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DISSERTATION SUBMITTED IN COMPLIANCE WITH THE REQUIREMENTS OF THE FACULTY OF LAW AND OF THE SENATE OF THE UNIVERSITY OF THE WITWATERSRAND IN COMPLETION OF THE DEGREE MASTER OF LAWS (INCOME TAX) BY COURSE WORK

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A review of the trend in the judicial interpretation of, and judicial attitudes towards tax avoidance in the United Kingdom, Australia and South Africa, with reference to the "declaratory" and "choice" theories of jurisprudence

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Chapter One

Introduction

In this dissertation I shall examine the trends displayed by the judiciary in interpreting anti-tax avoidance legislation and the judicial approach to tax avoidance schemes in the United Kingdom and Australia. I shall compare this with corresponding developments in the Republic of South Africa. Additionally, I shall deal, in passing, with the position in the United States of America and in Canada. I propose to show how the judges have, on several occasions, reached their findings by applying their choice of the competing principles, not by declaring the law as they find it to be.

A consideration of the judiciary's approach to anti-tax avoidance legislation and of the cases where tax avoidance schemes have come before the courts for decision leaves one with an impression of the swing of a pendulum. In the Hamlyn Lectures HH Monroe demonstrated the way in which judges in England have, by reason of personal persuasion, not been unwilling to legislate judicially in order to plug the holes which they perceive Parliament has left. The same observations may be made about cases decided in South Africa and in Australia.

I shall show how the initial approach was a strict, legalistic one. On the contrary, the approach adopted by the judiciary nowadays stresses the commercial substance or underlying purpose of a scheme. It is difficult to advance an explanation for the change in approach. It seems that it may lie in the frustration experienced by the judiciary in dealing with cases brought before them, where the legislation which they are required to apply cannot adequately cope with the schemes evolved to circumvent the legislation. However, how one can fit that explanation into a science of jurisprudential analysis becomes even more difficult, and, as I shall show, the lack of a jurisprudential explanation makes the task of an income tax adviser difficult.

The approach of legislation by the judiciary has tended to obliterate the distinction created by the doctrine of "substance" and "form". In the recent English tax avoidance cases the distinction between "form" and "substance" has become blurred to such an extent that the "form" of the transaction is now almost irrelevant. This is also the case in South Africa. To some degree

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this may be attributed to the failure to appreciate the nature of a tax on "income", which is not "income" in an economic or commercial sense, but in a technical sense, and which allows deductions or allowances in calculating "income" which are technical deductions, which would not necessarily be deductible or allowable in the economic or commercial sense. It appears that some judges in South Africa do not understand the distinction which arises in income tax cases between a "tax loss", as opposed to an "economic loss": to allow a taxpayer the benefit of a "loss" which is not an "economic loss" seems to offend against the judges' feelings of what is and what is not right. In South African law this confusion is frequently demonstrated by the judges' reference to "profit" and "loss", where those concepts play no part, by definition, in determining "income" or "expenditure", as these terms are defined and used in the Income Tax Act, No 58 of 1962, as amended.

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In this dissertation I shall deal with the position in the United Kingdom first, because income tax law developed there first, and the systems in South Africa and Australia both owe their origin to the law in that country.

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Chapter Two

The interpretation of fiscal legislation in the United Kingdom

In Partington v Attorney General (1869) LR 4 E & I App HL 100 at 122 Lord Cairns held:

> "......if the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown seeking to recover the tax, cannot bring the subject within the letter of the law the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

The original approach was that adherence to the statutory words was the judicial motto when tax was claimed, but liability for tax was not clearly imposed. It was adherence to the words used, rather than to the sense, to what the statute said rather than to what the statute meant. It is interesting to note that Lord Cairns had been Solicitor General and Attorney General, and as Member of Parliament for Belfast, had been present when the Bill which became the Income Tax Act 1853 was debated in Parliament.

Lord Cairn's attitude to the interpretation of fiscal legislation should be compared with his attitude to interpretation, as expressed in Hammersmith and City Railways Company v Brand (1869) LR 4E & I App HL 171, reported in the same volume of the law reports as the previous case. In this case Lord Cairns rejected the narrow construction adopted by the majority of the court, namely, that compensation was only due for damage sustained when authorised works were carried out, being damage directly occasioned by the carrying out of the work. He concluded, after reviewing the law, that a land owner had no direct claim against the railway company in respect of works which were positively authorised by Parliament. He held, at page 215:

> "That fact alone would certainly predispose the mind to find, in the enactment upon the subject, compensation given, in some form or other, for the loss which beyond all doubt, the land owner in such a case sustains. I do not mean to say that it would be safe to strain the words of an Act of Parliament on account of considerations of that kind, but if there be any doubt or ambiguity in the words, the consideration ought not to be overlooked that, beyond all doubt, the intention of legislation of this kind is that, in some shape or other, compensation should be made to those who sustain loss or harm by the operation of the Parliamentary powers."

In Pryce v Monmouthshire Channel and Railway Company (1879) 4 AC 197(HL) Lord Cairns suggested an explanation as to why he was prepared to take a wider view where compensation was in issue, and a narrower view if tax was in issue. He held:

> "The cases which have decided that taxing acts are to be construed with strictness and that no payment is to be extracted from the subject which is not clearly and unequivocally required by Act of Parliament to be made, probably meant little more than this, that, inasmuch as there was no a priori liability in a subject to pay any particular tax, nor any antecedent relationship between the taxpayer and the taxing authority, no reasoning founded upon any supposed relationship of the taxpayer and the taxing authority could be brought to bear on the construction of the Act, and therefore the taxpayer had a right to stand upon a literal construction of the words used, whatever might be the consequence."

Rowlatt J in Cape Brandy Syndicate v IRC (1929) 12 TC 358, at 366, follwed this approach where he held:

> "It simply means that in a taxing Act one has to look at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."

Lord Clyde extended the implication of this ruling in Ayreshire Pullman Motor Services and Ritchie v IRC (1929) 14 TC 754, at 763, where he held:

> "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue".

The normal rule of interpretation of taxing statutes is that where there is ambiguity the taxpayer should have the benefit of the doubt. See Scott v Russell (1945) 30 TC 375, per Viscount Simons at 424, and Kanjee Naranjee v ITComrs (1965) AC 1238 (PC).

This principle has been cut down in the case of a provision which gives relief from a section which clearly imposes liability. See Littman v Barron [1951] 2 All ER 393 at 398 per Cohen LJ, affirmed sub nom Barron v Littman (1953) 33 TC 373.

The courts have developed three principal rules of interpretation, known as the "literal rule", the "Golden Rule" and the "mischief rule".

In Clerical, Medical and General Life Assurance Society v Carter (1889) 22 QBD 444 at 448 it was held, per Lord Esher MR, that it will be presumed that all statutes use words in their popular sense, unless the context otherwise requires. In this way the words of a statute will be given their ordinary grammatical meaning. However, where the "literal" rule gives rise to an unrealistic result, the "Golden Rule", as expressed by Lord Wensleydale in Grey v Pearson (1857) 6 HLC 61 at 106, will be applied. The ordinary sense of the words will be modified to avoid absurdity or inconsistency.

The "mischief" rule was derived from Haydon's case (1584) 3 Co Rep 7, in which the Barons of the Exchequer held that:

"for the sure and true interpretation of all statutes in general four things are to be discerned and considered:

(1) what was the common law before the passing of the Act;

(2) what was the mischief and defect for which the common law did not provide;

(3) what remedy the Parliament later resolved and appointed to cure the disease of the Commonwealth;

(4) the true reason of the remedy;

And then the office of all the judges is always to make such construction as shall suppress the mischief and advance the remedy, and to suppress subtle invention and evasions for the continuance of the mischief".

The principles applicable to the interpretation of fiscal legislation were summarised by Lord Donovan in Mangin v IRC (1971) AC 739 at 746 as follows:

"First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices .. Secondly, .. one has to look at what is clearly said. There is no room for an intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used... Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If, therefore, a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to it being passed may be used as an aid to its construction".

At around the time of the Second World War the judicial attitude began to change, and tax avoidance arrangements began to attract the hostility of the Courts. The hostility towards these schemes was also manifested in the United States of America. The strongest and most robust manifestation of the judicial attitude of hostility in the United Kingdom was the speech of Lord Greene MR in Lord Howard de Walden v IRC (1941) 25 TC 121, at 134, where he remarked:

> "It scarcely lies in the month of the taxpayer who plays with fire to complain of burnt fingers."

Lord Denning MR, who has strong views against tax avoidance schemes, appears to adopt the view that one should look at the avoidance scheme first, which comes close to applying the "mischief" rule. See Escoigne Properties Ltd v IRC (1958) AC 549 at 565 and Shop and Store Developments v IRC (1966) Ch D 108 at 130.

In Shop & Store Developments Ltd the capital of the taxpayer was re-organised and increased. A number of shares were issued to the shareholders in the taxpayer, who transferred these to a clothing company. In the result, the clothing company acquired more than 90% of the shares in the taxpayer, a property owning company. The clothing company then transferred valuable freehold and leasehold properties to the taxpayer, to be satisfied by the issue of renounceable letters of allotment, being the whole of the unissued capital of the taxpayer. The letters of allotment were sold to an issuing house, which, after being split, were offered to the public. They were taken up and were paid for. The money received in this way was passed back through the clothing company to the shareholders in the taxpayer. It was all part of one arrangement. All the stages prior to the public issue took place on one day, and were dealt with in one agenda comprising 28 items. In his judgment Lord Denning MR held:

> "In my opinion the Revenue authorities are right. We have to look, as was said in the Escoigne case, (1958) AC 549, at the mischief which this section was intended to remedy and give it an interpretation which will prevent the mischief."

In terms of Section 460 of TA 1970, which is aimed at transactions designed to avoid tax, the courts have been given statutory authority to look at transactions as a whole, which can come close to adopting the "mischief rule".

Lord Denning's views on tax avoidance are demonstrated in re Western's Settlements (1969) 1 Ch D 223 at 242. In that case settlements were entered into when capital gains tax did not exist. In the following year, 1965, Parliament imposed a capital gains tax payable on capital gained between persons resident in the United Kingdom. The tax was calculated at the rate of 30%. The taxpayer took steps to remove his family to the Channel Islands together with the trust. After three months the taxpayer applied to the Chancery Division to sanction the removal of the settlement to Jersey, on the grounds that this would be to the financial advantage of the young children and unborn children. Lord Denning MR held (at page 245) -

".....there are many things in life more worth-while than money. One of these things is to be brought up in this our England, which is still 'the envy of less happier lands'. I do not believe it is for the benefit of children to be uprooted from England and transported to another country simply to avoid tax. It was very different with the children of the Seale family, which Buckley J considered. That family had emigrated to Canada many years before, with no thought of tax avoidance, and had brought up the children there as Canadians. It was very proper that that trust should be transferred to Canada. But here the family had only been in Jersey three months when they presented this scheme to the Court. The inference is irresistible: the underlying purpose was to go there in order to avoid tax. I do not think that this will be all to the good for the children. I should imagine that, even if they had stayed in this country, they would have had a very considerable fortune at their disposal, even after paying tax. The only thing that Jersey can do for them is to give them an even greater fortune. Many a child has been ruined by being given too much. The avoidance of tax may be lawful, but it is not yet a virtue. The Court of Chancery should not encourage or support it - it should not give its approval to it - if by doing so it would imperil the true welfare of the children, already born or yet to be born.

There is one thing more. I cannot help wondering how long these young people will stay in Jersey. It may be to their financial interest at present to make their home there permanently. But will they remain there once the capital gains are safely in hand, clear of tax? They may well change their minds and come back to enjoy their untaxed gains. Is such a prospect really for the benefit of the children? Are they to be wanderers over the face of the earth, moving from this country to that, according to where they can best avoid tax? I cannot believe that to be right. Children are like trees: they grow stronger with firm roots.

The long and short of it is, as the judge said, that the exodus of this family to Jersey is done to avoid British taxation. Having made great wealth here, they want to quit without paying taxes and duties which are imposed on those who stay. So be it. If it really be for the benefit of the children, let it be done. Let them go, taking their money with them. But, if it be not truly for their benefit, the Court should not

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> countenance it. It should not give the scheme its blessing. The judge refused his approval. So would I. I would dismiss this appeal."

With respect, Lord Denning's judgment in Western's case demonstrates the extent to which personal prejudice governs the judgments in many tax avoidance cases. It is difficult, putting it at its lowest, to extract any principle of law from this quotation which could be used as a basis of advising on a tax avoidance scheme. The "principle" established in Western's case is devoid of definable content, however laudable the sentiment may be, and however well it was expressed by Lord Denning MR.

In Latilla v Inland Revenue Commissioners [1942] 1 All ER 214, the appellant's wife, her two daughters and another woman, all resident in the United Kingdom, had sold their shares in a partnership carrying on the business of mining in Rhodesia to a trust. The trust was resident in Southern Rhodesia. The consideration for the sale consisted of shares and non-interest bearing debentures in a company. The company declared no dividends, but applied its profits in redeeming the debentures which it had issued. The appellant contended that the share of the profits derived from the mining partnership was not liable to income tax, but this was disallowed. The approach of the Appeal Court was approved and upheld in Latilla v CIR (1943) AC 377 Lord Simon held, at 381, in regard to arrangements to avoid "sharing the appropriate burden of British taxation"-

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> "There is of course no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase <u>pro tanto</u> the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."

In <u>Vestey v IRC (nos. 1 and 2</u>) (1980) STC 10 the "normal meaning" rule of interpretation was set aside. Two interpretations of the section were possible. The one, arrived at by looking at the preamble to the section and by reading the section as a whole, would confine its application. On that basis, Lord Wilberforce held that the section would be:

> ".. directed against persons who transfer assets abroad, who by means of such transfers avoid tax, and who yet manage when resident in the United Kingdom to obtain or to be in a position to obtain benefits from those assets."

The alternative interpretation was to give the whole section an extended meaning, so as to embrace all persons, born or unborn, who in any way might benefit from assets transferred abroad by others.

The House of Lords selected the narrower interpretation, namely, that the taxpayer to be taxed is the person who deliberately puts his assets outside the tax net. In reaching this conclusion the

House of Lords had to reverse their earlier decision in Congreve v IRC [1948] 1 All ER 948(HL), despite the fact it was a case which had received the express approval of the 1955 Royal Commission. Furthermore, when the section in question was introduced in Parliament in 1936 any intention to visit on the children the sins of the fathers was expressly disclaimed. (Hansard 1936 Vol 313 Col 688, cited by Monroe).

Monroe expresses the view that the Vestey case shows that where legislation is aimed at dispositions which have tax avoidance as their sole or principal object, even though the House of Lords had previously declared in favour of a wide interpretation, if an alternative view is possible, reason and fairness can prevail in favour of an individual taxpayer. This view has not, however, received much support in the recent decisions of the House of Lords!

Vestey v IRC (No 1 and 2) (1980) STC 10 HL raised two important points. These are the circumstances that must exist before a previous decision of the House of Lords will be reconsidered, and secondly, the status of extra-statutory concessions. In regard to the status of earlier decisions of the House of Lords, Lord Wilberforce expressed the view that the Practice Direction [1966] 3 All ER 77, which enables the Law Lords to reverse previous decisions in the House, should be used sparingly and should be governed by stated principles. He qualified this by stating that where the facts of a case could not be brought within these principles, it would not necessarily be fatal. The doctrine of precedent and certainty of interest usually dictate that once a decision has been reached it should be applied subsequently to new and unforeseen circumstances. In Vestey's case he thought that to follow the previous decision would create serious administrative and constitutional problems. He did not elaborate on what he had in mind, although in the context of the case he may have meant that the Revenue's practice of granting extra-statutory concessions, having no basis in law, was an abuse of the rule of law.

In his judgment Lord Edmund-Davies pointed out that it was difficult to reconcile the practice of granting extra-statutory concessions with the view expressed by Lord Loreburn in Drummond v Collins (1915) 6 TC 525, at 539, namely that if a person comes within the letter of the law, he must be taxed irrespective of how inequitable the tax is.

Judicial comment regarding extra-statutory concessions has been mixed. In F S Securities Ltd v IRC (1963) 41 TC 666, at 683, Donovan LJ held that the income tax code was difficult to administer, and that practical considerations justified some departure from the strict law for the common convenience of the Revenue and of the taxpayer. In Bates v IRC (1966) 44 TC 225, at 268, Lord Upjohn expressed the view that concessions had arisen because the Commissioners, realising the result of applying the legislation strictly, worked out more equitable ways of operating it. He was unable, however, to understand the legal basis of extra-statutory concessions. He commented favourably in Korner v IRC (1969) 45 TC 287, at 297, on an unpublished concession. Lord Wilberforce, in IRC v Bates, supra, held that administrative moderation was no substitute for legislative clarity and precision. As opposed to this, Lord Radcliffe held, in IRC v Frere (1964) 42 TC 125, at 154, that he never understood how extra-statutory concessions came into operation, having regard to the fact that Parliament could and does adjust the income tax code every year. Scott LJ endorsed the finding in Absalon v Talbot (1943) 26 TC 166, at 181, that judicial countenance ought not to be given to extra-statutory concessions, despite the fact that in many cases they avoided undue hardship. Their existence was, in his view, indicative of the fact that the legislation was defective.

This analysis of some decisions over a period of about one hundred years shows how the trend has swung from the formalistic towards a purposive interpretation, as also the extent to which personal prejudice plays a part. It also shows how the judiciary has had to deal with extra-statutory concessions. In doing so the judiciary has had to resort to a power to legislate, for how otherwise can they affix a stamp of approval to an extra-statutory concession?

Chapter Three

The attitude of the English Courts towards "form" and "substance"

Where a taxpayer has entered into a series of artificial transactions in order to create a loss or to avoid an assessment to tax a doctrine, known as "the sham doctrine", is sometimes cited by the Revenue in attacking the scheme in question. For example, in Eilbeck v Rawling (1981) STC 174 (HL) which will be dealt with later, the taxpayer manufactured a capital gains tax loss by the use of a reversionary interest and an advance from a settlement. All the transactions were pre-arranged and were carried out with what the courts have described as "military precision". The Revenue relied on the "sham" doctrine in attacking the scheme in that case.

The "sham doctrine" first developed as a result of a number of hire purchase and bills of sale cases. See Stoneleigh Finance Ltd v Phillips [1965] 1 All ER 513(CA).

"Sham" is defined in the Oxford English Dictionary as -

> "something that is intended to be taken for something else, or that is not what it purports to be; a spurious imitation, a counterfeit ... something not genuine or true."

In Snook v London and West Riding Investments Limited [1967] 1 All ER 518, at 528, Diplock L J put forward the following definition:

> "... if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create."

For the transaction to be treated as a sham, having regard to what Diplock L J held, there must be an intention on the part of the parties to mislead, and there must be an element of incompleteness or deceit. Diplock LJ stipulated that there must be a common intention that the acts or documents are intended not to create the legal rights and obligations which they give the appearance of creating. It is normally the second leg of this test which prevents the Revenue from successfully invoking the doctrine in the United Kingdom, even where the transactions are part of a highly artificial tax scheme. It follows that where a transaction or document is genuine and creates legal rights and obligations intended by the parties, it cannot be set aside as a sham, however artificial or commercially unjustifiable the transactions may be. In the result, the Revenue do not often seek to maintain the "sham" argument in cases which come before the court. See Black Nominees Ltd v Nichol (1975) 50 TC 229, at 250.

As one cannot classify all tax avoidance schemes as being false or sham, and having regard to the difficulties of establishing a sham, the Revenue tends to rely on the "form and substance" doctrine more often. The argument follows the line that although the transactions when taken in isolation fall outside the scope of the statute, when taken together as a scheme, the transactions can be brought within the statute on the basis that they represent the situation posited by the statute. In other words, it is argued that the courts should ignore the legal effect of the transactions, and should substitute the substance of the transactions when taken together.

Some early decisions supported the argument that in revenue matters a court might ignore the form of a transaction in favour of its economic effect in which the tax avoiding intention was present. See IRC v Wright (1926) 11 TC 198 at 203.

The form and substance doctrine was considered and established in Duke of Westminster v IRC (1935) 19 TC 490 and IRC v Duke of Westminster (1936) AC 1. As remarked by HH Monroe in a posthumously published article, Fiscal Finesse: Tax Avoidance and the Duke of Westminister 1982 British Tax Review 200, the Duke of Westminster is the starting point, since it has been identified, "unfairly, as some kind of tax avoider's charter".

In that case the taxpayer contracted with his personal servants to transfer to them a slice of his income, who paid tax on the amount so transferred at a lower rate. The servants acknowledged at the same time that the transfer of income was by way of remuneration for their services, without looking for wages as well. In this way the taxpayer would reduce his income tax. By a majority of 4 to 1 the House of Lords rejected the claim by the Revenue to disallow the payments under the covenant as a surtax deduction, on the grounds that whilst the payments had the legal character of annuities, in substance they were payments for services. The clearest statement of the doctrine is found in the speech of Lord Russell, who held, at 524:-

> "The Commissioners and Mr Justice Finlay took the opposite view on the ground that, as they said, looking at the substance of the thing the payments were payments of wages. This simply means that the true legal position is disregarded and a different legal right and liability substituted in the place of the legal right and liability which the parties have created. I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with the courts' view of what it considers the substance of the transaction, the court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or by analogy, but only by the plain words of the statute applicable to the facts and circumstances of his case ... If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non-taxability in accordance with the legal rights, well and good ... If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what

> in law they are, then I entirely dissent from such a doctrine."

Lord Tomlin held:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he canot be compelled to pay an increased tax. This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."

The line of decisions which approved this approach was followed in Vestey's (Lord) Executors v IRC [1949] 1 All ER 1108 (HL). Twin brothers entered into a lease with Union Cold Storage Co Ltd, "UCS", and three trustees living in Paris, in terms of which they demised property situate abroad to UCS for a period of 21 years, terminable on 6 months notice. UCS undertook to pay to the Paris trustees a rent of £960 000 per annum in quarterly instalments. It was common cause that the Paris trustees would have received the rent as trustees for the brothers. Thereafter, a trust deed was executed in terms of which the brothers' children were appointed as beneficiaries of the trust fund. The Crown made claims against the brothers for income tax and surtax in respect of the rents payable under the lease, and in respect of the income arising from the investments and accumulations under the trust deed. It was held that the lease and deed of trust together constituted an "arrangement" within the meaning of the <u>Finance Act</u>, 1938, and consequently constituted a "settlement" for the purposes of that Act.

Lord Normand held at 1120, that:

> "Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the Courts will not stretch the terms of taxing acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved."

Avoidance of tax should not be confused with evasion of tax. The latter constitutes a fraud, in respect of which Parliament is able to and does impose, Draconian penalties. With respect to Lord Normand, the statement "tax avoidance is an evil" expresses a view of moral opprobrium which clouds the issue. Similar sentiments have been expressed in Parliament in South Africa when emotive issues such as tax avoidance are under debate. A similar statement was recently made by the Minister of Finance in South Africa, in regard to the auditors' profession. In my view tax avoidance does not merit the opprobrium cast upon it, unless it can be shown that it constitutes tax evasion, in which case the imposition of penalties would not be difficult. It may be argued that income tax is the price one must pay for the privilege of living in a modern welfare state. However, that enters the arena of social and political issues which are not appropriate for this dissertation. The writer's thesis is that tax law and tax morality will not coincide, unless the utility of tax is demonstrated. Unless this is done attempts to avoid tax will continue. The function of the law is to be certain, yet, more and more, particularly as a result of judicial legislation, the law of tax is uncertain. In turn, as tax rates increase, and uncertainty and unfairness develop, tax-paying morality declines.

The issue of tax avoidance obliges one to consider the doctrine of "substance" and "form". In IRC v Wesleyan Assurance Society [1948] 1 All ER 555 (HL), at 557, it was held, approving the dictum of Lord Greene MR in Duke of Westminster, that a taxpayer may, in order to reduce his liability for tax, acquire investments which would produce income which the Act does not classify as gross income, or which it exempts from tax. Similarly, there may be two methods at least of achieving the same financial result -

> "If one of these methods is adopted, tax will be payable. If the other method is adopted tax will not be payable. ...... The net result from the financial point of view is precisely the same in each case, but one method of achieving it attracts tax and the other method does not. There have been cases in the past where what has been called the "substance of the transaction" has been thought to enable the Court to construe a document in such a way as to attract tax. That particular doctrine of substance as distinct from form was, I hope, finally exploded by the decision of the House of Lords in Duke of Westminster v Inland Revenue Commissioner."

The principles enunciated in the Duke of Westminster have been affirmed by Lord Wilberforce in IRC v Europa Oil (NZ) Ltd (1971) AC 760, at 771,(PC), by Buckley L J in Newstead v Frost (1979) STC 45, at 53,(CA), by Sir John Pennycuick in Floor v Davis (1978) STC 436, at 441,(CA) and by Walton J in Burman v Hedges and Butler Ltd (1979) STC 136, at 147,(ChD).

In referring to "form", the doctrine refers to the legal rights and obligations created by the transaction or document. It means that irrespective of the way in which the transaction is dressed up, it will not necessarily be decisive of its form, although it will be of evidential value.

The term "substance" is used in two contexts, and this can lead to confusion.

In the first place, where a financial result can be obtained in two or more ways, one of which may result in tax being payable, and the other of which may result in no tax being payable. If the second method is adopted, on the authority of Duke of Westminster and IRC v Wesleyan and General Assurance Society, the Revenue will not be able to extract the tax that would have been payable had the first method been adopted.

In the second place, "substance" has a narrower meaning, and that is, whether in looking at the transactions and documents as a whole it would be legitimate to look at the result, rather than looking at each part of the scheme separately and in isolation.

In recent cases the Courts have tended to adopt the narrower meaning. For example, in Ransom v Higgs (1974) 50 TC 1, Lord Wilberforce held that the Courts are entitled to look at all the transactions together, where there is evidence that each step is dependant on other steps, in deciding whether the taxpayer was trading. He also took this view in Europa Oil, although Lord Donovan and Viscount Dilhorne dissented, and held that legal rights and obligations had to be taken in isolation, and not together.

In Black Nominees v Nichol, supra, a complicated tax avoidance scheme was devised by the advisers of the actress, Julie Christie. It involved the incorporation of a number of companies and the formation of a number of trusts, having the purpose of capitalising the money that she could expect to earn as an actress so as to avoid tax on the income that she would have earned for filming and acting contracts. Templeman J, as he then was, followed the approach of Lord Wilberforce in Ransom. This case was, perhaps, the first major step away from the "form" towards the "substance" of the transactions in issue. He held that the transactions entered into by the participants could not be viewed in isolation, without regard to the consequences of the other transactions. The scheme as a whole had to be considered, as each step was dependant upon the other steps being carried out. (Templeman L J is known for his negative attitudes towards tax avoidance schemes, see W T Ramsay Ltd v IRC (1979) STC 582(CA), and Scarman L J at 590, and Templeman L J in Eilbeck v Rawling (1980) STC 192(CA)).

In Eilbeck's case Templeman L J held, at 202:

> "... one single circular contract or a series of interdependent contracts which revolves one property in a circle cannot be divided into separate transactions in order to determine the effect of the contract or series.
>
> A circular contract which requires one asset to be revolved in a circle must be judged by the difference (if any) between the position of each party at the start and at the finish of the contract."

However, in IRC v Plummer (1979) STC 93, at 97, Lord Wilberforce did not accept the thesis expressed by Templeman L J: He qualified the proposition in an important respect:

> "the plan now involved was explained by the brokers in great detail and its intended accomplishment set out, with timetables, in almost military precision. This (as I ventured to suggest in IRC v Church Commissioners for England (1976) STC 339) entitles and requires us to look at the plan as a whole. It does not entitle us to disregard the legal form and nature of the transactions carried out".

The difficulty of distinguishing between words that are clear and words that are not clear, or in deciding what words in the statute mean and whether they apply to particular circumstances, which amounts + [illegible]gislating" (an offside activity) or "interpreting" (an acceptable activity,) (per H.H. Monroe) is illustrated in IRC v Plummer [1978] 3 All ER 513 (CA).

The case conc:rned a straightforward tax avoidance scheme, in the sense that it lacked the complexity, subtlety and window dressing associated with capital gains tax avoidance schemes. The taxpayer followed the same route relied upon in the Duke of Westminster: in return for a lump sum he undertook to make a series of annual payments. A company with charitable objects would receive the annuity. The company issued a series of promissory notes, payable when each annuity was paid in satisfaction of the obligation to provide the lump sum, which were treated as security by the taxpayer. Each payment of the annuity was by way of overdraft, which was extinguished on deposit of the promissory note. In other words, the money went round and round, but at the end the taxpayer could claim to have made a number of deductible payments, and the charity could claim to have received payments on which tax paid was recoverable.

If the agreement by which the individual made annual payments to the charity was a "settlement" the scheme failed.

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The agreement did not look like a settlement, but the statute gave to the term:-

"Any disposition, trust, covenant, agreement or arrangement...

an extended meaning.

Lords Wilberforce, Fraser of Tullybelton and Keith of Kinkel all found that there was an agreement to pay an annuity. The way in which it was financed was one of convenience for the taxpayer. He chose to use it for the provision of promissory notes, but that did not rob the agreement to pay an annuity of its legal effect.

Lord Wilberforce held:

> "This raises a question of some difficulty and general importance. Are the words of the definition to be given the full unrestricted meaning which apparently they have, or is some limitation to be read into them, and if so what limitation? If given the full unrestricted meaning, the section would clearly cover the present agreement, and would also cover a large number of ordinary commercial transactions.
>
> My Lords, it seems to me to be clear that it is not possible to read into the definition an exception in favour of commercial transactions whether with or without the epithet "ordinary" or "bona fide". To do so would be legislation not interpretation: if Parliament had intended such an exception it could and must have expressed it. But it still becomes necessary to enquire what is the scope of the words "settlement" and "settlor" and of the words which are included in "settlement" in the context in which they appear. If it appears, on the one hand, that a completely literal

reading of the relevant word would so widely extend the reach of the section that no agreement of whatever character fell outside it, but that, on the other hand, a legislative purpose can be discerned, of a more limited character, which Parliament can reasonably be supposed to have intended, and that the words used fairly admit of such a meaning as to give effect to that purpose, it would be legitimate, indeed necessary, for the courts to adopt such a meaning."

In the result the majority found a legislative purpose: "bounty" was the key to interpreting the section. As there was no bounty, there was no settlement. There was no bounty in the tax avoidance scheme, but it was a bargain for hard cash. In the result, there was no "settlement". (As I shall show later, Schreiner JA reached a different conclusion in interpreting the word "disposition" which he held would extend to cover every act affecting property.)

Lords Dilhorne and Diplock, in the minority, arrived at a different conclusion.

Lord Dilhorne held:

"It cannot, in my opinion, be right for the Courts to amend the definition by adding words to it limiting its scope. That would be legislating. On the other hand, it is open to the Courts when considering particular transactions and whether they come within the definition, to conclude that Parliament cannot have intended that they should be treated as doing so; and to decide, if that conclusion is reached, that they do not. There must be a number of cases in which it cannot have been the intention of Parliament that income transferred to another pursuant to an agreement or arrangment should nevertheless continue to be treated as the income of the transferor."

Lord Diplock held:

"It is common ground between my noble and learned friends that upon a literal interpretation of what, according to (the definition section), is understood as included in the expression settlement the transaction would fall within it. It is likewise common ground that Parliament must have intended some narrower construction than this to be placed on the word settlement in the context of (the charging section): for, unless it is, it is difficult to think of any transaction in consequence of which income is paid by one person to another that would not fall within the section. The competing views are, on the one hand, that the context in which the word settlement appears in (the relevant part) of the Act shows a Parliamentary intention to exclude from its meaning <u>bona fide</u> business transactions only and on the other hand, that it shows an intention to include only transactions in which there is an element of bounty."

Lord Diplock went on to consider whether there were indications in the sections that one or other of these limitations of the statutory words were appropriate. He concluded that they were not, and continued as follows:

"So it seems to me that in order to reach a conclusion whether in addition to those transactions which are expressly excluded from (the charging section) any other kinds of transactions whereby income is paid by one person to another were intended to be excluded from its operation, it is necessary to apply to this Part of the Act a purposive construction and to ask oneself the question in relation to the particular kind of transaction which is under consideration 'Can

Parliament really have intended to tax this particular kind of transaction by the wide words that the draftsman has used?'

"If the only sensible answer to that question is 'No' the words of the Act should be understood as inapplicable to that transaction. That question when asked about a transaction which not only falls within the literal meaning of the words used in the section but has no other object than to enable the settlor to avoid a liability to surtax on his income which he would otherwise be obliged to pay, so far from inviting the answer 'No' invites the answer: 'Whatever kind of transaction Parliament may have intended to exclude, it cannot have been this one'."

Monroe demonstrates how in the Plummer case the majority in the House of Lords "legislated" for the application of the section, by construing the section to draw the dividing line in one place, whilst the minority drew the dividing line in another place. The minority judgment echoes the proposition that Parliament cannot be intended not to include a tax avoidance device within the scope of a tax avoidance section. In other words, the proposition is that when anti-avoidance provisions are employed in taxing acts, adherence to the "plain words" used may be abandoned as a guide to construction in favour of a broader approach, namely, that of identifying the risk, danger or mischief. It starts from the hypothesis that Parliament was aiming at that scheme, and was on target. This echoes the proposition of Buckley LJ in IRC v Garvin and Rose (1980) STC 295 where he held:

"a statutory provision aimed at restricting tax avoidance is not to be construed in the way which is traditionally adopted in construing charging provisions in taxing statutes."

In support of this proposition Buckley LJ relied on Lord Wilberforce in CIR v Joiner [1975] 1 WLR 1701, 50 TC 449, who had, in turn, commented on what Lord Reid had said in Greenberg v CIR (1972) AC 109, 47 TC 240:

> "For whereas it is generally the rule that clear words are required to impose a tax, so that the taxpayer has the benefit of doubts or ambiguities, Lord Reid made it clear that the scheme of the sections, introducing as they did a wide and general attack on tax avoidance, required that expressions which might otherwise have been cut down in the interest of precision were to be given the wide meaning evidently intended, even though they led to a conclusion short of which judges would normally desire to stop."

Buckley LJ concluded that this meant that in dealing with an anti-avoidance section he should adopt the approach which he later adopted in Berry v Warnett (1980) STC 514. This case involved an avoidance device and not an anti-avoidance section. He held:

> "This, as I understand it, does not mean that a court should officiously strive to construe a section in its widest possible significance in order to give it the widest possible operation, but that one must look for the meaning evidently intended by the language used bearing in mind the object of this section, and apply that section accordingly without giving either the taxpayer or the Revenue the benefit of any doubt or ambiguity."

The decisions in Chinn v Hochstrasser (Inspector of Taxes) [1979] 2 WLR 411 and in Chinn v Collins (Inspector of Taxes) [1979] 2 WLR 411 demonstrate the new approach by the courts to tax avoidance.

In terms of Paragraph 13 of Schedule 7 to the Finance Act, 1975, no chargeable gain shall accrue on the disposal of an interest under a settlement by any person except one who acquired it as, or through, a purchaser for value. Chinn (and his brother), having a contingent interest in a settlement by his father of 370 100 shares in Lex Garages, his father being a director and joint chairman, and the Chinn family owning 909 572 shares, representing 25% of the equity, was entitled to sell his interest to a third party without himself incurring any liability to capital gains tax. A scheme was evolved in terms of which, using merchant bankers in Guernsey and Jersey, the following steps were taken:

(a) On 31 March 1969, a Rothschild subsidiary bank and two employees, all resident outside the United Kingdom, replaced the United Kingdom resident trustees.

(b) On 28 October 1969, the trustees appointed 184 500 shares to Chinn absolutely, contingent on his survival past midnight on 31 October/1 November 1969.

(c) Chinn sold his interest to another Rothschild subsidiary, "Rosel", with a paid up capital of £150, for £352 705, payable on 1 November 1969. The middle market price of 184 500 Lex shares as at 27 October 1969 was £355 162,50. Insurance on Chinn's life to cover the intervening period was taken up.

(d) On selling his interest to Rosel, Chinn contracted to buy from Rosel for delivery in Guernsey on 1 November 1969, time being of the essence, 184 500 Lex shares for £355 162,50, and handed to the bank a letter asking that his account be debited on 1 November 1969 with that sum. This means that the "real money" that passed was the difference of £2 457,50.

(e) On 1 November 1969, the registered owner of all the 370 100 Lex shares, a nominee for the foreign trustees, was notified by them that 184 500 shares were beneficially owned by Chinn.

(The same facts applied in relation to a scheme in respect of Chinn's brother).

The Revenue launched a three pronged attack. The Revenue contended, firstly, that the scheme was a composite whole, whose sole legal effect was the intended end result. Consequently, Rosel's purchase of the interest was to be discarded as mere machinery for effecting the taxpayer's purpose. Secondly, that in all the circumstances the contract to buy from Rosel was a contract to buy back the parcel of shares, for which he had paid, and consequently that he had an equitable interest in the parcel, and therefore that it was just and reasonable to apportion the whole of the gain to him. Thirdly, relyied on <u>section 42</u> of the <u>Finance Act</u>, on the grounds that the scheme was "an arrangement" under which Chinn was the beneficiary.

Before the Special Commissioners the first and second attacks failed, but the third attack succeeded. Before Templeman J (as he then was) the first line of attack was not mentioned, but the second and third both succeeded. In the Court of Appeal, however, all three attacks failed.

In Chinn v Collins (1981) STC 1(HL), Lord Wilberforce modified the approach he had adopted in Plummer's case. He held that where there is a prearranged, pre-drafted tax avoidance scheme, the Court is entitled to look at the plan as a whole without disregarding the legal form and nature of the transactions.

In Floor v Davis (Inspector of Taxes) [19/8] 2 All ER 1079; [1979] 2 All ER 677 the taxpayers evolved a scheme in order to sell their shares in one company to another company. A third company was incorporated, so the shares in the first company were sold to the second company via the newly incorporated company, in consideration of an allotment of shares, and a subsequent transfer of shares for a cash consideration. This was followed by re-organisation of the incorporated company and its liquidation, which had the effect of passing its assets, including the cash received from the purchasing company, to a fourth company, registered in the Cayman Islands. It was held that the transactions which made up the first stage of the transaction could not be regarded as a disposal by the taxpayers of the shares. In a dissenting judgment Eveleigh L J held:

> "It is clear that right from the beginning the American Company (KDI) indicated that it would purchase the shares. The only reason for avoiding a direct sale to them was the prospect of capital gains tax. In an attempt to avoid paying this, as is frankly accepted, the initial transfer to FNW took place. There was however no real possibility at any time that the shares would not reach the American Company. By virtue of their control of FNW the shareholders guaranteed from the moment they parted with the legal ownership that the shares would become the property of the American Company. No-one could prevent this against their wishes. By virtue of the arrangement initially made between them each was under an obligation to the other to do nothing to stop the shares arriving in the hands of the American Company. They controlled the destiny of the shares from beginning to end in pursuance of a continuing intention on their part that the shares should be transferred to KDI."

This view has received approval in two speeches in the House of Lords, particularly in Furniss v Dawson (infra). Eveleigh LJ was attracted by the alter ego theory of the intermediate purchaser/vendor. He based his judgment on the fact that A sold the shares in X Ltd to Z Ltd, because A at all times controlled Y Ltd, the intermediate purchaser/vendor. In other words he was not constrained to observe the separate legal personality of the intermediate purchaser.

In Eilbeck v Rawling; W T Ramsay Ltd v IRC (1981) STC 174(HL), two appeals were heard together. They both involved the question whether a tax avoidance scheme which involved a number of separate transactions, none of which was a sham, should be considered as one transaction comprising a number of sub-transactions, or as two groups of transactions. If the first view was accepted, the taxpayer's capital loss would be the difference between his position at the start of the scheme and his position at the end of the scheme. In effect, the capital loss would be restricted to the fees paid to the promoters of the scheme. If the second view was accepted, the scheme would produce a deductible capital loss and a matching, non-taxable, capital gain. The House of Lords unanimously accepted the first view, the main speeches being by Lord Wilberforce and Lord Fraser of Tullybelton.

In W T Ramsay Limited v IRC [1981] 1 All ER 865 (HL) a farming company realised a chargeable gain of £188 000 on the sale of farm land in Lincolnshire. In order to mitigate the capital gains tax that would be payable, the taxpayer embarked on a scheme designed to manufacture a paper loss of £175 647 by means of a series of loan and share transactions. The scheme was characterised by the fact there was no commercial justification for it, nor was there any prospect of a profit. There was bound to be a small loss in the form of the fees and expenses which would be payable. Each step in the scheme was carried through genuinely and was exactly what it purported to be. There was no binding arrangement that each step would be followed by the next planned step, although it was reasonable to assume that the steps would be carried out. The scheme was designed to, and did, return the taxpayer to the position which he had occupied before it began, apart from the obligation to pay