A Review of HMRC’s Consultation Document on Financial Products Avoidance

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In the U.K. prebudget report published on October 9, 2007, HM Revenue & Customs announced their intention to publish a consultation document toward the end of 2007 in which a principles-based approach to tax avoidance involving financial products was to be set out.

In early December 2007, HMRC and HM Treasury published a document entitled “Principles-Based Approach to Financial Products Avoidance: A Consultation Document.”1 The consultation document contains proposals (draft legislation) for statutory provisions in relation to disguised interest and the sale of income streams. HMRC have suggested in the consultation document that principles-based legislation is a viable approach to tackling tax avoidance, and thus are potentially moving away from closely articulated and prescriptive legislation that is focused on preventing the avoidance of taxation in very specific circumstances.

HMRC held an open meeting for companies and tax practitioners in London on January 11, 2008, to discuss initial reactions to the consultation document, with final comments on the draft legislation required to be submitted to HMRC by February 28, 2008. On February 7, 2008, HMRC published revised legislation2 reflecting changes made in response to the points made in the January open meeting. HMRC have indicated that their goal is for the revised draft legislation to be included in Finance Bill 2008 and for the enacted form of the legislation to take effect for companies on April 1, 2008.

The first part of this article considers HMRC’s proposed approach to targeting tax avoidance through the use of principles-based legislation. The second part considers how that approach is reflected in the revised draft legislation. As will be seen, the differences between a principles-based legislative approach and the established method of drafting antiavoidance legislation in a narrow and prescriptive manner raise a number of questions about the operation of the revised draft legislation in practice.

This article states the position regarding the consultation document and the draft legislation as of February 12, 2008. Because of the draft legislation being subject to public consultation as of the date of this article, the final form of the legislation to be included in Finance Bill 2008 may differ from the version commented on herein.

1Available at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_028173.

I. Principles-Based Legislation

What Is Principles-Based Tax Legislation?

In essence, the consultation document describes principles-based legislation as being an approach to drafting tax statutes that enshrines in the relevant legislation a fundamental taxation principle. 3 The stated aim in the consultation document regarding principles-based legislation is that it “would be clear, on a first reading, what was being addressed and with what outcome in mind.”4

The two fundamental taxation principles identified by HMRC in the consultation document are discussed in detail in the second part of this article. Both of the fundamental taxation principles have been selected by HMRC and have not been directly derived from case authority. 5 HMRC propose that the selection of a fundamental principle of U.K. taxation also be accompanied by a statement setting out how the legislation intends to operate by reference to that principle. The statutory principle selected would also be broad enough to encompass not only transactions that are now targeted by existing legislation but also to encompass transactions that are designed to circumvent existing rules through adopting a literalist or formalist construction of taxing statutes. One inference that may be drawn from such an approach is that the fundamental principle embodied in the legislation would be a definitive taxing provision in respect of which any accompanying legislation would be subordinate. This inference is considered in further detail below. The introduction of such principles-based legislation would be a significant development in U.K. tax legislation.

HMRC’s approach in the consultation document regarding principles-based legislation does not appear to have changed significantly in the announcements made by HMRC on February 7, 2008, which accompanied the publication of revised draft legislation. It is submitted that HMRC’s focus on a principles-based approach to tax legislation is less clearly stated in the HMRC’s announcements on February 7, 2008, although that is likely because the announcements were addressing specific concerns that had been raised through the consultation process and at the January open meeting concerning the operation of the draft legislation in practice.6 There is nothing in HMRC’s announcements on February 7, 2008, to indicate that the principles-based approach to drafting legislation as described in the consultation document is being abandoned.

It is helpful to consider why this new approach to drafting tax legislation is being considered by HMRC now. The introduction to the consultation document alludes to the frustration that HMRC feel as a result of legislation being introduced to combat specific tax avoidance schemes, with unintended weaknesses in that legislation being exploited by new or evolved tax avoidance schemes. The current U.K. government has attempted several times to break the cycle of tax avoidance and corrective legislation. In 2004 Parliament enacted Part 7 of Finance Act (FA) 2004 requiring the early disclosure of some tax avoidance schemes, described by one senior HMRC official as an attempt to “put HMRC on the front foot in dealing with avoidance and change the balance of risk for promoters of schemes.”7 While the legislation in FA 2004 has led to many early disclosures of tax avoidance schemes and the targeting of legislation to combat arrangements that are disclosed, HMRC appears to believe that offensive tax schemes continue to be developed and that there remains a strong demand for them.

HMRC have therefore considered “whether what we are calling a principles-based approach has a role to play in legislation that seeks to prevent taxpayers exploiting distinctions in tax law in order to pay less tax than the tax principles require.”8 The consultation document sets out HMRC’s suggested approach in this regard, offering draft legislative clauses based on specified underlying principles. The draft legislation is accompanied by a commentary and notes for guidance on the draft legislation (guidance notes). On February

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3Consultation document para. 1.8: “Principles-based legislation would embody a principle of U.K. taxation, and would be accompanied by a statement of how the legislation intends to operate by reference to that principle.”

4Consultation document para. 1.8.

5See in particular the footnotes to paras. 3.4 and 3.5 of the consultation document in which the statement is made that “U.K. case law on the taxation of surrogates for income receipts is ambiguous.” This statement is amplified by a number of case authorities in which the courts reached different decisions on the taxation of transfers of income streams; see infra note 82.

6HMRC expressly state on their Web site that the changes in the revised draft legislation have been proposed to address “specific concerns” regarding the operation of the draft legislation as set out in the consultation document. Further references are made in the HMRC document “Main Changes Following Open Day,” published on the HMRC Web site on February 7, 2008, to the revised draft legislation following “more closely the wording of the principle behind the legislation as set out in paragraph 2.5 of the Consultation Document.” It can be inferred that although the draft legislation has been revised, the principle on which it is based remains within the contemplation of HMRC.

7Quotation from David Hartnett of HMRC in his address to the Chartered Institute of Taxation in May 2005 regarding the operation of the disclosure of tax avoidance schemes legislation in FA 2004. Available at http://www.hmrc.gov.uk/ait/speech-to-ciot.pdf.

8Consultation document para. 1.7
When not expressly required to do so by statute. The courts may recharacterize legal transactions for the courts to recharacterize legal transactions (and the interaction between such statutes and the jurisprudence of the English courts); (2) legislation that contains a purposes or objects clause; and (3) principles-based legislation. The distinction between legislation that contains a purposes clause and principles-based legislation is not always clear. This is considered to be the case in the consultation document.

The United Kingdom has no general statutory provision under which tax saving schemes can be void or recharacterized. Parliament has instead enacted antiavoidance legislation targeting specific transactions and arrangements. Some of this antiavoidance legislation can have a wide application, a prominent example being the “transactions in securities” legislation in section 703 to section 709 Income & Corporation Taxes Act 1988 (ICTA 1988). A common feature of the U.K.’s existing antiavoidance legislation is that the circumstances in which such legislation applies are clearly articulated, to help ensure that the targeted transactions and arrangements will clearly fall within the relevant taxing provisions. Exclusions from the effects of such antiavoidance legislation are, as a general rule, narrowly drafted to permit the exclusions to apply to a precisely delineated class of transactions. It is also unusual to see within the U.K.’s antiavoidance legislation any statement in which the express purpose of the antiavoidance legislation is set out.

The English courts have not evolved a jurisprudence under which transactions designed to avoid tax and otherwise lacking in commercial reality can be rendered void or have their legal form disregarded. The current judicial position is broadly focused on the courts having regard to the purpose of a particular provision and interpreting the statutory language in a way that best gives effect to that purpose. There is no basis for the courts to recharacterize legal transactions when not expressly required to do so by statute. Tax legislation that includes a purposes or objects clause remains unusual in the U.K.’s taxing statutes.

Such clauses have been used to set out explicitly the purpose of the legislation of which they form a part. A purposes or objects clause is not itself a charging provision and will have effect only when the purpose of the detailed legislation (of which the purposes or objects clause forms part) is unclear or ambiguous. Accordingly, a purposes or objects clause does not replace the need for detailed and closely articulated legislation; such a clause merely seeks to avoid uncertainty as to the underlying purpose of such detailed provisions. Any subsequent dispute should, so the theory goes, be relegated to that of statutory construction.

The notion of principles-based legislation is not new. The framework under which tax policy and principles could be embedded within statutory provisions has been examined by commentators for years. However, any change in HMRC and HM Treasury policy to make a principles-based approach to the drafting of tax statutes commonplace would be a significant change.

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The characteristics of principles-based legislation, as explored by various commentators, are that a fundamental taxation principle would be codified in statute and would serve as a definitive taxing rule. The rationale and purpose of the legislation would be discernible.

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9 Supra note 2.

10 While the U.K. tax statutes contain numerous examples of antiavoidance provisions, frequently based around a tax avoidance purpose test or motive test, there is no all-embracing single provision equivalent to Part IVA of the Australian Income Tax Assessment Act 1936.

from the principle embodied in statute. Any accompanying mechanical or prescriptive provisions would be subordinate to the statutory principle. In the event of uncertainty, or if the accompanying provisions did not address the specific circumstances of a given transaction, the statutory principle would be dominant and would be followed even if the adherence conflicted with accompanying mechanical or prescriptive provisions. As any accompanying detailed rules would be subordinated to the fundamental taxing principle enshrined in the statute, closely articulated (and invariably lengthy) prescriptive legislation should not be required. Even if such prescriptive legislation was present, it would not be permitted to override or obscure the statutory principle in the event of ambiguity. The use of principles-based legislation to combat tax avoidance and to move away from closely articulated and detailed provisions that are vulnerable to circumvention and formalistic construction has obvious attractions for any tax authority. HMRC's decision to consider using principles-based legislation to combat perceived avoidance regarding disguised interest and the transfer of income streams is therefore far from accidental.

Is the draft legislation included in the consultation document, and the revised draft legislation published by HMRC on February 7, 2008, actually principles-based legislation along these terms, or does the legislation merely contain a purpose clause similar to other existing U.K. legislation, such as the purposes paragraph at the commencement of the repo legislation in paragraph 1(1) of Schedule 13 FA 2007? This is a challenging question to answer. The draft legislation that is proposed in the consultation document contains many elements of the principles-based legislation described in the preceding paragraph, as it is intended to apply to many potential transactions identifiable only by falling within the scope of the fundamental taxing principle embodied in the statutory language. Further, various statements made by HMRC in the consultation document that contrast a principles-based approach to drafting legislation as opposed to a more traditional prescriptive drafting suggest that HMRC intend the original draft legislation, and the revised draft legislation, to be construed as principles-based legislation of the sort described above. Several key indicators of principles-based legislation are in the revised draft legislation — it is shorter and far less detailed than other typical anti-avoidance provisions (including those provisions that would be repealed if the revised draft legislation is enacted). Conversely, the revised draft legislation contains paragraphs entitled “Purpose of Schedule,” the introductions of which are similar to the introduction of purpose clauses within existing legislation. Nor is there any express subordination in the revised draft legislation of the mechanical and operative provisions to the paragraph that embodies the fundamental taxing principle in the legislation (although such a subordination might be inferred from statements made in the consultation document). The preferred view is that the revised draft legislation in the consultation document is likely to mark a significant demarcation from the traditional approach adopted by Parliament in drafting taxation statutes.

While all of the features of principles-based legislation identified by commentators as indicative of the adoption of such a legislative approach may not be present, there appears to be sufficient grounds for considering that HMRC, at least, would like the revised draft legislation to operate like principles-based legislation. The use of principles-based legislation to combat tax avoidance and to move away from closely articulated and detailed provisions that are vulnerable to circumvention and formalistic construction has obvious attractions for any tax authority. HMRC's decision to consider using principles-based legislation to combat perceived avoidance regarding disguised interest and the transfer of income streams is therefore far from accidental.

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**Perceived Advantages**

In the consultation document, HMRC have cited several advantages as deriving from a principles-based approach to drafting legislation. One is that by elucidating an underlying taxing principle within tax legislation, the legislation should remain flexible. Given that

15Clause 1 of the revised draft legislation states: “The purpose of this Schedule is to secure that (subject to exceptions, and except where double taxation would result) a return designed to be economically equivalent to interest is treated in the same way as interest for the purposes of corporation tax.” (Emphasis added.) As an example of the similarity with existing provisions, see the opening of the purposes clause in para. 1(1) Schedule 13 of FA 2007:

The purpose of this Schedule is to secure that in the case of an arrangement — (a) which involves the sale of securities and the subsequent purchase of securities, and (b) which equates, in substance, to a transaction for the lending of money at interest from or to a company (with the securities which were sold as collateral for the loan), the charge to corporation tax in that case reflects the fact that the arrangement equates, in substance, to such a transaction. (Emphasis added.)

Neither provision expressly refers to a principle, although the revised draft legislation incorporates the fundamental taxing principle as set out in para. 2.5 of the consultation document. However, the methods of drafting the revised draft legislation and Schedule 13 of FA 2007 are different, with the revised draft legislation being brief and Schedule 13 of FA 2007 being prescriptive.

16In particular see consultation document para. 1.10: “And it should be more difficult for avoiders to argue that a scheme does not contravene principles than to argue that a scheme meets the literal requirements of the statute.” In this regard, the inference to be drawn is that principles-based legislation offers something more than legislation that includes a purpose clause. Whereas a purpose clause is effective when the purpose of detailed legislation is unclear, the implication of the consultation document is that even when the “literal requirements of the statute” are clear, the fundamental taxing principle should prevent tax avoidance from taking place.

17See in particular consultation document para. 1.6 through para. 1.8, “Contrasting approaches to countering tax avoidance.”
even the most detailed legislative provision cannot realistically aspire to contemplate every commercial situation, that flexibility is viewed by HMRC as a major step forward in combating avoidance schemes that seek to exploit narrowly drafted legislation. HMRC identify another consequential advantage from the introduction of principles-based legislation as being the repeal of some existing antiavoidance legislation, thereby reducing the overall complexity of the U.K. tax system.

The use of principles-based legislation has obvious attractions for any tax authority.

Both arguments are, at least initially, persuasive. The desire to reduce the complexity of the U.K. tax system, and any simplification of the densely worded swathes of antiavoidance legislation that exist in the U.K.’s taxing statutes, is commendable. Also, legislation that is flexible, responsive, and fair is in the interest of both taxpayers and tax authorities. The ability to clearly identify the principles on which primary legislation is based, and the context in which a transaction should be considered, should in theory be helpful to taxpayer and tax authority alike.

A less tangible, but important, benefit of both legislation that includes a purpose clause and principles-based legislation may be that a clear statement of the principles on which the legislation is based may assist any court in being able to identify the purpose of the legislation. The importance of ascertaining the purpose of a statute is derived from case law. The decision of the Judicial Committee of the House of Lords in Barclays Mercantile Business Finance Limited v. Mawson has endorsed the principle that, when construing a statute in the context of a particular transaction, “the ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.” This approach, which has been followed by the English courts ever since Mawson, requires the identification of the purpose of taxing statutes as a precursor to the determination of whether the legal transactions entered into are the type of transaction that the legislation, purposively construed, is addressing. While an ostensibly simple task, identifying the purpose of taxing legislation is rarely straightforward. Statutory words can be construed differently depending on the factual, legislative, or linguistic context in which they are viewed. Traditional aids to construction frequently fall short. In particular, while a court may refer to the material facts and events that it is apparent that Parliament was dealing with, including consultation of Hansard records to interpret the words of legislation, the consideration of taxing statutes in Parliament rarely provides a precise description of the purpose of legislation being enacted. Recourse can be made to the explanatory notes prepared by HMRC to accompany new legislation, but their status as an aid to statutory construction is unclear.

It could therefore be argued that if principles-based legislation entrenches a fundamental taxation principle within the statute, a purposive construction of that statute by a court should be easier. The same could, of course, be argued of legislation that includes a purpose or objects clause such as the repo legislation in Schedule 13 of FA 2007; indeed, this is the sole rationale for the inclusion of such provisions in tax legislation. However, as noted above, a statute that includes a purpose clause is not necessarily liberated from the presence of narrowly drafted and detailed legislation. As Lord Hoffmann has observed, “It is one thing to give the statute a purposive construction. It is another to rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but are not actually there.” In this regard, principles-based legislation may offer a potential benefit over other tax legislation. It would combine a statutory principle — thereby allowing a court to readily discern the purpose of Parliament in enacting the legislation — with briefer and less prescriptive supporting legislation. The reduction in the amount and degree of prescriptive supporting legislation would be a consequence of the statutory principle being relied on in any conflict with that supporting legislation.


21 Daniels v. IRC [2005] STC (SCD) 684, particularly 688 (paras. 19 and 21). See also the comments for the special commissioners in HSBC Life (U.K.) v. Stubbs [2002] STC (SCD) 9 that “the Revenue’s Life Assurance Manual is clearly not evidence of what Parliament would have intended in passing the legislation.” Further, HMRC explanatory notes are not generally updated in accordance with legislative amendments proposed in the Finance Bill standing committee debates.
22 This is the case with Schedule 13 of FA 2007, which runs to 15 paragraphs.
Potential Reservations

For all the apparent benefits that principles-based legislation may provide, there remain some significant concerns, particularly regarding whether the legislation can deliver enough certainty and clarity to avoid the dislocation of legitimate commercial activity.

A boundary inevitably needs to be drawn between the incidence of taxation and an absence of taxation. It is a principle of legal policy that law should be certain, and therefore predictable, and it is in the mutual interest of all parties for that boundary to be readily identifiable and understood, thereby providing certainty. Certainty is particularly important for a taxpayer. Taxing statutes deal with the relationship between the taxpayer and the state, unlike other branches of law that govern the relationship of the state’s citizens with each other. Moreover, given the nature of taxation, revenue law regulates the expropriation by the state of a taxpayer’s assets. Accordingly, the taxpayer must be able to identify and predict the scope of legislation (and the resulting taxes).

When tax legislation precisely states the circumstances in which taxation arises, that boundary is at least readily identifiable (if susceptible to tax avoidance arrangements navigating through weaknesses in legislative drafting). Narrowly drafted, prescriptive legislation can assist in providing certainty in taxation, although in tax policy terms the legislation is unlikely to be viewed by HMRC as wholly satisfactory. The revised draft legislation in the consultation document, which as considered above may constitute principles-based legislation, offers a potentially more ambiguous boundary. While such a boundary would be flexible and responsive enough to address the evolution of transactions or schemes, the critical question remains whether the principles on which the legislation is based provide enough certainty for a predictable outcome to be arrived at in any dispute. For the principles-based legislation to fulfill its role, there will be times when HMRC will seek to apply the legislation, in accordance with the principles described therein, to transactions that were not anticipated when the legislation was enacted. A key element of principles-based legislation is the interpretation of the statutory principle as filling any gap that is not directly addressed by that statutory principle or supporting legislation. This role appears to be suggested by HMRC in the consultation document as one that the draft legislation would fulfill, with paragraph 1.9 of the consultation document stating that “even if taxpayers were to find that some of the detail of their specific case was not mentioned in the legislation, they would know whether and, if so, how to apply the legislation, as they would understand the underlying principle.” In this regard, principles-based legislation goes much further than legislation that merely incorporates a purposes clause that is effective when the purposes of detailed legislation are unclear. Judicial construction of the statutory principle as operating to fill any legislative gaps would therefore be critical. However, the operation of the statutory principle in this way, and the judicial interpretation of a statutory principal of the type proposed in the draft legislation in the consultation document, is untested. In this light, the draft legislation could introduce uncertainty and ambiguity rather than offering certainty of application and predictability of taxation treatment.

One anticipates that any legislation setting out a general principle on which tax is to be paid may require a clear delineation, understood by all interested parties, as to when that principle ceases. Anything less might lead to uncertainty or ambiguity and could be worse than the most rigidly drafted statute. Seeking confirmation of whether a transaction falls within the statutory principle will place demands on the advance clearance system operated by HMRC, even if the staffing is available to extend that system to the principles-based legislation proposed in the consultation document. A preferable approach is to include a general filter in any principles-based legislation, such as a motive-based or purpose-based test, that would allow commercial transactions that are untainted by tax avoidance to remain unaffected by the application of the statutory principle. As will be explored in the second part of this article, a general filter was not in the draft legislation contained in the consultation document, but one has now been added in the revised draft legislation published on February 7, 2008, although the terms under which the filter operates are, at least arguably, less than ideal.

Furthermore, it is difficult to foresee such a “principles-based” approach working without the explanation of the underlying principles in a clear and transparent manner. If such an explanation results in long, detailed extrastatutory guidance, there would be a concern that a person may be taxed by a conjunction of legislation and guidance (or, worse, taxed by legislation and untaxed by guidance or informal concession). HMRC guidance is usually subject to caveats.

24 “Statutory Interpretation,” FAR Bennion (4th ed., London, 2002), pp. 682-689 and in particular 684: “Unless men know what the rule of conduct is they cannot regulate their actions to conform to it. It fails its primary function as a rule.” Certainty is identified by Bennion as an integral element of legal predictability.

25 A recent example of such skillful navigation is the tripartite repo transaction considered in Commissioners for HM Revenue & Customs v. Bank of Ireland (2007) EWHC 941 (Ch).

26 See Part II of this article.

and is frequently general in its application. And the characteristics of principles-based legislation may make the production of, and reliance on, extensive HMRC guidance particularly problematic. Since the revised draft legislation does not identify which specific actions fall within its scope, any HMRC guidance on which transactions fall within the scope will almost inevitably become critical in any transaction planning. Any general withdrawal by HMRC of that guidance, or any future refusal of HMRC to adhere to that guidance owing to the particular circumstances of a transaction (especially those that are unusual or atypical), would leave taxpayers in an unsatisfactory position given that the revised draft legislation is less prescriptive, and therefore potentially more ambiguous, than existing narrowly drafted antiavoidance legislation. If HMRC were to withdraw from published guidance or practice on the revised draft legislation and seek to assess a tax liability in contravention of that guidance or practice, the taxpayer’s remedy would be to seek a judicial review, but the review process is complex and costly. The inherent uncertainties of relying on HMRC guidance to interpret the revised draft legislation may therefore partly defeat HMRC’s stated objective in considering principles-based legislation, which is to attempt to simplify the legislation addressing tax avoidance, and by extension its construction.28

It is also unclear whether the fundamental taxing principles embodied in principles-based legislation will be, or should be, immutable or whether they may be subject to refinement as the legislation is applied in practice. It is possible to foresee HMRC wishing to refine or expand such principles in the event that any future litigation regarding principles-based legislation is decided in favor of the taxpayer. As the rationale of the draft legislation is to limit the incidence of tax avoidance, a likely response of HMRC to any defeat in the courts could be the broadening of the fundamental principle and amended legislation encompassing an even wider class of transactions.29 However, once the fundamental principles on which principles-based legislation have been identified and enshrined in legislation, they should not need to be varied. Any potential for amendment, qualification, or change of the fundamental principles therefore sits slightly uncomfortably with the concept of principles-based legislation as being legislative provisions that should not require revision and that are already flexible enough to respond to a variety of evolving transactions. Whether HMRC agree is not clear from the consultation document.

The draft legislation could introduce ambiguity rather than offering certainty of application and predictability of tax treatment.

An important parallel can be drawn with the United Kingdom’s human rights legislation in this regard. The Human Rights Act 1998 (HRA 1998) incorporates the European Convention on Human Rights (ECHR) into U.K. legislation.30 The ECHR codifies in a legal form the implicit principles of inalienable human rights and is a prominent example of principles-based legislation outside the taxation area. The European Court of Human Rights in Strasbourg has consistently constructed the ECHR as “a living instrument which must be interpreted in the light of present-day conditions.”31 This is based on the underlying intention in the ECHR that it should remain responsive to the evolution of European society and flexible enough to encompass the cultural differences of the member states. Ultimately, this evolution protects the individual. Any suggestion that the fundamental taxing principles in the consultation document should evolve and vary (such as following defeat in tax litigation) is less attractive. Changing a fundamental taxing principle is different than changing narrowly drafted and closely articulated tax legislation or a purpose clause in existing legislation. It is considered that fundamental taxing principles that regulate the power of HMRC to impose taxation, once they are enshrined in legislation, should not be subject to periodic amendment. Anything less would lead to uncertainty. The evolution of the ECHR as a living instrument is permitted to protect the individual citizen, the same dominance over supporting prescriptive legislation as principles-based legislation may have in a conflict.

28While some final guidance from HMRC on the application of the revised draft legislation once enacted will be welcomed, it is not inconceivable that the brevity of the draft legislation (in its current form) could be seen by HMRC as an opportunity to expand on how the legislation might apply in some practical circumstances and situations not directly addressed in the draft legislation. Experience to date of existing narrowly drafted antiavoidance legislation, such as the rules on avoidance involving tax arbitrage in sections 24 to 31 Finance (No. 2) Act 2005, is that such guidance contains important clarifications on the application of the legislation in practical situations. Such clarifications should be included in the primary legislation, thereby allowing taxpayers to rely with confidence on primary legislation rather than nonstatutory guidance.

29Such flexibility would not be possible with legislation that includes a purpose clause. The purpose clause would simply describe the purpose of the legislation as drafted. It would not have

(Footnote continued in next column.)
thence safeguarding human rights against infringement by the state. But any evolution in the fundamental taxing principles in the consultation document is likely to favor only HMRC; the state, and not the taxpayer, would benefit from such evolution and flexibility, which sits uncomfortably with the fundamental constitutional principle that a taxpayer should have certainty and predictability in the scope of the state’s expropriation of his assets through taxation.

Any evolution in the fundamental taxing principles in the consultation document is likely to favor only HMRC.

Further, the interpretation of HRA 1998 takes place in the context of the principles enshrined in the ECHR, including the rights to life, liberty, and a free trial. These principles are themselves not static and offer a floor of protection to the individual regarding his rights. The totality of the rights of the individual does not need to be articulated; only the threshold at which they commence needs to be identified. This is entirely logical, as HRA 1998 and, by incorporation, the ECHR regulate the protection for the individual from the state.

Similarly, the draft legislation in the consultation document also creates a threshold at which point the fundamental taxing principles apply to tax a transaction in a particular manner. The universe of transactions to which the draft legislation could apply is not specified; one merely applies the principle to each transaction that could be affected. The concern with this approach in the context of taxing legislation lies in the difference between the imposition of taxation by the state against the taxpayer and the infringement by the state of the human rights of the individual. In HRA 1998, the individual needs merely to reach an identifiable threshold, namely that of human rights protection. Conversely, under the draft legislation in the consultation document, it is HMRC that is required to reach a point at which the fundamental taxation principle embodied in the draft legislation has effect. Owing to the broad spectrum of transactions to which the draft legislation can apply, it is the taxpayer who is likely to remain uncertain where the taxation boundary or threshold lies; this seems to run contrary to the fundamental requirement mentioned above that a taxpayer should be able to clearly identify and predict the scope of taxing legislation.

Finally, it is interesting to consider whether embedding a principle within legislation in a visible manner leads to any concerns with the legitimacy of that approach when viewed in the context of English law jurisprudence. One principle of U.K. revenue law is that:

a subject is only to be taxed on clear words, not on “intendment” or on the “equity” of an Act. Any tax law is to be construed in accordance with this principle. What are “clear words” is to be ascertained on normal principles.32

If a fundamental principle of revenue law is the imposition of taxation by “clear words,” a question may arise as to whether the statutory words remain sufficiently “clear” when the legislation is intended to apply to circumstances that are outside the prescribed scope of any supporting legislation. Are the circumstances unambiguously within the scope of the statutory principle? One anticipates that HMRC are hoping that a court will consider that the extrastatutory material within the consultation document will inform the construction of the statutory language that embodies the fundamental taxing principle in the revised draft legislation. Much might be achieved in this regard through a thorough discussion of the revised draft legislation in the Standing Committee of the House of Commons when Finance Bill 2008 is presented to Parliament.

In summary, the revised draft legislation within the consultation document requires that a balancing act be performed between clarity and flexibility and between certainty and purposive construction. Reconciling these requirements will dictate the success of the revised draft legislation.

II. The Consultation Document

The consultation document contains proposals for principles-based legislation and guidance notes in two areas: disguised interest and transfers of income streams. The revised draft legislation published on February 7, 2008, by HMRC affects only revisions to the draft legislation regarding disguised interest. The draft legislation regarding the transfer of income streams remains unchanged as of the date of this article.

32 Lord Wilberforce in W.T. Ramsay Ltd v. IRC. [1982] STC 174 at 179. While Lord Wilberforce’s judgment in Ramsay was extensively quoted in Barclays Mercantile Business Finance v. Mawson [2005] STC 1, this statement was not among the quotations chosen by the House of Lords. While the opinion of the Judicial Committee of the House of Lords in Mawson focused on the purposive construction of statute, it is difficult to see that the importance of clear words from which the scope of taxation can be discerned can be challenged as a fundamental principle of U.K. revenue law.
Disguised Interest

The revised draft legislation regarding disguised interest is based on the fundamental principle set out in the consultation document that “a return designed to be economically equivalent to interest is to be taxed in the same way as interest.” The principle was not originally transposed word-for-word into the draft legislation; a reference to a return being “designed to equate in substance to a return on an investment at interest” was originally included in the draft legislation in the consultation document. However, the wording of paragraph 1 of the disguised interest schedule in the revised draft legislation follows more closely the wording of the fundamental taxation principle set out in the consultation document, stating, “The purpose of this Schedule is to secure that (subject to exceptions, and except where double taxation would result) a return designed to be economically equivalent to interest is treated in the same way as interest for the purposes of corporation tax.”

Economically Equivalent

Several existing legislative provisions already target arrangements that exploit differences in tax treatment between interest and other receipts (such as dividends) and that thereby seek to convert a source of taxable income into an exempt dividend or a capital gain. These arrangements seek to produce a return economically equivalent to interest while not having the legal form of interest for tax purposes. One example of such an arrangement would be when cumulative redeemable preference shares are issued carrying a dividend that economically replicates a return on an investment of money at a commercial rate of interest. Such an arrangement is countered by the detailed and closely articulated “shares as debt” legislation in FA 1996. Rather than eliminating tax avoidance in this area, the consultation document suggests that similar preference shares and analogous partnership arrangements have continued to evolve despite the enactment of the shares-as-debt legislation. One difficulty faced by HMRC in the shares-as-debt legislation is that the form of the investment instrument identified in the legislation (namely, shares) is closely defined, unlike the far broader description of the return that the legislation seeks to target. The persistent development of new products to navigate around statutory provisions that are potentially capable of being narrowly or strictly construed (regardless of whether a court would agree with that construction) appears to be a major concern of HMRC as described in the consultation document.

The consultation document contains proposals for principles-based legislation and guidance on disguised interest and transfers of income streams.

It is perhaps unsurprising that, to avoid a similar situation under the draft legislation, the consultation document and paragraph 1 of the revised draft legislation focus on a return that is “economically equivalent to interest” without specifying the legal form of the instrument from which that return is derived.

Broadly speaking, there is no doctrine of economic equivalence under English law. Consequently, where U.K. taxation is based on economic equivalence, specific legislation is necessary. Examples of current tax legislation that seeks to assess taxation based on economic substance are the U.K. repo legislation and provisions for “alternative finance arrangements” (which broadly encompasses Sharia compliant financings). Given that such legislation already exists, HMRC’s proposal is to prevent provisions such as the repo and alternative finance arrangements from being affected by the revised draft legislation on disguised interest. Further, as noted in Part I of this article, there is also no all-embracing general antiavoidance rule that counteracts transactions motivated by tax avoidance, or that taxes in accordance with the economic equivalent of any tax-motivated transaction. Had such a general principle-based legislation already been in place, HMRC’s proposals may have been unnecessary.

It should be noted that, in the context of the consultation document, there is no indication that HMRC is proposing any change in the treatment of existing arrangements. The consultation document does not address arrangements that have been in existence prior to the introduction of the shares-as-debt legislation, or those that may arise but does not include a share in a building society (section 91B(8) FA 1996). The provision was exploited through the use of schemes in which shares were issued on terms that would have been within the shares-as-debt rules but for the fact that the shares issued carried no right to a distribution except on a winding up (HMRC explanatory notes to Finance Bill 2007, Schedule 5, paras. 71 to 73). Section 91B(8) FA 1996 was amended in FA 2007 to eliminate the scheme. But, in a similar vein, the consultation document now references schemes based around partnership contributions, which would not fall within the section 91B(8) FA 1996 definition of share and, it appears, are designed to circumvent the shares-as-debt rules.

35Consultation document, para. 2.5

36Sections 91A to 91G of FA 1996 were introduced by Schedule 7 of Finance (No. 2) Act 2005 and later amended in FA 2006 and FA 2007. When these provisions apply, some classes of shares can be reclassified as loan relationships in the hands of the shareholder, with a requirement that the shares concerned are revalued each year with the resultant movement in value being brought into charge to tax.

37For example, section 91B(1)(a) FA 1996 requires that the company investing must hold a share in another company. The definition of share used was, before FA 2007, “any share in the company under which an entitlement to receive distributions may arise but does not include a share in a building society” (section 91B(8) FA 1996). The provision was exploited through the use of schemes in which shares were issued on terms that would have been within the shares-as-debt rules but for the fact that the shares issued carried no right to a distribution except on a winding up (HMRC explanatory notes to Finance Bill 2007, Schedule 5, paras. 71 to 73). Section 91B(8) FA 1996 was amended in FA 2007 to eliminate the scheme. But, in a similar vein, the consultation document now references schemes based around partnership contributions, which would not fall within the section 91B(8) FA 1996 definition of share and, it appears, are designed to circumvent the shares-as-debt rules.


39Sections 46 to 57 FA 2005, as amended.
antiavoidance rule existed, it might have served to counteract some of the arrangements that seem to be in the forefront of HMRC’s concerns in the consultation document. The principle of an economically equivalent return therefore needs to be introduced into the revised draft legislation.

Accordingly, the principle is embodied in paragraph 1 of the disguised interest schedule in the revised draft legislation. The expression “economically equivalent” is not found elsewhere in the U.K. taxing statutes, and it will be interesting to see how a court construes these words. The more familiar wording of “equate in substance to” is retained in the revised draft legislation in the context of a “tax privileged investment return” (see further below), but no longer forms part of what may be considered to be the articulation of the key principle of the revised draft legislation on disguised interest as set out in paragraph 1.

‘Return Designed to Be Economically Equivalent to Interest’

The revised draft legislation is broader than the existing shares-as-debt legislation and is not limited to investments of a particular type or the production of a return of interest at a particular rate. The concept of a return within the revised draft legislation is therefore left as wide as possible. If an arrangement is “designed to produce a return economically equivalent to interest,” that return should fall within the scope of the revised draft legislation, provided it is reasonable to assume that the production of the return is or was a main purpose of the arrangement.

As the disguised interest rules apply only when a return “is not charged, or not wholly charged, to tax on the company as an amount of income and is not brought, or not wholly brought, into account when calculating for tax purposes any income of the company,” some transactions will be unaffected. Transactions such as those relating to alternative finance (encompassing Sharia compliant financings) and creditor repos (which treat return as interest when the sale and subsequent purchase of securities equate in substance to the lending of money, regardless of the taxpayer's intentions) will continue to be taxed under specific rules within the Taxes Acts. Whether other legitimate commercial transactions could still be caught will depend on whether the transaction is designed to produce a return that is economically equivalent to interest.

The word “designed” carries no statutory definition that is applicable to paragraph 1 of the disguised interest schedule in the revised draft legislation. It is submitted that the word “designed” would extend to a design in the abstract, a design by any person (whether or not a party to the investment), and to the design of any part of a wider instrument. The guidance notes in the consultation document state that “the arrangement must be designed to produce such a return, so there must have been the deliberate object that the return would arise and that (apart from the new rule) it would not have been taxed as income.” Why a return is not taxed as income is not specified; an absence of taxation of a dividend in the hands of some U.K. companies, or treatment of the return as capital return would be sufficient. The guidance notes also explain that “the use of the word ‘designed’ makes clear that there must be an intention that the arrangement will produce such a return.” It is possible, therefore, to infer that, at least in the mind of HMRC, the word “designed” connotes a deliberate action into which a subjective qualification (the “intention” referred to in the guidance notes) is embedded. It is understood that HMRC consider that the presence of “intention” extends to seeing that the return is not taxed, as well as seeing that the return achieved equates in substance to

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38 Judges are lawyers, not economists, and the analysis of what is an economic equivalent might encompass not only fiscal substance but also economic theory.

39 Statutory provisions that include the expression “equate in substance to” include section 49(1)(d) of FA 2005, dealing with alternative financing transactions; section 736C(1)(c) ICTA 1988 and section 597(1)(c) of the Income Tax Act 2007, both dealing with deeming of interest on cash collateral under stock lending arrangements; section 560(4) of the Income Tax (Trading and Other Income) Act 2005 (IT(TOI)A 2005), dealing with some guaranteed returns produced from a disposal of a future or option; and para. 1(b) of Schedule 13 to FA 2007, setting out the purpose of the repo legislation.

40 The shares-as-debt legislation refers to a return “on an investment of money at a commercial rate of interest”: section 91D(1)(b) FA 1996. The HMRC PowerPoint presentation made to the January open meeting stated that the draft legislation “can apply to return regardless of nature of arrangements that produces it” (sic).

41 Para. 2(4)(b) of the revised draft legislation.

42 Section 46 to 57 FA 2005.

43 Schedule 13 to FA 2007.

44 Para. 2(5) of the disguised interest schedule in the revised draft legislation defines when an arrangement is designed to produce a tax privileged investment return, but that definition does not extend to para. 1 of the disguised interest schedule.

45 Consultation document para. 2.20.

46 Consultation document para. 2.13. Note also that the HMRC PowerPoint at the January open meeting identified that, in the view of HMRC, “‘Designed’ indicates positive intent.” Further note that the revised guidance notes published on February 7, 2008, repeated, in para. 3, the statements made in consultation document para. 2.13 in this regard.
interest. Given HMRC’s statements in the guidance notes, it appears the construction of the word “designed” in a subjective context is more likely than the words being construed objectively.

It is likely that evidential support for the presence, or lack, of a return that is “designed” will be critical in determining whether a transaction is caught by the revised draft legislation. It is submitted that evidence identifying the presence or absence of an intention or a deliberate object on the part of the taxpayer in designing a return will also be relevant.

It is also submitted that if HMRC want the meaning of any principles-based legislation to be construed in accordance with potentially subjective elements (such as “intention” and “deliberate object”), those subjective elements should be embedded in the principles-based legislation and form part of the statute to be enacted by Parliament. It seems at odds with the concept of principles-based legislation for the principles chosen by HMRC to require further detailed amplification by reference to nonstatutory guidance. More preferable would be the importation into the legislation itself of

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47 HMRC PowerPoint at the January open meeting.

48 The Oxford English Dictionary defines “designed” as “(a) Marked out, appointed, (b) Planned, purposed, intended, (c) Drawn, outlined; formed, fashioned, or framed according to design.” The more objective meaning of the word in (c) is likely to be vigorously opposed by HMRC.

49 Prudential plc v. Commissioners for HM Revenue & Customs [2007] SpC 00636 at paras. 71 to 86 provides a recent example of the importance of evidential support for any argument regarding whether the purpose of a transaction was a purpose of securing a tax advantage.
any explanation necessary to effect the correct construction of the principles chosen. Anything less may lead to ambiguity, or at least a raft of guidance under which the key principles will need to be interpreted.

'Interest'

One other point of consideration will be the interaction of the substantive return with the word ‘interest.’ Is interest to be defined specifically, or does it have a meaning in accordance with decided case authority? If the latter, the disguised interest rule would encompass any interest currently treated for tax purposes as a distribution of profits, any return equating to interest on a transaction that is other than a loan, and potentially any return other than a return of such an excessive amount that the nature of the amount as a payment of interest would be called into account.51

'Tax Privileged Investment Return'

The main operative provision of the revised draft legislation is paragraph 2 of the disguised interest schedule, entitled ‘Disguised interest to be treated as interest.’ Paragraph 2(1) introduces the concept that when “a company is party to an arrangement designed to produce for the company a tax privileged investment return,” the return is treated for corporation tax purposes as a profit from a creditor loan relationship of the company. A tax privileged investment return is defined as “a return from money or any other asset that (a) equates, in substance, to the return on an investment of the money at interest (or an amount of money equal to the value of the asset), and (b) is not charged or not wholly charged to tax on the company receiving the return as an amount of income and is not brought, or not wholly brought, into account when calculating for tax purposes any income of the company.” In essence, the definition of tax privileged investment return is a more detailed encapsulation of the return targeted by the statutory principle specified in the revised draft legislation, with the reference to “economically equivalent” being replaced with the more legalistic expression “equates, in substance.” The credits to be brought into account regarding a tax privileged investment return are deemed to be determined on an amortized cost basis of accounting, which a definitional clause effectively identifies as being a basis of accounting under which an asset or liability is shown in the company’s accounts at cost adjusted for cumulative amortization.54 This is different than the shares-as-debt legislation that reclassifies shares as loan relationships requiring fair valuation each year. Any return not actually recognized in determining a company’s profit and loss for any period is to be treated as being recognized regardless.55 This deemed accounting recognition is intended by HMRC to prevent any absence of recognition of the return for accounting purposes resulting in the return falling out of the charge to tax, for example as a result of the return being capitalized when paragraph 14 schedule FA 1996 does not apply. A tax privileged investment return is therefore taxed regardless of its actual accounting treatment. This is a divergence from the usual drafting of financial products legislation in the United Kingdom, where the accounting treatment of a return would generally determine its taxation treatment.

With the draft legislation originally included in the consultation document, there had been uncertainty as to when a return should be charged to tax to avoid being a tax privileged investment return. This has now been clarified. A return is not a tax privileged investment return if it is already wholly charged to tax on the company receiving the return as an amount of income for any accounting period.56 This would include the return being taxed as trading profit under Case I of Schedule D, and it should also include when the taxation recognition of a return equating to interest is deferred. Provided the return is ultimately taxed in whole as income, the revised draft legislation should be inapplicable. Concerns with the original draft legislation that a tax charge may arise in a given accounting period owing to the timing of the accounting recognition of the return (for example, when the actual return is computed on a fair value basis) have been reduced following the publication of the revised draft legislation.

The definition of tax privileged investment return makes it clear that the return must equate in substance to interest, the word “substance” conveying that the legal form or labeling of the return should not affect the application of the rule. As with the meaning of economically equivalent, guidance will no doubt be required regarding exactly what substance connotes and how it is to be identified.57 This is particularly relevant given the ostensible difference between the statutory principle, which refers to an economically equivalent return, and the definition of tax privileged

50Note that the provisions of section 100 FA 1996, which can apply to tax interest under a money debt not arising from the lending of money, are not repeated in clause 6(5) of the draft legislation (the paragraph that identifies the statutory provisions HMRC intend to repeal if the proposed legislation is enacted).


52Para. 2(1) of the revised draft legislation.

53Para. 2(4)(a) and (b) of the revised draft legislation.

54Para. 7 of the revised draft legislation, referring to the meaning of amortized cost basis of accounting in section 103(1) FA 1996.

55Para. 2(3) of the revised draft legislation.

56Para. 3 of the revised draft legislation.

57Section 91D(1)(b) FA 1996 requires that a condition of the shares-as-debt legislation is that the share “is designed to produce a return which equates, in substance to the return on an...
investment return, which refers to a return equating in substance to interest. It would be surprising if HMRC were to identify any material difference between these two expressions, but guidance is desirable to settle the question.

One further point to note is that the identification of the tax privileged investment return and the application of the revised draft legislation do not result in a legal recharacterization. The revised draft legislation does not (unlike the shares-as-debt rules) deem the instrument from which the return is derived to constitute a loan relationship in its own right. The tax privileged investment return is therefore not deemed to be interest for tax purposes. Consequently, the tax privileged investment return should not, it appears, be subject to U.K. withholding tax on interest payments.

Revised Draft Legislation Introduces a ‘Purpose Test’

On reading paragraph 2(1) of the revised draft legislation, the question arises as to what constitutes an arrangement designed to produce for the company a tax privileged investment return.58 Before the publication of the revised draft legislation, HMRC’s view appeared to be that the construction of “designed” in the context of a tax privileged investment return should follow the construction of the same word in paragraph 1, which enshrines the fundamental tax principle as described above. HMRC’s initial approach, adopted in the consultation document, was that the meaning of the word “designed” was sufficient to serve as a filter through which commercial transactions not motivated by tax avoidance would not pass. Concerns were raised by tax professionals in correspondence with HMRC and at the January open meeting that the construction of the word “designed” was not certain enough to serve as an effective filter or purpose-based test equivalent to those existing elsewhere in the Taxes Acts that would prevent an innocent commercial transaction from being affected by the draft legislation.

The revised draft legislation has therefore introduced a purpose test in paragraph 2(5) of the disguised interest schedule. This provision specifies that “an arrangement is designed to produce a tax privileged investment return if it would be reasonable to assume that that is or was the main purpose, or one of the main purposes, of the arrangement.” The revised guidance notes recognize that paragraph 2(5) echoes the language of other antiavoidance provisions.59 HMRC’s approach appears to be that transactions should not fall within the revised draft legislation through a combination of the construction of the word “designed” together with the application of the purpose test in paragraph 2(5).60 The revised guidance notes state that arrangements that are structured to produce a tax privileged investment return but that do not have a main purpose of producing a tax advantage should not be caught. HMRC consider that this combination of provisions should prevent commercial structures from falling within the revised draft legislation when the return on an instrument inadvertently replicates a hypothetical return on an investment at interest and when that return is not taxed as income. HMRC have emphasized this point in the guidance notes on the revised draft legislation, stating that “truly contingent returns which happen to approximate to the level of return that might have been achieved by simply investing money at interest” would not be within the scope of the new rules.61

However, despite the introduction into the revised draft legislation of the purpose test in paragraph 2(5), the test might be considered to be less than ideal for several reasons:

- First, the test of whether the arrangements are designed to produce a tax privileged investment return is satisfied when it is reasonable to assume that the main purpose of the arrangement is to produce a tax privileged investment return. Other existing antiavoidance provisions that contain a reference to when it is reasonable to assume the presence of a particular state of affairs exists are of a narrower application than the revised draft legislation62 and have not generally been considered in detail by the courts. It is considered that the test is likely to require the identification of a subjective purpose by reference to a set of objective circumstances. The purpose of a company is

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58Para. 2(1) of the revised draft legislation.
60See revised guidance notes, para. 11.
61Consultation document para. 2.13, repeated in the revised guidance notes, para. 11.
62E.g., (i) section 559(5) IT(TOI)A 2005, relating to whether a disposal of a future or option involves a guaranteed return; (ii) para. 7A(6) of Schedule 23A ICTA 1988, in the context of whether transactions involving manufactured payments that are tax motivated may be related; and (iii) section 767AA(7)(c) ICTA 1988, in viewing whether two transactions could be taken as forming part of a series of transactions or scheme in the context of highly prescriptive legislation targeting an antiavoidance scheme involving a change in company ownership. In each of these circumstances, the ambit of the legislative provision (and therefore the effect of it being “reasonable to assume” a state of affairs exists) is narrower than the circumstances of the revised draft legislation on disguised interest.
its intention and is judged subjectively. It is considered that, prima facie, the test of whether it is reasonable to assume that the main purpose of the arrangement is to produce a tax privileged investment return is likely to require the consideration of the circumstances by a hypothetical observer with full knowledge of the terms of the transaction and surrounding circumstances. The totality of the arrangements is likely to need consideration, including the background documents and correspondence. If the purpose test in paragraph 2(5) is construed in this manner, it would be a subjective test determined by objective circumstances, but a confirmation of HMRC’s understanding in this regard is absent from the revised guidance notes. The test is also complicated by not actually requiring a purpose, but only a reasonable assumption of the presence of a purpose. Many other prominent antiavoidance purpose tests require the presence of a purpose that consists of securing a tax advantage (albeit that the purpose is subjectively construed), and this would have been a clearer test to include in the revised draft legislation.

• Second, under other legislation currently in force, when the legislative expression “reasonable to assume” is used, it generally specifies that such an assumption can be ascertained by reference to specified effects or circumstances of the transactions in question. Such a provision has the effect of focusing the scope of what needs to be considered in discerning whether it is reasonable to assume the presence of a given circumstance. Such specification is absent from the revised draft legislation. It is unclear whether the omission of this qualification is an oversight by HMRC, or a more deliberate omission in keeping with the breadth of application of the revised draft legislation.

• Third, under the provisions of paragraph 2(5), an arrangement is within the scope of the revised draft legislation if a main purpose is the production of a tax privileged investment return. The presence of an actual purpose of securing a tax advantage thereby is not required. The purpose test in paragraph 2(5) does not therefore by itself

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63 IRC v. Brebner (1966) 43 TC 705, in particular Lord Pearce at 708 and Lord Upjohn at 711, and FA and AB v. Lupton (1978) 47 TC 586. While intention is subjective, in Marwood Homes Limited v. IRC [1999] STC (SCD) 44, reference was made to the examination of relevant documents to determine the intention of the board of directors of a company, from which can be inferred that intention might in some instances be determined, at least in part, by objective factors. In the recent Special Commissioners’ decision Prudential plc v. Commissioners for HM Revenue & Customs [2007] SpC 00636, evidential factors were considered in detail in ascertaining a taxpayer’s purpose.

64 Similar circumstances have been considered as relevant by HMRC in their internal guidance on section 767AA(7)(c) ICTA 1988 (see Company Taxation Manual CTM 6540) and the now-repealed para. 6(5) of Schedule 26 to FA 2002 (see Corporate Finance Manual CFM 13140). In the latter case, the HMRC internal guidance states that the test of whether it was reasonable to assume that a derivative contract designed to produce a guaranteed return was to be judged — on the basis of an objective look at the facts. Para. 6(5) provides a statutory basis for looking not only at the terms of the relevant contract, but also at the totality of the arrangements of which it forms a part, as evidenced by the contemporaneous documents (including tax advice, where relevant).

65 E.g., as set out in para. 13(4) and (5) of Schedule 9 FA 1996.

66 E.g., section 559(6) IT(TOI)A 2005.
remove innocent commercial transactions that are not motivated by tax avoidance from the scope of the revised draft legislation, but simply excludes transactions when the purpose is not the production of a tax privileged investment return. The two will usually be the same, but not necessarily in all circumstances.

Taking these concerns together, it may be considered that the purpose test in paragraph 2(5) of the disguised interest schedule in the revised draft legislation is a broadly subjective filter that is likely to be determined by objective circumstances. The important residual concern is that in exceptional situations it is not inconceivable that the provisions of paragraph 2(5) would not offer an exclusion for a transaction that is not motivated by the securing of a tax advantage.

Application Only to Companies

The principles-based legislation in relation to disguised interest is applicable only to companies, with a warning that, if it is successful, the principle can be extended to other persons. An entity not within the charge to U.K. corporation tax, including a company that is treated for tax purposes as a tax-transparent equity (such as a limited liability partnership), is not within the scope of the revised draft legislation.

Change to Paragraph 1 of Schedule 9, FA 1996

The revised draft legislation makes an important change to the current legislation applying to loan relationships. Paragraph 1 of Schedule 9, FA 1996 states that accounting credits and debits relating to any amount that is treated, when paid, as a distribution is excluded from the loan relationships regime, with the result that the amount is neither deductible for a U.K. corporate payer nor taxable in the hands of a U.K. tax resident company receiving the distribution. The revised draft legislation makes an addition to the current rules. If enacted, the legislation would require any amount that is actually interest that is paid by a U.K. company and recharacterized under section 209 ICTA 1988 as a distribution to be taxed as taxable income in the hands of a U.K. corporate creditor. Such taxation will arise only when the recharacterized distribution would be taxable under the disguised interest rules but for the fact that the distribution is actually interest.

The corporate payer of the interest will still not obtain any deduction for the interest (because of the recharacterization of the actual interest as a distribution).

At first, the proposed additional subparagraph to be added into paragraph 1 of Schedule 9, FA 1996 appears to be a circular provision aimed at deterring tax avoidance. Comparable provisions exist in the “shares as debt” rules in sections 91A to 91G FA 1996. However, the breadth of circumstances under which interest may be recharacterized as a distribution under section 209 ICTA 1988 (including when interest on a loan is more than a reasonable commercial rate68) raises the possibility that the proposed change could apply more widely. In particular, it is axiomatic that any actual interest (judged by reference to its legal form) is almost sure to be economically equivalent or equate in substance to interest. It may also be the case that the instrument was designed to be, or at least acknowledged as likely to be,69 recharacterized as a distribution (and therefore not charged to tax in the hands of the holder) for commercial reasons divorced from any motivation to avoid tax. In those circumstances, the presence of the purpose test to be introduced in paragraph 2(5) of the revised draft legislation would not exclude the transaction from the ambit of the disguised interest legislation, or from the asymmetry thereby created. Such an asymmetry was not created under the equivalent provisions in the shares-as-debt rules.

Disaggregation and Bifurcation of Arrangements

Other problematic features of the revised draft legislation on disguised interest include the potential disaggregation of arrangements in some situations and tax credit situations. Paragraph 2(6) of the revised draft legislation provides that when more than one company is a party to an arrangement designed to produce a tax-privileged investment return when viewed as a whole (but when each company does not enjoy an interest-equivalent return), the disguised income rules apply to each of the companies participating in the arrangement. The treatment of the disguised interest return is applied to each participating company as is “reasonable.” There is, however, no suggestion that each participating company needs itself to have designed the arrangement relating to the disguised interest, or contributed to that design; mere participation in that arrangement would appear to be sufficient. Valuation issues, or at least added complexity, would result from the need to disaggregate the tax privileged investment return from a single composite asset, or a parcel of assets. While HMRC state that the provision is designed to prevent the fragmentation of instruments as part of an attempt to avoid the existence of an interest-equivalent return, no example is given in the guidance notes of how companies should proceed to examine

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67The revised draft legislation does not tax returns of actual interest, only returns designed to be economically equivalent to interest.

69In this context, it is less than clear in the revised guidance notes whether “designed” could encompass the position when the characteristics of an instrument are structured to achieve a wholly commercial result, but when it is acknowledged and appreciated by the parties that the instrument will be treated in a particular way for tax purposes and when that treatment is not desired by the parties.
which composite assets may include elements providing for an interest-equivalent return.

Some scenarios potentially cause problems. For example, an instrument that partly replicates a return at interest but predominately offers a return subject to certain business results of the investee company is likely to fall within the revised draft legislation. When the return is determined under a complex formula and the aggregated return is itself adjusted by business results, any disaggregation of an interest-equivalent return under the provision described above is likely to be difficult. It is, however, understood from HMRC that hybrid instruments will not be bifurcated under the revised draft legislation (whether or not such an instrument was subject to an accounting bifurcation) when existing tax rules already apply to tax both elements of the instrument.

No Double Taxation; Availability of Tax Credits

The statutory principle in paragraph 1 of the revised draft legislation states that the disguised interest schedule is subject to exceptions and to the requirement that double taxation should not result. The revised draft legislation has been amplified in this regard from the draft legislation published in the consultation document, with the remodeling of an earlier clause dealing with the availability of tax credits and new provisions preventing the application of the disguised interest provisions in some situations.

The newly introduced paragraph 4 of the revised draft legislation prevents the application of the disguised interest provisions if income corresponding to the interest-equivalent return is already treated as a trading loan relationship receipt for any company or as a nontrading loan relationship credit, regardless in both instances of the accounting period in which such a receipt or credit is recognized and regardless of the main purpose of the arrangements. This exclusion is not effective when corresponding income is brought into account as a nontrading loan relationship but is sheltered by nontrading loan relationship deficits brought forward from earlier periods.

A similar exclusion is available when the return to a U.K. resident company arises from a participation in a controlled foreign company when the CFC follows an acceptable distribution policy under section 748(1)(a) ICTA 1988 or when chargeable profits of the CFC are apportioned to the participating U.K. company in accordance with section 747(4) ICTA 1988 and are thereby subject to U.K. tax. These exclusions, added to the revised draft legislation, do not disapply the disguised interest rules when the CFC in question passes the exempt activities test in section 748(1)(b) ICTA 1988 and Part II of Schedule 25 ICTA 1988 or the motive test in section 748(3) ICTA 1988. HMRC have stated that this is deliberate, because “it would in practice be exceptional for a main purpose of the arrangements to be the production of a [tax-privileged investment return] if these tests were met.” Even if such an exceptional situation exists (or in circumstances when the overseas company distributing profits is not a CFC) and a tax privileged investment return is taxed in the hands of the participating U.K. company under the revised draft legislation, no further tax charge arises when the foreign company distributes profits corresponding to that return. Section 80(5) FA 1996 would prevent the loan relationship credit attributed to the tax privileged investment return from being taxed under any other provision. Further, an express statement is made in the statutory principle set out in paragraph 1 of the revised draft legislation prohibiting double taxation.

The revised draft legislation specifically provides for credit to be given to a taxpayer company when it is liable under the disguised interest revised draft legislation for tax on any interest-equivalent return and when any other company pays tax (which is not reimbursed) on the income corresponding to that return. “Tax” includes both U.K. tax and foreign tax. The original explanatory notes in the consultation document drew a comparison with the provisions of section 91C FA 1996, under which some shares are excluded from the shares-as-debt rules when the whole, or substantially the whole, of the issuing company’s assets are income producing. However, rather than introducing an exclusion, the revised draft legislation allows the company receiving the tax privileged investment return to claim credit “of such amount as is appropriate having regard to any tax (including foreign tax) paid by (and not reimbursed to) any other company on income corresponding to the return.” Since the company that is taxed by reference to the tax privileged investment return is not specified, credit may be easier to arrange in chains of companies, when a single return is reflected in more than one company’s share value, with the credit arising at any level.

The revised guidance notes state, somewhat optimistically, that the amount of the credit will in most cases

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70 Accounting standards in International Accounting Standard 39.11 and U.K. Financial Reporting Standard 26.11 require a holder of some hybrid instruments (such as convertible security) to account for the security in two parts, one relating to the host debt contract, the other to the embedded derivative relating to the right to convert the security.

71 HMRC document “Main Changes Following Open Day,” published on the HMRC Web site on February 7, 2008, commentary on para. 5 of the revised draft legislation.

72 Para. 6 of the revised draft legislation.

73 Id.
be “reasonably obvious” and “determined on an appropriate basis.”

Consequential Repeal and Amendment of Legislation

HMRC have suggested that any enactment of the revised draft legislation on disguised interest would be accompanied by the repeal of a substantial body of antiavoidance legislation. Many of the provisions targeted for repeal have been enacted recently. They include the shares-as-debt legislation contained within sections 91A to 91G of FA 1996 and provisions dealing with stock lending arrangements (and quasi-stock lending arrangements) that are designed to produce a return to the stock borrower equating in substance to the return that could have been achieved on an investment of the cash collateral provided under the stock loan. Antiavoidance legislation introduced in 2004

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Example 3

1. A U.K. group treasury company, A, invests £100 in B, an investment company. The investment produces a return that may come within the scope of the disguised interest legislation.

2. B receives interest on the deposited investment of £100, such interest being taxable in B’s hands as a nontrading loan relationship credit. Accordingly, A should not be subject to the disguised interest legislation on the return achieved on A’s investment. If no return is paid by B to A, the value of the shares in B increases but no tax advantage is secured by A because B pays tax on the interest received.

3. If B sheltered the taxable interest with any nontrading loan relationship deficits brought forward from an earlier period (assuming no group relief surrender), the exclusion from taxation on the interest received by B will not apply.

4. It may therefore be necessary for A to seek confirmation or warranty protection from B for confirmation that any taxable nontrading loan relationships credits received by B, which correspond, to A’s return, will not be sheltered by available nontrading loan relationship deficits.

5. Had the investment by A been designed to ensure that tax was not payable on the interest arising to B, the return to A may have been a “tax privileged investment return.” Had B paid no return to A, HMRC would probably argue that the accretion in value of A’s shares in B equates in substance to interest.

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74Para. 2.31 of the guidance notes and para. 23 of the revised guidance notes.

75HMRC stated in their PowerPoint presentation at the January open meeting that the use of credits in para. 6 of the revised draft legislation is “far less prescriptive” than the equivalent exclusion available under section 91C FA 1996 in the shares-as-debt rules.

76Sections 736C and 736D ICTA 1988. Both provisions contained revisions to the complex stock lending legislation and were introduced in FA 2006. HMRC concern was present during the introduction of the legislation that amendments to the terms of the arrangements could result in the provisions of section 736C being circumvented, hence the introduction of the quasi-stock lending legislation in section 736D ICTA 1988.
relating to companies in partnerships is also repealed, motivated by the desire to encompass within the revised draft legislation partnership arrangements that offer a return that is economically interest but may, on a legal construction, be of a capital nature.77

Any enactment of the revised draft legislation on disguised interest could be accompanied by the repeal of a substantial body of antiavoidance legislation.

As noted above, several provisions have not been repealed that have a broadly equivalent effect to the disguised income rules. The U.K. repo rules and provisions dealing with alternative finance arrangements remain unchanged. Other provisions of the loan relationships code that involve accounting debits and credits for taxation purposes on a money debt that is not a lending of money might also have been included as provisions to be repealed, but remain outside the draft disguised income rules.78

Transfer of Income Streams

The fundamental taxation principle governing the draft legislation in the consultation document on the transfer of income streams is that “receipts which are derived from a right to receive income and do not involve the loss of capital are economic substitutes for income and are to be treated for tax purposes as income.”79 Any diminution in value of the underlying asset in consequence of the stripping from that asset of the component of its value represented by future income is ignored.80 The HMRC announcement of February 7, 2008, did not extend to any revision of the draft legislation addressing the transfer of income streams. The draft legislation in this area is generally considered to be applicable to a narrower class of transactions and arrangements than the revised draft legislation on disguised interest.

Rationale of Legislation

HMRC’s explanation of the need for such draft legislation is, again, their concern that avoidance schemes have been designed to take advantage of technical and prescriptive tax legislation. HMRC also refer to the existing antiavoidance legislation in this area having been introduced in a “piecemeal fashion over the years,”81 including sections 730, 775A, and 785A Icta 1988. The draft legislation therefore represents a consolidation of various existing statutory provisions under the aegis of the principle referred to above. HMRC’s intention in the legislation appears to be to prevent a taxpayer from arguing that receipts for the sale of an income stream constitute a capital receipt (with capital losses being potentially available to set against that capital receipt). The focus is firmly on the transferor of the income stream rather than the transferee, as is the position set out in section 785A IctA 1988, which the draft legislation closely resembles albeit that section 785A Icta 1988 is confined to addressing the transfer of a stream of rentals under a plant and machinery lease.

While the draft legislation on the transfer of income streams consolidates a number of existing statutory provisions, the fundamental taxing principle that is embedded within the draft legislation on the transfer of income streams goes significantly further. Owing to the ambiguous case authorities that address the sale of income streams,82 HMRC acknowledge that “what is required is a way of determining in relation to many types of receipt whether they are income or not.”83

77The genesis of the section 131 to 134 FA 2004 legislation addressing companies in partnership was to counter arrangements that exploited the ability within partnerships for partners’ income-sharing proportions to differ from the proportions in which their capital was contributed. While the consultation document states that HMRC have been concerned with tax avoidance schemes that navigate around the shares-as-debt rules through partnership-based (rather than share-based) structures, it is submitted that the intention to repeal sections 131 to 134 FA 2004 arises because the draft legislation targets the tax avoidance that is already addressed by sections 131 to 134 FA 2004. However, the extent to which the draft legislation is to be construed as encompassing the identical ground covered by section 131 to 134 FA 2004 is an interesting question that the consultation document does not address.

Sections 100 FA 1996. While section 100(1)(b) FA 1996 specifies that it applies when the money debt arising did not arise from a transaction for the lending of money, and when no loan relationship exists, the disguised interest rules could still be able to apply to such situations given that the “return” in para. 1 and para. 2 of the revised draft legislation would only need to be designed to be economically equivalent to interest and equate in substance to a return on an investment of money at interest. The investment itself need not be present.

79Consultation document para. 3.6
80Id at footnote 3.
81Consultation document para. 3.3.
82The consultation document refers to an “ambiguous” line of case authorities: Lowe v. J W Ashmore 46 TC 597, Greyhound Racing Association (Liverpool) v. Cooper 20 TC 373, McGuckian v. IRC 69 TC 1, and IRC v. John Lewis Properties Limited 75 TC 1. The fundamental taxation principle selected is acknowledged by HMRC to be closest to that elucidated in the Australian case Henry Jones (IXL) Limited v. Federal Commissioner of Taxation (22 ATR 328).
83Consultation document para. 3.6.
HMRC has decided that the method by which this determination is achieved should not be a list of indicators as to the fundamental nature of the receipt in question. Rather, the determination is to be achieved through the codification of the fundamental taxation principle referred to above, which, once reduced to statute, is intended not only to fill any gap in existing consolidated statutory provisions but also to attempt to eliminate the distinctions between income and capital that have historically been drawn in the case authorities concerning the nature of the receipts arising from the sale of income streams.

**Principle and Draft Legislation Explored**

The draft legislation consists of two clauses, regarding corporation tax and income tax. The principle on which both clauses are predicated is that the "purpose of this section is to secure that receipts (a) which equate in substance to income, but (b) which are not fully tax-able as income, are treated as income."\(^{84}\) The draft legislation applies when a company or an individual within the charge to U.K. tax transfers a right to receive income arising from an underlying asset to another person in circumstances that the underlying asset is not transferred. The legislation does not specify the type of asset that is required. It is considered that the asset could include shares, annuities, and a lease of plant and machinery, and could also extend to debt securities, real estate, intangible assets, and trade contracts.\(^{87}\) Transfer is defined as including a number of dispositions (sale, exchange, gift, surrender, and assignment) as well as any other arrangement equating to a transfer.\(^{88}\)

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\(^{84}\)Clause 1(1) and clause 2 (the latter inserting the new section 809A Income Tax Act 2007).

\(^{85}\)Unlike section 730 ICTA 1988, there is no limitation on the transferred income to distributions on shares. While previous formulations of section 730 ICTA 1988 specifically excluded loan relationships from the scope of assets within section 730 ICTA 1988, no such specific exclusion is in the draft legislation.

\(^{86}\)The assignment of rentals is not prevented from falling within the scope of the draft legislation, although usually such an assignment would probably fall under the rules for structured finance arrangements in sections 774A to 774G ICTA 1988 (which replaced the previous rent-factoring rules in section 43A to 43G ICTA 1988 regarding transactions entered into on or after June 6, 2006).

\(^{87}\)There is no specific wording to preclude the income stream being transferred from having the nature of contractual payments. Indeed, one of the examples in the consultation document deals with the assignment of a right to payments from a long-term contract that have not yet been recorded as trade receipts. HMRC contemplate in the consultation document that when the vendor’s consideration is not subject to tax as income, the draft legislation would apply.

\(^{88}\)The concept of transfer does not appear to extend to any waiver or forgoing of income arising from any property. This

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Example 4

<table>
<thead>
<tr>
<th>U.K. Bank</th>
<th>Dividends paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price for Dividend Right: £100 million</td>
<td></td>
</tr>
<tr>
<td>Right to dividends</td>
<td></td>
</tr>
<tr>
<td>U.K. PLC</td>
<td></td>
</tr>
</tbody>
</table>

1. U.K. Bank acquires the rights to certain dividends on shares owned by U.K. PLC, the purchase price being £100 million.
2. The purchase price lump sum is treated as income of U.K. Co under clause 1(2) of the draft legislation (unless already taxed as income in U.K. PLC’s hands).
3. Dividends received by U.K. Bank will remain taxable in the hands of U.K. Bank (section 95 ICTA 1988 and clause 1(7) of the draft legislation).
to be income of the seller, is treated in the same manner as the stripped income would have been treated. The timing of the seller’s tax charge on the consideration broadly follows the accounting treatment of the receipt of that consideration. An exemption is provided when the income transferred by a company arises from a non-long-funding lease, and in such circumstances the consideration is taxed in the accounting period in which the transfer takes place. The draft legislation does not require the repeal of existing statutory provisions dealing with repos, alternative financing arrangements, and structured finance arrangements when a transaction is, broadly, already accounted for as a loan in accordance with its economic substance and when the tax treatment is analogous to that applicable to a loan at interest. The return from such transactions is already taxable as income.

The consideration for the transfer will be treated as income in the hands of the transferor and not as a capital receipt. This appears to be the case even when the disposal is in substance a permanent disposal of all the future income receivable regarding a fixed capital asset of the transferor. Tax is charged on an amount equal to the consideration for the transfer. There is nothing to prevent the income itself (for example, the dividends paid or annual payments received) from being taxed in the hands of the transferee of the income stream.

In this regard, the draft legislation does not prescribe any tax credit if the transferee is taxed on the actual income received (such actual income arising in respect of the income right purchased by the transferee) and the transferor is taxed on the income proceeds it is treated as receiving in respect of the sale of the income right. While this position may at first seem surprising, the draft legislation broadly replicates the equivalent position under section 730 ICTA 1988, which was amended by FA 2005 to permit the taxation of the transferor on the dividend right transferred in addition to taxing the transferee on a deemed receipt of that same dividend income. The draft legislation differs from section 730 ICTA 1988 in some, but not material, detail. While the draft legislation deems the transferor to receive consideration of an income nature for the sale of the income right, section 730 ICTA 1988 deems the transferor to still be the recipient of the dividend income, with the transferor being charged under a restrictive Schedule D Case VI charge. In this regard, the draft legislation is a slight relaxation of the provisions of section 730 ICTA 1988. Perhaps unsurprisingly, section 730 ICTA 1988 (as well as other similar provisions) would be repealed if the draft legislation is enacted, and it is apparent that HMRC have contemplated that the new legislation may serve a similar role as these existing provisions.

The preservation in the draft legislation of these features of section 730 ICTA 1988 appears to be a consequence of HMRC seeking to encompass important existing statutory provisions within the draft legislation. Another indication of this approach is that there is no requirement in the draft legislation that the transfer of the income stream must be occasioned by a main purpose of obtaining a tax advantage, or must be designed in such a way to ensure that tax is avoided. Such a requirement is absent from section 730 ICTA 1988. Similarly, any intention (or otherwise) of the transferor or transferee to mitigate or avoid taxation is not taken into account in the draft legislation. In this regard, there has been no announcement by HMRC of the introduction into the draft legislation on the transfer of

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89A long funding lease is defined in section 70G of the Capital Allowances Act 2001. A finance lease will be a long funding lease unless one of several exclusions apply. One exclusion is that any lease with a term of five years or less will not be a long funding lease. When a lease is a long funding lease, the hirer will not be entitled to capital allowances.

90In this regard, the draft legislation in the consultation document goes significantly further than merely reversing the decision of the Court of Appeal in CIR v. John Lewis Properties Ltd 75 TC 131, in which the disposal of a right to five years’ rents was held not to be a disposal of income but of capital.
income streams of a purpose test on similar terms to that proposed in the revised draft legislation on disguised interest.\(^92\) However, the draft legislation is inapplicable if and to the extent that the consideration for the transfer is already taxed as income or brought into account as a disposal receipt for the purposes of the capital allowances legislation.\(^93\)

It may well be that HMRC consider that the replication of the features of existing statutory provisions (such as section 730 ICTA 1988) is unavoidable when embarking on such an exercise as set out in the consultation document. To do otherwise, HMRC might argue, would be to invite tax avoidance in any gaps in which the repealed legislation is not superseded by new principles-based legislation. However, as explored below, replicating the features of existing statutory provisions may have adverse consequences when the class of transactions falling within the draft legislation is wider and less certain than the scope of transactions that would fall within existing, more narrowly targeted legislation.

**Comparison With Existing Legislation**

Existing legislation addressing the transfer of income streams such as section 730 ICTA 1988 and section 775A ICTA 1988 was similarly drafted, with the application of such provisions not being dependent on the presence of a purpose or design to avoid tax. The consequence of the breadth of application of the draft legislation is, however, that a number of legitimate commercial transactions come within the scope of the draft legislation. Examples might include securitisations or repackagings in which a true sale of a receivable may be effected without the transfer of the corpus of the underlying asset, although for the most part the transferor is already likely to be subject to tax on the sale consideration.\(^94\) This is the case with provisions such as section 730 ICTA 1988, which apply to a variety of commercial situations. However, unlike section 730 ICTA 1988, the breadth of transactions that could be caught within the draft legislation is far wider than the more prescribed circumstances in current legislation such as sections 730, 775A, and 785A ICTA 1988.

This potentially broad ambit of the draft legislation is intended to prevent circumvention through narrow, formalistic interpretations of statutory provisions. However, the broad scope of the draft legislation inevitably means that more transactions could be caught in its net.

It is possible that the guidance notes on the draft legislation and any future HMRC guidance will assist in this regard and provide a clearer understanding of which transactions are not affected. However, this would be an unsatisfactory incidence of being taxed by reference to broadly drafted legislation and untaxed by a nonstatutory HMRC concession articulated in published guidance of uncertain standing. Such guidance would lack the standing of a statutory motive or purpose test. To avoid the draft legislation on the transfer of income streams creating commercial uncertainty, some limitation or filter should be included in the draft legislation on the transfer of income streams that mirrors the equivalent provision now proposed in paragraph 2(5) of the revised draft legislation on disguised interest. This would not need to be a narrowly drafted exclusion, but could be expressed as a counterbalancing statutory principle that the legislation has no effect when the transfer being effected is not motivated by seeking a tax advantage.\(^95\)

**Conclusion**

The enactment of principles-based legislation in U.K. tax law would be a new and significant development. Such legislation would constitute a greater change in U.K. tax legislation than the insertion of a purpose or objects clause in detailed and prescriptive legislation, as was recently undertaken in the repo legislation in paragraph 1(1) of Schedule 13 FA 2007. The focus of HMRC and HM Treasury in the principles-based legislation in the consultation document is clearly on targeting and eliminating perceived tax avoidance. In this context, the weapon of a statutory principle to which any mechanical and prescriptive supporting legislation may be subordinate must have been very attractive to the U.K. tax authorities.

However, as this article has demonstrated, the revised draft legislation and the approach of HMRC to

\(^92\)See above, passim, in the paragraphs under the heading "Revised Draft Legislation Introduces a 'Purpose Test.'" See also para. 2(5) of the disguised interest schedule in the revised draft legislation.

\(^93\)Clause 1(6) and clause 2 (introducing new section 809 C(1) Income Tax Act 2007) of the draft legislation.

\(^94\)On a typical U.K. residential mortgage securitization, the originator of the mortgages would effect an equitable transfer of the mortgages to a special purpose vehicle and would be subject to tax under the loan relationships legislation regarding that disposal. Non-U.K. originators of commercial mortgages or intangibles may also be unaffected by the treatment of the sale consideration as being income for U.K. tax purposes. However, the concern remains that the potential breadth of the draft legislation may create concerns for many commercial transactions that are unconnected with the tax avoidance that HMRC purport to be targeting.

\(^95\)Such a counterbalancing principle could be worded in a similarly brief style as is used in clause 1 (and clause 2 introducing the new section 809B(1) of Income Tax Act 2007) of the draft legislation. Alternatively, a similar formulation of words to para. 2(5) of the revised draft legislation on disguised interest could be used. One result may be that, as with the disguised interest rules as revised, subjective tests would govern both the entry into, and exclusion from, the draft legislation, but the alternatives seem even less attractive.
principles-based legislation as proposed in the consultation document could also create uncertainty and a lack of predictability in the taxation of commercial transactions and arrangements. While it is helpful that the revised draft legislation on disguised interest now includes a purpose test in paragraph 2(5) in the disguised interest rules, the terms of that purpose test are subjective, and the test does not by itself remove from the legislation transactions that are not motivated by the securing of a tax advantage. Accordingly, the inclusion of a purpose test in paragraph 2(5) in the disguised interest rules does not entirely allay concerns that the potential scope of the disguised interest rules could lead to uncertainty and ambiguity. A further concern is that the draft legislation on the transfer of income streams still contains no equivalent purpose test.

While cogent arguments have been advanced that principles-based legislation should not be judged by whether they achieve certainty, as opposed to fairness, this approach is difficult to reconcile with the demands of the commercial world in which market participants must be able to precisely evaluate the risks inherent in a course of action. If the breadth of the legislation relating to both disguised interest and the transfer of income streams raises the possibility that many bona fide transactions could fall within the scope of the legislation, even though their main purpose is not the securing of a tax advantage, the legislation is unlikely to be successful in delivering its stated aims of “conceptual simplicity and a more coherent regime.”

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97 Consultation document, para. 1.9.