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Proposed UK Code of Practice on Taxation for Banks

The recent proposals for a Code of Practice on taxation for banks transacting business in the UK is either a restatement of existing statutory interpretation or a blurring of the boundaries between the executive and the judiciary. Adam Blakemore, a tax partner, and Oliver Iliffe, a tax associate, with the London office of Cadwalader, Wickersham & Taft LLP, explore the issue.

Introduction

On 29 June 2009, HM Revenue & Customs published a 24-page consultation document setting out proposals for a Code of Practice on Taxation for Banks.[1] The consultation document outlines a 'new and innovative approach'[2] by the UK government and HMRC to combating tax avoidance by banking groups operating in the UK. The intention of HMRC, by introducing the code, is to initiate and entrench changes in the behaviour and attitude of the banking sector towards tax avoidance. The first paragraph of the proposed code, which is currently in draft form, clearly articulates the expectation of the UK government:

> *'The Government expects that banking groups, their subsidiaries, and their branches operating in the UK, will comply with the spirit, as well as the letter of the law, discerning and following the intentions of Parliament'*[3]

HMRC's intention is that the code will engender a new level of transparency in the activities of the UK banking sector. Although HMRC's expectation appears to be that all banking groups operating in the UK will sign up to the code, the sanction for non-adoption will be to attribute direct reputational and compliance risk to any that do not.[4] The code sets out why the government considers that a code of conduct is required, together with practical aspects of the administration and implementation of the proposed measures. The deadline for comments in respect of the code passed on 25 September 2009, and it is anticipated that a final text will be published later this year.

The context of the code's proposed introduction

While acknowledging the vital role played by the banking sector in the UK economy, the consultation document indicates the government's view that 'it is clear that some banks have been involved in tax avoidance which goes well beyond reasonable tax planning'.[5]

Despite an increasingly restrictive legislative framework in which transactions motivated by tax avoidance are subjected to early disclosure

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under the rules in Part 7 of Finance Act 2004 and subsequently targeted by remedial legislation, the code expresses a concern that banks are uniquely placed to avoid their own tax liabilities or to provide services to their customers 'which are sensitive to tax and some of which can be used for tax avoidance'.[6] The perception of HMRC is that the 'unique position of the banking sector imposes a particular responsibility on them to comply with the spirit as well as the letter of the law'.[7] Modifying bank's behaviour in order to ensure that such 'responsibility' is met is the key objective of the code.

The provenance of the code can be traced to the recent OECD report *Building Transparent Tax Compliance by Banks*, published in May 2009, to which HMRC contributed. The language used in the OECD report is echoed in the wording of the consultation document. The key principles of encouraging transparent relationships between banks and HMRC, and ensuring independence of a bank's internal tax department, are also transposed into the code from the OECD report.

The consultation document develops the themes present in the OECD report, proposing a fresh approach to tax avoidance, at least concerning the method by which HMRC's aim is to be achieved, if not the aim itself. The UK has no general statutory provision under which tax saving schemes can be void or recharacterised. In place of such a general statutory provision, Parliament has enacted anti-avoidance legislation targeting specific transactions and arrangements. There is no explicit basis for courts to tax transactions by reference to economic equivalence, rather than their legal form, unless the relevant statute expressly permits this.

The significant innovation of the code is that it seeks to achieve a result through extra-judicial means that is more normally achieved through legislation. The code would be a non-statutory and voluntary means to compel, ultimately through the possibility of reputational and compliance sanction, certain behaviour among banks. It is difficult to avoid the suspicion that HMRC prefers a non-statutory approach because it both avoids the usual parliamentary process required for the implementation of taxing legislation and is less likely than legislation to be subject to interpretation by the courts.

Administrative law considerations

Although ostensibly there are attractions for HMRC in such an approach, the corollary is the doubt that arises regarding the constitutional and administrative law status of the code. Questions arise as to the standing of HMRC, as a public body performing a public function, in introducing and policing the code. Accordingly, the government might, not unreasonably, take the view that the formulation and implementation of the code falls within HMRC's current responsibility for the collection and management of the taxes within its statutory care. Adoption of this position by HMRC would be an acceptance that any decisions by it as to whether there had been a breach of the code would be susceptible to judicial review by the courts. This could assist in providing the appropriate safeguards to banks on any occasions where it was alleged that HMRC had acted unfairly in reaching a decision that there had been a breach of the code.

Accordingly, HMRC might plausibly be expected to adhere to certain minimum standards in assessing whether a breach of the code had occurred. This would include applying the same standards of objective assessment to all signatories to the code, acting proportionately, adopting fair procedures for assessing whether a breach had occurred, and applying the rules of natural justice in following those procedures.

It would, nonetheless, be surprising if HMRC were not given any additional statutory responsibility or powers to underpin the implementation and management of the code. The absence of such responsibilities and powers might invite a challenge to the effect that HMRC's activities in relation to the code, or the aims of the code itself, were *ultra vires*.[8]

Much may depend in this context on what HMRC means when it refers to the 'spirit' of the law. If, as appears likely, HMRC intends the spirit of the law to be applied in the context of preventing perceived tax avoidance more often than the letter of the law (as might be applied by a court), then HMRC will need to address a concern that this approach could go further than HMRC's statutory function of the collection and management of tax.

This is for the simple reason that HMRC does not currently have the power or responsibility to raise any more tax than that which is lawfully chargeable. Such considerations also inform what is meant by the statement that taxpayers should pay 'their fair share of tax'[9] which, in the absence of further legislation or jurisprudence, can only mean the amount of tax prescribed by the letter of the law construed purposively (as applied by the courts) as opposed to the spirit of the law where the spirit is said to depart from the letter.

The possible alternative approach of relying on the Crown's prerogative powers as a basis for the code would also raise complex constitutional questions. In addition, expecting the code to be adopted by banks

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(and, by implication, applying different standards to banks) and not all companies must be capable of being demonstrably fair and should not amount to 'unjustified discrimination'.[10]

Key components of the code

The code states that 'banks' should:

- adopt adequate governance to control the types of transactions they enter into;
- not undertake tax planning that aims to achieve a tax result that is contrary to the intentions of Parliament;
- comply fully with all their tax obligations; and
- maintain a transparent relationship with HMRC.

Pervading all this is the expectation that banks will discern and comply with 'the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament'.[11]

In the eyes of the courts, it is possible that the 'spirit' of tax legislation is nothing more than the intention of Parliament in enacting the statute in question. As Lord Hoffman stated in *Norglen Ltd (in liquidation) v Reed Rains Prudential Ltd*[12]:

> *'The question is simply whether, upon its true construction, the statute applies to the transaction … It is not that the statute has a penumbral spirit which strikes down devices or strata-gems designed to avoid its terms or exploit its loopholes. There is no need for such spooky jurisprudence'.*

The critical change proposed under the code is that whereas statute is approved by the legislature (namely, Parliament) and then construed where necessary by the judiciary (namely, the courts), the executive (acting through HMRC) will be the initial arbiter of whether a bank's discernment of the spirit of the legislation under the code is correct.

Another question is what the 'spirit of the legislation' actually means. In particular, the final form of legislation will often reflect compromises and significant digression from what the government originally proposed. In other words, while discerning the intention of the government in proposing the legislation might be relatively easy, discerning the spirit or the intention of Parliament in enacting the final form of the legislation might be less so.Indeed, that is presumably why judges have previously stressed that the true intention of legislation can only be discerned from its text.

Scope of the code

The consultation document sets out the intention that the code will apply to all banks operating in the UK, including foreign banks, together with 'similar organisations undertaking banking activities' – and not only those entities regulated to do banking business by the FSA. It is hoped that greater certainty in this area will be possible before the code is finalised.

Governance

The code will require banks to have a written policy encompassing their strategy and governance process for tax matters in respect of which the board of directors or (for UK branches of overseas banks) a senior accountable person in the UK will be held responsible. The policy must contain a commitment 'to comply with tax obligations and maintain an open, professional and transparent relationship with HMRC'.

It is highly likely that banks will already have a detailed strategy for complying with their tax obligations and managing tax risk. Accordingly, the governance requirements appear to be the least controversial aspect of the code. The effect of the governance provisions of the code is to ensure that a bank's internal tax department should 'play a critical role and [that] its opinion should not be ignored by business units'. The consultation document, therefore, supports a role for a bank's internal tax department as a 'gatekeeper', acting 'independently of the business units, with the tax function having the final say on the tax analysis'.[15]

Tax planning

The code states that a 'bank should not engage in tax planning other than that which supports genuine commercial activity'. The question arises as to what the word 'genuine' adds. The words of Lord Upjohn in *IRC v Brebner*[16] shed some light on how far a bank might go and still be within the bounds of 'genuine commercial activity':

> *'[W]hen the question of carrying out a genuine commercial transaction … is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax.'*

In a *Brebner* sense, then, 'tax planning ... which supports genuine commercial activity' (and which would be permitted by the code) arguably encompasses tax planning that seeks to eliminate any tax from applying to a genuine commercial activity. In other words, there must

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be something other than tax that motivated the transaction. The tax planning must come second. If 'genuine commercial activity' can be viewed in this light, the code might actually permit tax planning in a wide range of circumstances.

The code goes on to provide that a bank 'should reasonably believe that the transaction is structured in a way that gives a tax result which is not contrary to the intentions of Parliament'. A similar expression is used both where the bank acts as principal, and where it acts as the provider or facilitator of transactions by third parties. In reality, banks are very unlikely to act where they have a reasonable belief that their actions are contrary to Parliament's intentions as interpreted by the courts. To do so would be to deliberately overstep the bounds of legality. Under the code, however, it seems that it is the government (through HMRC), and not the courts, that wants to be the arbiter of what Parliament intended.

Accordingly, the code includes examples of what tax avoidance 'can involve', by using subjective concepts, namely:

- exploiting loopholes in tax law,
- juxtaposing two unrelated provisions in tax law in a way never intended or envisaged at the time the provisions were enacted; or
- artificially creating the conditions for a tax relief or deferral.

A number of hallmarks of avoidance are also listed in the code, including the use of offshore vehicles, arbitrage between tax jurisdictions using hybrid entities, and instruments and 'other arrangements, the purposes of which are to achieve a tax advantage'. The body of the consultation document also lists further 'signposts' of tax avoidance, among them transactions bearing little or no pre-tax profit, transactions that rely on mismatches such as between legal and accounting form or between the tax treatment of parties or entities in different tax jurisdictions.

Both the hallmarks and signposts identified in the consultation document and the code are indicative and not definitive. However, they could plausibly be expected to provide the salient points for discussion with HMRC when it comes to applying the principle of transparency discussed below.

Relationship between banks and HMRC

The expectation in the code is that where a bank 'believes its proposed transaction may be contrary to the intentions of Parliament, the bank will explain its plans in advance with HMRC'. As it stands, the proposals for the management of the relationship between HMRC and the banks are likely to give rise to the most uncertainty in practice, both regarding the nature of a bank's 'belief' (and the evidence needed to demonstrate whether such a belief exists) and the degree of 'transparency' expected by HMRC.

It is well understood that no tax planning or transactions should be entered into if they depend in any way on non-disclosure of information to HMRC. However, the code also anticipates the banks 'disclosing fully the significant uncertainties in relation to tax matters' and disclosing 'issues that HMRC would want to know about and might want to discuss'[17]. The onus on a bank of disclosing not only difficulties of interpretation but also issues that HMRC 'might want to discuss' places a materially greater obligation on that bank than the routine self-assessment of its own tax liabilities.

It is proposed that HMRC will raise any concerns over non-compliance with the designated board member or senior officer who signed the code. Where the code is deliberately breached, HMRC will consider making a report to any professional body of which that signing director or senior officer is a member. This focus on individual responsibility for corporate action is another relatively novel feature of the code, although comparable changes have been enacted in Finance Act 2009 regarding senior accounting officers of large companies,[18] and is unlikely to be welcome.

Although HMRC states in the impact assessment accompanying the consultation document that 'all banks will be expected to sign up to this', a refusal to sign the code will not, in itself, directly result in any additional tax liability. Nevertheless, it is made clear that greater scrutiny from HMRC will result and the inference to be drawn from the consultation documents and code is that 'direct reputational risk'[19] could be occasioned by such a refusal. Owing to the confidentiality requirements of the banks as taxpayers, it is difficult, but not impossible, to construe this slightly oblique reference as relating to the publication of names of banks signing the code (or those not signing).

Implementation

In terms of implementation, HMRC anticipates that banks with good relationships with HMRC might notice little additional burden (apart from the initial implementation)[20]. In this light, it must be asked whether the code would have any real effect other than the 'moral censure' of those banks which chose not to sign up.

The answer lies possibly in the government's own perception. If the government perceives that

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'inappropriate behaviour' persists, it states that it might introduce reporting or auditing requirements to examine a bank's 'compliance' with the code and, it might be inferred, the mandatory adoption of the code by banks.[21]

The UK banking sector might also be concerned about the possible consequences of changes in attitudes and behaviours towards tax avoidance following the introduction of the code. It is at least possible that banks declining to accept the code might obtain, or be perceived to obtain, a competitive advantage over banks which accept the code. The risk of such a situation arising is particularly pronounced where foreign banks that do not lend from their UK branches (but rather, say, from elsewhere in the EEA) might be able to offer cheaper finance to UK corporates and businesses, such cheaper finance being generated in whole or in part through aggressive tax planning. This might in turn place UK banks accepting the code at a competitive disadvantage against such foreign banks. Given the disparity of tax regimes even within the EU and the mobility of finance in the current markets, the code's possible creation of such competitive disadvantages could be a significant concern in the UK banking sector.

Conclusion

HMRC appears to believe that certain key components of the code, in their focus on adherence to the 'spirit' of the law, might be seen as restating in a different format existing canons of statutory construction under UK tax law. Less charitable readers of the code might fear that HMRC's construction of the spirit of the law could diverge from that of the new Supreme Court of the United Kingdom. A critical question is likely to be whether the government, as the executive, believes that HMRC can give expression to its interpretation of the spirit of the law without needing to enact legislation to support that interpretation. In this regard, the government might do worse than remembering the words of Lord Wilberforce from *Black-Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG*[22]:

> *'Legislation in England is passed by Parliament, and put in the form of written words. This legislation is given legal effect on subjects by virtue of judicial decision, and it is the function of the courts to say what the application of words to particular cases or particular individuals is. This power, which has been devolved on the judges from the earliest times, is an essential part of the constitutional process by which subjects are brought under the rule of law – as distinct from the rule of the King or the rule of Parliament; and it would be a degradation of that process if the courts were to be merely a reflecting mirror of what some other interpretation agency might say …'.*

It might be that the government will accept that the imposition of more wide-ranging obligations on banks and other tax payers than is currently envisaged by the code would be a degradation of the constitutional process or simply unworkable in practice. However, the concern must be that the code presages the type of penumbral spirit or spooky jurisprudence that Lord Hoffman objected to in the *Reeds Rain Prudential* case referred to above – albeit through extra-legal initiatives.

Endnotes

1. *A Code of Practice on Taxation for Banks*, Consultation Document, published by HMRC on 29 June 2009 (the 'Consultation Document').
2. Consultation document, para 4.1
3. Consultation document, Appendix 1, para 1.
4. Para 35 of the UK Government's document *Building Britain's Future*, published in tandem with the Code on 29 June 2009.
5. Consultation document, Foreword by The Financial Secretary to HM Treasury, Rt. Hon. Stephen Timms MP.
6. Consultation document, para 2.10.
7. Consultation document, para 2.9.
8. See for example, *Laker Airways Ltd v Department of Trade* [1977] 2 All ER 182.
9. Consultation document, paras 2.1 and 2.11.
10. See *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2002] STC 347 at 360 per Moses J.
11. Para 1 of the code.
12. *Norglen Ltd (in liquidation) v Reed Rains Prudential Ltd* [1999] 2 AC 1 at 14.
13. Consultation document, para 3.11.
14. Consultation document, 'Appendix 1: The Code of Practice on taxation', para 2.2.
15. Consultation document, para 3.13
16. *IRC v Brebner* (1966) 43 TC 705, at 718-719.
17. Consultation document, para 3.24.
18. Section 93 and sched 46, Finance Act 2009.
19. Para 35 of *Building Britain's Future*.
20. Consultation document, para 4.9
21. Consultation document, para 4.10 and p22.
22. *Black-Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG* [1975] AC 591 at 629F-G.

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