SLAUGHTER AND MAY/

CLIENT BRIEFING

August 2020

# STANDARDS IN TAX: THE INFLUENCE OF ECONOMICS AND POLITICS ON TAX POLICY AND TAX PROFESSIONALS

*Over the years, tax policymakers have faced dilemmas when trying to balance the competing objectives of politics and economics. The obvious problem with giving incentives to particular people through the tax system is that others see how they can be exploited. This has been brought into particularly sharp focus by the action being taken during the pandemic. A number of factors are at play here: whatever the UK government decides must then be responded to by taxpayers, administered by HMRC and decided on by tax professionals before ultimately being pronounced on by the courts. Somewhere along the process, politics or prejudice may well intervene.*

It has been encouraging to see the way in which government has obviously placed great faith in HMRC, giving it the responsibility to feed money back into the economy through the furlough scheme and various other incentives to keep people working. This has been an interesting use of tax machinery in a slightly different context, and it is just one of the ways in which government can use the tax system to achieve its economic aims.

At the same time, the European Commission lost its case against *Apple* on state aid in Ireland (Cases T-778/16 and T-892/16). As a result, Ireland is not obliged (subject to any appeal) to ask Apple to pay taxes to Ireland. These were deemed to have been 'waived' as an encouragement to make an investment in the Irish economy and create jobs there. The widespread reaction in the media to that as encouraging tax avoidance was revealing.

All this comes at a time when the government will no doubt be thinking of further tax measures that could help get the UK economy back on its feet again — and other measures that might be relevant to stave-off economic threats arising from Brexit.

So, once again, we are in the midst of the debate as to whether the rules of economics or politics should determine tax policy — and what sorts of actual or perceived tax avoidance should be targeted by tax administrators.

If the government is trying to target tax reductions or reliefs to achieve an economic aim, it will always be vulnerable to people seeking to exploit such a situation for their own purposes rather than helping government achieve its economic aims (such as film financing, for example). That thought will always be in HMRC's mind as it seeks to administer the system fairly.

Responsible tax advisers also need to think about what they should do in these circumstances to maintain their own professional standards and self-respect, as well as giving best advice to clients.

## Memory lane

For many years, the *Duke of Westminster* case ([1935] UKHL 4) showed a totally different attitude to tax avoidance (taxpayers were positively encouraged to take extreme measures such as remunerating staff with a tax deductible deed of covenant). Case law since then contains many examples of some really abusive schemes.

Things probably came to a head in the 1960s and 1970s with a 98% tax rate on unearned income (rising to 101% under a Conservative administration in 1971) and an 83% rate on earned income until the late 1970s.

Denis Healey's Budget in 1974 contained the memorable aspiration of 'squeezing the rich until the pips squeak'. But not long after that, Labour had to considerably reduce the rates it was proposing to charge on the benefit of company cars on the basis that many of its supporters made the cars, while other supporters drove them and were within the scope of the new charge. Mention of the 'brain drain' was common in the media at the time, as the best qualified and most successful left the UK.

At the same time, by virtue of deliberate government policy, the capital allowance system (with a 100% write-off of new plant and machinery in the year in which expenditure was incurred) was doing its best to tilt investment decisions in the direction of modifying Britain's industrial facilities, while also encouraging (largely very successfully) foreign motor companies

that were thinking about creating manufacturing plants in Europe to make that investment in the UK. The same debate would now probably go in favour of the UK on the basis of expertise and efficiency, but at that time tax was seen as a very influential factor.

In 1984, in a reversal of this policy, capital allowances were reduced on the stated grounds of not giving preference to machines over people.

Eventually, however, we got to a situation where the generosity of capital allowances and the finance leasing regime was seen by government and HMRC to be too fruitful a ground for tax avoidance, so major changes were made.

## Human nature and avoidance

The problem with giving incentives to particular people through the tax system is, of course, that others see how they can be exploited. Business expansion schemes and special investment schemes in development areas provide ample evidence of that. It is no coincidence that some of the major cases on the *Ramsay* area of case law (think *Ensign* [1992] 1 AC 655 and *Mawson* [2004] UKHL 52) involve attempts by people to exploit capital allowance rules directed at others.

## The prolonged war against avoidance

For a period, HMRC sought to persuade the courts to strike down any avoidance schemes on the basis that they could be rewritten if they had a tax motive. The decision in *Mawson* effectively brought that to an end: a realistic view must be taken of the facts, and that could lead to transactions being recharacterised to show their true legal effect. By and large though, striking something out just because it had a tax motive would not work unless either there was a specific anti-avoidance provision in that area or the purpose of a particular item of expenditure, etc. had to be tested against commercial purpose.

In the late 1990s, the UK government was beginning to recognise that the UK's tax system had to compete on a global basis. Labour started tax reform which the Coalition government then continued – leading to the 2010 corporation tax road map setting out the UK's aspirations to be a competitive economy with an appropriately competitive tax system. This was to have a profound impact on the way HMRC dealt with taxpayers; in the large business arena, in particular, people were surprised that they were now being called 'customers'.

The decision was also taken that 'people would only behave if they were treated as human beings'. For a period, the relationship, mainly initiated with large business, worked really well. There were still times, though, when retrospective legislation – the last resort for any tax administration – had to be used to deal with particularly extreme tax avoidance.

Outside the financial sector, businesses were generally prepared to behave in order to get the benefit of a more transparent and collaborative relationship with HMRC.

The financial sector was not seen necessarily as a true believer in this approach, however, so the 'code of conduct' was brought in and was eventually endowed with teeth. Senior management at the various financial services companies realised that it was in their own best interest to have a good relationship with government generally and, if that meant that they had to regulate any aggressive tax structuring, then that was a reasonable price to pay.

## GAAR: the answer to yesterday's problem

The GAAR came in as the ultimate legislative answer, but this was probably after the major behavioural change had taken place, and it is not surprising that there has been little litigation or other controversy in that area.

The fact that the GAAR firmly ended the *Duke of Westminster* principle is probably going to be its lasting legacy – and that is a highly appropriate one, of course. It is right that people should not be allowed to make a nonsense of the tax rules; the other side of that coin, however, is that HMRC generally has to abide by the law as it finds it, regardless of whether or not the result is 'right' as a matter of principle. Ironically, of course, it is HMRC's governance process, referred to below, that preserves this.

Human nature, however, continues to be the same, and lower tax rates have not necessarily meant that avoidance has disappeared – everything is relative.

Nor has the idea of linking tax profits and losses (as in the loan relationship and derivatives areas) to commercial accounting by reference to which a business would be judged totally succeeded, because it requires HMRC then to keep tabs on whatever is happening in the accounting area (as the recognition scheme which became the subject of retrospective legislation showed).

So, can governments and tax administrations cope with the tax system being used to encourage particular types of behaviour without human nature taking over and ruining the plan?

## International measures

The OECD clearly thinks that this is not possible, as its 'pillar two' approach demonstrates. This would bring tax rates up to a minimum level to deter multinationals from playing games. But it takes no account of

situations where the substance of generating profits is *genuinely* in a low tax area, and low taxes 'unfairly' prevent developed countries with higher tax rates from picking up inward investments.

There should be nothing to stop jurisdictions deciding that, in order to attract investment by balancing out their geographical or other disadvantages (as the Irish have been doing for many years highly successfully), they should collect lower taxes from business activities in order to generate employment etc. State aid questions aside, the key thing, in deciding whether or not tax has been avoided, must surely be where the substance of the operation is and where those profits are *really* being generated or belong.

*Apple* looks to have been decided on purely technical grounds (not getting the evidence out), but there is surely a view at the EU level that small countries should not compete with big countries if they then expect to be bailed out by their larger neighbours when things go radically wrong. Politics coming into play again...

Again, the shifting sands of trying to achieve political and economic objectives at the same time are creating uncertainties for small countries wishing to compete with larger countries (which have more to offer to inwards investors at first sight) by enhancing their tax systems. This is also creating problems for multinational investors who know that they have choices as to where they invest but will hate the long term uncertainty if countries or regulators intervene.

### What do governments do?

There is nothing wrong, in state aid terms, with countries having beneficial or benign tax regimes or low tax rates to encourage people to invest and create jobs in their economy, as long as those systems apply equally to all as part of the regular tax system.

There is also nothing wrong, in BEPS terms, with profits being taxed where they effectively arise because there is substance and investment there.

But EU countries clearly do not like tax competition, and the BEPS project has moved on to pillar two on the basis that low tax rates were seen as an inappropriate incentive.

At the same time, tax administrations have come under increasing internal political pressure to tighten up the tax regime on multinationals. The most dramatic examples of this have been seen in the UK when the Public Accounts Committee embarked upon a campaign against multinationals. A lot of publicity was given to that, but rather less publicity was given to the National Audit Office report which showed that HMRC had actually done a rather good job.

In the train of that period in our political lives, however, HMRC introduced governance to make sure that the same standards were applied to all. Every dispute has, therefore, got to go through a process under which the proposed resolution is tested for consistency with general standards, and HMRC case officers have to put their decision to the test with their contemporaries and superiors.

Inevitably, this has led to a more cautious attitude in resolving things: nobody wants to be criticised within their own organisation.

It is to be hoped that things will settle down over time, but tax administration is inevitably subject to some criticism by multinationals that have invested in the UK in the past. There are signs of strain here at present, particularly in the transfer pricing area. It's just another example of how you cannot keep everyone happy at the same time.

### Standards for UK tax professionals

It seems a long time since a former partner in Arthur Andersen set up a business to market tax avoidance schemes and was very successful in doing that. Participants probably saw themselves as evening out one tax inequity with another, but of course that sparked off the *Ramsay/Ensign* case law challenges.

A combination of case law, government and tax administration pressure and eventually the GAAR and other statutory measures against marketing tax avoidance schemes have since worked. That will be a good thing for most, if not all, professional advisers who are no longer being put under the same pressure to sign-off on aggressive schemes.

Tax departments in companies operating in the UK will be acutely aware of the fact that tax is now very much a topic of public discussion. Their boards will be actively involved in making sure that the company or group concerned does not receive public criticism for what it is doing. History has shown that such criticism is disliked by investors, consumers and employees working in the business.

Having said that, of course, much public criticism has been ill informed — though it is not easy for affected taxpayers or their advisers to correct an impression through a public response. The spirit of Mandy Rice-Davies lives on.

Does all this mean that tax professionals now have a compass that they can use to maintain their standards? Well it probably does, because there will be much less pressure from clients to achieve the impossible and the measure as to what is the right behaviour will be set by the likely response at board level.

Whether the pendulum has swung too far in the direction of the tax administration remains to be seen. Will some countries start losing inward investment because they are no longer able to compete for other shortcomings in their offering (pillar two) or because their tax administrations are perceived to be too fierce? Somehow, tax administrations have to find the right balance if uncertainty and aggravation is not to persist.

*This article was first published in the 31 July 2020 edition of Tax Journal.*

# CONTACT

Steve Edge
PARTNER
T: +44 (0)20 7090 5022
E: steve.edge@slaughterandmay.com



Published to provide general information and not as legal advice. © Slaughter and May, 2020.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com

990604960