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Recent Trends in United Kingdom Anti-Avoidance Law

Ian A. Saunders*

I. INTRODUCTION

The United Kingdom's approach to countering tax avoidance is a piecemeal one. The civil law concept of "abuse of law" has not been used in the United Kingdom,¹ nor does there exist a general statutory anti-avoidance rule.² Thus the law has evolved and developed through legislation, Inland Revenue practice and judicial decisions. To these traditional methods of legal development a further dimension is now of increasing importance. Not only are there a number of anti-avoidance provisions in the various double taxation agreements which the United Kingdom has with other states,³ but there are also such provisions in the new body of law embodied in the European Community Directives on Taxation.⁴

The armoury of anti-avoidance weapons should not, however, be seen as planned, complementary lines of attack. Each has developed separately. It is safe to assume that the judge-made doctrine referred to below would not have taken effect in its present form if a general anti-

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¹ The most obvious comparison is with French law. See Maurice Cozian, *What is Abuse of Law?*, 1991 INTERTAX 103 (Feb. 1991). It should also be noted that although the text refers to the United Kingdom, it is strictly true only of English law. Scots law on this point is quite different.

² For example, there is no equivalent in U.K. statutory law to the provisions of the Canadian Income Tax Act denying a tax benefit which would result, directly or indirectly from a transaction or series of transactions that are deemed to be "avoidance transactions." Canadian Income Tax Act, R.S.C., ch. 148 § 244, 245 (1983). An "avoidance transaction" is defined for this purpose as any transaction that would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit, or a transaction that is part of a series of transactions which series would have that result. *Id.* § 245(3).

³ See *infra* section IVA.

⁴ See Peter H. Schonewille, *Some questions on the Parent-Subsidiary Directive and the Merger Directive*, 1992 INTERTAX 13 (Jan. 1992). See also *infra* section IVB.

avoidance provision had existed in statute.⁵ On the other hand, any such doctrine would still be moulded by judicial methods and constraints which are of general application. Thus the reticence of U.K. judges to openly assume for themselves a legislative role has led them to see anti-avoidance doctrine as one of statutory construction⁶ or "statutory application."⁷ In fact, the judicial role has been twofold: first to construct their own doctrine, and secondly to interpret legislative rules in this sphere.⁸

The purpose of this article is to highlight the aspects of the U.K. system which distinguish it from that of other jurisdictions in this sphere and to do this by analyzing certain recent developments. The objectives are thus to examine critically some of the latest changes and trends, to make comparisons between the different modes of development, and to draw some conclusions on the present state of the law and the directions in which it is moving.

The division that has been made between treaties, statutes and judicial decisions is essential as there are differences in approach which go beyond those inherent in the form of the source in question. These differences will be brought out in the discussion below. On the other hand, it must be recognised at the same time that such divisions are artificial in the sense that any approach to anti-avoidance must be viewed in its totality; each division takes its place as a part of the full armoury referred to above.

II. STATUTORY PROVISIONS

The legislative methods of attack used in legislation are multifarious and not susceptible to closely defined classification. The choice of provi-

⁵ Compare the French tax system which has such a provision embodied in Article L.64, *Book of Fiscal Procedures*.

⁶ "[T]he taxpayers advanced the proposition that the *Ramsay* principle was *not* one of statutory construction but of some other sort I consider this proposition to be unsound." *Craven v. White*, [1988] 3 All E.R. 495, 538 (H.L.) (per Lord Jauncey) (emphasis added).

⁷ The term "statutory application" was coined by Nourse L. J. *Fitzwilliam v. I.R.C.*, [1992] S.T.C. 185, 198 (C.A.).

⁸ The recently reported decision of *Pepper v. Hart*, [1992] S.T.C. 898 (H.L.), marks a historic change in the U.K. courts' power to interpret statutes. The case involved taxation, the court holding that a benefit in kind received by an employee should be valued at its marginal cost for purposes of taxation in the hands of the recipient employee. The case's importance, however, goes beyond the sphere of taxation. For the House of Lords held that it is permissible for judges to refer to *Hansard*, the official report of Parliamentary proceedings, in interpreting a statutory provision, though only in limited circumstances. Hitherto there has been a complete bar. The "limited circumstances" are where the wording of the provision is ambiguous and, in addition, there is a clear statement as to the provision's meaning or purpose by a minister or other promoter of the Bill.

sions considered is, of necessity, eclectic. In broad terms, however, several different approaches can be detected. First, legislation may be designed to counter a particular type of scheme.⁹ This type of legislation attempts to define the scheme or transaction to be covered and sets out the tax implications which follow. At its simplest level this is a comparatively straightforward exercise. For example, the deduction of expenses, including incidental expenses, incurred in providing business entertainment is prohibited in computing taxable profits.¹⁰ The mischief targeted is the possibility of reciprocal arrangements leading to the leisure activities of businessmen being subsidised by the Revenue.

On the other hand, many schemes have necessitated attack with more complex provisions. The danger here is that the legislation may go further than is necessary to counter the tax avoidance element of the particular type of scheme, and thus bring in its wake all the concomitant consequences for ordinary commercial transactions. This type of anti-avoidance legislation can be found in provisions relating to group and consortium relief for companies.¹¹ These provisions demonstrate a number of points and are worthy of a comparatively lengthy discussion.

Rules set out in the Income and Corporation Taxes Act determine, in part, whether companies are in a group or consortium relationship.¹² This is mainly relevant for purposes of group and consortium relief, i.e. consolidation for tax purposes, group income elections and advance corporation tax surrenders from a parent to a subsidiary. An economic ownership test has been superimposed on the ordinary requirements of

⁹ An example of this can be found in the deep gains legislation. Debt securities were used to enable UK investors to take advantage of the more favourable tax regime for capital gains, by expressing what would otherwise have been an income return as capital which aims to treat any gain on a security which may be payable at a "deep gain" as income. Finance Act, 1989, ch. 26, § 94 and sch. 11 (Eng.). The Finance Act (No. 2) of 1992 modifies these provisions, recognising that the original legislation was drawn too widely so that certain default or event risk clauses potentially operated to render a security within the deep gain definition, though this was not intended. Finance Act (No. 2), 1992, § 33 and sch. 7 (Eng.) [hereinafter FA 1992].

¹⁰ Income and Corporation Taxes Act, 1988, ch. 1, § 577 (Eng.) [hereinafter ICTA 1988].

¹¹ The relevant part of the present legislation is now contained in ICTA 1988, sch. 18, as amended by FA 1992, § 24 and sch. 6. As will become apparent from the discussion below, the U.K. law in this sphere is totally different in form and substance from that operative in Canada and the U.S. In Canada, the basic rule is that unused losses may be claimed only by the corporation that incurred them and not by related companies. The main exemptions pertain to situations within a corporate reorganisation. In the U.S., while NOLs (net operating losses) can be utilised in the group situation, if there is a greater than 50% ownership change in a loss corporation within a three-year period, an annual limit on the use of NOLs, based on a fraction of the company's value, will generally be imposed. This significantly limits the possibility of abusive tax situations including "shell corporations" with unused losses.

¹² ICTA 1988, ch. 1, sch. 18.

ownership of ordinary share capital.¹³ The purpose of the economic ownership test is simply to confine the benefits of group or consortium membership to companies in specified economically connected relationships. Thus one is required to look further than the mere ownership of ordinary share capital in order to establish, in basic terms, who gains or loses if the company does well or badly. Thus there is a requirement that in addition to one company being a 75% subsidiary of the other, the parent company, by virtue of its equitable ownership of certain securities, has to be entitled to at least 75% of the subsidiary's distributable profits and to the same percentage of its assets on a winding up. The 75% entitlement is thus the crux of the test.

One facet of these anti-avoidance rules on economic ownership was quickly acknowledged to be too wide. The legislation includes within the term "equity holders" a loan creditor of a company in respect of a loan which is not an "ordinary commercial loan."¹⁴ Prior to 27 July 1989, non-commercial loans comprised:

- (i) losses convertible into shares and securities; and
- (ii) loans carrying rights to additional income or capital in excess of normal commercial terms.¹⁵

The width of this definition led, in its application, to a distortion of the equity holder/debtor relationship so that group relief was denied for no good reason in many cases.

As a result, amendments were made in the Finance Acts of 1989 and 1991, making clear that a loan is not prevented from being "commercial" in character simply because it carries rights of conversion into shares or securities in the company's quoted parent company. The 1989 amendments provided that subsidiary companies raising finance using such securities do not thereby lose their group relief. Similarly, losses carrying rights of conversion into fixed-rate preference shares or normal commercial loans are not precluded from being ordinary commercial loans.¹⁶ The 1991 amendments provide that loans made on terms under which the rate of interest is to be reduced in the event of an improvement of the company's business or of an increase in the value of its assets. Though strictly speaking, under the above definition, these loans are not commercial, loanholders are not treated as participators in the equity of the company.¹⁷ Secondly, loans which are limited or non-re-

¹³ FA 1989, ch. 26, § 101, *amending* ITCA 1988, ch. 1, sch. 18, para. 1.

¹⁴ ICTA 1988, ch. 1, sch. 18, para. 1(1)(b).

¹⁵ *Id.* para. 1(5).

¹⁶ FA 1989, ch. 26, § 101, *amending* ICTA 1988, ch. 1, sch. 18, para. 1.

¹⁷ Finance Act, 1991, ch. 31, § 77(1) (Eng.) [hereinafter FA 1991] *amending* ICTA 1988,

course in nature and the security for the payment of principal or interest is restricted to land other than dealing property are also treated as commercial loans.¹⁸

An important extension of the economic ownership test was the requirement that, where there were "arrangements" in force under which an equity holder's entitlement to profits or assets could be different as compared with the entitlement if the arrangements did not take effect, the relevant percentage tests were to be applied as follows: i) as if effect had been given to the arrangements, and ii) as if it had not. The lesser entitlement was then used.¹⁹ In other words, if the parent company's holding would fall below 75% *either* in the event of effect being given to those arrangements *or* on the basis that the arrangements were ignored, then the relief is not available. The 75% test is not satisfied.

Amendment of the above rules was prompted by the decision of *J. Sainsbury plc. v. O'Connor*.²⁰ The main issue in this case was whether the term "arrangements" covered options under which there might be a future change in the ownership of shares. Sainsbury owned 75% of the shares in Homebase while a Dutch subsidiary owned the remaining 25%. Put and call options, in force for a time, governed 5% of Homebase's share capital. These rights had not been exercised. Had effect been given to the arrangements, Sainsbury would have only had a 70% interest and so failed the economic ownership test for a group. Nevertheless, the court held that the options did not constitute "arrangements" and thus did not deprive Sainsbury of group relief.

The Revenue saw this decision as a means of defeating commercially realistic anti-avoidance rules designed to limit group and consortium relief related companies. Therefore, an announcement was speedily made, on 15 November 1991, stating that the Government would enact legislation designed to overturn the *Sainsbury* case.²¹ The promised legislation, now contained in the Finance (No.2) Act 1992, would apply to arrangements made on or after the date of the statement.

The crucial provisions in the new Act extended the definition of the term "arrangements" to encompass "option arrangements."²² The definition of such arrangements, which need not be in writing, requires com-

ch. 1, sch. 18, para. 1.

¹⁸ *Id.*

¹⁹ ICTA 1988, ch. 1, sch. 18, para. 5(3).

²⁰ [1991] S.T.C. 318 (C.A.)

²¹ Statement by the Financial Secretary to the Treasury published on 15 November 1991. [1991] S.T.I. 1042.

²² ICTA 1988, ch. 1, sch. 18, para. 5(5B), amended by FA 1992, ch. 48, sch. 6.

pliance with two conditions:

- (1) arrangements are ones by virtue of which there could be a variation in -
 - (a) the percentage of profits to which any of the equity holders is entitled on the profit distribution, or
 - (b) the percentage of assets to which any of the equity holders is entitled on the notional winding up;
- (2) under the arrangements, the variation could result from the exercise of any of the following rights (option rights) -
 - (a) a right to acquire shares or securities in the second company referred to above; or
 - (b) a right to require a person to acquire shares or securities in that company.²³

If an arrangement falls within the above definition, the percentage entitlement is calculated on the alternative assumption that the arrangements either (i) have, or (ii) have not, taken effect. The lower entitlement is then used. The point is well illustrated by the facts in the *Sainsbury* case since the transactions involved in that decision would now constitute "arrangements" under the Act. The fact that Sainsbury would only own 70% of the equity if effect were given to the "arrangements" would deny the possibility of relief. The fact that a 75% entitlement would remain if the options were not exercised is irrelevant. The lower entitlement is used.

The present amendments were initially issued in draft form. Comments were submitted to the Revenue on a number of points including the length and complexity of the legislation. However, the relevant point for the present article is that a number of bodies drew attention to the fact that the definition set out above would cause problems for joint venture arrangements. In virtually every case in a joint venture there is a mechanism for its conclusion, typically by one party buying out the other. This and other common arrangements involving pre-emption rights would fall within the definition of "option arrangements" so that consortium relief would be denied. The Financial Secretary to the Treasury rejected a change to the definition when the Finance Bill was debated in the Committee stage in the House of Commons.²⁴ He did, however, promise a Statement of Practice and extra statutory concession to deal with the problems of joint venture arrangements.²⁵

²³ *Id.*

²⁴ Committee Hearings, 23 June 1992 HANSARD 240.

²⁵ A Statement of Practice and Extra Statutory Concession were eventually published on 13

This particular saga, as suggested above, is instructive of the unsatisfactory way in which changes in this sphere of revenue law are taking place. The starting point was a set of provisions containing rules beneficial to groups or consortia. Superimposed on these provisions were the anti-avoidance rules in the form of the economic ownership test. Those rules, justifiable in their basic content, were seen to have been drawn too widely, the breadth of the "normal commercial loan" definition providing one illustration of this. Amending legislation, therefore, followed.

The chronology of the further changes in this sphere can be described as follows. The *Sainsbury* case embodied a decision which was at variance with the Revenue's understanding of the interpretation to be afforded to the term "arrangements." The Revenue reacted immediately and announced its intention to reverse the decision. The Statement by the Financial Secretary to the Treasury declared that the decision undermined a view of the law which had long been accepted. This view of the pre-existing law is, at the very least, open to doubt.²⁶ So, Step 1 was the *Sainsbury* decision. Step 2 was the Statement of the Financial Secretary which promised draft legislation. Step 3 was the publication of the draft legislation²⁷ for the purposes of consultation.

The unsatisfactory nature of the *method* of reform can already be seen. First, the Statement of 15 November 1991 promised legislation which would have retrospective effect in the sense that it would apply to arrangements made on or after that date (though the legislation had not then been published, let alone enacted). In the period between 15 November 1991 and 29 January 1992 a taxpayer could not know the form or scope of the promised amendments. This itself is perturbing. The former understanding, until recently accepted by the Revenue, was that legislation should not be introduced which would retrospectively increase any taxpayer's liability.²⁸ Now it seems that,

[w]here it is discovered that the tax law does not have the effect that the Government and taxpayers generally thought it had, there are circumstances in which it is right to introduce legislation to restore the position retrospectively to what it was thought to be.²⁹

January 1993.

²⁶ Tom Scott, *A Sledgehammer to Sainsbury*, 1992 BRIT. TAX. REV. 65 (1992).

²⁷ The draft legislation was published on 29 January 1992.

²⁸ This is different from the fundamental rule of English law that no statute shall be construed to have retrospective operation unless such a construction is clear in the terms of the Act. In *re Athlumney*, [1898] 2 Q.B. 547, 551-52. The more general convention against retrospective legislation forms part of the rule of law and, in the specific spheres of taxation, has links with the historical treatment of taxation as "penal" and a form of confiscation of property. See Robert Stevens, *Law and Politics* 170-71, 264 (1978).

²⁹ Written Answer to Parliamentary Question, Committee Hearings 29 June 1992 HANSARD

The practical result was that for several months the taxpayer was in a position where he could not know the legal rules which were being operated. And this uncertainty existed in an area of real *commercial* importance.

But matters did not end there. Step 4 was the consultation process which, as indicated above, resulted in no significant changes being made to the draft clauses. Step 5 was the enacting of the legislation presented "as a package" with the promise of a Statement of Practice or extra statutory concession to mitigate the full rigours of its strict application. Step 6, the publication of the Statement or concession in final form, is awaited.

The fundamental criticism is an obvious one, yet no less serious for that. Even before the provisions became law it was recognised that they were defectively drafted. Instead of amending *the legislation* as drafted, it was stated that amendment would follow by concession. Such a method of legislating is indefensible and further comment is superfluous.

Other categories of legislation can be indicated. For example, certain legislation substitutes a different tax treatment from the normal one if the transaction or scheme is between connected persons or is not at arm's length.³⁰ Other legislation depends on the taxpayer's motive.³¹ Some rules straddle more than one category. The statutory provisions which can be viewed under the broad heading of "thin capitalisation" can be so regarded.³² Under the principal provision relating to "thin

378 (per Financial Secretary to the Treasury).

³⁰ See, e.g., ICTA 1988, ch. 1, § 209 (governing the payment of interest between related parties). Compare the Canadian treatment dealt with in Robert Couzin, *Of Arm's Length, and Not Dealing Thereat*, 26 Can. Tax J. 271 (1978). The principles set out in that article still hold good despite its date of publication.

³¹ See, e.g., ICTA 1988, ch. 1, § 787(1) (governing receipt of a tax deduction for an interest payment).

Relief shall not be given to any person under any provisions of the Tax Acts in respect of any payment of interest if a scheme has been effected or arrangements have been made such that the sole or main benefit that might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by the means of any such relief.

Id. See also Brian J. Arnold, *Is Interest a Capital Expense?*, 40 CAN. TAX J. 535 (1992) (discussing the Canadian approach).

³² The problems arising under this broad heading are faced by all tax systems. In Canada, section 18(4) of the Income Tax Act contains specific provisions that deal with the limitation of a deduction, for income tax purposes, of interest paid or payable by thinly capitalised corporations. But, in addition, it is important to note that Canada has special rules applicable to the deductibility of interest which must be taken into account when considering the capitalisation of a Canadian subsidiary or related company. For interest to be deductible it must be paid pursuant to a legal obligation to pay interest, paid in the year, or payable in respect of the year, and the

capitalisation,"³³ any interest (or other distribution out of the assets of a company) in respect of securities is treated as a distribution for U.K. tax purposes where the securities issued by the company are held by a non-resident company of which the issuing company is a 75% subsidiary, or where both companies are 75% subsidiaries of a third non-resident company.³⁴

This treatment of interest may be overridden or modified by double taxation arrangements. Though the terms of the agreements vary, many of them disapply this distribution rule. A common limitation applies where the interest paid is more than would be paid but for the existence of a "special relationship" so that no relief is given in respect of the excess interest paid. In general terms, two types of "special relationship" clauses exist. Some require examination of the amount of the debt in respect of which the interest is paid. In such cases the clause, if generally accepted, restricts only the relief where an excessive *rate* of interest

interest must be reasonable. Interest expense in excess of a "reasonable rate" will be denied under section 68 of the Income Tax Act when it relates to Canadian resident lenders and under section 69(2) where it is paid to a related or associated non-resident lender. The Canadian approach to thin capitalisation is to deny the deductibility of interest expense paid to specified non-residents on that portion of the debt that is in excess of three times the borrowing corporation's equity. The Canadian Income Tax Act, therefore, identifies and deals with thin capitalisation upon a simple formula basis. For an excellent recent analysis of the rules, see Tim Edgar, *The Thin Capitalization Rules: Role and Reform*, 40 CAN. TAX J. 1 (1992). See also Brian J. Arnold & Tim Edgar, *The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis*, 40 CAN. TAX J. 267 (1992).

In the United States, section 385 of the Internal Revenue Code, enacted in 1969, authorised the Internal Revenue Service to issue regulations defining corporate stock and debt for the purposes of U.S. tax law regulations relating to cross border situations which had never been issued and regulations concerning domestic situations which were issued and then withdrawn. I.R.C. § 385 (1992). In the absence of such regulations, section 482 of the Internal Revenue Code contains the general intercompany pricing rules which could potentially be used to disallow deductions of "excessive" interest payments. I.R.C. § 482 (1992). However, the most important restriction on the deductibility of interest paid by a U.S. subsidiary corporation to its foreign parent company was enacted by section 7210 of the Omnibus Budget Reconciliation Act which added section 163(j) to the Internal Revenue Code. This in essence provides that interest paid by a corporation to a related person is not currently deductible if the interest is eligible for an exemption or reduction from U.K. tax under a treaty (or is otherwise exempt from U.S. tax) and the corporation's net interest expense exceeds 50% of its "adjusted" taxable income. Omnibus Budget Reconciliation Act, ch. 101-239, 103 Stat. 2106, 2339 (1989).

The restriction does not defer related party interest deduction if the payer has a debt to equity ratio, using the adjusted tax basis of assets, of no more than 1.5:1. See, e.g., Jim Fuller, *New Earnings-Stripping Rules Under Code Section 163(j) Proposed*, 3 TAX NOTES INT'L 730 (July 1991); Carl Estes, *Recent Developments in U.S. Taxation of Foreign Direct Investment* 45 BULL. INT'L FISC. DOC. 17-25 (Jan. 1991).

³³ ICTA 1988, ch. 1, § 209(2)(e).

³⁴ *Id.*

is paid. The other type of clause found in these arrangements, including that found in the U.K./U.S. Double Taxation Treaty,³⁵ is more widely worded. The Revenue has always argued this type of clause permits it to restrict when the *amount* of the interest paid exceeds that which would have been paid in the absence of the "special relationship" for whatever reason. This, in effect, includes a consideration of "thin capitalisation" policy.

This was the position until recently. At this stage one has a workable set of provisions. Perhaps strangely, the U.K. tax authorities have no power to regulate with regard to a company's ratio of debt to equity capital. Guidelines to their approach are unpublished and strictly informal. Against this background, the rules form a typical compromise under which an unworkably strict statutory provision has been modified and relaxed. In this case, this has been done under double taxation agreements. However, the balance in this compromise between the Revenue and the taxpayer has recently been tilted by further statutory amendment.³⁶

A 1992 Special Commissioner's decision opined that regard could be had only to the rate of interest and not other factors, even where the wider clause was used. The Revenue immediately announced that this decision was at variance with its understanding of the law hitherto and that legislative amendment would follow. Finance (No 2) Act 1992 provided a new rule applicable to interest payments made after 14 May 1992. For such payments, unless the double tax provision specifically limits the factors to be considered, all relevant factors must be taken into account.³⁷ This will in effect bring "thin capitalisation" factors into play since the factors will include the question of whether the loan would have been made at all, how much would have been lent, and the rate of interest. In addition the burden of proof is placed on the paying company to show that no "special relationship" is in existence, or, if it is, how much interest would have been paid in its absence.

³⁵ Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975, U.S.-U.K., art. 11, 31 U.S.T. 5668, S.I. 1980, No. 568.

³⁶ FA 1992, ch. 48, § 52.

³⁷ *Id.* § 52(2) states that all factors include:

- (a) the question whether the loans would have been made at all in the absence of the relationship,
- (b) the amount which the loan would have been in the absence of the special relationship, and
- (c) the rate of interest, and other terms which would have been agreed in the absence of the relationship.

There is no doubt that this leaves the rules flexible, not changing the situation referred to above under which the Revenue has no regulatory powers in relation to debt/equity ratios. On the other hand, it leaves the law uncertain and provides the Revenue with wide powers. When these latter points were made during the passage of the Bill through the House of Commons, all that emerged was a promise from the Financial Secretary to the Treasury to the effect that "the Revenue does not intend to challenge every inter-company loan on the basis of the potential thin capitalisation rules."³⁸

A further result of the same Special Commissioner's decision was in the sphere of equity notes. The Revenue found the decision unacceptable because the return on the loans was not taxed as interest in the state of receipt, the U.S. in the particular case, while the paying company was able to obtain a deduction for the interest paid. Such interest is to be treated as a distribution if paid after 14 May 1992. The drafting of the amendments is extremely wide, and they are not displaced by the distribution override provisions referred to above. Despite a further promise by the Financial Secretary that the amendment "will not operate solely by virtue of the fact that a parent company has borrowed money from its subsidiary"³⁹ the legislation provides another example of anti-avoidance legislation which will only operate satisfactorily if not applied as drafted. In this sphere there is to be no Statement of Practice or concession.

III. JUDICIAL DECISIONS

A. The *Ramsay* doctrine

The modern era in the judge-made anti-avoidance doctrine began, it is generally agreed, with the decision in *Ramsay v. I.R.C.*⁴⁰ The litera-

³⁸ Committee Hearings, 30 June 1992 HANSARD 450.

³⁹ *Id.* The legislation is to be found in FA 1992, ch. 48, § 31.

⁴⁰ [1982] App. Cas. 300. The judicial doctrine is normally referred to as "the *Ramsay* doctrine" or "the new approach." Purists confine the term "*Ramsay* doctrine" to circular, self-cancelling transactions, preferring to refer to the doctrine as that of *Furniss v. Dawson*, [1984] App. Cas. 474, when the transactions are linear. The case of *I.R.C. v. Duke of Westminster*, [1936] App. Cas. 1, had been the bedrock of the earlier judicial attitudes to tax avoidance. In the oft quoted words of Lord Tomlin:

Every man is entitled if he can to arrange 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 that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

ture and commentaries on that case and *Furniss v. Dawson*,⁴¹ the other decision forming the basis of the new approach, is voluminous.⁴²

Development since then has seen the doctrine refined, modified and extended in some situations while treated as inappropriate in others.

In *Craven v. White*,⁴³ the court reviewed the *Ramsay* doctrine and provided a number of guidelines to aids in its application. The *Craven* decision has also received much comment and the aim here is to set forth the *Craven v. White* formulation of the *Ramsay* doctrine, specifically as it was adopted in *Hatton v. I.R.C.*,⁴⁴ and then to review the

Id. It had been said that the decision required a court to look at the form of a transaction rather than its substance. Such a formulation is a gross over-simplification. At about the same time the courts in the U.S. adopted a quite different approach in *Gregory v. Helvering*, 293 U.S. 465 (1935). It was therein held that a corporate reorganisation must serve a business purpose before it is recognised for tax purposes. *Id.* at 469. It should be noted that a showing of a business purpose is not to be confused with the showing of a *lack* of a tax avoidance motive. See *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965); *Chisholm v. Commissioner*, 79 F.2d 14 (2d Cir. 1935); Peter Millett, *Artificial Tax Avoidance: The English and American Approach*, BRIT. TAX REV. 327 (1986). Compare Canadian approach as illustrated, for example, in *Stuart Investments Ltd. v. M.N.R.*, 84 D.T.C. 6305 (1984).

⁴¹ [1984] App. Cas. 474.

⁴² See, e.g., G.R. Bretten & Fay Stockton, *The Ramsay Doctrine, An Interim Review*, 1987 BRIT. TAX REV. 280 (1987); S.N. Frommel, *Tax Avoidance and the House of Lords: Uncertainty as Deterrent I*, 1984 INTERTAX 378 (Oct. 1984); RICHARD BRAMWELL, ET. AL., *TAXATION OF COMPANIES AND COMPANY RECONSTRUCTIONS* 161-90 (1991); William D. Popkin, *Judicial Anti-Tax Avoidance Doctrine in England: A United States Perspective* 1991 BRIT. TAX REV. 283 (1991); Tiley, *Judicial Anti-Avoidance: The U.S. Alternatives, Parts I & II* 1987 BRIT. TAX REV. 180 (1987).

The leading cases which have not been referred to in the text include *I.R.C. v. Burmah Oil Co.*, [1982] S.T.C. 30 (H.L.); *I.R.C. v. Bowater Property Dev.*, [1989] App. Cas. 398; *Bayliss v. Gregory*, [1980] App. Cas. 896 (reported together with previous case *I.R.C. v. Plummer*); and *Moodie v. I.R.C.*, [1991] S.T.C. 433 (C.A.); *Stuart Investments Ltd. v. The Queen*, 84 D.T.C. 6305 (1984) (Canadian case reviewing all the leading English authorities then decided and *Gregory v. Helvering*, 293 U.S. 465, when rejecting the "business purposes test").

⁴³ [1989] App. Cas. 398.

⁴⁴ [1992] S.T.C. 140 (Ch.). In this case, by the summer of 1978, it had become clear that Mrs. Cole (the deceased) was terminally ill. On 2 August 1978, she granted a power of attorney to her daughter (Mrs. Hatton) and to her solicitor (Mr. Lawson), and expressly authorised them, jointly and severally, to make gratuitous dispositions of her property in favour of her children and remoter issue, including Mrs. Hatton.

On 10 August 1978, Mr. Lawson, acting on the advice of a firm which dealt in tax avoidance schemes, executed a settlement (the first settlement) which provided that the trust fund should be held in trust to pay the income thereof to the deceased for the period of her life or the period from the execution thereof until midnight on 11/12 August 1978, whichever was the shorter period, and subject thereto in trust for Mrs. Hatton absolutely. On 11 August 1978, Mr. Lawson informed Mrs. Hatton that the first settlement had been executed in her favour and suggested that she take advice as to whether any further action should be taken. As a result a second settlement was executed on the same day whereby Mrs. Hatton as settlor assigned her interest under the first settlement to trustees, expectant on the termination of the deceased's inter-

case law since then. *Fitzwilliam v. I.R.C.*,⁴⁵ which will also be referred to, was decided soon after *Hatton*. Its facts need not concern us, however, as they related to capital transfer tax which has now been abolished.

Although there was another possible ground for the decision in the *Hatton* case, the judge, Chadwick J. concentrated on the anti-avoidance doctrine, concluding that the *Ramsay* doctrine applied. He took as his starting point, *Craven v. White*, and his judgment was, in effect, based on his interpretation of Lord Oliver's speech in *Craven*, treating it almost as if it had the status of a statutory provision. That in itself is not surprising given that Lord Oliver is a judge in the House of Lords, the final appellate tribunal, and Chadwick J. sits in the High Court as a judge at first instance. Chadwick J., however, not only accepted the conditions, but went on to closely analyze the *actual* words in which they were expressed, concentrating on Lord Oliver's speech to the exclusion of other equally authoritative statements of the law. In that sense the judge treated the speech of Lord Oliver as akin to a statutory provision.

It should be said from the outset that this approach — analyzing one of many judicial statements in this area of the law as if it enjoyed such statutory authority — should normally be guarded against and

est, to hold in the trusts of the second settlement. Under the second settlement the trustees were to hold the fund in trust to pay the income thereof to the deceased until her death or until midnight on 12/13 August 1978, whichever occurred first, and subject to that, as to capital and income, for Mrs. Hatton absolutely.

The deceased died on 20 August 1978. Notices of determination were made against the appellants (the personal representatives of the deceased and the trustees of the second settlement) on the basis that a chargeable transfer of value had been effected in favour of the appellants by the deceased on 10 August. The appellants appealed against those determinations contending that no charge to capital transfer tax arose on the execution of the first settlement because the property had reverted to Mrs. Hatton as settlor within the meaning of the Finance Act of 1975. Schedule 5, paragraph 4(5) provided: "If the interest comes to an end during the settlor's life and on the same occasion the property . . . reverts to the settlor, tax shall not be chargeable . . . unless the settlor had acquired a reversionary interest in the property for a consideration in money or money's worth."

The issues before the Special Commissioners were inter alia: (1) whether the deceased, rather than Mrs. Hatton, was properly to be treated as the settlor in relation to both settlements; and (2) whether the principle of fiscal nullity, explained in the *Ramsay* decision, had any, and if so what, application to the transactions. The Commissioners confirmed the notices of determination on the ground that the deceased was the settlor of the second settlement having provided the only funds which were subjected to it so that the property did not revert to Mrs. Hatton within the meaning of paragraph 4(5).

The Commissioners found that the settlements were transactions preordained to the extent required for the application of the *Ramsay* principle. The appellants appealed. Chadwick J. dismissed the appeal. It should be noted that capital transfer tax as such has been abolished and superseded by inheritance tax.

⁴⁵ [1992] S.T.C. 185 (C.A.).

indeed rejected. While the speech of Lord Oliver is undoubtedly an important one and contains a clear exposition of the relevant principles, it is not definitive.⁴⁶

That having been said, this was the approach adopted by Chadwick J. He thus set out four conditions, laid down by Lord Oliver in *Craven v. White*, as being conditions to be satisfied before the *Ramsay* doctrine would apply with the result that the transaction at issue could be disregarded. First, the series of transactions was, at the time the intermediate transaction was entered into, preordained to produce a given result. Secondly, the sole purpose of the intermediate step was to save tax. Thirdly, there was at the time no practical likelihood that the pre-planned events would not take place. Fourthly, the preordained events actually did take place. These four stages, suggested by Lord Oliver, were set out in the judgment of Chadwick J. He then proceeded to consider each condition in turn.

The crucial condition in the *Hatton* case was the first. Chadwick J. rejected the taxpayer's contention that the steps were not preordained, explaining that this element required merely that: i) steps toward the second transaction must have been taken upon the completion of the first transaction; ii) there was an expectation that the second transaction would be carried through; and iii) there was no likelihood in practice that it would not be.

In the *Fitzwilliam* case, "the essential question was whether it was preordained [that the relevant party] would participate in the last two steps of the scheme."⁴⁷ To that extent, therefore, the issue can be viewed as being the same as in *Hatton*. The first condition of Lord Oliver, that the series of transactions was at the time when the intermediate transaction was entered into, preordained in order to produce a given result, was at issue.

⁴⁶ Other judges have explained the law in different terms. See, e.g., Lord Templeman's interpretation in *Craven v. White*:

Dawson decided that where a taxpayer adopts and carries into effect a scheme to avoid an assessment to tax on an *intended* transaction by a *prior* tax avoidance transaction which serves no business purpose except apart from the avoidance of tax which would otherwise become payable if the taxable transaction were carried out, the court will construe and apply the taxing statute to the scheme as a whole and not to the separate transactions which make up the scheme.

[1989] 1 App. Cas. at 486. Compare also *Ensign Tankers (Leasing) Ltd. v. Stokes*, [1992] 2 All E.R. 275 (H.L.), in which the court concentrated on the intention rather than on whether the steps were preordained.

⁴⁷ *Fitzwilliam*, [1992] S.T.C. 185 (C.A.) (per Nourse L.J.).

Several comments may be made on this decision. First, it was decided by the Court of Appeal so that, like the High Court in *Hatton*, the Court was bound by the House of Lords' decision in *Craven v White*. Secondly, differences from the decision of Chadwick J. may, however, be noted. Although the two decisions both turned on the question of whether the transactions were preordained, the Court of Appeal judges in *Fitzwilliam* did not confine themselves to the meaning attributed to that term by Lord Oliver in the *Craven* decision.⁴⁸ Thirdly, while accepting that the earlier decisions had settled that the *Ramsay* doctrine was one of statutory construction, Nourse L.J. in *Fitzwilliam* explained the court's function as follows:

[While the *Ramsay* doctrine has been described as one of statutory construction] . . . that was without doubt true in the sense that once the single composite transaction had been identified the question was whether it was caught by the taxing statute on which the Crown relied. However, it did not usually involve a question of statutory construction in the sense that the meaning of the statute was in doubt: usually the question was whether a statute whose meaning was clear applied to the single composite transaction. Hence, the principle might equally be described as one of *statutory application*.⁴⁹

So what conclusions can be drawn from these decisions? First, support is lent to the narrow view favoured by some in the post-*Craven* era, that the arguments will, for the present, principally revolve around the question of whether or not steps are preordained and this question will be treated as one of fact. In this context it is important to note that the term preordained was given a strict interpretation in *Shepherd v Lyntress*.⁵⁰ There must not only be a purpose of tax avoidance or mitigation, but it must be the case that treating a number of transactions as a single composite one has the effect of taking the transaction out of the statutory purpose of the relief from tax on which the taxpayer relies. A more specific point, directly relevant to the *Hatton* case in particular, was made by Vinelott J. in the *Lyntress* case: "The brevity of the period . . . [between the steps] may be an important or decisive factor in determining whether the steps were part of a single composite transaction."⁵¹

⁴⁸ Reference was made to Lord Oliver's speech but the other speeches were *also* relied upon. For example, Staughton L.J. quoted from the speeches of Lords Jauncey and Goff in *Craven*.

⁴⁹ *Fitzwilliam*, [1992] S.T.C. 185 (C.A.).

⁵⁰ 62 T.C. 495 (Ch. 1989).

⁵¹ *Id.* at 555.

Second, the *Hatton* case confirms one other attitude that can be perceived throughout the case law. Marketed, pre-packaged schemes of tax avoidance are likely to fall afoul of the doctrine. There is, not unnaturally, a judicial distaste for the commercialisation of tax avoidance.

Third, little has been added to the law on the role of certainty for the taxpayer. In *Craven v. White* the majority thought that such certainty was important. Even Lord Goff, who gave the leading dissenting speech, in which he argued powerfully that the anti-avoidance principle should not be artificially restricted by arguments on questions of fact, referred to tax avoidance as an "animal [which] is easily recognisable."⁵² In other words, while accepting that taxpayer certainty was important, the judge did not see it as a real problem. In this context it might be noted that the Revenue, in their letter of 20 September 1985⁵³ dealing with the routing of losses in the group situation, while recognising that some uncertainty was inevitable, expressed a readiness to co-operate in reducing uncertainties. The importance of taxpayer certainty has, in theory at least, been acknowledged, therefore.

The most recent important decision in the area of anti-avoidance is that of *Ensign Tankers Ltd. v. Stokes*.⁵⁴ Its facts can be stated briefly. The taxpayer company had been successfully engaged in leasing plant. In 1981 its managing director became aware that first-year allowances were available for expenditures on film making. As a result, the company entered into two agreements with other companies governed by the Limited Partnership Act 1907 to engage in film production.

The partnership entered into agreements under which they paid substantial amounts towards the cost of producing the films and undertook to meet the entire costs of the production and in return proposed to acquire the ownership rights of the films. Under a number of loan agreements, the production companies lent to the partnership sufficient monies for completing the films. The loans were non-recourse loans repayable only out of the receipts of the films.

The partnership expended \$3.25 million to produce and promote one such film. This was held to be capital expenditure "for a trading

⁵² *Craven*, [1988] 3 All E.R. at 534 (per Lord Goff).

⁵³ Letter to the Institute of Chartered Accountants in England and Wales following meeting with the Institute and the Law Society.

⁵⁴ [1992] 2 All E.R. 275 (H.L.). The next important decision is likely to be that of the House of Lords in *Moodie v. I.R.C.*, reported at the Court of Appeal's level, [1991] S.T.C. 433 (C.A.). The House of Lords decision, which will consider whether the *Ramsay* doctrine is applicable to "reverse annuity schemes," is likely to be heard in the middle of 1993. Their earlier decision, *Plummer v. I.R.C.*, [1980] App. Cas. 896, upholding the validity of such schemes, was decided before *Ramsay*. At the least, a full review of the *Ramsay* doctrine is possible.

purpose" within section 41, of the Finance Act 1971 and eligible for relief. However, the taxpayer's claim to relief for full cost of the film's production failed. The non-recourse nature of the borrowing ensured that the taxpayer would not be liable for the cost of the film in excess of \$3.25 million. The series of transactions forming the basis of this claim was held to be a composite transaction for the purposes of tax avoidance.

A number of points emerge from the *Ensign* case. First, the status of the *Ramsay* doctrine as a rule of statutory construction is confirmed. This had become apparent in *Craven v. White* and was put beyond doubt in the present case. The approach adopted was put succinctly by Lord Keith in *Craven*:

The court must first construe the relevant enactment in order to ascertain its meaning; it must analyse the series of transactions in question, regarded as a whole, so as to ascertain its true effect in law; and finally it must apply the enactment as construed to the true effect of the series of transactions and so decide whether or not the enactment was intended to cover it.⁵⁵

On one view, to analyze the doctrine as one of statutory construction or "statutory application" is of great practical significance in developing this body of the law. It recognises that a middle course can be steered through the two extremes of, on the one hand, generalising about all tax avoidance schemes and, on the other hand, looking at each scheme in isolation so that no coherent body of law can develop. Indeed it makes it obligatory to steer this course. In the present case the scheme was categorised as one in which a taxpayer sought "a reduction in his taxable income without suffering any loss or expenditure."⁵⁶ Perhaps the most significant aspect of *Ensign Tankers* was the introduction by Lords Templeman and Goff of a distinction between tax mitigation and tax avoidance.⁵⁷ The latter occurs only when the taxpayer reduces his liability to tax without incurring the loss which entitles him to that reduction. This point is, of course, at the heart of the actual decision in the *Ensign Tankers* case. The decision recognised that tax mitigation was outside the ambit of the doctrine. Lord Goff described mitigation as occurring in "cases in which the taxpayer takes advantage of the law to plan his affairs so as to minimise the incidence of tax."⁵⁸

⁵⁵ *Craven*, [1988] 3 All E.R. at 500.

⁵⁶ *Ensign*, [1992] All E.R. at 290.

⁵⁷ In the earlier case of *I.R.C. v. Challenge Corp. Ltd.*, [1987] App. Cas. 155, Lord Templeman had first drawn this distinction.

⁵⁸ *Ensign*, [1992] 2 All E.R. at 295.

The other important point to emerge from the decision is that the principles of *Ramsay* do not authorise the court to disregard *all* the fiscal consequences of a single composite transaction on the ground that it appears that the transaction is a tax avoidance scheme.

However, perhaps, inevitably, a note of caution is needed. The need for "certainty for the taxpayer" which was accorded some importance in the majority speeches in *Craven v. White*, received scant attention. The fear that the "new approach" might result in unfair and unexpected burdens on a taxpayer who can not know whether the transaction he is contemplating will fall afoul of the anti-avoidance principles was recognised and stated. Lords Templeman and Goff answered this concern by noting that schemes falling within the doctrine are easily recognisable. Such schemes, they noted, which achieve "apparently magical results"⁵⁹ and constitute "raids on the public funds,"⁶⁰ are easily recognisable animals.⁶¹ This suggests that, in the judges' view, the matter is not one which will cause difficulty.

On the other hand, there was express recognition that there might be difficulty in defining and identifying a single composite transaction distinct from two or more transactions which are independent. Lord Templeman saw this as a quite separate problem. He made it clear that his speech in *Ensign Tankers* was based on the certainty that a single composite transaction had taken place. His speech was, therefore, devoted to the method of applying the *Ramsay* doctrine once the existence of a composite transaction had been firmly established.⁶²

But in borderline cases, how is one to decide whether or not such is the case? Lord Templeman simply referred to the difference of judicial opinion on the matter noted in *Craven v. White* and gave no further guidance. This was regrettable. The majority view in *Craven*, as expounded by Lord Oliver, determined that the crucial issue was whether or not a series of transactions was preordained, so that it would be carried through to its conclusion. This would be so if there were no practical likelihood that the pre-planned events would not take place. The failure of the *Ensign* case to lend support or otherwise to this view is unfortunate since it had appeared that this was an aspect of the doctrine which had become settled. It had, for example, been applied in the cases of *Hatton* and *Fitzwilliam*.

⁵⁹ *Id.* at 288 (per Lord Templeman).

⁶⁰ *Id.* at 295.

⁶¹ *Craven*, [1988] 3 All E.R. at 534 (per Lord Goff).

⁶² *Ensign*, [1992] 2 All E.R. at 278-94.

B. Interpretation of Legislative Anti-Avoidance Provisions

In considering the above comments on the role of the judiciary in developing an anti-avoidance doctrine, it is important to bear in mind the United Kingdom's traditional approach both to statutory interpretation and to judicial "legislation."⁶³ The role played by judges in interpreting specific anti-avoidance provisions has been surprisingly limited. This is not principally because the judges have shied away from their task in this sphere but rather because the number of cases in which taxpayers have challenged the provisions is few. Doubtless the complexity of the legislation has played its role here.

A pertinent area in which judges have struggled with the complex statutory terms is the taxation of "transactions in securities."⁶⁴ In basic terms the provisions seek to deal with the mischief which may result when sums which could come out of a company as income are extracted either in capital form, with the possibility of more beneficial taxation as a capital gain, or in non-taxable form. In order for charges to apply under section 703, three conditions must be satisfied. First, there must be one or more transactions in securities.⁶⁵ Second, a "tax advantage" must have been obtained.⁶⁶ Third, one of the prescribed circumstances set out in section 704 must be present.⁶⁷ A typical example would be the receipt of an abnormal dividend through a transaction in securities. In this case, the taxpayer may avoid assessment if he can show that the transaction was carried out for bona fide commercial reasons or in the ordinary course of making or managing investments, and that the main object, or one of the main objects, of the transaction was not to obtain a tax advantage. It is crucial that both legs of this requirement are satisfied.

In *Hasloch v. I.R.C.*⁶⁸ the Revenue was successful because the taxpayer failed to prove that tax avoidance was not one of the motives of

⁶³ A comparison with the American approach, for example would need to consider, inter alia, the U.K. doctrine of Parliamentary sovereignty, the differing rules on considering legislative purpose, the relative ease with which Parliament can correct statutes which prove inadequate or defective, etc. See Michael Zander, *The Law Making Process* (2nd ed., 1985); Lord Devlin, *Judges and Lawmakers*, 39 MOD. L. REV. 1 (1976); Lord Reid, *The Judge as Lawmaker*, 12 J. SOC'Y PUB. TCHRS. L. 22 (1972); P.S. Atiyah, *Common Law and Statute Law*, 48 MOD. L. REV. 1 (1985); Popkin, *supra* note 42.

⁶⁴ ICTA 1988, ch. 1, §§ 703-709.

⁶⁵ *Id.* § 709(2).

⁶⁶ *Id.* § 709(1).

⁶⁷ *Id.* § 704(A)-(E).

⁶⁸ 47 T.C. 50 (Ch. 1971).

the transaction, even though the bona fide commercial test was satisfied. In *Clark v. I.R.C.*,⁶⁹ the taxpayer carried out transactions involving investment companies in order to provide him with funds to purchase land adjoining his farm. The commercial reasons related to the farming enterprise and not to the companies which were the subject of the "transaction in securities." Nevertheless, the court held that the commercial reasons need not be directly connected with the company or companies with which the taxpayer was concerned. In *I.R.C. v. Brebner*⁷⁰ it was held that transactions were entered into for bona fide commercial reasons because they were carried out to frustrate an unwelcome takeover bid. The case further demonstrates that a subjective test is to be used.

It is important to note that section 707 provides a "clearance procedure" whereby the taxpayer can furnish the Board of Inland Revenue with particulars of transactions which are to be put into effect (or have been effected) and obtain notification from the Board as to whether or not it is satisfied that the transactions are such that no action should be taken against him under section 703(3). Once the Board has notified the applicant that they are satisfied, then section 703 may not be applied to the specific transaction referred to in the application.

The two most important cases in interpreting this legislation are *Greenberg v. I.R.C.*⁷¹ and *I.R.C. v. Joiner*.⁷² In the *Greenberg* case, both A and R each entered into a contract, before 5 April 1960, with shareholders for the sale of shares in a company on terms described as a "forward dividend-stripping operation." In A's case, the purchase price was paid by instalments as and when dividends were paid on the shares by the company to be stripped, the greater part being paid after 4 April 1960. In R's case the purchase price was paid immediately, but the vendor was required to deposit an equal amount with a bank, which was released to him by instalments depending on the payment of dividends by the company to be stripped. All the relevant dividends were paid after 4 April 1960.

The crucial issue on appeal against notices issued under sections 703-709 was precisely *when* the transactions in securities had taken place. The House of Lords held, although it was not the sole ground of their decision, that each payment of a dividend and of the corresponding instalment of the purchase price was a separate "transaction relating to securities," thus enabling specific dates to be ascertained. Lord Reid

⁶⁹ [1978] S.T.C. 614 (Ch.)

⁷⁰ [1967] 2 App. Cas. 18.

⁷¹ [1971] 3 All E.R. 136 (H.L.).

⁷² [1975] 3 All E.R. 1050 (H.L.).

said:

The word "transaction" is normally used to denote some bilateral activity, but it can be used to denote an activity in which only a single person is engaged. It would not be wrong to say of a person doing office work that he is transacting business. This definition shows that no bilateral element is necessary for it includes applying or subscribing for new securities which are single acts done by one person alone. Then the definition includes not only transactions in securities but transactions relating to securities. A previous definition states as one would expect that "securities" include shares. So on the face of it any single act done by one person alone is a transaction in securities if it is one "relating to securities." This is a vague phrase but I do not see how to stop short of giving to it a very wide meaning. Taking acts done in carrying out these schemes I think that declaration of a dividend and payment of dividend by the taxpayer's company to the finance company were acts relating to shares. Certainly a declaration of a dividend is an act done relating to the company's shares and if that is so I do not see how to draw a line and say that the actual payment of dividends is not also an act relating to the shares.⁷³

Lord Simon of Glaisdale put it thus:

In my view, the payment of each dividend by the company to Finsbury, and the payment of the corresponding instalment of the purchase price by Finsbury to the Greenbergs, was itself, being a transactions "relating to securities," a "transactions in securities" (within the meaning of s.43⁷⁴) in consequence of which a tax advantage was obtained or obtainable. I have already referred to *Inland Revenue Comrs. v. Parker*,⁷⁵ which I think is authority for this view.⁷⁶

In *I.R.C. v. Joiner*, another section 703 case, Lord Wilberforce speaking more generally stated:

[w]hereas 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 in-

⁷³ *Greenberg*, [1972] 3 All E.R. at 149.

⁷⁴ Now ICTA 1988, ch. 1, § 709(2).

⁷⁵ [1966] App. Cas. 141.

⁷⁶ *Greenberg*, [1972] 3 All E.R. at 161.

tended, even though they led to a conclusion short of which judges would normally desire to stop.⁷⁷

These cases are currently of particular importance in view of the recent attacks by the Revenue against attempts by companies to use surplus advance corporation tax (ACT).⁷⁸ In broad terms the Revenue is seeking to deny parent companies the ability to use tax credits attaching to dividends paid by their subsidiary companies. The situation under consideration is that a parent company, wishing to make dividend payments, is unable to use the full amount of the ACT against its own or its subsidiaries' current year mainstream corporation tax liability or against its previous taxable profits. The problem relates to the surplus ACT which the parent then has and must use within three years or write off.

A traditional solution to this problem was to identify a subsidiary with ACT capacity and cause that subsidiary to pay a dividend to the parent outside the group income and dividend election. The subsidiary would then offset the ACT paid against its mainstream corporation tax liability for the accounting year in which the dividend was paid. The surplus would be carried back for up to six years and set off against mainstream tax paid in those years resulting in a repayment of tax to the subsidiary. The parent company would then offset the tax credit due to it from the receipt of the franked payment against the ACT payable on the dividend to its shareholders.

This "tax planning" is now the subject of attack by the Revenue which is seeking to use both the *Ramsay* doctrine and section 703. One aspect of the latter argument is that the payment of a dividend is "a transaction in securities." The matter is, clearly, of great practical importance. Presently, the Revenue's approach has not been tested by the courts,⁷⁹ though negotiations continue in a number of cases. The out-

⁷⁷ *Joiner*, [1975] 3 All E.R. at 1055.

⁷⁸ See Docherty & Smith, *Is the Ordinary Abnormal?*, TAXATION, 23 April 1992, at 73.

⁷⁹ The November 1992 issue of the Inland Revenue Tax Bulletin (a quarterly document issued by the Revenue since November 1992 setting out their thinking and views on particular issues) devoted a question to section 703 (Intra-Group Dividends). Particular attention is paid to the question of when a dividend can be regarded as "abnormal." The following extract exemplifies the Revenue's approach:

Section 703 does not apply where the transactions in question were carried out for bona fide commercial reasons and the obtaining of a tax advantage was not one of the main objects of the transactions. This means that Section 703 would not normally be invoked to counteract a tax advantage which arose through the payment by a subsidiary of a dividend to its parent company outside a group income election unless there were one or more additional factors involved. Such factors might include the

come of these cases, which cannot be confidently predicted, is likely to depend on a number of factors such as whether the subsidiary was acquired principally for tax reasons and whether the price paid reflected the potential tax benefit.

IV. THE INTERNATIONAL DIMENSION

As in municipal law, there is a constant fear that taxpayers may abuse or take advantage of relieving provisions in double taxation agreements. As a result, greater attention has been paid to anti-avoidance or anti-abuse provisions contained within these agreements.

A. Double Taxation Agreements

The U.K.'s basic approach is only to grant relief for example to allow reduced withholding tax rates under the terms of a treaty, subject to advance authorisation. The Revenue may delay or refuse consent if the terms of the treaty are being abused in an attempt to avoid the U.K. tax net. One example of this, the "thin capitalisation rules" has already been considered above.

In addition, however, a number of the treaties include, in relation to the reduction of withholding tax rates on dividends, interest and royalties, a rule denying such reductions if the structure was set up, or the debt claimed created or assigned, mainly for the purposes of taking advantage of the treaty and not for bona fide commercial reasons.⁸⁰

In general, the United Kingdom has not gone as far as the United States has in insisting on strict "treaty-shopping" clauses.⁸¹ The U.K. began to include such specific anti-avoidance clauses after double taxation treaties extended the dividend imputation tax credit to non-residents.

shares in the subsidiary being transferred within the group with no apparent purpose other than to enable a dividend to be paid to a company which is in a position to apply the franked investment income for [setting off losses or for calculating a company's liability to pay ACT]: the profits out of which the dividend was paid being artificially created in some way: or the dividend being financed (directly or indirectly) by the recipient or by another company in the same group. The question of whether a transaction gives rise to a tax advantage within the scope of Section 703 had to be decided on the facts and circumstances of the individual case.

⁸⁰ See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Nov. 7, 1980, U.K.-Neth., art. 10, para. 6, 1980 Tractenblad van het Koninkrijk der Nederlanden No. 205, 1980 S.I. No. 1961.

⁸¹ Treaty-shopping refers to a situation in which a resident of one state which is not a party to a treaty establishes a "body" within a state which is a party to the treaty in order to use the treaty's benefits or advantages. See the new Netherlands/U.S. Draft Treaty on Taxation, signed on 18 December 1992, containing a comprehensive anti-treaty abuse article.

The unlimited availability of such credits to non-residents would have been very expensive. The possible application of the *Ramsay* doctrine to treaty-shopping has not yet been tested.⁸²

In the United States the Internal Revenue Service and the courts have taken a much stronger position. While, the courts have not gone so far as to deny recognition to a body⁸³ if that body has a real business purpose in accordance with *Gregory v. Helvering*,⁸⁴ such treatment has been given to bodies established simply for treaty-shopping purposes.⁸⁵

The OECD has provided a Model Double Taxation Convention which forms the basis or starting point of many bilateral treaties.⁸⁶ In particular the United Kingdom generally uses the Model as a basis for negotiating double taxation agreements. The United States too has its own model based on that of the OECD.⁸⁷

The OECD Model contains no general anti-avoidance provision.⁸⁸ This was noted by the Report of the Committee on Fiscal Affairs in 1987⁸⁹ which suggested a number of possible ways of dealing with this lacuna or deficiency. The weight attached to this Report and the problems it highlights with regard to "conduit companies"⁹⁰ is impossible to assess. But the problems pinpointed and the possible solutions will clear-

⁸² See J.F. Avery-Jones, *Anti-Treaty Shopping Articles - A United Kingdom View*, 1989 INTERTAX 331 (Sept. 1989).

⁸³ The term "body" is used to encompass any legal person and, in particular, corporations. The term "body of persons" is frequently used in treaties. See *Padmore v. I.R.C.*, [1987] S.T.C. 36 (Ch.).

⁸⁴ See *supra* note 39.

⁸⁵ *Johansson v. U.S.*, 336 F.2d 809 (5th Cir. 1964); *Aiken Industries Inc. v. Commissioner*, 56 T.C. 925 (1971) (U.S. case). See Granwell, *Life after Rev. Rul. 84-152*, 1986 BULL. I.B.F.A. 215.

⁸⁶ The Model Double Taxation Convention on Income and Capital of the Organisation for Economic Co-operation and Development, Apr. 7, 1977, available in LEXIS, Intlaw Library, IBFD File.

⁸⁷ June 1981 Model, in *MODEL INCOME TAX TREATIES* (Kees van Raad ed., Dec. 1983). The treaty shopping anti-avoidance provision, article 16, was amended in December 1981.

⁸⁸ *Cf.*, *id.* Article 16.

⁸⁹ *DOUBLE TAXATION CONVENTIONS AND THE USE OF CONDUIT COMPANIES* (1987). Suggestions included i) the inclusion of provisions which exclude from treaty benefits any company which is used merely as a "channel" for payment of the income to a resident of a third company; or ii) the inclusion of "bona fide" provisions which may limit treaty benefits to companies set up for bona fide purposes and not simply to take advantage of treaty benefits.

⁹⁰ The typical "conduit company" is set up in a state which is a party to a treaty in order to receive income. The "conduit" may not be recognised as a body of persons or as a legal entity if it is not "liable to tax . . . by reason of . . . domicile, residence, place of management or any other criterion of a similar nature." OECD Model Double Taxation Convention, *supra* note 85, art. 4, para. 1. See also R.T. Bartlett, *The Making of Double Taxation Agreements*, 1992 BRIT. TAX REV. 76, 77 (1991) (on negotiating double tax agreements).

ly be factors borne in mind by those negotiating or re-negotiating bilateral treaties.⁹¹

B. EC Directives

With effect from 1 January 1992, a new dimension has been added to tax planning for groups of companies operating in Europe through the introduction of two significant measures aimed at European corporation tax harmonisation.⁹² On 23 July 1990, the Council of the European Community adopted three measures in the field of direct company taxation with a view to solving a number of problems on a community-wide basis:

- i) a Directive on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member states ("the Mergers Directive");⁹³
- ii) a Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member states ("the Parent/Subsidiary Directive");⁹⁴
- iii) a convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises ("the Arbitration Convention").⁹⁵

The two Directives took direct effect on 1 January 1992 and implementing legislation is contained in the Finance Act (No. 2) of 1992. The Arbitration Convention has not been ratified by every Member State and is not yet operative.

The "single market" only has any meaning if firms are able to operate within the Community on the basis that domestic rules of taxation will not hinder the expansion of cross-border business activity. The objective of the Directives is to remove the tax barriers in two specific spheres. The Mergers Directive aims to enable companies from different Member states to merge or demerge their business operations without

⁹¹ The OECD has now published its model, in the form of a looseleaf volume, updated as of 1 September 1992. Alterations to the text of the Model itself are minimal and do not affect the above decisions.

⁹² Parent-Subsidiary Directive, 1990 O.J. (L 225) 6; Mergers Directive, 1990 O.J. (L 225) 1. See also Robert H. Boon & Hachiel V. Lambourj, *EC Parent-Subsidiary Directive: Steps Towards Harmonization of Direct Taxes*, TAX PLAN. INT'L REV. 7 (April 1991).

⁹³ Mergers Directive, *supra* note 92.

⁹⁴ Parent-Subsidiary Directive, *supra* note 91.

⁹⁵ See David Williams, *The British Reaction to the French Package*, 1991 INTERTAX 560, 564 (Dec. 1991).

giving rise to immediate capital gains tax charges. Although the Mergers Directive deals with four types of transaction, only transfers of assets and exchanges of shares are dealt with in the implementing legislation.⁹⁶ The aim of the Parent/Subsidiary Directive is to eliminate double taxation of dividends flowing from a subsidiary in one Member State to a parent company in another.⁹⁷ It thus abolishes withholding taxes on such dividends by exempting the dividends from tax in the hands of the parent, or by requiring the parent company state to allow relief for tax paid in the subsidiary state on profits out of which dividends are paid. Little U.K. legislation is needed in order to implement this Directive as existing law, in essence, provided the relief required.

The bulk of the implementing legislation⁹⁸ relates to "the Mergers Directive" including specific anti-avoidance provisions.⁹⁹ The relief will not be available unless the transfer of the trade or part of the trade is effected for bona fide commercial reasons not forming part of a scheme or arrangement of which the main purpose is avoidance of liability to income tax, corporation tax or capital gains tax. A clearance procedure is, however, provided. A similar anti-avoidance provision and clearance procedure already exists for domestic "paper for paper" takeovers.¹⁰⁰ These latter rules were initially introduced in the Finance Act 1977. At that time, a Ministerial assurance was given on behalf of the then Labour Government that "[w]e are seeking to stop major tax avoidance schemes. That is all we are about. We are not seeking to catch the innocent taxpayer."¹⁰¹

The general understanding of the intention of the legislation was that the government was anxious to stop transaction schemes which resulted in a deferral of capital gains tax but with the benefit of the sale proceeds being made directly available to the shareholders. It appears, however, that the Board of Inland Revenue is reluctant to grant clearance where one company acquires another with part of the consideration being satisfied by the issue of loan stock that is redeemable within a relatively short period, if the Board considers that the company had sufficient cash reserves to have bought the shares for cash had the par-

⁹⁶ FA 1992, ch. 48, §§ 44-49.

⁹⁷ See Fred C. de Hosson, *The Parent-Subsidiary Directive*, 1990 INTERTAX 414, 416 (Oct. 1990).

⁹⁸ See *supra* note 78. FA 1992, ch. 48, § 30, is the only provision on the Parent-Subsidiary Directive.

⁹⁹ See Schonewille, *supra* note 4.

¹⁰⁰ Taxation of Chargeable Gains Act, 1992, § 135 (Eng.)

¹⁰¹ Statement by Sir Joel Barnett, Financial Secretary to Treasury, Committee Hearings, 12 May 1977, HANSARD 126.

ties chosen so to structure the transaction.¹⁰²

Two points might be made on the anti-avoidance provision in the Mergers Directive. First, it is too soon to know whether it will be applied in the same way as the existing municipal law provision. Secondly, it is applicable not only to share exchanges but also to transfers of assets.

The Mergers Directive also sets out a further important anti-avoidance provision.¹⁰³ Its provision and relief are applicable only to companies which are resident in a Member state and also which are not, under the terms of any double taxation agreement concluded between a Member state and a country outside of the European Community, considered to be resident for tax purposes in a country outside of the Community. The purpose is to deal with companies which are dually resident for taxation purposes in an EC country and in another country outside of the EC in circumstances such that the double taxation treaty treats them as a resident of the non-Community country so that future profits and gains which might otherwise have been taxed in a EC country are excluded by virtue of the double tax treaty provisions. Such companies are prevented from taking advantage of the Directive.¹⁰⁴

The anti-avoidance content of the Parent/Subsidiary Directive is phrased in different, more general terms. The second paragraph of Article 1 provides that the Directive shall not preclude the application of domestic or agreement based provisions required for the prevention of fraud or abuse. This, obviously is a clause drawn in the widest of terms. It represents a vivid example of a mismatch between the concepts of the British tax system and that of some other members of the Community. No equivalent of the French "abus de droit" exists under U.K. law.¹⁰⁵

The basic question left open by such a broadly drawn provision is whether Member states are free to define the concepts of fraud and abuse, which will inevitably lead to substantial variation, or whether a "European" concept will emerge.¹⁰⁶ The role of the Court of Justice in Luxembourg is likely to be crucial in this sphere.

¹⁰² Letter from Inland Revenue to Institute of Chartered Accountants in England and Wales published on 10 April 1987.

¹⁰³ Mergers Directive, *supra* note 92, clause 11.

¹⁰⁴ The Mergers Directive also allows a Member State to refuse to grant its benefits where the merger, division, transfer of assets, or exchanges of shares would result in failure of the company to fulfill the necessary conditions for the representation of employees on the company organs according to the arrangements which were in force prior to that transaction.

¹⁰⁵ See *supra* note 1.

¹⁰⁶ See Schonewille, *supra* note 4, at 13.

V. CONCLUSION

To attempt to extract an underlying rationale or a series of general principles when viewing the U.K. approach to tax avoidance would be a fruitless exercise. Certain trends can, however, be detected. As indicated, piecemeal development has resulted in a complex interrelationship among treaty, statutory and case law. Added to this is the expanding role of the Inland Revenue in this sphere. While Revenue Statements of Practice do not have the force of law, for all practical purposes they constitute, until successfully challenged, the applicable rules for any area to which they are relevant. The extrastatutory concessions of the Revenue are also important. The use of broadly worded legislation with an accompanying concession to mitigate the rigours of a literal interpretation of the provisions is an increasing practise. This is nothing less than legislation by the Revenue and is a worrissome development. Consultation conducted by the Revenue, where a draft concession is published before effect is given to it, either in a modified or precisely the same form, is no substitute for Parliamentary scrutiny. The claim of the Revenue that concessions,

are made to deal with what are, on the whole, minor or transitory anomalies . . . and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter,¹⁰⁷

is totally at odd with the facts.

The point has been illustrated above by the consideration of the group relief amendments. The legislation seems to control a whole range of situations outside the scope of the judicial decision it was designed to reverse. The promised concession, deals not with "minor or transitory anomalies," but with transactions and arrangements of significant commercial importance.

Each concession is accompanied by a general statement that a concession will not be given where an attempt is made to use it for tax avoidance. This was held to be a proper and lawful exercise of discretion and in no way discriminatory in *R. v I.R.C., ex part Fulford Dobson*.¹⁰⁸ The principle enunciated in this decision is easy to understand and justify. It is wholly sensible for the Revenue, having offered a concession, to take steps to prevent its abuse. The argument that conces-

¹⁰⁷ Inland Revenue Press Release, 16 February 1989, [1989] S.T.I. 74.

¹⁰⁸ [1987] Q.B. 978.

sions are not themselves lawful is no longer tenable,¹⁰⁹ if indeed it ever was. In deciding whether tax avoidance is at the root of the claim to use the concession, the courts have at their disposal the case law emanating from the *Ramsay* decision. Quite clearly, however, this procedure and use of concessions is totally different from that exemplified by the amendments to group relief.

One further aspect of extra-statutory considerations is illustrated by the recent case of *Campbell, Connelly & Co. v. Barnett*.¹¹⁰ The facts of the case need not be considered. The main issue the case related to the correct interpretation to be afforded to section 175(1) of the Taxation of Chargeable Gains Act of 1992, a provision extending the scope of rollover relief in relation to groups of companies. It reads:

. . . for the purposes of section 152-158 [roll-over relief] all the trades carried on by members of a group of companies shall, for the purposes of corporation tax on chargeable gains, be treated as a single trade (unless it is a case of one member of the group acquiring, or acquiring the interest in, the new assets from another or disposing of, or of the interest in, the old assets to another).¹¹¹

The judge in the case, Knox J., concluded that this subsection does not permit gains realised by one company in a group to be rolled into replacement assets acquired by another member. This may well represent an exemplary exercise of statutory interpretation. The problem is that Revenue statutory concessions have accepted that a "roll-over" in such circumstances is permissible and tax planning by companies has commonly been based on this premise.¹¹² From the anti-avoidance point of view, the case is a further demonstration of the problems caused by inadequate legislation being supplemented by Revenue concession.

However, it may at least be said of concessions that they are in published form and there is authority¹¹³ for the principle of "legitimate expectation" used in administrative law. In other words, in the absence of special circumstances, a taxpayer should be able to rely on a published concession and to apply for judicial review if it is denied.¹¹⁴

¹⁰⁹ *R. v. I.R.C., ex parte Kaye*, [1992] S.T.C. 581 (Q.B.).

¹¹⁰ [1992] S.T.C. 316 (Ch.).

¹¹¹ Taxation of Chargeable Gains Act, 1992, ch. 12, § 175(1).

¹¹² 93 ESC D19 and S/P 8/81. The Revenue have issued a Press Release indicating that they will continue to apply the concession and practice, despite the judges remarks in *Campbell, Connelly*, [1992] S.T.C. 316.

¹¹³ *Preston v. I.R.C.*, [1985] 1 App. Cas. 835; *R. v. I.R.C., ex parte M.F.K. Underwriting Agencies, Ltd.*, [1990] 1 All E.R. 91 (Q.B.).

¹¹⁴ For a recent House of Lords case illustrating the increasing role of judicial review in taxation, see *Woolwich Equitable Building Society v. I.R.C.*, [1992] S.T.C. 657 (H.L.).

In other realms, the Revenue's discretionary powers¹¹⁵ are free from such constraint. The policies underlying the decision to "attack" a particular type of transaction are not published and therefore, not a matter for scrutiny or challenge. Reference has been made above to the Revenue's new attitude toward the surplus advance corporation tax problem. While activities which the Revenue regard as pure tax avoidance can expect to be challenged, it is more difficult to understand why transactions and practices which were long viewed as acceptable and commercially prudent can suddenly be regarded as potential vehicles for tax avoidance. It has been made clear by the judges that they must not "stand still" in the face of more sophisticated techniques of tax avoidance.¹¹⁶ The same must apply, also to the Revenue. That having been said, it is difficult to justify a change in policy towards a hitherto acceptable transaction without any statement of the new approach and the principles on which it will be applied.¹¹⁷

In drawing any conclusions on the present role of the judiciary and case law in the field of anti-avoidance, it is important to avoid a dichotomy between judicial decisions on anti-avoidance and the other restraints. *Ex hypothesi* a limited number of cases reach the courts and are reported.¹¹⁸ But the judicial attitude to anti-avoidance cases and the status of the *Ramsay* doctrine have an importance which transcends the actual cases decided. The judicial attitude must inevitably guide the Revenue. The view taken by the judges on the distinction between tax mitigation and tax avoidance and on the point at which desirable commercial prudence becomes unacceptable tax avoidance is the background against which all disputes between the Revenue and a taxpayer take place.

¹¹⁵ The term here is not used in its strict technical sense for administrative law purposes.

¹¹⁶ *Ramsay*, 54 T.C. at 187 (per Lord Wilberforce).

¹¹⁷ The term "acceptable" does, of course, beg many questions. Distinguishing between tax avoidance and commercial prudence does, of necessity, involve a value judgment. This dichotomy pervades anti-avoidance law. One man's tax avoidance scheme is another man's commercially acceptable transaction. Judges and commentators alike have tended to assume that there is such an animal as "an ordinary commercial transaction." The view that some form of moral judgment is involved was expressly rejected by Lord Goff in *Craven v. White*: "[A]ny idea that the principle in *Ramsay* is a moral principle . . . is . . . destroyed by the recognition of the . . . principle as a principle of statutory construction." [1988] 3 All E.R. at 531. It is interesting to note that a recent National Audit Office Report entitled *Countering VAT Avoidance* accepts, and indeed is based upon, the dichotomy between acceptable and unacceptable tax avoidance.

¹¹⁸ At present, the first level of appeal from an inspector of tax is to a body of General Commissioners who are comprised of laymen or to a Special Commissioner. The decisions of the Commissioners are not, at present, reported, though the Revenue have access to them. Power to report selected decisions of Special Commissioners has been introduced. FA 1992, ch. 48, § 3. The provision is an enabling one and has not yet been given effect.

In 1985 the Revenue set out its views on the *Ramsay* doctrine as extended.¹¹⁹ It was accepted that the doctrine had brought a measure of uncertainty to tax planning. This was seen as inevitable. However, the Revenue outlined its views as to the applicability of the doctrine in particular areas. Though the views were necessarily general, the guidance given was helpful. However, the case law has moved on since then and Revenue practice has moved on with it. If, as suggested, the judicial decision and statements, especially those made in the House of Lords, have an importance beyond the specific facts and law being passed upon, it is essential to study in detail each decision to ascertain whether there has been some refinement, or a change of emphasis or additional limitation added. For what is certain in this ever changing field of anti-avoidance, is that no general anti-avoidance provision will be added by legislation in the foreseeable future and that the *Ramsay* doctrine or "new approach" will continue to evolve and develop. To an extent which is very unusual in the House of Lords, most of the present judges have made their particular approach to the anti-avoidance doctrine clear. Significant changes may come with the appointment of new judges.

¹¹⁹ TR 588 (Exchanges of correspondence between Inland Revenue and Institute of Chartered Accountants in England and Wales on the effects of *Furniss v. Dawson*).

