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For the attention of Mr Mike Pettit

30 October 2009

Dear Sir,

## **Re: HM Revenue & Customs Discussion Document: Simplifying Unallowable Purpose Tests**

We are grateful for the opportunity to comment on the above discussion document dated 31 July 2009.

By way of background, the City of London Law Society (“CLLS”) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

Our comments on the discussion document are as follows.

### **1. General comments**

We agree that this is an appropriate time for HMRC to consider its strategy on anti-avoidance legislation which uses “unallowable purpose tests” to counteract tax avoidance.

If a framework can be developed that will improve consistency, both in the legislation and in the approach taken by HMRC, that is to be encouraged.

However, we are disappointed that HMRC has not decided to review the various unallowable purpose tests which are already in force. Such a review would have increased certainty and consistency across the board.

Overall, the proposals and options outlined in the discussion document do not appear to move very far towards one of its stated two aims, i.e. simplification. Unallowable purpose tests are by their nature complex as they are broadly drafted and can apply in a number of different contexts.

Similarly, we find it difficult to see how the proposals drive forward the need for certainty in tax legislation.

We note that HMRC has published a large amount of draft guidance on the unallowable purpose tests. This in itself indicates that this form of legislation is complex and is likely to cause a compliance burden for taxpayers.

Given the above points (and the points made below), an effective clearance system for this type of test would be welcomed.

## **2. Section 6: The framework**

Section (i) includes discussion of the uses to which a purpose test might be put. We would suggest that “main purpose” tests be used sparingly. We consider this to be necessary to preserve a degree of certainty for taxpayers. In contrast, overuse will result in a compliance burden for taxpayers (requesting clearances which should not be necessary) and - accordingly - an increased administrative burden for HMRC.

Section (v) discusses unallowable purposes. One suggestion is the purpose of obtaining a tax advantage. We note that in recent years the definition of “tax advantage” has widened significantly. It should in all cases be limited to advantages arising in respect of UK tax and should specify the tax the avoidance of which causes the harm which HMRC is seeking to prevent.

Section (vi) lists the options for the threshold of purpose to be included. In the interests of certainty, we would strongly recommend the use of a dominant or sole purpose test. While this would narrow down the scope of the tests HMRC currently envisages using, in addition to the important effect on certainty, HMRC does have the ability to legislate against specific schemes which may fall outside a narrower test.

Section (vii) describes various alternatives to determine the quantum of any adjustment. This should always be limited to the amount of any tax advantage that has actually been obtained.

## **3. Section 7: Filters**

Filters are necessary to keep unallowable purpose tests reasonably focused. However, they can leave taxpayers which have undertaken commercial transactions trying to prove a negative to be sure that the transactions in question fall outside the rules. This compliance burden for the taxpayer needs to be kept in check.

#### **4. Sections 8 and 9: Entity etc to which the test applies and the purpose to be tested**

Ultimately, any unallowable purpose test must look to the purpose of a taxpayer, whether or not it purports to be a purpose of an arrangement. The discussion in Section 9 of the discussion document highlights the difficulties and uncertainty caused by this type of test.

HMRC is right to ask whether this consultation is likely to result in increased simplification and certainty. These points indicate that increasing use of unallowable purpose tests result in increasing complexity and accordingly increased compliance burdens for taxpayers.

#### **5. Section 10: Unallowable purpose**

In our view, the most appropriate purpose test will usually be the question whether a person or entity has obtained or secured a tax advantage. Determining whether or not a purpose is “not among the business or other commercial purposes of the business” or facilitating “activities not within the charge to tax”, can be difficult as those terms are ambiguous and uncertain.

##### Defining tax advantage

As we have mentioned above, if the legislation is to be sufficiently clear and certain, it will need to set out the nature of the relevant tax advantage in each case. The recent trend towards broad wording can again give rise to uncertainty.

##### Identifying the comparator

We agree that the most reliable focus is likely to be the transaction which would have taken place in the absence of the actual transaction and the tax purpose. This is broadly in line with Lord Hoffman’s comments made in the Hong Kong case, *Tai Hing Cotton Mill*.

#### **6. Section 11: Tax consequences**

We note the references in Section 11 to “policy attitude to downsides”. We note HMRC’s aim to have unallowable purpose tests as a deterrent but we do not consider it an acceptable policy aim to put a taxpayer in a worse position than that in which it would have been but for a tax motivated transaction. That is a particularly difficult policy to put into practice where the test involved is a “main purpose” test, i.e. where the taxpayer may well also have one or more main purposes that are sound commercial reasons for entering into a transaction or arrangement.

More generally, the aim of using unallowable purpose tests as a deterrent is understandable, but it may well deter taxpayers who are carrying out commercial transactions but who are sufficiently prudent to take advice or request a clearance. It may not, on the other hand, deter persons who intend to avoid tax.

We agree that ignoring the arrangements is unlikely to be appropriate.

In general, care needs to be taken that these tests do not go further than to counteract tax avoidance.

#### **7. Draft guidance**

Save for the points mentioned below, we are not making specific comments on the draft guidance. It is partly an expression of HMRC’s views on the interpretation of case law.

While we may take different views to HMRC on such points, we do not expect that HMRC will wish to discuss alternative interpretations.

In paragraph 10140 (main purpose) we note HMRC's view that any purpose which is "more than incidental" is, on the face of it, a "main" purpose. Aside from the difficulty one may have in defining the term "incidental", we are concerned that to take that view would be to over-simplify the many possible permutations of purposes for which a transaction may come into being. That in turn would limit the practical use of the guidance to the extent that a taxpayer's scenario differed factually from previous cases.

The effectiveness of the guidance would be much improved if it were to include a set of specific examples illustrating transactions which HMRC considers to be harmful and those which it considers to be acceptable.

Yours faithfully,

**David McIntosh**  
**Chair**  
**City of London Law Society**

**THE CITY OF LONDON LAW SOCIETY  
REVENUE LAW COMMITTEE**

Individuals and firms represented on this committee are as follows.

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