt obligations issued prior to October 15, 1984. Treas. Regs. s.1.881-3(f).

<sup>21</sup> Factors indicating tax avoidance include: significant tax reduction, closeness in time of the steps in a multi-party arrangement, and relationship or dependence of the parties. Treas. Regs. s.1.881-3(b)(2).

<sup>22</sup> US Model Income Tax Convention of November 15, 2006, Art.22(2)-(3).

<sup>23</sup> 26 USC, ss.6111, 6661 and 6662.

<sup>24</sup> 26 USC, ss.6662, 6707 and 6707A.

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### Ascendancy of the economic substance doctrine

The US economic substance test has been described as:

“merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.”<sup>25</sup>

Since the *Gregory v Helvering* decision, this doctrine has required that transactions that comply with the literal terms of the tax code but lack economic reality be disregarded.<sup>26</sup> Because it involves the judicial enforcement of a statutory purpose, the courts have applied the doctrine with varying results.

For example, the Fifth Circuit Court of Appeals refused to disregard a tax-motivated purchase and re-sale of stock designed to manufacture a capital loss because the transaction had economic substance. In that case, *Compaq Computer Corp v Commissioner*, the court respected the transaction for tax purposes because it resulted in pre-tax profit for the seller who ran a risk in the market of receiving less than the expected dividend (afforded to purchasers holding stock on a certain date) or re-selling shares at a lower-than-anticipated price.<sup>27</sup>

By contrast, in *ACM Partnership v Commissioner*, the Third Circuit Court of Appeals disallowed a capital loss resulting from a short-term acquisition and immediate disposition of corporate bonds (notes) because the transaction lacked objective economic consequences. The circumstances in *ACM Partnership* involved “only a fleeting and economically inconsequential investment in and offsetting divestment from [the] notes”, so the court found that the transactions left the taxpayer “in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes.”<sup>28</sup>

In *Coltec Industries v United States*, the Federal Circuit Court of Appeals applied the economic substance doctrine to disallow a loss on the sale of its shares in a subsidiary.<sup>29</sup> Prior to sale the parent had transferred a bond and contingent liabilities relating to future asbestos litigation to the subsidiary. Corporate tax provisions then in existence provided a high basis for the shares, affording a very large capital loss which offset a capital gain realised by the parent on the sale of shares in a different subsidiary. The court disallowed the loss, disregarding the transfer to the subsidiary. In its view, the transfer:

“effected no real change in the ‘flow of economic benefits,’ provided no true ‘opportunity to make a profit’, and did not appreciably affect the parent’s beneficial interests aside from creating a tax advantage.”<sup>30</sup>

In general, the US courts have held that a transaction will not be recognised for tax purposes when: (1) the taxpayer has no business purpose other than obtaining tax benefits; and (2) the transaction has no economic substance because there is no reasonable

<sup>25</sup> *Coltec Industries Inc v US*, (Fed Cir 2006) 454 F 3d 1340, 1354, vacating and remanding, 62 Fed Cl 716 (2004), cert. denied, (2007) 127 S Ct 1261.

<sup>26</sup> *Coltec Industries Inc v US* 454 F 3d at 1352.

<sup>27</sup> *Compaq Computer Corp v Commr* (5th Cir 2001) 277 F 3d 778, rev’g (1999) 113 TC 214.

<sup>28</sup> *ACM Partnership v Commr* (1998) 157 F 3d 231, 250, cert. denied, (1999) 526 US 1017.

<sup>29</sup> *Coltec Industries Inc v US* (Fed Cir 2006) 454 F3d 1340 at 1354, vacating and remanding, 62 Fed Cl 716, cert denied, (2007) 127 S Ct 1261. See also *Black & Decker Corp v US*, (4th Cir 2006) 436 F 3d 431 (discussing the economic substance doctrine in the context of a similar transaction).

<sup>30</sup> *Coltec Industries Inc v US*, 454 F3d at 1360.

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possibility of profit.<sup>31</sup> Some courts have rejected this two-step approach, looking at the lack of business purpose and economic effect as factors that assist in the determination of whether a transaction has sufficient substance, apart from tax advantages, to be respected for tax purposes.<sup>32</sup> Development of a type of economic substance doctrine in the United Kingdom has somewhat approximated that in the United States.

The decisions of the House of Lords, in *WT Ramsay Ltd*, disallowing a loss manufactured by the manipulation of interest rates on identical bonds, and *Furniss v Dawson*, ignoring an intermediate transfer of shares and treating the gain on sale as that of the transferors instead of the intermediary, reached results similar to those in US cases.<sup>33</sup> A recent decision by the court in *Barclays Mercantile Business Finance Ltd v Mawson*, indicated that the governing principles in the United Kingdom are quite different.<sup>34</sup> In that case, the House of Lords upheld a capital allowance to a purchaser of a gas pipeline who leased it back to the seller. It found that a separate arrangement whereby the lessee in effect deposited funds with a party related to the seller, in effect guaranteeing return of the purchase price to the purchaser-lessor, did not undermine the allowance. To determine whether a taxpayer is eligible for tax benefits claimed, the court offered a two-step formula: (1) employ a purposive examination of the statute to determine what it covers; and (2) decide whether the transaction fits. It is likely that this formula, less flexible than the economic substance doctrine used by the US courts, will produce different results.<sup>35</sup>

## Conclusion

The broad leeway accorded to Congress to levy an income tax to the fullest extent of its constitutional power places considerable power in the federal courts as well. This allows the US courts to determine not only the breadth of the tax base by deciding what constitutes income, but also to prescribe the constitutional limitations on Congress's taxing power.<sup>36</sup> While courts in both countries possess the power to discern the meaning of tax legislation, US courts seem less constrained to take an activist approach. This distinction in the court's exercise of power to dismantle tax avoidance schemes was noted by Lord Wilberforce in *Ramsay*, when he announced a new approach to evaluating tax avoidance schemes lacking economic reality:

"It is probable that the United States courts do not draw the line precisely where we with our different system, allowing less legislative power to the courts than they claim to exercise, would draw it, but the decisions do at least confirm me in the

<sup>31</sup> *Rice's Toyota World v Commr*, (4th Cir 1985) 752 F 2d 89, 91.

<sup>32</sup> *ACM Partnership v Commr* (3rd Cir 1998) 157 F 3d 231.

<sup>33</sup> *W.T. Ramsay Ltd v IRC* [1982] AC 300 (HL); *Furniss v Dawson* [1984] AC 474 (HL). Compare *Craven v White* [1989] AC 398 (HL) (refusing to treat gain on sale by intermediary as gain of another).

<sup>34</sup> *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51; [2005] 1 AC 684 (HL).

<sup>35</sup> See, e.g. *Del Commercial Properties Inc v Commr*, (DC Cir 2001) 251 F 3d 210, cert. denied, (2002) 534 US 1104.

<sup>36</sup> See, e.g. *Eisner v Macomber*, (1920) 252 US 189 (holding that stock dividend was not income within the meaning of the 16th Amendment) and *Commr v Glenshaw Glass Co* (1955) 348 US 426 (holding that punitive damages and treble damages for antitrust violations constituted taxable income); *Murphy v US* (DC Cir 2007) 493 F 3d 170 (holding that Congress had the power to tax compensatory damages for emotional distress and loss of reputation).

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belief that it would be an excess of judicial abstinence to withdraw from the field now before us.”<sup>37</sup>

More recently the House of Lords maintained that the *Ramsay* decision rested upon general principles of statutory construction that allowed a court to construct a “purposive”, not literal, interpretation of a statute and to determine whether a given transaction was covered.<sup>38</sup> It concluded that insertion of commercially meaningless steps did not affect the taxpayer’s acquisition of ownership, which was the pre-requisite to permit the operation of the tax benefits in question.

The US courts have employed the more general economic substance doctrine to address tax avoidance, seemingly without regard to developments in the United Kingdom or elsewhere. Except in the early years of the income tax, US courts made very little reference to precedent in the United Kingdom.<sup>39</sup> While the US “economic substance” decisions do not look to UK decisions for guidance, some developments are parallel. For example, an appellate court’s recent rebuke of a trial court’s suggestion that application of the economic substance doctrine might violate the prerogative of the legislature echoes those found in the more recent UK cases.<sup>40</sup> The IRS Chief Counsel’s opposition to codification of an anti-avoidance rule also supports judicial review of tax avoidance schemes. With safeguards in place that limit the number and types of cases moving forward, he prefers to leave it to the courts to decide what is unacceptable tax avoidance.<sup>41</sup> <sup>LT</sup>  
[Please see the Appendix overleaf.]

<sup>37</sup> *WT Ramsay Ltd v IRC* [1982] AC 300 (HL) (Lord Wilberforce).

<sup>38</sup> *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51; [2005] 1 AC 684 (HL).

<sup>39</sup> See, e.g. *Eisner v Macomber* (1920) 252 US 189 (rejecting the decision in *Swan Brewery Co Ltd v Rex* [1914] AC 231, which upheld imposition of a dividend duty on a stock dividend); *Merchants’ Loan & Trust Co v Smetanka*, (1921) 255 US 509 at 521. Compare *Pollock v Farmer’s Loan & Trust Co* (1895) 158 US 601 at 630.

<sup>40</sup> *Coltec Industries v US* (2004) 62 Fed Cl 716, 756 (2004), vacated and remanded, (Fed Cir 2006) 454 F.3d 1340, cert. denied, (2002) 127 S Ct 1261 (where a taxpayer has satisfied all the statutory requirements established by Congress, as Coltec did in this case, the use of the “economic substance” doctrine to trump “mere compliance with the Code” would violate the constitutional separation of powers).

<sup>41</sup> See William B. Barker, “A Comparative Approach to Income Tax Law in the United Kingdom and the United States” (1996) 46 Cath U L Rev 7, 8–9.

<sup>LT</sup> Double taxation; Economic substance doctrine; Tax avoidance; Treaty shopping; United States

**APPENDIX—Extracts from the Tax Reduction and Reform Act (Bill) 2007**

**Section 3501. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE**

(a) **IN GENERAL.**—Section 7701 [of 26 USC] is amended by redesignating subsection (p) as subsection (q) and by inserting after subsection (o) the following new subsection:

**(p) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE**

(1) **APPLICATION OF DOCTRINE.**—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) **SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.**—

(A) **IN GENERAL.**—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) **TREATMENT OF FEES AND FOREIGN TAXES.**—Fees and other transaction expenses and foreign taxes shall be taken into account as expenses in determining pre-tax profit under subparagraph (A).

(3) **STATE AND LOCAL TAX BENEFITS.**—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) **FINANCIAL ACCOUNTING BENEFITS.**—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if such transaction results in a Federal income tax benefit.

(5) **DEFINITIONS AND SPECIAL RULES.**—For purposes of this subsection—

(A) **ECONOMIC SUBSTANCE DOCTRINE.**—The term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) **EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.**—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) **OTHER COMMON LAW DOCTRINES NOT AFFECTED.**—Except as specifically provided in this subsection, the provisions of this subsection



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shall not be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any such other rule of law.

(D) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection. Such regulations may include exemptions from the application of this subsection.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

### Section 3502. PENALTIES FOR UNDERPAYMENTS.

#### (a) PENALTY FOR UNDERPAYMENTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE.—

(1) IN GENERAL.—Subsection (b) of Section 6662, as amended by this Act, is amended by inserting after paragraph (6) the following new paragraph:

(7) Any disallowance of claimed benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(p)) or failing to meet the requirements of any similar rule of law. . . .

[Without this amendment, section 6662(a) adds a penalty equal to 20% of an underpayment of tax arising out of specified taxpayer behaviour, including negligence, omissions, overstatements, understatements, or valuation misstatements. Sec. 3502 goes on to add a new subsection at the end of section 6662, the relevant part of which is reproduced below.]

#### (j) INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—

(1) IN GENERAL.—To the extent that a portion of the underpayment to which this section [6662] applies is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting “40 percent” for “20 percent.”

(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—For purposes of this subsection, the term “nondisclosed noneconomic substance transaction” means any portion of a transaction described in subsection (b)(7) [of s.6662] with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

# The Administration of the Revenue: the Growth of Bureaucracy 1839–66

STEPHEN MATTHEWS\*

## Abstract

*This article examines the nuts and bolts of office working to show how one particular department, the Inland Revenue (now HMRC), evolved from the loosely decentralised structure of the 1830s to a tight knit and closely-controlled organisation 40 or so years later. This was achieved by management exercising an increasing degree of detailed control over systems which eliminated individual and local practices to create a truly uniform national service.*

## Introduction

THIS article addresses a neglected—and to many people an uninviting—subject: the growth of bureaucracy. This term has many meanings and most commentators have concentrated upon its growth “as an institution or a caste, a mode of operation, an ideology, a way of viewing and organising society or a way of life.”<sup>1</sup> They have rarely looked below the upper tiers of central government and the growing interest of government in managing social change. Sabine has traced the development of the Revenue Department in national and political terms but this article examines a lower tier: how things actually worked at office level.<sup>2</sup> The author has tried to avoid covering aspects already explored by others, and thus there is little mention of staff numbers, administrative cost or the broad sweep of legislation. Studies of the growth of central administration have followed one of two paths: to address the growth of government in the abstract; or to study the political purpose of a department, its impact upon society and the economy of the state. Even when administrative detail has been introduced, there has been theory but little hard fact.<sup>3</sup> Studies have also tended to overlook the fact that governmental administration did not operate in isolation but developed in parallel with private sector administration. Webber and Wildavsky argued that:

“... gradually governments accepted knowledge accumulated in the private sector—about channels of authority and control; about organisation of work; about

\* Retired Inspector of Taxes. The author owes much of the information on early members of the Henzell family to Mr Keith Livesey and Dr Robert Colley, the latter also commented on an earlier version of this article: the author is extremely grateful to both. The author is also indebted to Mr Andrew Harper for critical comments and for going well-beyond the call of duty in obtaining documents from the National Archive. The failings that remain are the author's.

<sup>1</sup> E. Kamenka, “Introduction” in E. Kamenka and M. Krygier (eds) *Bureaucracy: The Career of a Concept* (Edward Arnold, London, 1979) at vii.

<sup>2</sup> The best history of the Revenue remains B.E.V. Sabine, *A History of Income Tax* (Allen and Unwin, London, 1966), especially Chs IV and V.

<sup>3</sup> H.A. Simon, *Administrative Behavior* (2nd ed., Macmillan, New York & London, 1957), Ch.8.

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efficiency, cost cutting and honest management of resources—and formulated it in new ways making it useful in the larger scale and varying situations of public organisations.”<sup>4</sup>

They ignored the possibility that in return government influenced the private sector and the question remains of who copied from whom. They gave no evidence to support either, and the question is too big for this article: sufficient to say that on the evidence given below, although government was becoming more intrusive in its legislation, not only in taxation, its administrative tools tended to follow only one step behind the private sector. It is worth pausing to consider a few parallel situations. Historically, the largest administrative departments had been concerned with war and in the middle of the century the Crimean War gives us two examples. One is the building of the railway to support the troops, an enterprise conceived and managed solely by private enterprise but from which the army was to learn much. As Brian Cooke observed somewhat extravagantly:

“In a few months, Morton Peto and Beatty and their men had enabled the art of war to be taken from Waterloo to the Somme”.<sup>5</sup>

The other is the development of veterinary services. The war created an unprecedented demand for horse-power and military veterinary services were as inadequate as its others. Russell noted that the pack animals used by the railway contractors were much better cared for than the military, and veterinary surgeons attempted to improve care both by experimental treatment and contact with their French equivalents. There was from then on a close relationship between the military and the civilian veterinary practices developing under the Royal College of Veterinary Surgeons.<sup>6</sup> The closest commercial parallel is with bankruptcy reform, where the government demonstrated a revealing ambivalence. In the 1830s the thrust had been towards official interference, but although this took legislative form, it was largely in response to unease with the existing arrangements expressed by non-governmental bodies. Thirty years later most of these reforms had been repealed, once more in response to by now changed commercial opinion. Despite criticism that the earlier reforms had been intrusive the reality seems to have been less a government intent upon close control than a government trying to accommodate confused and changing commercial opinion.<sup>7</sup> Commercial rather than political necessities were the dynamic and further examples of the interaction between private and government administration is provided by the railways, which are reviewed below.

More often than not, the existence of a link has to be a presumption for we lack the evidence to trace it. As Dr Colley wrote *à propos* Revenue papers, “[t]here would inevitably have been a flow of instructions and correspondence between the surveyor and Somerset House”: but he went on to lament its destruction or disappearance except for a little

<sup>4</sup> C. Webber and A. Wildavsky, *A History of Taxation and Expenditure in the Western World* (Simon and Schuster, New York, 1986) at 316–17.

<sup>5</sup> B. Cooke, *The Grand Crimean Central Railway* (Cavalier House, Knutsford, 1990) at 149.

<sup>6</sup> W.H. Russell, *The War*, Vol.II (Routledge, London, 1856) at 107; *The Veterinarian*, April 1856, January 1857, April 1857, April 1867; I. Pattison, *The British Veterinary Profession 1791–1848* (J.A. Allen, London, 1983) at 16–17, 39, 118–19.

<sup>7</sup> For the reforms in insolvency, see V. Markham Lester, *Victorian Insolvency* (Clarendon Press, Oxford 1995) Chs 2 and 4, especially at 40, 44–48, 56, 64–70, 86–87, 123.

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isolated material.<sup>8</sup> Some remains: the National Archives contain at least four collections of instructions to surveyors which demonstrate the close relationship between the Board and its servants, but this article is based upon a fifth collection, now deposited in the Cheshire Record Office.<sup>9</sup> This was assembled by Mr J.H. Henzell, a Surveyor of Taxes from 1839 to approximately probably 1869. This bundle is precisely that flow of instructions whose loss Dr Colley lamented and, although not unique, it covers a longer span of time than some of the others and contains personal material not included elsewhere. My theme can therefore be detail. What I want to show is how this department evolved into an efficient office network. How far its development was mirrored by other departments is another and more difficult question.<sup>10</sup>

### The course of development

The Revenue Department on the eve of the new Income Tax Act of 1842 was a decentralised affair, running on the well-established network of clerks and commissioners, with the Surveyor acting as a monitor of performance. The emphasis was on local initiation: the commissioners appointed their clerk, made the assessments and appointed the collector and other officials. The surveyor was the only representative of central government and his role was limited to monitoring the workings of the local bodies to ensure that all assessments were made, that they were made in adequate amounts and that the collector didn't cheat. Although the bundle of papers upon which this article is based did not see the process to conclusion, by the time it ends in 1866, the department was well on the way to being transformed into a tightly-managed affair, whose control mechanisms made it the preferred choice for the administration of the first ever livestock census, an exercise that had defeated previous governments for many years. The process was seen as part of intrusive centralisation in other areas of government which resulted in complaint about the omnipresent activity of the state.<sup>11</sup> In reality what the Board<sup>12</sup> achieved was a paradox that may be termed "devolved centralisation": with the exception of some activities that were the prerogative of the Special Commissioners (below), power and discretion came to rest increasingly with the local surveyors, but their subjection to a rigorous regime of uniform training and supervision gave tremendous power to their masters in Somerset House. This structure fitted exactly that set out by Rowe in another context:

"It should not be thought that a decentralised structure implies a weak centre: it is simply an alternative mechanism for maintaining control, only it operates on terms laid down by the centre and is still control. It is maintained not by centralising decisions towards the top, but by setting clearly defined tasks, rules and procedures within which people can operate. This less visible form of power sets limits on what

<sup>8</sup> R. Colley, "Destroy'd by Time's Devouring Hand? Mid-Victorian Income Tax Records: a Question of Survival" in (April 2000) XXV *Archives* 74 at 79.

<sup>9</sup> TNA:PRO IR78/73, 78/74, 78/276, 78/277, Chester Record Office, D6148.

<sup>10</sup> For a discussion see M. Ogborn, "Local Power and State Regulation in Nineteenth-Century Britain" in (1992) 17 *Transactions of the Institute of British Geographers* (TIBG) 215.

<sup>11</sup> C. Dandeker, *Surveillance, Power and Modernity: Bureaucracy and Discipline from 1700 to the Present Day* (Blackwell, Oxford, 1994) at 143.

<sup>12</sup> "The Board" is used indiscriminately to include The Board of Stamps and Taxes and its successor from 1849, the Board of Inland Revenue.

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subordinates might do, and provides a kind of freedom of manoeuvre within bounds; but it is still bureaucratic control.”<sup>13</sup>

The Revenue is a prime example of this: the Surveyor became the eyes of central government in the locality in a role that in other matters had to be fulfilled by peripatetic inspectors. It is surprising that it has attracted so little attention. This type of structure gave little scope for the tensions noted elsewhere. In the Revenue structure there were two separate local bodies, the Board’s own officers and the General Commissioners. The former, by training and by loyalty, remained a detached segment of the centre while the latter, although locally based and independent, had their origin in the same body of legislation as the centre. To that extent they were interdependent, not opposed.<sup>14</sup> Further, the Board had neither the legislative power nor the inclination to interfere with the workings of the commissioners, provided that they did their duty, and the weight of tradition and familiar usage continued, as noted elsewhere by Dandeker.<sup>15</sup>

Communication flowed both ways for not only did the Board issue instructions, but it called for local reports on particular issues, some of which survive in the bundle. These included analyses of tax payments for the Surveyor’s area, and of local house values for electoral purposes. In addition, the Surveyor was free to consult the Board if he was in doubt, as Mr Henzell did.

The development in communication is evident in consultation. Masters had always consulted their servants on a one-to-one basis, in the farmyard, estate office or stable, but improved postal services, linked once more to the railways, made consultation *en masse* possible, in sufficient time for administrative decisions to be based upon the opinions of large numbers of employees. To some extent Webber and Wildavsky missed the point in noting the contribution of individual officers of lower rank.<sup>16</sup> Their cumulative voice also became important, as when, preparing for the 1866 livestock census, the Board asked the Surveyors whether they thought it was worthwhile to extend the census to include holdings of fewer than five acres, and depending upon the answer, how many copies of the return would be required. The request was made on December 2, 1865; the reply had to be received by December 11 and revised instructions were issued on December 26. Such flexibility would have been impossible half a century before.<sup>17</sup>

Some old ways persisted, notably the failure to preserve papers for future reference or evidence, but despite those failings, in these years central control had been established and locally the surveyor increasingly came to rival the clerk as the dominant administrative figure. It was not achieved without some pain. Surveyors felt the pressure of reform and

<sup>13</sup> C. Rowe, *People and Chips: the Human Implications of Information Technology* (Paradigm, London, 1986) at 100. As a personal reflection of the power of the (now) Inspector, the author remembers being reminded, albeit nearly 30 years ago, by a local accountant that in business matters, he was “the most important man in Altrincham”: hyperbolic, but he had a point.

<sup>14</sup> See, for example, the discussion in TIBG, fn.10, especially at 119.

<sup>15</sup> Dandeker, fn.11 at 121: “These considerations account for the pattern of police administration in England during the nineteenth century: it was at one and the same time a break with the past and a continuation of traditional structures. The element of continuity was the persistence of localism until well into the twentieth century and the *gradual* process by which the central state intruded into local affairs.”

<sup>16</sup> Webber and Wildavsky, fn.4 at 318.

<sup>17</sup> S. Matthews, “The Administration of the Livestock Census of 1866” (2000) 48 *Agricultural History Review* 223 at 225.

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the increased legislative burden, which was to culminate, outside the years covered by this study, in a petition, signed in 1868 by 210 of them, for better terms of employment and enhanced promotion prospects.

### The background

Revenue collecting agencies have been a feature of government ever since the idea of government was born, and in the United Kingdom each legislative change relied upon the structure of the last, so that change continued within an existing framework. In a legislative sense, the origin of the modern department of Inland Revenue was different, born out of the “big bang” of one Act, the re-introduction of income tax in 1842. The administration nevertheless had to be grafted onto an existing structure. There had been an earlier income tax but although it had been repealed its memory remained. Both that, and what followed from 1842, were operated from within an existing structure of assessed taxes, using the same officers, local geographical divisions, and an existing network of commissioners. That continuity was contrasted with a profound psychological difference, for the income tax was not only seen as a burden, but it was intrusive, with its officials prying into the citizen’s private affairs.<sup>18</sup> It is a difference that the citizen still feels in the contrast between VAT, where tax is paid unknowingly and by someone else within an overall item price, and income tax, which painfully faces the employee every time he receives his remuneration. This permanent change of emphasis where the state taxes the individual citizen rather than his life-style was brought about by the 1842 Act and has no parallel in indirect tax systems. The intrusion into the citizen’s privacy resulted in the growth of a separate and parallel assessing body, the Special Commissioners, based in London, not locally, whose task it was to assess those whose complex affairs or vanity compelled them to have their income assessed outside the locality, lest their neighbours might find out. They also—and this was an innovative centralisation—acquired the power to assess nation-wide undertakings, notably railways, whose activities lay beyond the capacity of any one local official.<sup>19</sup>

With hindsight, the revenue department of 1842 would plainly not be capable of carrying the burden of the new tax, but this was not apparent at the time. The new charge was a temporary one, only intended to tide the government over a temporary difficulty. It would be gone in a few years. Consequently, the Board saw no need to increase the complement of 140 surveyors beyond an addition of 80 supernumerary (trainee) surveyors. It appears not to have been until the early 1870s that the Board publicly accepted that this was an illusion, when it became apparent to all. That did not imply complete stagnation and the impact of the Trevelyan reforms and the reconstitution of the Board in 1849 must have stimulated change.

If the local official was to have power, the immediate need was for public conformity across the country matched by internal consistency. The network of taxing officials has to be seen in the context of changes in nineteenth-century society. Two that were probably the most influential were communications and finance. The railways, developed only a short time before the re-introduced income tax, created a unified society as nothing had

<sup>18</sup> Sabine, fn.2 at 63.

<sup>19</sup> C. Stebbings, “Access to Justice before Special Commissioners in the Nineteenth Century” [2005] BTR 114 at 134; R. Colley, “Railways and the Mid-Victorian Income Tax” (2003) 24 *Journal of Transport History* 78 at 94.

before: the creation of railway time, a national time, rather than local time, is often cited. Ruskin might complain in his well-known rural rant that “every fool in Buxton can now be in Bakewell in half-an-hour and every fool in Bakewell at Buxton” but his ire masked an important social change.<sup>20</sup> The practical outcome was that the fool in Buxton could easily find out what tax offices elsewhere were doing, and if there were any significant variation, complaint and ridicule could follow. Railways enabled a national press to be read across the country within hours, which provided the same opportunity for comparison.

The growth of large limited liability companies in the nineteenth century, of which railways were perhaps the most prominent example, introduced three new practices which in time were adopted or mirrored by government. Particularly after the early railway scandals, companies had to produce reports to inform their shareholders of how their investment has been handled. It is probably impossible to demonstrate a direct link but nearly a decade after its reconstitution, in 1857, the Board produced a report summarising progress in those years, and thereafter produced an annual report of its activities, very much in corporate style.<sup>21</sup> Its production may in part have arisen because, having no minister responsible to Parliament, the Board had to find a mechanism to account not only to government but to the public for its greatly increased responsibilities, but whatever the cause, the solution was a corporate one. Secondly, the expansion of businesses beyond the grasp of a small family or known group created avenues for economic and social advance for employees outside the traditional world of patronage and nepotism. What skill you had became more important than who your father knew and Mr Henzell is very probably an example of this type of “new” employee. We know little of his background, but there are certain indications that it was not gentry and that patronage played little part in his career. One relation in Stockport was a shirtmaker, another, who might be identified as an uncle of his wife, was the same, whilst in his will, made after he retired, he described himself as a “common brewer”. As he was in partnership with one of his sons, it may be that he was a passive investor, but he was content with the trade title, despite living in a smart Manchester suburb. Arrangements for interim payment of salary and personal touches like the transfer back to London of Mr Gilbert to enable him to be with his sick mother, suggest that we are looking at a new breed of employee, without a patron in support. Together, these developments demonstrate a relationship between corporate and public administration that has never lessened, so much so that by the constant engagement of private management consultants in governmental affairs, we accept it as normal. Thirdly, as enterprises not only covered large sections of the kingdom, uniformity of practice became essential, and uniformity frequently within a very narrow time frame. There had always been volumes of instruction, amended or replaced every few years, but these were too inflexible with new technology, in the case of railways or shipping, or new legislation, in the Revenue. Hence the adoption of the printed circular, setting out broad policy or detailed instruction. Mr Henzell’s circulars have a parallel in the issue of circulars to railway personnel or shareholders, and we will return to this below.

Movement away from patronage in departments like the Revenue was mirrored in other walks of life. The granting of a charter to the Royal College of Veterinary Surgeons in 1844 was the prelude to a long debate over the training, and indeed the very purpose of the profession. Was it to be the preserve of the “hands-on” practical man of modest status

<sup>20</sup> J. Ruskin, *Præterita* (Allen, London, 1886–87), Vol.III at iv.

<sup>21</sup> Report of the Commissioners of Inland Revenue C.2199 Sess.1 (1857).

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or was the curriculum to retain the traditional emphasis on the classics, even Greek, in order to achieve a social status equal to that of the more gentlemanly doctors? Even one of the most traditional careers, that of the estate manager, was changed by the establishment of the Agricultural College at Cirencester in 1845. These “new men” had to be educated, and commercial publishers responded to the need with numerous educational works, especially histories of England, designed to help the aspiring candidate to pass the entry examinations. Some of these works ran to many editions and hundreds of thousands of copies.<sup>22</sup> All this reflected a swing towards professionalism and away from patronage: a change that public administration could not ignore.

Increasingly, the government used the network of surveyors to provide information for its own planning, and this had its culmination, as far as the bundle is concerned, in the instructions issued to them for the administration of the livestock and crop censuses of 1866, with which it ends. The choice of the surveyors for this task is a testament to the improvements made by the Board since 1845 when Gladstone rejected their use.<sup>23</sup>

With that preliminary and before we turn to the contents of the bundle, we must divert to look at it and the other available sources.

### The sources

This article is based primarily upon a collection of instructions and memoranda issued to Surveyors of Taxes in the years 1839–1866 by two bodies, the Board and the Clerk to the Special Commissioners. The overwhelming majority relate to income tax, which is understandable as the assessed taxes used long-established procedures, but some do reflect the past rather than the future. It was assembled by John Harrop Henzell, who, after several career moves, probably ended his service as Surveyor in Manchester. There are about 250 documents, glued into a bound volume (in the author’s time called a guard book) designed for the purpose; this is of a kind now long obsolete, consisting when bought of simply two covers and a number of strong spinal strips to which the required documents could be attached. The much battered spine bears the remains of a manuscript title “Circulars 4[?] January . . . 9 to 29 May 1866”, which is probably when he left Stockport. We can only speculate as to why he left it there: it was not full and he could have added to it. Maybe there was a complete set in Manchester or perhaps his successor needed it. The author found it in a cupboard, about 120 years after the last entry in it. Apart from a few misnumberings, Henzell’s bundle is deceptively tidy and appears to be complete except for an obvious gap in the latter part of 1849 and all of 1850 but in fact there are many circulars missing. At its end is an index giving the name and subject of each document. Some of the missing circulars can be recovered by comparison with other bundles held in the National Archives, described below, but there may still be some that have disappeared entirely. There are probably several causes for the gaps in Henzell’s bundle. A few early circulars may have preceded or coincided with his joining the Revenue so he never had them: others may have been retained by his predecessors in office or left behind for his successors; others may simply have been lost before being pasted in or thought to be ephemeral and not worth preservation. None of the bundles examined was complete and the table of issues at the end of this article is a combination of three.

<sup>22</sup> For a review of this material, see V.E. Chancellor, *History for Their Masters: Opinion in the English History Textbooks 1800–1914* (Adams and Dart, Bath, 1970).

<sup>23</sup> Matthews, fn.17 at 224.



Henzell's bundle probably covers the longest time span. One bundle reached the National Archives in 1940 from Exeter 3rd district, having probably been assembled by Henzell's contemporary, William Kite, in various west-country postings.<sup>24</sup> It was not maintained in a guard book but loose tagged, and neither that nor the third collection<sup>25</sup> are exactly the same, each containing some material not in the other. The last of these was compiled by a Mr Lloyd, who was probably a Metropolitan Surveyor. It not only contains circulars addressed to the surveyors but copies of those sent to Inspectors and clerks to General Commissioners and also a number which, although sent to the Surveyor, concerned the collectors who had to be told of their contents. Mr Kite's is a loose bundle of papers. As important as what was sent to the surveyors are copies of some of the replies that both Mr Kite and Mr Henzell sent. How any of the collections survived is remarkable, but we will never know their later history.

Other sources include the Board's reports, and while parliamentary papers are a mine of statistical and formal information they inevitably reflect the range of matters that would interest Parliament and the minutiae of office life were not among them. More light is cast on day-to-day matters by evidence given to the Hume and Hubbard Committees, but they tell more of the public face of the Department, as in relations with commissioners, rather than its detailed inner workings.<sup>26</sup> That is largely where official sources cease. There is occasional information in *Hansard*, as when there was a scandal over the sale of Revenue paper, and the odd newspaper report, as when the Chester Surveyor was tried for corruption.<sup>27</sup> At the instigation of Basil Sabine, the nineteenth-century records of the Manchester General Commissioners were preserved.<sup>28</sup> An interesting glimpse of life at Somerset House is provided by the diary of Samuel Bamford, though what he says should not be accepted uncritically. He was an awkward man who felt that he alone had the answers to most issues, and he plainly enjoyed describing the petty infighting and mistakes of office life. It is a pity that he was about to retire—at the age of 70—when the diary started in 1858 and we have nothing of his previous seven years of service. One suspects that his tone would have been little different.<sup>29</sup> With all caution though, the stories in the first ten printed pages ring true, and they give weight to the fictional description of office life given by Anthony Trollope in *The Three Clerks*.<sup>30</sup> Another classic anecdote is that of Mrs Carlyle in her encounter with the Appeal Commissioners on her husband's behalf but this tells us little of the internal workings of the department.<sup>31</sup> They all add colour to the administrative material but each is told with an eye to a story rather than scrupulous accuracy. One unexpected source is *The Veterinarian* in 1855, when three practitioners' experiences were contrasted and the Board's role revealed (below).

<sup>24</sup> TNA:PRO IR78/276.

<sup>25</sup> TNA:PRO IR78/277.

<sup>26</sup> The proceedings of these two Committees can be most conveniently read in Sabine, fn.2 at 67–71 (1851 Hume) and 83–87 (1865 Hubbard), rather than wading through the full reports in Parliamentary Papers.

<sup>27</sup> S. Matthews, "A Chester Scandal of 1854: A Study in Administrative Failure" [2000] BTR 154.

<sup>28</sup> They were deposited in the Preston Record Office by the then clerk. The present author deposited the minute book for General Commissioners' hearings held by one of the central Manchester districts in the Greater Manchester Record Office.

<sup>29</sup> M. Hewitt and R. Poole (eds), *The Diaries of Samuel Bamford* (Sutton Publishing, Stroud, 2000).

<sup>30</sup> A. Trollope, *The Three Clerks* (Bentley, London, 1857) at Chs 2, 3.

<sup>31</sup> T. Holme, *The Carlyles at Home* (OUP, Oxford 1965) at 142.

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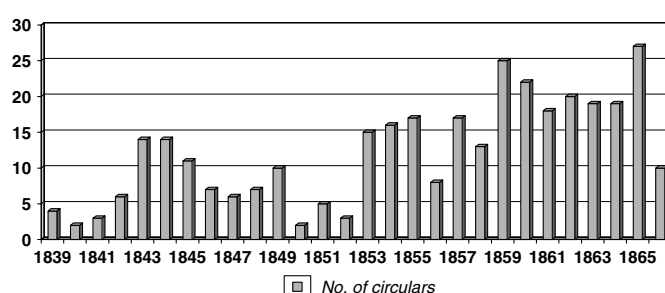
The paucity of evidence hinders study of the early history of the department. So much is missing. For over 20 years of its life the new income tax was a temporary imposition, whose abolition was always just around the corner. That, and its perceived inquisitorial nature, meant that once all accounts for a particular year had been settled, records were destroyed, not preserved. This was recounted in court when Ambrose Clarke was tried in Chester in 1854, for the prosecution lacked evidence of his misdoings for all years except the most recent. Dr Colley has set this out at length, and shown how casual some employees could be to the disposal of confidential papers.<sup>32</sup> We will return to these lapses below, but for the moment merely remark that although the Board achieved a great deal in the creation of a modern administration, it failed in this one respect. The past was a dead subject. To some measure the attitude survives, though now in the interests of efficiency: one can only regret the destruction of the old Schedule A records after its abolition in 1961.

Mr Henzell's career is worth mention but it is not directly relevant to the theme of this article. I have therefore put a summary at the end in an Appendix, for its interest in its own right and as an example of how the career system worked.

### The circulars

The extent of the Board's intervention is shown by Table 1, which sets out the number of circulars issued each year: it must be read with the caveat that they may still not be complete. Although the analysis does not show it, almost all in the later years were concerned with administration rather than the technicalities of legislation. I have divided the circulars into four groups, but the boundaries are arbitrary and at times overlapping. Little hangs upon the division, but it does enable themes to be followed. They are personnel, procedural, assessment and departmental management. It will be no surprise to devotees of C. Northcote Parkinson that the largest group is personnel, which we will look at first, nor that in 1861 Mr Henzell's summary of departmental forms in use, given in reply to a request for that and other information, showed 120 internal forms but only 100 that involved the public.<sup>33</sup>

**Table 1: Number of circulars issued 1839–1866<sup>34</sup>**



<sup>32</sup> Matthews, fn.17 at 156; Colley, fn.8.

<sup>33</sup> See also Stebbings, fn.19 at 139.

<sup>34</sup> Source: CRO D6148. TNA:PRO IR78/276, 78/277. Note that the annual totals include the few items individual to the particular officers, such as Henzell's leave application.

### Circulars on personnel matters

#### *Discipline*

It must soon have become apparent that the expansion of the surveyors' duties had created a new kind of service. The body of surveyors had to be welded into a uniform body: irregularity and to some extent individuality had to be ironed out. There was probably room for sensible discretion, but gross departures could not be tolerated. For example, some surveyors had misunderstood or ignored the rules for the taxation of gigs being driven to and from market. A sharp note was issued to bring them into line.<sup>35</sup> The centralisation was neither un-noticed nor unopposed at the time.<sup>36</sup> There were still a number of officials who failed to meet the new standards, and we will return to them individually below. The Board's punishments for failure varied from demotion to dismissal, according to the severity of the offence. Some offences caused the Board to issue general warnings, with the threat that improper behaviour could jeopardise superannuation. This had been set out in an Order of February 10, 1853,<sup>37</sup> issued at the direction of the Treasury:

“ORDERED, That the several Officers of this Revenue be hereby informed that their Lordships [of the Treasury], in considering the cases of persons for allowances of superannuation, will invariably, by granting the *minimum* amount only, mark with their displeasure the conduct of any Officer which shall be of such a nature as to bring discredit upon the Department in which he may be serving.”

This could only have an effect long in the future and the Board needed something more immediate. By 1858 it was prepared to set out its disciplinary procedures in outline, which it claimed would prevent re-investigations of allegations of misconduct.<sup>38</sup> It outlined a system of written hearings and appeals. It set out its disciplinary aims internally with a published table of punishments. This was issued on March 20, 1860 and it set out a:

“... system of gradation of punishment by means of recorded censures which has been found so useful in the Excise Branch. These censures are as follows:-

Cautions  
Recorded Cautions  
Admonitions  
Reprimands

A caution, unless the Board order it to be recorded, is merely a warning in cases of slight negligence.

A Recorded Caution remains on the Book for one year.

An Admonition also remains on record for one year.

A Reprimand for two years.

<sup>35</sup> TNA:PRO IR78/276, June 30, 1854.

<sup>36</sup> Sabine, fn.2 at 120.

<sup>37</sup> No.79. The text includes references to three separate collections. Most are to Mr Henzell's and these are simply given as a number, with date of issue where appropriate. The other two are referenced by their TNA reference and date of issue.

<sup>38</sup> Second Report at 30.

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When three cautions stand recorded against the same Officer at one time, they are considered equal to an Admonition.

In the same way, two Admonitions are equal to one reprimand.

No Officer is considered worthy to be promoted so long as either an Admonition or a Reprimand remains on record against him.”<sup>39</sup>

These were not empty threats. This formal scale must have followed an earlier, less public practice, for in the early years particularly, a trickle of punishments handed down to offenders had been circulated to surveyors. Generally we know no more about them than the bare report that was issued. There is no need to catalogue them all, but eleven offences were detailed, mostly involving money. Some offenders are mentioned below, but only one has been explored in detail, Ambrose Clarke and the Collector in Chester, for financial irregularity. Note here, as we will again below, the Board’s willingness to use in one department the good practice in another.

### Staff improvement

The Revenue shared in the mid-nineteenth century desire for improvement in its public servants, and the Board arranged for the proper training, supervision and examination of its supernumerary surveyors, or trainees as they would now be called. It was not anxious to appoint too many of these. In its 1871 report it assured the Chancellor that although the authorised number of Assistant or Supernumerary Surveyors in England was 60:

“There are 9 vacancies, which it is not our intention to recommend your Lordship to fill up at present. The actual number of Assistant Surveyors is 51.”<sup>40</sup>

Training was then, as now, very much a hands-on affair. The Supernumerary Surveyor had to learn on the job and the Surveyor was responsible for teaching him. This ensured consistent quality of knowledge and practical skill, essential if an officer were to move around the country.

On May 26, 1859 Mr Henzell received a visit from a Mr Gilbert, the “bearer of this letter” newly appointed as a Supernumerary Surveyor.<sup>41</sup> His letter stated that he “shall be stationed in your district, for the purpose of acquiring a knowledge of the duties of the Office, and acting as your assistant.”

Mr Gilbert had passed the entrance examination in:

“Reading, Writing, Writing from Dictation, Arithmetic, including Vulgar and Decimal Fractions, Book Keeping by Double Entry, Correspondence, Geography and the History of the British Empire.”<sup>42</sup>

<sup>39</sup> No.154.

<sup>40</sup> Fourteenth report of the Commissioners of Her Majesty’s Inland Revenue for the years ended March 31, 1870 and 1871, [c.370] 1871 at 101.

<sup>41</sup> No.140.

<sup>42</sup> The modernity of these subjects is itself an interesting illustration of a debate over the relevance of education to (then) modern administration. The same debate was raging over the necessary education for a veterinary surgeon, while traditionalists like the historian E.A. Freeman were defending the advantages of a classical education. See Freeman’s *Thoughts on the Study of History with Reference to the Proposed Changes in Public Examinations* (John Henry Parker, Oxford, 1849). For the background see, T.W. Heyk, *The Transformation of Intellectual Life in Victorian England* (Croom Helm, London, 1982) especially Ch.6.

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Armed with those skills the aspiring candidate had:

“... also been employed for a short time in different Departments of this Office [Somerset House], in order to obtain an insight into the mode in which the Business generally is conducted, and he is now to be instructed by you in the duties of a Surveyor.”

One purpose of the initial spell at Somerset House must have been to monitor suitability and instil conformity. Mr Henzell was given a list of tasks that Mr Gilbert had to master under his guidance and was to make from time to time “a faithful report” of his progress not only in knowledge of the Acts of Parliament and Official Instructions, but:

“... as to his sobriety and regularity of conduct, his demeanour towards those with whom he may have business to transact, and his behaviour generally.”

When the Surveyor thought that his assistant was:

“... qualified to undertake the charge of a District in the Junior Class, you will make a report to that effect, when instructions will be given to the Inspector of the District to examine him as to his proficiency without delay.”

We will return to staff reporting later, but for the moment will pursue Mr Gilbert’s early days, as illustrating the ways of the department. Like most young folk when they start a career, Mr Gilbert was probably short of money, especially as he had been transferred a long way from home, and he may well have taken advantage of an arrangement that the Board had set up and notified to surveyors earlier the same month:

“I have to acquaint you that in consequence of applications which the Board have received from time to time from Supernumerary Surveyors representing that it would be a convenience to them to receive a portion of their Salaries at the half-quarter instead of being paid quarterly as heretofore, they have been pleased to direct that advances on account of the quarter’s Salary shall be made in future. . .”<sup>43</sup>

A request had to be counter-signed by the Surveyor and lodged with the Receiving Officer, for round sums not “fractions of a pound”, not exceeding £14 for those in the first class and £10 for those in the second, or pro rata for anyone appointed between quarter days, using the form provided, of which a copy is still filed below the circular.

Mr Gilbert stayed with Mr Henzell in Stockport until February 1860 when he returned to London on a compassionate transfer because of his mother’s ill health. Unlike the usual printed circulars, the transfer was confirmed in a handwritten letter (no.153) although the appointment of his successor, Mr McCance, was a pre-printed statement, which, like Gilbert’s, served also as formal identification. His training was to last a minimum of 12 months “that being considered the shortest period within which a competent knowledge of all the duties can in ordinary circumstances be acquired” and his salary was to be £90 a year. The immediate replacement suggests either that Stockport was considered to be a “heavy” district which needed an assistant, or that Mr Henzell was reckoned to be good at training juniors.

<sup>43</sup> No.138.

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### Conduct and promotion

The influence of post-Trevelyan thinking can be seen in the Board's attitude to promotions. It emphasised that promotion was by merit, "not being guided by seniority alone".<sup>44</sup> In its second report the Board claimed that it was well aware of the merits of its officers.<sup>45</sup> In the previous year it had instituted a system of periodical inspections to match that previously practised in the Excise. One result had been fewer cases of misconduct.<sup>46</sup> In the past, staff had enlisted help, for as early as March 1845, staff had been forbidden to communicate with Members of Parliament (no.47a). In 1849 an Excise regulation on the subject was extended to the whole of the Department and later, in April 1859 officers were again forbidden to canvass for promotion.<sup>47</sup> This was repeated in February 1860 and again a month later.<sup>48</sup> The first of these suggests that some officials had solicited testimonials from commissioners to help their cause, a reflection of the traditional local base.

In January 1864 officers were forbidden to stand as security for a loan, following the case of an employee who had done so and been made bankrupt as a result. Another quite proper restriction was participation in public, and especially political, affairs and elections.<sup>49</sup>

### Annual leave

Staff were entitled to annual leave, and the procedure was set out in circular 134 (January 1859). The application had to be made through the Inspector (the Surveyor's supervising officer) and had to include a summary of previous leave. We have Mr Henzell's application for leave in August and September 1862, and of the report of his return.<sup>50</sup> Samuel Bamford set out a satirical account of the fuss surrounding his application for six days leave shortly before his retirement in 1858. His first application had to be re-written "in the usual official manner", and sent to a different person, and so letters passed to and fro within the office.<sup>51</sup> Maybe the formality lessened with distance from Somerset House but it always remained a requirement.

In May 1859 circular 139 restricted absence during parliamentary sessions, when no lengthened leave was to be taken. This reflected the increasing use of the surveyors as a source of information, exemplified in June 1860 when circular no.160, required an early report upon inhabited house duty, with properties listed in value bands from £8 upwards. Mr Henzell's reply, which he copied into the guard book, could well be of use to local historians of his area. A later circular addressed sick leave.<sup>52</sup> That entailed a loss of salary after 16 weeks' absence and "relinquishment" after 24 weeks.

<sup>44</sup> *Examinations and Tests for Revenue Staff* C.628 (1849) at 1.

<sup>45</sup> Second Report C.2387 (1857–58).

<sup>46</sup> Second Report at 30.

<sup>47</sup> TNA:PRO IR78/276, May 22, 1849; Henzell, no.136.

<sup>48</sup> Nos 151, 155a.

<sup>49</sup> No.209, January 28, 1864; no.234, June 15, 1865.

<sup>50</sup> No.191.

<sup>51</sup> Diary entries April 24, 1858.

<sup>52</sup> No.162, June 1860.

## Procedural matters

### *Internal relations*

Surveyors (and their assistants) not only had to respect their relationship with commissioners but with collectors. The latter were not, at this time, under the Board's direct control, and caution was stressed. Circular 41 of November 1844 forbade surveyors to lodge with or employ collectors or assessors as well as to be on too friendly terms. It was "highly objectionable, as tending to an intimacy between those two offices that ought not to exist". A number of circulars set out the fiscal relationship, both for efficiency and to combat fraud. One particular sanction was the threat that any overpayment made by the collector and not spotted by the Surveyor through carelessness might be deducted from the latter's salary.<sup>53</sup> This fate had already fallen upon Mr Harvey of Surrey who was negligent in checking the Collector's schedules. The latter had been reporting properties as empty and exempt when they were in fact occupied and chargeable. Mr Harvey had to make good the deficiency from his own pocket as well as being demoted.<sup>54</sup>

The separation of duties caused difficulties for the public, and surveyors might find it hard to be on distant terms with officers who worked in the same premises. In its 1870 report, the Board noted that:

"... to meet the convenience of the public and in order to facilitate business between the various branches of the Department throughout the country, we have made arrangements in many large towns to bring the offices of the Collector of Inland Revenue, Surveyors of Taxes, and Stamp Distributors under one roof."<sup>55</sup>

It is hard to interpret two circulars of October 1857 which forbade surveyors to claim for the expense of renting extra offices or changing office without the Board's consent, even when it was claimed that it had been done with the inspector's approval.<sup>56</sup> The most likely explanation is that some surveyors had not come to terms with the changed disciplines of their employment and regarded themselves as free agents. It may have been a subsidiary reason for the later policy of centralising offices.

Surveyors were reminded that they were not to handle tax money but for all the Board's efforts it happened. Mr Coode was dismissed in 1844 for receiving public monies from collectors in Newark, and only a month later Mr Thompson at Grantham was dismissed for similar misconduct. The next year, it was the turn of Mr Walker, Receiving Officer in Liverpool, who accepted money without the knowledge of the Surveyor. He was also accused of claiming for "travelling expenses for journies [*sic*] made by his clerk and claimed for them as if he had gone himself." Despite this plethora of sins, he was only reduced to "a lower situation in the Department".<sup>57</sup> Financial irregularity was not the only offence, for in 1849 Mr Gibbs of Lichfield was demoted to Surveyor of the fourth class and removed from his district for continued rudeness to the public and his highly offensive character.<sup>58</sup>

<sup>53</sup> No.89, January 1854.

<sup>54</sup> No.64, August 1847.

<sup>55</sup> Fourteenth report at 42.

<sup>56</sup> TNA:PRO IR78/277.

<sup>57</sup> Circulars 38, April 1844; 39, June 1844; 49, May 1845.

<sup>58</sup> TNA:PRO IR 78/276, March 17, 1849.

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### *Routine administration*

The Board also addressed routine administrative matters, mostly procedures that are so familiar to us that we never give them a moment's thought. It recognised that it was giving more guidance, and on legal matters, more specific instruction, than before. Old systems designed for taxes whose quantum varied little from year to year were no longer fitting. Offices had not been models of organisation and consistency and apart from the increased need for accuracy in assessment, the policy of having officials able to serve effectively anywhere in the country both required and generated an unprecedented level of standard practice between offices. Movement was reduced to career moves quite early on, for by 1858 the Board had abandoned the practice of compulsory transfer after five years.<sup>59</sup> We see from the summary of his career that Mr Henzell served in at least five offices as well, presumably, as Somerset House and there is no reason to suppose that his career was unusual.

### *Filing*

One can only speculate about the state of some surveyors' offices before 1842 but it became apparent that the Board could not accept what we must presume was a system of keeping loose rolls of paper on the floor or wherever convenient. To judge by Samuel Bamford's experience it may have been a case of the pot calling the kettle black, for in Somerset House:

“Hart is superintending the arrangements of the papers, that is, in his way, which is doing, and undoing, putting up, and pulling down, the floor and passages all the time littered with bundles of accounts, of all sorts in mixed bewilderment. Syne, poor fellow, comes and looks at all this; and goes away again without appearing to have the least notion of either beginning, middle, or end of the thing.”

He also noted the inefficient way of working, by which Brown was writing labels which should have been in printed capitals and was producing “a score or two a day, whereas by types and a press, thousands might have been produced in the same time.”<sup>60</sup> Local offices must have been in a similar state of confusion for surveyors were first issued with books for keeping records: shortly after, they were instructed to buy a guard book to contain the circulars and instructions issued to them.<sup>61</sup> Such is Mr Henzell's bundle today—though much battered. Primitive they sound, but they were easier to use than a modern lever arch file and papers could not inexplicably disappear. It is testimony to the need for them that Henzell's bundle has many early omissions; Kite's has them throughout, while another collection in the National Archives starts with this authorising circular.<sup>62</sup>

Part of the Surveyor's duties was just that, to survey his territory and to know what went on in it. When he was at Chichester Henzell's responsibility was for 14,543 taxpayers and efficient monitoring required method. To assist in this, in 1864, surveyors were instructed to provide themselves with distinctive pocket notebooks where they could note

<sup>59</sup> Second Report at 29.

<sup>60</sup> Diary entries April 15, March 27, 1858.

<sup>61</sup> Nos 128, July 1858; 137, April 1859.

<sup>62</sup> TNA:PRO IR 78/74.



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matters that needed enquiry. There was already a compare book which served to compare and reconcile assessments but that was not flexible enough to be taken on the obligatory personal survey of their Districts.<sup>63</sup> Surveyors were instructed to report the number of pages required.

### *Referencing*

A further refinement came with the reference number, where once again there was a development in line with the private sector. We need instance only one example to illustrate the point. In 1858 the Secretary to the Great Western Railway issued a circular letter, one of a kind, setting out the company's practice in relation to free passes.<sup>64</sup> By modern standards this is unremarkable: it set out precisely for its employees the terms upon which they were entitled to free travel. Its relevance for us here is that it was numbered 930, indicating the use of number referencing in a way that had also been adopted by the Board from at least 1839. Even then it did not do so consistently: one circular of June 8, 1849 had no reference, although one of August 18 did.<sup>65</sup> They still adopted some stock formula as directed by the Office Circular of July 11, 1849. The Board was apparently late to see the point of notifying the recipients of the significance of a reference number, although it came close to doing so in one circular issued on January 7, 1850.<sup>66</sup> This read:

“Referring to the directions contained in the last paragraph of the Board's Circular Letter dated 21st September last (R5714/49P) relative to the Surveyor's Receipts Accounts, no. 184.”

It touched upon the point in a handwritten note of September 1859 to Mr Lloyd, but it was only a year later, in August 1860, that a general instruction told surveyors, when replying, to quote the number at the top left hand corner of the relevant communication.<sup>67</sup>

The Board was prepared to listen to its officers and adopt their ideas. As early as 1846 it acknowledged that the use of the same number for assessments as for repayments to ease identification of the individual had originated that way.<sup>68</sup> No mention was made of a staff suggestion scheme.

### *Instructions*

Initially the rule was that instructions should be retained in the district when officers were transferred but the Board realised that some surveyors used them as a running form of *aide memoir* and that they would be losers if they had to hand them to their successor. Consequently, circular 137 (April 1859) altered the rule, though not quite specifying that they had to be taken with the departing officer. So:

<sup>63</sup> TNA:PRO IR78/277, April 26, 1864. A selection of these for the early 20th century was deposited by the author in the Greater Manchester Record Office, having formed the basis for “Self Assessment in Edwardian Manchester” [1999] BTR 298.

<sup>64</sup> TNA:PRO RAIL 1014/31/4.

<sup>65</sup> Both in IR78/276.

<sup>66</sup> TNA:PRO IR78/276, September 5, 1849, January 7, 1850.

<sup>67</sup> No.165.

<sup>68</sup> No.54.

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“ . . . when a Surveyor has been at the pains of making marginal notes and references in his copies of the Acts of Parliament or in the Board’s General Instructions which may be valuable for his future guidance, it is not unreasonable that he should desire to retain them . . . in his possession so long as he remains in office.”

This ambiguity must have created a measure of confusion.

### *Postage and paper*

Although its concern was not communicated to the surveyors, the Board was concerned about the supply of paper for envelopes. Apparently the size it wanted was only manufactured by one firm, Delarue, which prevented fair tendering. Torn between economy in obtaining the size it wanted to reduce waste to a minimum, and a desire for fair competition the Board decided to abandon the market altogether and obtain its supplies from the Stationery Office.<sup>69</sup>

An example of misplaced zeal, or greed, depending upon the motive, was the disposal of paper. In 1848 when it was said that one of the Metropolitan Surveyors, Mr Gooday:

“ . . . had sold, amongst waste paper, a quantity of official forms that were fit for use and in ordinary demand, as well as certain documents of a confidential nature relating to the income tax.”

That story had a beneficial outcome. We may feel a little sorry for Mr Gooday, who was demoted to “a Surveyorship of the second class”, for his imprudence led the Board to adopt “measures for securing, through the Inspectors of the several districts, a better control on the consumption of the forms supplied to the Surveyors, than heretofore.”<sup>70</sup> In future, no forms were to be disposed of without the sanction of the Board, preceded by a certificate from the Inspector that the “forms or documents in question are wholly useless.” A duplicate of the certificate was to be retained for later inspection. The system was refined in June 1853 when the Board directed that when any accumulation of usable papers had reached an inconvenient extent, after certification they were to be sent to the Stationery Office. For some reason, income tax and land tax papers were to be distinguished. Others were to be destroyed:

“With regard to the Returns and other Documents relating to the Income Tax under Schedules D and E, it is the direction of the Board that such papers shall be burned by the Surveyors; and as it is most important that none should fall into the hands of the public, the Board rely upon the Surveyors taking care that the whole be effectually destroyed.”<sup>71</sup>

In theory, accumulations should have been avoided by the provision that quarterly requisitions should be forwarded through the Inspector, who should satisfy himself that the supplies were necessary.<sup>72</sup> In proper fashion, duplicates of the requisitions were to be kept. The rules were apparently not always followed, for a stern reminder had to be issued in December 1856 (no.117) after more damaging episodes occurred, in 1851–52

<sup>69</sup> Third Report, 1859 at 20.

<sup>70</sup> Sabine, fn.2 at 44; no.69, June 1848.

<sup>71</sup> No.80.

<sup>72</sup> No.70, June 1, 1848.

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near Brixton and in Wiltshire in 1856. There was trouble in 1858 when more than 1,000 returns relating to the City of London were found in Billingsgate Fish Market. They had been taken from Somerset House and sold by a charwoman over a period of several months.<sup>73</sup>

### *Real basics*

It is testimony to the inherited low level of competence and informal habits that the Board had to issue instructions on trivia. An early circular of December 1843 instructed surveyors to write separate letters on different topics but even before that they had been instructed to economise by putting several letters in one large parcel, to save postage. In May 1858 they were reminded of the correct address for Somerset House, and instructed to add the initials of the Metropolitan Postal District. In October 1862 an instruction from the Special Commissioners' Office reminded surveyors that parcels sent to them should be properly sealed so that they did not open in the post. Then, as now, cost was foremost: surveyors were to be economical in distributing forms to clerks. Later, a system of free postage was instituted for mail to Somerset House, with the OHMS frank. This did not apply to registered post which still had to be paid for. In much the same spirit, surveyors were instructed, when writing, to leave a wide margin down alternately the left and right hand side of the page, presumably for comment or note by the recipient.<sup>74</sup>

Local costs were to be limited. From the start no local staff were to be engaged without authority, to be given by the Receiving Officer. This only features as an issue in 1866 when additional staff had to be engaged to process the extra returns issued during the first livestock census. No debts were to be created for carriage hire. Instead, costs were to be met by advances and receipts were to be obtained and kept. From 1862, a quarterly report of travelling expenses was required.<sup>75</sup> Receipts for payments of salary to collectors were also regulated. From August 1863<sup>76</sup> they were no longer to be sent to the Chief Accountant but retained in the district for future reference.

Finally, in these basic matters (there is no need to explore them all), was the use of the circulars to notify surveyors of changes of structure and person. To give just one example of the former, the abolition of the post of Inspector General and its replacement by that of Chief Inspector (Edward Hyde), with the names of his subordinates, was announced in February 1861. In April 1860 the death of Thomas Keogh was announced with the division of his duties between two junior successors.<sup>77</sup>

### **Assessment and consistency**

The circulars not only addressed relations with collectors but with the Special Commissioners. Their clerk periodically issued instructions to the surveyors which set out the procedure for reporting to his office the details of those who had elected

<sup>73</sup> Colley, fn.8 at 84–85.

<sup>74</sup> In order, nos 28, 125, 192 and IR 78/276, October 11, 1839; 125, May 1858; 220, June 1864; 223, September 1864; IR 78/277, dated July 1860.

<sup>75</sup> No.29, January 1844; no.146, August 1859; no.187, August 1862; Matthews, fn.17 at 226.

<sup>76</sup> No.204.

<sup>77</sup> Nos 167, 156.

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to be assessed by the Special Commissioners. It was important to avoid both double assessment and no assessment. They were mostly variations on a theme but occasionally the programme was altered as in 1863 when surveyors were asked to co-operate in enabling “Special” assessments to be made early and appeals cleared before the commissioners departed for Ireland.<sup>78</sup>

More important for our purposes was the simple fact that an explanatory circular accompanied every Finance Act, to ensure that surveyors were aware of changes in the law and how they were to operate. It was imperative that the new tax was applied consistently across the country: it was already controversial and blatant variations could destroy its credibility.<sup>79</sup> At the very start, in August 1842, both surveyors and clerks to commissioners were given guidance, by way of a theoretical example, of the treatment of rent charges under the Tithe Commutation Act.<sup>80</sup> At much the same time, surveyors had to be reminded of the need to issue returns and those to whom they should be issued. They were urged to ensure that the assessors did their job properly and to make taxpayers aware that domestic servants need not be included unless their income exceeded £150.<sup>81</sup> The Inspector General published a *Guide to the Income and Property Tax Act* which was available publicly, and, for surveyors, there were successive issues of a volume of instructions. The Board was prepared to offer general advice, as when surveyors were informed that it would be placing an advertisement in *The Times* detailing how exempt persons could receive their dividends free of tax.<sup>82</sup> These measures were plainly not enough, and the Board recounted the 250,000 queries that it received and had to resolve.<sup>83</sup> Mr Hensell himself wrote to the Board in August 1856, asking for advice about the taxation of empty mills, an issue perhaps more common in Stockport during the cotton famine than elsewhere.<sup>84</sup> Some questions affected the whole country: surveyors were advised in circular 52 (December 1845) that voluntary contributions made to dissenting ministers were taxable, despite lobbying to the contrary; they featured again in circular 92 (May 1854) when the Board warned surveyors of a widespread evasion of tax due on interest from loans secured on pew rents from dissenting chapels. Charities and life insurance received considerable attention, as did the taxation of railways. These sprawling enterprises needed central assessment and eventually fell to the Special Commissioners. Significantly, the gathering of relevant information and its transmission to the Special Commissioners stayed with the Surveyor.<sup>85</sup> Horses had a long history of causing trouble. Sabine referred to the mixed use of an apothecary’s horse, though noting that 10 years later the Birmingham Surveyor allowed the deduction.<sup>86</sup> In the same year, and in a reminder that the Surveyor had other responsibilities than income tax, three veterinarians wrote to their journal complaining of variable treatment under the assessed taxes. Under the guinea levy on horses, the first was able to win a 50 per cent reduction when the commissioners over-ruled the Surveyor, making a parallel with surgeons. A second also won on appeal,

<sup>78</sup> No.198, July 1863.

<sup>79</sup> Sabine, fn.2 at 74.

<sup>80</sup> No.13.

<sup>81</sup> No.8, August 1842.

<sup>82</sup> No.21 and *The Times*, both dated May 6, 1843.

<sup>83</sup> Second Report, at 28–29.

<sup>84</sup> No.114.

<sup>85</sup> Colley, fn.19.

<sup>86</sup> Sabine, fn.2 at 72.

whilst a third failed, stating that the Surveyor had successfully opposed the reduction. Being dissatisfied he had written to the Board, which had confirmed the Surveyor's view. To add to their concerns, the editors of *The Veterinarian* thought that, though it was unfair, the reduction was not due.<sup>87</sup> Variations of this kind could only cause resentment. Surveyors were always at risk to the charge that they influenced assessments in order to increase their remuneration—an accusation made by the aggrieved veterinarian—and as a result they were forbidden to lay information in relation to game licences without the Board's prior permission.<sup>88</sup>

### Departmental management

#### *Performance of duties*

We can infer what a qualified Surveyor had to do from the training requirement set out for Mr Gilbert, but it is not easy to establish how he set out about it. Sabine used the records of the Manchester General Commissioners to show how their clerk played an important role in obtaining advice from Somerset House, seemingly after some delay.<sup>89</sup> This reminds us of the initial role of the Surveyor as a monitor for the commissioners, who were running the process. The relations between commissioners, their clerk and the Surveyor must have varied over time from one division to another, though there is not enough information to track the individual changes. The Surveyor's role as monitor does deserve comment. His prime task was to ensure efficiency in assessment and prevent favouritism or perversion of the law. Not all clerks wrote to the Board for advice: the Surveyor had to know the law, or at least have an opinion himself, strong enough to influence the commissioners.

#### *Fraud protection*

The fact that the Board had direct control over only a part of the system inevitably created opportunities for fraud. It did its best and one obvious form of protection was to instruct incoming surveyors to examine the state of the office, the method of keeping books and make a report to the Board.<sup>90</sup>

Collectors probably posed the greatest risk as they were appointed by the commissioners and could only be monitored by surveyors at some distance. The Board was well aware of the dangers imposed by this system of employing collectors and assessors and in August 1847 a general warning on the need to check the work of the Collector, arose from the negligence of Mr Harvey (above). It was stressed that:

“... no part of the Surveyor's duties demands more vigilant attention than the investigation of [the Collector's] schedules, in order to guard against negligence in the collection as well as fraudulent practices, on the part of the Collector”.<sup>91</sup>

<sup>87</sup> *The Veterinarian*, XXVIII, 1855, nos 328, 329, 330.

<sup>88</sup> No.133, November 1858.

<sup>89</sup> Sabine, fn.2 at 73–74.

<sup>90</sup> TNA:PRO IR 78/277, dated September 17, 1857.

<sup>91</sup> No.64.

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In 1854 there was a most instructive scandal just to the west of Manchester. John Cheadle had been the collector of poor-rates for 25 years at Barton-upon-Irwell. Complaints about irregularities in his duties led to a call for his resignation, but before going he had to make good deficiencies in his accounts, which he did by drawing upon money which he held as Collector for both assessed and income taxes. At the time of the newspaper report final deficiencies had not been established but there was also an unquantified deficiency in his accounts for assessed taxes, about £400 for income tax and an estimated £40 each for highway and church rates. He was also registrar of births and deaths. He disappeared on the pretext of going to Southport for his health, but was believed to be hiding in Liverpool. The employment of separate individuals with defined and discrete duties would have put the township much less at risk for even though the assessors, who were jointly responsible for the Income Tax, had sold his furniture, other debts would fall upon the ratepayers.<sup>92</sup> The legislative intention was that these duties were a communal responsibility, but understandably few wanted to perform them and the concentration of roles in one person was as inevitable as it was dangerous.<sup>93</sup> In its second, 1858, Report, The Board referred to the Collector for the Bassishaw Ward of the City of London who had absconded with large sums of money. His fraud had been made possible because, contrary to the Board's wishes, he was also the Assessor. The criticism of the commissioners was muted but unmistakable, limited to saying that they could not be expected to exercise the same level of supervision as would an officer of the Crown. The Board later noted that where it had been obliged to appoint collectors in default of local action, the results of its intervention had been wholly beneficial.<sup>94</sup>

The problem was how and when to undertake radical reform. That would require much thought, legislation and an upsetting of many established attitudes: the dilemma was set out clearly in the Third Report. After expressing a desire for improvement the Board concluded that:

“... until it is determined whether the income tax is to cease (as it will according to law in April 1860), or to be continued as a permanent portion of our system of taxation, it would be idle to attempt the remodelling of our mode of assessment and collection.”<sup>95</sup>

In the meantime, the Board tried to prevent these episodes by regulating the terms of engagement. A start could be made by greater care in selection. In the wake of the Bassishaw defalcation the Board issued a lengthy series of rules in circular no.132 (October 1958) to clerks to Commissioners, to apply when making appointments. First, nobody was to be appointed a Collector “without giving good and sufficient security”; this had been a major cause of trouble before. The second rule was more complicated:

“That when a person who has acted as Collector for one year, he should not be appointed Assessor for the succeeding year, or Collector for two consecutive years,

<sup>92</sup> *Manchester Guardian*, May 27, 1854.

<sup>93</sup> No.131, October 12, 1858. “In making the appointment of Collectors an annual one, the legislature did not contemplate the service of the office by the same person for two years successively, but intended that the office should be executed, in turn, by the several inhabitants of the Parish or Place who might be found fit”.

<sup>94</sup> Second Report at 25; (Third Report) at 27; for the later Manchester scandal, B.E.V. Sabine, “The General Commissioners” [1968] BTR 31.

<sup>95</sup> Third Report at 27.

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or if he be so appointed, that the Duplicates of the Assessments for the second year should not be delivered to him unless he shall have finished his accounts for the previous year, a reasonable time being fixed for the purpose.”

The snag was the “should”: the Board had no power to enforce any of these measures and difficulties arose when they were not observed. As we have seen, surveyors were discouraged from being too friendly with collectors and assessors and periodic transfer made long term fraud less likely. The threat to deduct any overpayments from their salary would help to reduce careless error, but would be ineffective against deliberate fraud. Their efforts failed on occasion, as in Chester in the 1850s when the Surveyor and Collector colluded to deceive an ineffective clerk to commissioners.<sup>96</sup>

Another structural weakness had emerged in 1847 when William Gates, a chief clerk in the Special Commissioners’ Office, was able to embezzle money by making out fraudulent claims for repayment. He forged claims for repayment by three charities, forged receipts from them, and took the money. In evidence, all three bodies denied either making the claims or receiving any money. He was able to do this because the Special Commissioner who authorised the repayment claims did so without enquiry—for which he might well not be blamed—and Gates was only rumbled when one of his colleagues became suspicious. Ultimately, he pleaded guilty to two counts and was sentenced to deportation for 12 years.<sup>97</sup>

### Conclusion

When the new tax of 1842 was introduced, it continued in parallel with the existing assessed taxes, its structure decentralised and subject to local control, with little opportunity for the Board to do more than watch and advise. Its local agents, the surveyors, varied in capability and skill but they were not a disciplined body. By 1866, when the bundle comes to an end, a new regime of supervision, reporting and instruction had created a body of men who could be relied upon to carry out the complex and potentially offensive task of arranging the first ever livestock census. It is perhaps indicative of their standing that public opinion, as expressed through newspapers, was on their side, and the task was completed without rancour or significant lack of co-operation. In that, it was more successful than the slightly later crop census, conducted by excise officers. We do not know whether the surveyors were chosen simply because they represented a nationwide coverage for a central department—though that existed elsewhere—or because they had acquired a reputation for obedience, competence and discretion which made them the prime choice. In view of the Board’s efforts and the success of the exercise, it is tempting to assume the latter. The end of the story lay well in the future but in little more than a quarter of a century the Board had created a Department that can be seen as recognisably modern.

<sup>96</sup> See fn.27

<sup>97</sup> Report of the preliminary hearing, *The Times*, August 12, 1847 at 7, col.A; sentence, Central Criminal Court, August 19, 1847, at 6, col.F.

## APPENDIX

## Mr Henzell's career

John Harrop Henzell was born about 1812 at Boldon, County Durham, into a family which, we can be fairly confident, had lived around South Shields for at least three previous generations. We know nothing of his upbringing or education, the next firm reference to him being his marriage in about 1835 to Ann Lumley, at her birth town of Stockton on Tees.

His movements in the next few years are obscure. It is probable that he joined the Revenue in 1839. Like many young people embarking on a new career, he may have left his wife and family in the north, until he was certain of continued and congenial employment. The custom was for new surveyors to serve a spell in Head Office before being posted to a district for training. He was in Braintree by 1841, for circular 4, issued on March 25, bears his name, although his family did not follow him until later in the year. Once arrived in Essex, his travels were not over, for although we do not know when he was promoted to take charge of a district, we may assume it was at least by late 1841, as circular 6 was sent in his name to district 27. A further move is shown by his preparation of a report in July 1847. This related to the discharge of assessments where incomes did not exceed £150 (the exempt amount) in the two divisions of Upper and Lower Arundel, which must be Chichester. As a son, Edward, was born at Bexhill in 1849, he must have been there for some time. We can gain some idea of his responsibilities there, for his taxpaying population totalled 12,577, with a further 1,966 discharged because their incomes did not exceed the taxable threshold: 14,543 in all.

Shortly after the Chichester report was made, Mr Henzell was sent to Cheshire, as is shown by an appendix to the Hume report of 1848–49. I have not been able to identify the exact date of Mr Henzell's appointment to Stockport. He followed a Mr Shaw whose name does appear on one of the circulars, no.67, dated May 17, 1848. His transfer was certainly before June 1851 for Septimus was born at 219 Higher Hillgate, Stockport on the 26th of that month. The first circular addressed to him by name in Stockport was no.85, dated August 17, 1853.

We do not know exactly when Mr Henzell retired, but he was a signatory, from Manchester 2 district, to a petition rehearsing grievances over pay and conditions, prepared in 1869. The reference to Mr Tennant in the inside cover of the guard book suggests that he had left the department by February 1869. The Return of Reductions in Public Departments dated August 10, 1871 shows him as receiving a pension of £308 6s 8d at that time. His final salary had been £500 and he had seven years added to his pension entitlement, with a cash uplift of £58 6s 8d. More detail is given by another Parliamentary Report, showing pensions granted to retired officers. There the cause of his retirement was given as reduction in the number of surveyors: altogether there were 39 of them in the list, of whom Henzell received the joint fourth largest pension, after 30 years and six months service.<sup>98</sup> If he joined the Department in 1839 and served 30 years, retirement in 1869 would fit with Tennant's entry in the guard book.

An interesting insight can be drawn on the status of a Surveyor at that time, by a comparison of salaries. Mr Henzell's final salary was £500. In the same decade, the

<sup>98</sup> *Public Departments Reduction* C.445 (1871) at 61; "An account of compensations granted. . ." C.155 (1871) at 32.



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extremely responsible land agents of the Marquis of Westminster and John Tollemache of Peckforton, the latter the largest landowner in Cheshire, who owned over 25,000 acres, were paid virtually the same amount, between £500 and £550.<sup>99</sup>

The 1871 census shows Mr Henzell living in a pleasant part of Manchester, 56 Plymouth Grove, near the Unitarian Minister William Gaskell and described as a “compensated Surveyor of Taxes”. He did not spend his time in idleness, but set up in business as a “common brewer”, the description adopted in his will dated May 17, 1876. He died on June 30, 1878 and his will was proved in March 1879. His executors were his wife, his son in law, Nicholas Pring Rundle (himself a former Surveyor of Taxes) and his son, Septimus, also described as a common brewer and possibly his partner. <sup>LT</sup>

<sup>99</sup> S. Matthews, “The Cheshire Estates of John Tollemache of Peckforton 1861–72” (2005) 154 *Transactions of the Historic Society of Lancashire and Cheshire* 120.

<sup>LT</sup> Inland Revenue; Legal history; Special Commissioners; Taxation administration

## Book Reviews

STAMP DUTY LAND TAX: A PRACTICAL GUIDE FOR LAWYERS. BY ANN L HUMPHREY AND PHILIP FREEDMAN. Second Edition (Spiramus Press, 2007). £75.00.

STAMP Duty Land Tax (SDLT) contains many traps, even for the wary, whether conceptual, computational, or merely completion of the forms. An error at any stage may mean additional tax, interest and, usually, penalties.

The singular advantage of this edition, as was the case with the first edition, is that it describes the law; refers to any published guidance available, whether from HMRC, Hansard or other sources (such as the Stamp Tax Practitioners Group); and then provides guidance on the land transaction returns.

Your reviewer dipped into sections on diverse topics such as partnership transactions; whether works constituted consideration; whether sales and leasebacks were subject to the market value rules; abnormal rent increases; and sharia compliant transactions: all were as clear as the subject matter permits. This is not a book—remember the title contains “a practical guide”—that identifies every planning idea or, for example, forensically analyses the (many) conceptual shortcomings of section 75A of the Finance Act 2003: nevertheless it provides useful guidance on planning associated with the nature of the tax—e.g. the advantage of options to renew, rather than longer leases with break clauses—and what planning ideas various parts of the SDLT legislation block or were intended to block.

It is undoubtedly a work to which even experienced SDLT practitioners will wish to refer (for instance the list of non-tax statutes that exempt transactions from SDLT, see pp.205–206) to complement other works on SDLT. Their real estate colleagues can be expected to have well-thumbed copies of their own, not least because over 100 pages justifiably deal with the niceties of completion of the Land Transaction Returns and SDLT administration.

GARY RICHARDS\*

GLOBAL PERSPECTIVES ON E-COMMERCE TAXATION LAW. BY SUBHAJIT BASU (Ashgate, 2007). 344 pages. £60.00.

E-COMMERCE has developed from a novelty to a cornerstone of commercial legal practice. Its multijurisdictional nature throws up tax compliance issues not normally encountered by commercial lawyers. Taxation of electronic commerce is definitely one of the big issues in the global market yet it straddles two inherently difficult and non-user friendly subjects which presents, in turn, a major problem to those seeking to be enlightened.

This useful book is laid out in a simple but logical way, which makes it easy for the reader to follow, with chapters that are not too long, and thus provides a solution to the problem. The language which is used is not unnecessarily complicated and this makes it a useful research tool in that one does not have to sit with a dictionary to hand in order to try

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and decipher what a sentence actually means. The work is contemporary in its approach and up to date with developments in the law. This reviewer has found it difficult to find books which can be listed for student use, which combine good law with good technology information. This book, however, meets both these criteria.

The introduction to each chapter is a good feature—setting out what will be covered in the chapter with an excellent indexing system. This is essential for research and helps the non-expert who is time-constrained. The two final chapters are of particular use in the way in which they draw together emerging tax policy and future development of the taxation of e-commerce. As both a teacher of undergraduate and postgraduate students and as an academic researcher in tax law, computer and e-commerce law, this reviewer has found this to be a particularly good book and would not hesitate to recommend it to other teachers and researchers. Overall, it is an enjoyable, accessible read; something which sadly cannot often be said of academic works.

WILLIAM J. CRAIG

INTERNATIONAL TAXATION OF PHILANTHROPY: REMOVING TAX OBSTACLES FOR INTERNATIONAL CHARITIES. BY INEKE A. KOELE (IBFD Publications, Amsterdam, 2007). xvi + 413 pp.

THIS book comprises the author's Utrecht Ph.D. thesis, prepared between 2002 and 2007 and inspired by her work for an unnamed large international charity. She evidently feels a great sense of injustice from her experience (her middle name being, curiously appropriately, "Alien"), but despite that, the tone of her work is rarely hectoring. The book does suffer from the disadvantages of its origins—the lack of an index or table of cases is frustrating, and judicious editing by someone at IBFD would have been appreciated—but is nevertheless a surprisingly good read, despite the esoteric nature of its subject matter.

The central part consists of a comparative study of the conditions currently required for direct tax relief on the part of charities or donors to them, in the United States, Germany and the Netherlands. This is introduced by a general discussion of the surprising history, particularly the putative role played by INTERPHIL and the Council of Europe, of the debate and the conceptual issues in domestic law, bilateral treaties, unilateral relief and European Union (EU) obligations; and followed by a careful discussion of the European Court of Justice (ECJ) jurisprudence as developed to date, before the concluding summary and recommendations.

The subject matter turns out to be more complex than might be casually expected within each country, apparently as a result of historical and cultural differences more than differences in legal systems. Even for a reader not especially interested in the domestic arrangements in the chosen countries, the triangulation provides a rich framework for analysis, particularly of the application of credit methods (for example, the case of a US citizen, or alternatively in some examples, a UK resident, with Netherlands source income out of which a donation is made to a German established charity). Some common international themes emerge.

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Within the EU, the critical impact of the *Stauffer* case<sup>1</sup> is of course discussed extensively, particularly reinforcing the robust defence against French *chauvinisme* in *Laboratoires Fournier*<sup>2</sup> and explicitly criticising, in a new context, the decision in the *D.* case.<sup>3</sup> The jurisprudence of the ECJ, and associated enforcement action by the Commission, evidently still both have a long way to go.

The tone is sometimes extremely wordy, especially when most worthy, and exhaustingly unpunctuated. Here is the author's central description of her mission (at page 38): "As the conceptual arguments referred to above in fact block the possibility of any progress in this area it is the motivation of this author to demonstrate that tax legislators do not or at least should not substantiate the landlock on alleged unbridgeable differences between different legal systems since this is a policy of fear that does not contribute to the world's actual problems." The terminology is in part curious and perhaps suffers in translation. "Landlock" is the author's chosen term for restriction of tax relief to domestically operating or controlled (as in the United Kingdom) charities. At times the argument becomes a little convoluted to follow with ease, and there are occasional but repeated slips (Commissioner "McGreevy" must surely be aboard the Euro McGravy Train). The reader's overall experience, however, is a stimulating and surprisingly satisfying one at the technical level, whether or not the author's case for fully global pluralism is ultimately found persuasive.

MARK H. ROBSON \*

<sup>1</sup> Case C-386/04 *Centro Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2006] ECR I-8203; see M.H. Robson, "*Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften*: 'Je, sans frontières, soussigné. . .'"—transnational gifts to charity within the European Union" [2007] BTR 109.

<sup>2</sup> Case C-39/04 *Laboratoires Fournier SA v Direction des vérifications nationales et internationales*, [2005] ECR I-2057, in which France purported to restrict a tax credit available for research to research activities carried out in France—one of the few countries that limits the scope of potentially activities exclusively to its own territory.

<sup>3</sup> Case C-376/03, *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen*, [2005] ECR I-5821, in which it was held by the Court (rejecting the Advocate-General's reasoning) that non-residents are not entitled to most favoured nation treatment with respect to bilateral tax treaties entered into by Member States.

\* Bank of England.