Financial Instruments

TAX AND ACCOUNTING REVIEW

The monthly briefing service for tax and treasury specialists

Matching and transfer pricing – compliance does not pay

In this article ***John Lindsay*** *draws readers' attention to a new pitfall for the unwary that arises where an intra-group loan is made in order to enable the borrower to obtain matching treatment for tax purposes. In such cases where the amount of the borrowing is non-arm's length and the loan is interest bearing, some or all of the exchange movements arising on the creditor loan relationship will be disregarded for tax purposes, whilst the whole of the exchange movement on the corresponding debtor loan relationship will still be treated as matched for tax purposes and will be brought into account when the matched asset is disposed of. Surprisingly, this pitfall only arises where the loan is advanced on interest-bearing terms.*

As readers will be aware, from 1 April 2004 the scope of UK transfer pricing legislation was extended to transactions between UK resident companies. As a result a tax asymmetry can arise where one company within a group of companies makes a foreign currency loan to another group company (matching company) in order to enable the matching company to obtain matching treatment for tax purposes and a lesser amount would have been lent had the two companies been dealing at arm's length. It is possible for a debtor (liability) loan relationship to be treated as matched against shares and other assets provided that exchange gains or losses on the debtor loan relationship and the matching asset are taken to reserves in the matching company's accounts. In such cases any exchange movement arising on the matching loan is ignored for the purposes of the loan relationship legislation and instead is brought into account for tax purposes when the matching company disposes of the matched asset.

Often a parent company might borrow in a foreign currency from outside the group and then make a loan in the same currency to the matching company. On a group basis, after taking account of matching treatment, no net exchange movement arises. The parent company is perfectly hedged as any exchange movement on the external borrowing is offset by an equal but opposite exchange movement on its loan to the matching company and equally no exchange gain or loss is taken into account in computing the matching company's profits or losses for the purposes of the loan relationships legislation.

Before 1 April 2004 it was not uncommon for such intra-group loans to be made on interest-free terms. From 1 April 2004 if the loan continues to be interest-free, an arm's-length rate of interest will be imputed on such loans for tax purposes. Where a lesser amount would have been lent had the two

May 2004
Volume 9 • Issue 4

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companies been dealing at arm's-length, an arm's-length rate of interest will be imputed on the arm's-length amount of the borrowing. In certain cases a group of companies may decide to charge an arm's-length rate of interest on such loans in order to avoid a transfer pricing adjustment. Surprisingly, this could put the group in a worse tax position than if such loans continued to be interest-free.

The reason for this lies in the different way in which debtor and creditor loan relationships are treated for the purposes of paragraph 11A of Schedule 9 to the Finance Act 1996 (non-arm's-length loans - exchange gains and losses). In the case of a debtor loan relationship exchange gains or losses will be left out of account in whole or in part for tax purposes where an adjustment arises on that debtor loan relationship under paragraph 1 of Schedule 28AA of the Income and Corporation Taxes Act 1988. Under this provision, where a debtor loan relationship is interest-bearing and the subsidiary in question could not have borrowed the full amount in question were it dealing with the lender on arm's-length terms, a restriction will arise on the amount of interest for which the subsidiary can claim tax relief. In such circumstances, under paragraph 6 of that Schedule, the lender can claim that an equivalent amount of interest is left out of account in computing its taxable profits.

Where an adjustment arises under paragraph 1 of Schedule 28AA of the Income and Corporation Taxes Act 1988, under paragraph 11A(2) of Schedule 9 to the Finance Act 1996 (as amended by clause 34(4) of the Finance Bill 2004) only exchange movements on the arm's length element of the borrowing will be taken into account for the purposes of the loan relationship legislation. (Where the entire loan would not have been made, under paragraph 11A(1), the whole of any exchange gains and losses arising on the loan relationship will be disregarded; it is considered that this situation would be unlikely in a matching context as typically the matching company would be able to offer the matched asset as security for the loan.) Subparagraphs 11A(1) and (2) only apply, however, to the extent that exchange gains and losses are brought into account for the purposes of the loan relationship legislation on the relevant debtor loan relationship. Where matching treatment applies exchange gains and losses are left out of account for the purposes of the loan relationships legislation. Instead such matched exchange gains and losses are brought into account for tax purposes when the underlying asset is disposed of. The effect, therefore, is that where the borrower could not have borrowed the full amount that it did borrow were it dealing at arm's-length, provided that matching treatment applies, no adjustment will arise under the provisions of paragraph 11A(1) or (2). So far so good.

The anomaly arises when one looks at the corresponding creditor loan relationship. Here, where the lender would not have lent the amount that it did, were it dealing with the borrower on arm's-length terms, only exchange gains and losses arising on the arm's length amount of the loan will be taken into account for tax purposes (paragraph 11A(5)). This particular provision does not apply where there is a corresponding debtor loan relationship and equal and opposite exchange movements arising on that debtor loan relationship are taken into account for the purposes of the loan relationship legislation, or would be so taken into account but for matching treatment. In the present case, however, a restriction would arise under the provisions of paragraph 11A(1) or (2) on the exchange gains and losses which are taken into account for the purposes of the loan relationships legislation on the corresponding debtor loan relationship, but for the fact that exchange gains and losses arising on that debtor loan relationship are left out of account under the matching provisions. Thus there is nothing to prevent a restriction from arising on the exchange movements which are taken into account on the creditor loan relationship and where the lender has borrowed externally in order to make the loan it will no longer have a perfect hedge for tax purposes against exchange movements on the external borrowing.

Furthermore, where a restriction arises on the exchange gains and losses which may be taken into account on a creditor loan relationship under the provisions of paragraph 11A(4) (which applies where no loan would have been made had the parties been dealing at arm's length) or (5) there is nothing which provides for there to be an equal but opposite adjustment to the amount of exchange gains and losses on the corresponding debtor loan relationship which are treated as matched. Thus the whole of such exchange gains and losses will still be brought into account under SI 2002/1970 (matching bringing into account regulations) when the matching company disposes of the relevant matched asset.

Let us now examine the position which would apply where the lender decides not to charge interest on the matching loan. In such cases an arm's-length rate of interest would be imputed on the creditor loan relationship, under paragraph 1 of Schedule 28AA to the Income and Corporation Taxes Act 1988, and such interest would be determined by reference to the

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amount which would have been lent had the two companies been dealing at arm's-length. In this case the debtor company would be able to claim tax relief for the interest which has been imputed on the lender in computing its taxable profits provided it makes a claim under the provisions of paragraph 6 of Schedule 28AA to the Income and Corporation Taxes Act 1988. Thus there would be no difference in the amount of interest payable on the loan relationship which is taken into account for tax purposes.

A significant difference, however, would arise as regards the provisions of paragraph 11A of Schedule 9 to the Finance Act 1996. In this case no adjustment would arise on the exchange gains and losses which would be taken into account, but for matching treatment, in computing the matching company's taxable profits. This is because paragraph 11A(2) (as amended by the Finance Bill 2004) only applies where an adjustment arises under paragraph 1 of Schedule 28AA to the Income and Corporation Taxes Act 1988. This particular provision in turn only applies to the advantaged company being, in this case, the lender whose profits are less as a result of the loan being advanced on interest-free terms. Thus, but for matching, there will be nothing to prevent the full amount of the exchange gains and losses arising to the matching company from being taken into account in computing its taxable profits. The result, therefore, is that the conditions in paragraph 11A(5)(c) would be satisfied (i.e. but for matching equal and opposite exchange movements would be taken into account for the purposes of the loan relationships legislation on the corresponding debtor loan relationship) and thus there would be no restriction on the amount of exchange gains and losses which would be taken into account in computing the lender's taxable profits.

The draft amendments to UK transfer pricing legislation were published following the pre-budget report. Representations submitted by various bodies made it clear that an amendment was necessary to paragraph 11A of Schedule 9 to the Finance Act 1996.

The draft commentary which the Inland Revenue have issued at the time of the budget on the new transfer pricing regime has a section dealing with intra-group matching loans. Anyone reading this might be left with the mistaken impression that the problem has been wholly resolved. Following publication of the Finance Bill 2004 the author has had correspondence with the Inland Revenue on this point. The Inland Revenue accept that the anomaly exists but it would appear that it is unlikely that the wording of paragraph 11A will be amended to rectify this anomaly.

Unless an amendment is introduced at either the committee or report stage of the Finance Bill 2004, groups of companies will need to give very careful thought as to whether to charge an arm's-length rate of interest on intra-group loans which are made to enable the borrower to obtain matching treatment. Except where the group is confident that the borrower could have borrowed the amount in question, were it dealing at arm's-length, it would be safer to make all such loans interest-free.

John Lindsay, Linnlaters

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Thin capitalisation and transfer pricing on loans, post 1 April 2004

The revision of the UK transfer pricing and thin capitalisation tax rules with effect from 1 April 2004 significantly changes the playing field for both intragroup lending and, in some cases, external borrowing. ***Gareth Green*** *of boutique firm, Transfer Pricing Solutions Ltd, considers the specific impact the new rules will have on loans.*

Few UK tax advisers can have missed the fact that the UK has, with effect from 1 April 2004, faced up to the fact that if it continued its former King Canute tactics it was going to drown in the tide of ECJ judgements about discriminatory European thin capitalisation and transfer pricing legislation. The UK transfer pricing rules, Schedule 28AA ICTA 1988 (for the sake of brevity, referred to henceforth as "28AA"), have been shorn of their former exemption for UK-UK transactions, and, after six years of acting as understudy to section 209(2)(da) ICTA 1988 ("209(2)(da)"), are to take on the full burden of countering thin capitalisation.

However, it would be wrong to assume that the only significant change is that transfer pricing and thin capitalisation principles now simply apply to loans between related UK companies, rather than just cross border loans. For those of us who deal with taxation of loans on a regular basis, the effects of the revisions are a little more far-reaching than might, at first sight, be expected. Some will be welcome, and some not. There have been a number of general reviews of the new legislation, in this journal and elsewhere, but the purpose of this article is to dig deeper into the implications for loans, especially on thin capitalisation.

In order to have space to do so, it will be necessary to dispense with explanation of basic points, such as the nature of the arm's length principle and the concept of thin capitalisation. However, it is perhaps worth reminding ourselves that loans are unusual in the context of transfer pricing in that, at least in the UK, there are two separate (though interrelated) issues to consider. As with any other kind of transaction, it is necessary to consider if the price meets the arm's length test. For loans, the 'price' is the interest rate. But it is also necessary to consider if the quantum of debt exceeds the arm's length level of debt.

This article is necessarily based on the assumption that there will be no amendments to relevant parts of the Finance Bill, before it receives Royal Assent.

Wider scope of 28AA vs 209(2)(da)

Ever since 28AA was introduced in 1998, the Inland Revenue has considered it to apply to thin capitalisation. However, it is probably true to say that 209(2)(da) remained their primary weapon, and in many cases although 28AA did apply it was superfluous.

There were, nevertheless, a number of loans which were clearly not caught by 209(2)(da) or where the Inland Revenue was in a very small minority who thought that 209(2)(da) applied. Although the wider scope of 28AA has been the case for the last six years, the repeal of 209(2)(da) is obviously a salient time to remind ourselves of the wide scope of 28AA. No doubt the Inland Revenue will be doing the same.

For instance, 209(2)(da) only applied to loans made by one company to another. In contrast, 28AA applies to loans to partnerships as well as to companies. And it applies to loans made by any related party, such as individuals, trusts and partnerships, not just companies. However, recent Inland Revenue guidance reveals that they only consider non-corporates to be caught when they are enterprises.

Another example is that 209(2)(da) only applied where the lender was a 75% parent of the borrower, or they had a 75% parent in common. 28AA catches loans where the control relationship is as low as 50% or, for certain joint ventures, 40%.

UK-UK exemption

The removal of the UK-UK exemption means that many more loans now need to be considered in the light of transfer pricing and thin capitalisation principles.

Until now, it was only overseas multinationals that had to worry about whether they had injected too much debt into their UK subsidiaries. Now, all kinds of UK multinationals need to apply thin capitalisation principles to loans within the UK part of their group, as do even UK groups that have no overseas subsidiaries. Even overseas multinationals face new challenges, where they have loans between two of their UK subsidiaries.

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Similarly, concerns about whether the interest rate is arm's length are no longer restricted to UK and overseas multinationals that have loans into and out of the UK. Multinationals and domestic groups now have to consider UK-UK intragroup loans.

Unfinished business?

Before leaving the UK-UK exemption, we note that there are other parts of section 209(2) which, puzzlingly, continue to be subject to section 212(1) ICTA 88, the UK-UK exemption that used to apply to Section 209(2)(da).

As most readers will be aware, strictly this provision makes no reference to residence. Rather, it exempts interest paid to a lender who is within the charge to UK corporation tax. But in practice this had the effect of exempting loans made by UK-resident lenders and catching virtually everything else. This none-too-subtle sleight of hand was intended to sidestep accusations of discrimination, but recent cases have made it clear that the ECJ insists on judging discrimination by its practical effect rather than being swayed by contrived wordplay.

Although the government has repealed the reference in Section 212(1) to Section 209(2)(da), it has left section 212(1) otherwise untouched, so it continues to provide a UK-UK exemption for interest caught by most of the subparagraphs of Section 209(2)(e). These cover interest on:

- loans issued by way of bonus,
- convertible debt,
- debt that is 'connected' with shares,
- equity notes.

There is no obvious reason to consider these exemptions to be any more ECJ-proof than section 209(2)(da) was. So, by leaving the exemptions in place the government has arguably left paragraphs (i), (ii), (vi) and (vii) of section 209(2)(e) with dubious efficiency.

Withholding tax

In practice, withholding tax on interest is unlikely to be a major concern in most cases, as the revised 28AA includes a new paragraph 6E, which gives the lender the right to make a claim that will remove the liability to withholding tax. This is in line with former practice of the Inland Revenue, who were usually content to have either a denial of an interest deduction or a withholding tax charge, but rarely insisted on a double hit.

It will continue to be necessary for overseas lenders to apply for advance clearance to pay interest gross, but the nature of the application will change. The applicant will be asking for the Inland Revenue to confirm their acceptance that the arm's length portion of the interest is protected by the Interest Article in the relevant double taxation agreement ("DTA") and that the non-arm's length portion is protected by paragraph 6E. Except in cases where the DTA allows a rate of withholding tax on 'good' interest of more than zero, it would seem unnecessary (for withholding tax purposes) to determine how much of the interest is non arm's length.

The Inland Revenue have not commented on whether they will continue to expect to review thin capitalisation at the time of the clearance application. Many taxpayers would prefer it to continue, so it gives an advance indication (though not a guarantee) as to the amount of interest that will be non-deductible for the borrower. However, it would seem that taxpayers would, if they wish, have good grounds to refuse to discuss thin capitalisation at the time of the clearance.

The new paragraph 6E makes life easier, because we would otherwise have had to reinterpret the relevant DTA, now that "thin cap" interest is not recharacterised as a distribution. The consequence of recharacterisation varied depending on the wording of the relevant DTA, but in many cases it meant that the taxation of the excess interest was governed by the Dividend Article, which usually allows/allowed no withholding tax, or a low rate of withholding.

In some cases, the repeal of 209(2)(da) means that the Interest Article will apply, but the Interest Article in many of the UK's DTAs includes a "special relationship clause" that has been specifically worded to disapply the Article in the case of thin capitalisation. The thin capitalisation interest might then be governed by the Other Income Article, which would often forbid any withholding at source. In other cases, the interest may simply be outside the scope of the DTA, which (were it not for paragraph 6E) would leave the interest subject to full UK withholding tax at 20%.

It is interesting to note that section 209(2)(d) (as opposed to (da)) will continue, as it always has, to recharacterise as a distribution any interest to the extent that the interest rate exceeds an arm's length rate. So, 28AA and section 209(2) will continue their double act in respect of such interest, and the Dividend Article will continue to apply. Section 209(2)(d) has always applied to UK-UK transactions, so is unlikely to be at risk from the ECJ. It was therefore unnecessary to repeal it,

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though it is a pity that we now have the complication of a different treatment for "thin cap" adjustments compared with "excessive interest rate" adjustments.

Although paragraph 6E means that the effect of the repeal of 209(2)(da) on DTA withholding tax is moot, there may be other issues where the repeal gives an unexpected result, due to the DTA having been worded to suit a world where 209(2)(da) applied.

Paragraph 1A

Up until now, 28AA made no specific reference to thin capitalisation, though it was worded as widely as possible, one of the aims of which was to ensure that it applied to thin capitalisation. This is one of the reasons 28AA speaks of arm's length "provisions", rather than arm's length prices. In contrast, 209(2)(da) specified at length how taxpayers were expected to apply thin capitalisation principles. With the demise of 209(2)(da), most, though not all, of these rules have been re-housed in a new paragraph 1A of 28AA.

The basic requirement to deny a deduction for non-arm's length interest continues to arise under paragraph 1, but paragraph 1A now specifies (some of) the factors we must consider in determining the arm's length interest. These factors are:

- whether the loan would have been made at all, were it not for the connection between the two related parties,
- the amount the loan would have been in the absence of that connection, and
- the rate of interest and other terms which would have been agreed at arm's length.

Arguably, this would more appropriately belong in a guidance note than in legislation. Paragraph 2 of 28AA says that the whole of 28AA is to be construed in such manner as best ensures consistency with the OECD transfer pricing guidelines. The fact that the government found it necessary to specify how we should apply the arm's length test to loans suggests that the interpretation they prefer is not necessarily consistent with the OECD guidelines. It seems clear that paragraph 1A of 28AA cannot override the OECD guidelines, so this paragraph is either superfluous (if it is consistent with the OECD guidelines) or invalid (if it is inconsistent).

Adding to the mystery, paragraph 1A applies only where the two related parties are both companies. Somewhat surprisingly, it would seem to follow that the government does not necessarily expect non-corporate lenders, such as individuals and partnerships, to take into account the matters set out in paragraph 1A. But if so, how else should the arm's length principle be applied to such loans? Surely it cannot be intended that overseas partnerships and individuals are allowed to thinly capitalise their UK subsidiaries and charge excessive rates of interest to them? Nor that UK partnerships and individuals are not required to charge interest on loans to their overseas subsidiaries?

Guaranteed loans

Many of the changes to 28AA are intended to deal with guaranteed loans. The starting point is paragraph 1A(4), which, according to the Inland Revenue guidance released a few days after the Finance Bill 2004, specifies that in considering the three factors described above, we are to disregard any guarantee or other comfort provided by another related company.

The aim is to ensure that the creditworthiness of the borrower is considered in isolation from the rest of the group, particularly in cases where the loan is ostensibly an arm's length loan because the lender is an independent bank. For instance, many multinationals have in place cross-guarantees whereby every group member guarantees the borrowings of every other member. This often enhances the creditworthiness of group members for potential lenders, but subparagraph 4 is intended to ensure that this is disregarded.

Other comfort

Recall, though, that, like any part of 28AA, this is only valid to the extent that it is consistent with the OECD guidelines. The Inland Revenue has long insisted on this interpretation, and would regard any alternative as heresy, but taxpayers should not necessarily feel obliged to concur, even though this interpretation has been incorporated in statute. There are arguments that a guarantee should instead be treated as one of the characteristics of the loan, which should be taken into account in determining the arm's length quantum and interest rate of the loan.

As already mentioned, if the Inland Revenue are to be believed, we must disregard not only guarantees but also any "other comfort" that an arm's length lender might draw from the rest of the group. Paragraph 1A(7) certainly defines "guarantee" extremely widely, to include any "relationship, arrangements, connection, or understanding (whether formal or informal) such that the person making the loan to the issuing company has

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a reasonable expectation that in the event of default by the issuing company he will be paid by, or out of the assets of, one or more companies". This reflects long-standing (but not previously statutory) Inland Revenue practice, which was to perceive a guarantee at the drop of a hat. Let us consider three examples:

1. It has been known for the IR to allege that the borrowing capacity of a company has been boosted by the mere acknowledgement, for audit purposes, by the borrower's parent company that a loan exists. Arguably, this is not sufficient in itself to create a reasonable expectation that the loan is effectively guaranteed by the parent. Nor is it clear that this would be in line with the principles in the OECD guidelines.
2. A bank might be influenced, in assessing a loan to a UK company, by the desire to win a much larger piece of business from the company's overseas parent. One suspects that the Inland Revenue would consider this to fall within the definition of guarantee, even if the parent has given no indication that the UK loan will improve the bank's prospects of winning any other business, nor has it given any suggestion that it would stand behind the loan. The better view is that this does not give rise to any enhanced expectation of repayment, so arguably there is no guarantee, and the influence should not be disregarded under OECD principles.
3. The creditworthiness of companies is sometimes enhanced by the credit markets' judgement that company X is so important a part of the supply chain of company Y, another independent (and highly creditworthy) company, that Y would step in, should X ever become insolvent. There are no legally enforceable obligations, yet this purely passive association can lead to the ratings agencies (such as Standard & Poors) giving X a credit rating several notches higher than it would otherwise get. Yet if X and Y were, say, subsidiary and parent, and Y provided no other support for X's borrowings, it seems likely that the Inland Revenue would, nevertheless, argue that the passive association represents a guarantee.

Although section 209(2)(8A) has largely been directly transplanted, there is one difference that may sometimes be helpful. Whereas we are now required to take no account of any guarantee, Section 209(2)(8A) used to require that no account be taken "of (or of any inference capable of being drawn from) any other relationship, arrangements or connection (whether formal or informal) between the issuing person" and any other connected person. The new narrower wording may mean we are now spared some of the more idiosyncratic positions previously adopted by the Inland Revenue.

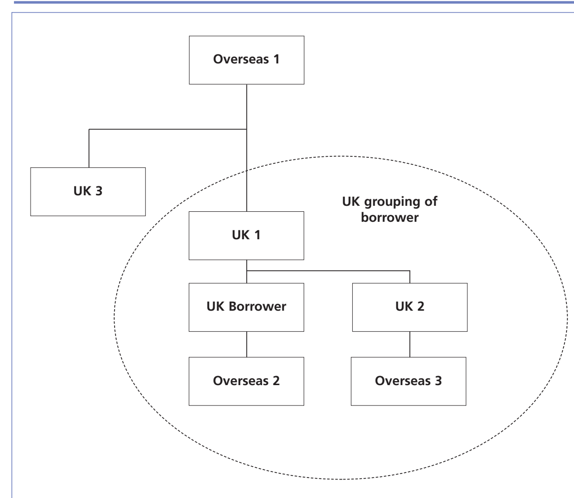
For instance, the writer has experienced a tax inspector asserting that although a UK company had sufficient income to service its interest commitments, this was only because its parent company did not require any dividends. The inspector argued that Section 209(2)(8A) required us to disregard the specific profit repatriation policies of the parent. It is difficult to see how this could be a guarantee, even on the most liberal application of the new definition.

One can foresee scope for almost endless potential argument on such points. Clearly it is intended that the mere lack of a formal written guarantee is not sufficient to mean that a loan from an independent bank must be on arm's length terms. Perhaps taxpayers should consider asking their banks to include in their loan agreements explicit acknowledgement that the bank has no expectation of support from anyone other than the borrower (or, in view of the next topic, other UK group members). This may not be conclusive, particularly if there is evidence to the contrary, but it may be of considerable help.

UK grouping

One welcome innovation is the effective retention and widening of the UK grouping rules. Section 209 included lengthy rules that specified which companies were exceptions to subparagraph 8A and therefore could be taken into account in assessing the creditworthiness of a UK borrower. The key effects of the UK grouping rules can best be summarised by Diagram A.

Diagram A



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The effect was that the creditworthiness of UK Borrower was assessed on the basis of the creditworthiness of the UK grouping as a whole.

There was consternation when it became clear that the UK grouping rules were not to be incorporated into 28AA. On first inspection it seemed that this meant that UK Borrower would be assessed on a standalone basis, without taking into account UK 1 & 2 and Overseas 2 & 3. However, since the Finance Bill was published the Inland Revenue has made it clear in draft guidance that a similar effect will be brought about by other means.

Firstly, the guidance clarifies that subsidiaries of the borrower (in the case above, this is Overseas 2) are taken into account because they represent assets of the borrower which would be taken into account by an unconnected lender. The guidance says that the practical effect will be to take into account the assets and liabilities of direct and indirect subsidiaries.

Secondly, they signal that they are willing to adopt a very liberal application of the compensating adjustment mechanism, which not only takes into account UK 1 & 2 and Overseas 3, but also UK 3. Previously, multinationals had to exclude from the UK grouping any UK companies if the only common parent with the borrower was overseas. They sometimes found themselves facing a disallowance of UK interest, despite the fact that if all their UK subsidiaries were taken into account they were not thinly capitalised in the UK. This was probably at risk of being found to be discriminatory, which is presumably why the grouping has now been widened.

However, it is important to note that the old mechanism has been replaced by something completely different. The old rules would have given the whole interest deduction to the borrower, whereas the compensating adjustment mechanism will potentially give the excess deduction to other members of the UK group.

Let's illustrate the way it is intended to work by reference to the above diagram. If UK Borrower has insufficient creditworthiness to support its debt (whether the lender is connected to it or not), even after taking into account the assets and liabilities of its subsidiary, Overseas 2, then UK Borrower's interest deduction will be reduced to the arm's length amount. But there will then be an opportunity for other related UK companies (in this case, UK 1, 2 & 3 and Overseas 3) to use the excess deductions, by making a claim that their own creditworthiness supports the debt. (Clearly, if they are themselves thinly capitalised then they will have no excess creditworthiness that would have allowed them to support UK Borrower's debt.) They are then given the deduction by way of a compensating adjustment for guarantors, under a new paragraph 6D of 28AA.

The Inland Revenue seem to have gone out of their way to be as helpful as possible, here. For instance, it seems to be unnecessary that the companies that claim the deduction have issued any guarantee. The very wide definition of guarantee from paragraph 1A has been imported into paragraph 6D, and it looks as though the Inland Revenue is prepared to deem there to have been a guarantee in almost any circumstance. To make sure, some groups may wish to put in place formal cross-guarantees between all UK members of the group.

Another helpful point is that the Inland Revenue guidance makes it clear that where there is more than one potential guarantor, the total compensating adjustment may be allocated between them in any reasonable manner. The guidance does say – not unreasonably – that the amount allocated to the guarantors cannot exceed the extra amount that would have been lent to the borrower as a result of their support alone. (And of course the amount allocated cannot exceed the total interest disallowed as a deduction for the borrower.) The guidance further states that it is not necessary to allocate any of the adjustment notionally to non-resident group companies that have (or might be deemed to have) provided a guarantee. Presumably the same would apply to a UK company that had insufficient profits to utilise the deemed deduction.

The current wording of the Finance Bill arguably needs some refinement in order more clearly to have the effect that is intended. Paragraph 6D only gives a compensating adjustment to the guarantor if deductions have been denied to the borrower "by virtue of paragraph 1B". The problem is that most of the denied deductions that one would hope would be available as compensating adjustment for guarantors appear to be denied by virtue of paragraphs 1 or 1A, not paragraph 1B. The latter paragraph merely requires that the following factors be taken into account:

- whether the guarantee would have been provided at all, were it not for the connection between the two related parties,
- the amount that would have been guaranteed in the absence of that connection, and
- the guarantee fee and other terms which would have been agreed at arm's length.

The explanatory notes to the Finance Bill say that paragraph 1B deals with the situation where a guarantee

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from a connected company results in excessive interest deduction. However, this situation is more obviously dealt with by paragraph 1A(4), rather than paragraph 1B. This seems to need a little tidying up.

Finally, there are further rules that allow (but do not require) the guarantor/s to make "balancing payments" to the borrower of up to the amount of the compensating adjustment. These payments are non-taxable and non-deductible. This allows the guarantor to 'pay' for what would otherwise be the windfall benefit of receiving a tax deduction without having borne the corresponding interest. If the balancing payment is equal to the full compensating adjustment, then it is as if the guarantor has assumed the interest burden. The group may, however, prefer to set the balancing payment at 30% of the compensating adjustment, in which case it is as if the guarantor has passed to the borrower the tax benefit of the windfall deduction.

Conclusion

No doubt more issues will become apparent as the new rules bed down. For now, it is hoped that this article is a useful examination of some of the key issues, as they relate to loans and thin capitalisation.

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Leasing's double benefits cancelled

*Amongst the 2004 budget press releases was the announcement of an anti avoidance measure targeting "double benefit leasing". **Richard Clarke** provides an examination of the principal changes, which took immediate effect from 17 March 2004; and the legislation that appeared in the Finance Bill on 8 April (clause 127 and Schedule 23).*

Timing

As readers will know, a far reaching consultative process on leasing taxation started in August 2003. The Chancellor's announcement in his budget speech that capital allowances will be retained, dealt with one important uncertainty but whether these will be available to the lessor or the lessee continues to be debated. Maximising the stimulus to the UK economy from the allowances and the contribution of an internationally competitive leasing industry relative to the tax costs is not a riddle with an easy answer!

It would no doubt have been attractive to make all the changes to leasing taxation together, after the consultative process was completed. Many who saw the prominent press coverage of a large double benefit leasing transaction in February 2004 thought that specifically targeted anti avoidance was inevitable. Its speedy appearance prevented an extended period of uncertainty.

What is double benefit leasing?

Double benefit leasing arises where the user of a piece of equipment obtains two tax deductions for the cost of an asset. One is in the form of relief for the rent paid under a hire contract, and the other as capital allowances as the asset's "owner". The legislation contemplates two scenarios where this occurs.

The first situation is sale and leaseback transactions within s221 Capital Allowance Act (CAA) 2001. This was originally enacted as s76A CAA 1990 in the summer of 1997. These provisions prevented an equipment user commercially transferring the value of its capital allowance (CA) pool by selling equipment at a high price to a lessor. This results in the sale proceeds reducing the user's CA pool and an increase in the lessor's CA pool by the same amount. The legislation capped the pool transfer at the tax written down value (TWDV) of the asset (on the assumption that the user had claimed all the available capital allowances). Accordingly from 1997 if the asset sale proceeds were greater than TWDV, the user received an untaxed payment that did not reduce the CA pool and continued to claim annual capital allowances based on the (relatively) higher pool value. Naturally the asset user paid a market rent to the lessor and claimed a tax deduction for this. In contrast, the lessor was taxed in full on the rental income with the deductions for capital allowances limited to the TWDV resulting in a high UK tax charge.

The second situation is lease and leaseback. Here the equipment user disposes of an economic interest in the asset by granting a lease at a premium. The user retains legal ownership of the asset and has a beneficial interest (being entitled to rent (if any) for the period of the lease and reacquiring unfettered control of the asset at the end of the lease). This is not viewed as a disposal for

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CA purposes and the user continues to claim the full amount of capital allowances. Although the lease premium will be a capital receipt it is unlikely to result in a taxable gain even after applying the rules for part disposals. The user then hires the asset under the leaseback contract claiming a full tax deduction for the rental expense. Again a UK based intermediate lessor is taxed in full on the leaseback rental income and has no offsetting entitlement to capital allowances.

Both scenarios result in a double benefit for the asset user offset by a high effective tax rate for a UK lessor. However if the lessor has losses or is not taxable in the UK, the symmetry is lost. Not surprisingly lease arrangers took this into account when identifying potential lessors.

Finance Bill 2004 – the basic scheme

The approach taken by the clauses in the finance bill is to eliminate the double benefit for the user by specifying that the rental deductions cannot exceed the "fair" tax amount. That is to say the rent which would have arisen if the asset had been sold at the value which is used for CAA purposes with the balance of any money received from the lessor treated as a loan at interest. (The legislation will be inserted at the end of the sale and leaseback rules in CAA 2001 rather than after the existing provisions dealing leaseback rentals, eg s782 Taxes Act 1988 - presumably because of the interaction with capital allowances.)

For lease and leaseback no value is included in the CA pool and only the interest element on the leaseback is allowed as a tax deductible expense with the balance of the rent (corresponding to the untaxed lease premium received) unrelieved. (Proposed section 228B(1) and (2) CAA as simplified by section 228F(2) CAA.) For sale and leaseback a deduction is obtained for the interest plus "depreciation" for the period which corresponds to an assumed asset cost equal to the TWDV included in the CA pool. Again the remainder of the rent (corresponding to the untaxed receipt on the original sale) is unrelieved. (Proposed section 228B(1) and (2) CAA.

In order to preserve overall symmetry, corresponding adjustments are made for the lessor, which is taxed in full on the interest but only on the proportion of the capital repayment element in the rent which corresponds to the amount on which capital allowances are claimed. (Proposed section 228D CAA as modified by section 228F(4) CAA in the case of lease and leaseback.)

Supplementary rules for different commercial outcomes

Many leasebacks are based on an assumption that the capital investment and the equipment value amortise to nil over the life of the contract. Where this is in fact the case no further adjustments are needed. However in practice the assumption may be invalid or the transaction may be terminated earlier than expected. Commercially this results in extra payments between the lessor and the user. The net effect of these corresponds to the difference between the lessor's current investment in the lease and the lessor's proceeds from disposing of the asset. In an actual transaction this may be documented in a variety of ways.

The new regime addresses this by taxing as income a termination amount based on the balance of the untaxed proceeds at the inception of the leaseback (the "Net Consideration") not already tax amortised by restricting the rental deduction (proposed section 228C). In order to ensure that the other elements are taxed as normal there is an explicit:

- relief for any actual termination payment by the lessee (proposed section 228B (3) and (4)) (although this is capped, this amount is higher than current book value and should generally give the user full relief for termination liabilities); and
- liability to tax on any refund of rentals received (proposed section 228C(5)).

> *Since the tax law is changing in favour of the lessor, any user of a leased back asset should review the lease documentation urgently*

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The lessor's normal reduction of rental income under the new regime applies to exclude from tax some or all of the capital element in any (gross) termination receipt (proposed section 228D(5)). The lessor also obtains relief for any rent refunded (eg. following the sale of the asset) up to a sum equal to the maximum amount of asset proceeds which can be taxed as income under the normal CA rules.

Transitional rules

To the extent that users were entitled to a double benefit up to 17 March 2004 that benefit is retained.

Schedule 23 to the Finance Bill achieves this for the asset user by comparing pre commencement rentals (rents paid prior to 17 March + arrears of rent related to previous periods + accrued rent at 17 March) with rental deductions already obtained. Any excess is deducted in 2004 or later years up to the amount that would have been relieved had the new regime not been introduced. Equivalent rules are applied to the lessor. Although the rules appear complex, in most situations their application should be straightforward and simply achieve the intuitively obvious cut off between the old and new tax regimes at 17 March 2004.

Restructuring

In addition to the basic rule, there is an additional transitional relief to facilitate the restructuring of a leaseback in place at 17 March 2004. It applies where the leaseback is:

- terminated early;
- the user of the asset acquires it within a month (either directly from the lessor or via a party connected with the user) at market value (or greater); and
- capital allowances are not fully available because they are restricted by reference to the tax written down value when the sale at the inception of the leaseback took place.

In these cases to the extent that the user cannot obtain capital allowances on the cost of the asset, the normal termination amount is not taxed unless the asset is disposed of within six years. If a disposal takes place prior to the sixth anniversary, only a proportion of the termination amount is taxed depending on the movements in value.

General comments

Where the user of the asset and the lessor are within the UK tax net both the old and the new rules create a symmetrical treatment. However from 17 March 2004, the lessor has a lower tax charge and the user reduced tax relief for rentals. Taxpayers entering in to leaseback transactions are likely to have appreciated that the double tax benefit was not intentional and therefore subject to a change of law risk. As such the leaseback documentation should have been drafted to achieve an appropriate balance between the party obtaining the economic value of the tax benefit and the tax risk.

Since the tax law is changing in favour of the lessor, any user of a leased back asset should review the lease documentation urgently. If the original tax benefit and tax risk was shared between the lessor and user, the contract may already include provisions for the rent to be varied. Alternatively the user may wish to approach the lessor and either negotiate a variation or terminate the lease taking advantage of the transitional restructuring provision.

There has been speculation that the tax rules would change ever since the sale and leaseback rules were enacted in 1997. Some may have hoped that existing leasebacks would be grandfathered but this became a remote possibility after press comments in February 2004. Although clearly the new rules will not be welcome to those benefiting from the previous regime, they should be relieved that only rents after 17 March are targeted and furthermore a transitional restructuring provision has been included.

The change of law in many cases will reduce the amounts of "double benefit" tax at stake on existing transactions. Nevertheless the Inland Revenue may still seek to challenge existing leasebacks where they were poorly implemented or did not fall fully within the previous tax legislation in Finance (No 2) Act 1997 or as rewritten in CAA 2001.

Finally it should be noted that changes may be made as the Finance Bill progresses through Parliament. The Government is aware that the new regime took effect on 17 March and any alterations are likely to be on points of detail only. However transactions of this type are generally of quite long duration and the general review of leasing taxation may result in further reforms impacting the taxation of leasebacks in due course.

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The Tax Roller Coaster Part 4: Conclusion

*This is the fourth in a series of four articles by **Nicholas Noble** of Field Fisher Waterhouse. The first article looked at sudden and arbitrary changes in tax legislation and arbitrary effects of tax legislation. The second article examined ambiguities in tax legislation. The third article considered the fact that tax legislation changes its meaning over time. This article seeks to conclude the series with three comments.*

The first comment

My first comment is that the UK tax system is truly awful in its complexity. I hope that the preceding three articles make this clear.

A level of scholarship is required to understand many key tax issues that is completely unacceptable both to taxpayers and everyone else involved in administering the UK tax system.

It is then a typically British (and human) reaction that, faced with this complexity, rather than attempt to find the root causes for this complexity and seek to remedy them, legislators set out on the herculean task of rewriting the tax legislation as it stands.

This is done with the best of intentions but, in the short to medium term, it can only add to the complexity because it immediately doubles the tax legislation which any taxpayer or his adviser has to understand. He or she has to read the original legislation and then has to read the new legislation and ascertain whether the new legislation means the same thing as the old legislation and, if it does not, whether this is an intended effect or not. Therefore the initiative which sets out with good intentions to ease the unnecessary burden of the UK tax system ends up, at the expense of a huge amount of effort, in doing the opposite, at least in the short to medium term. Even when written in crystal clear English, tax law remains fragmented, multi-layered and subject to change on a daily basis. It remains truly awful in its complexity.

The second comment

In the face of this awful complexity, the factors which make the system work are the truly outstanding quality of individuals in the professions and at the Inland Revenue who make it possible for the taxpayer to find his way through the jungle, and the outstanding quality of the judiciary which on the whole, and in the end, reach the "right" decisions.

There are many outstanding individuals one could select, but to commence my name and praise campaign I would refer to Adrian West, the Inland Revenue expert on the enterprise investment scheme, and Graham Turner the Inland Revenue expert on funds. They are named because they have, in one case retired, and in the other case moved on to another seat, and so are less likely to be embarrassed by this praise. They are just examples out of many and it is vital that this professionalism of the Inland Revenue is manitained with suffiicient specialist staff.

The courts are largely a back stop in the operation of any tax system. It is therefore really the ability of the professions, whether accountants, barristers or solicitors, in giving reasonably definite opinions on the legislation and the willingness of the Inland Revenue in giving reasonably definite guidance on that legislation that enables the system to work. It should be noted that this is a difficult task. I hope this statement can be evidenced as follows. By definition, members of the judiciary must represent individuals who are among the best of the best legal minds at any point in time. At the same time, it is clear that the courts regularly reach "wrong" decisions on the law without this being regarded in any way as strange and, in fact, with this being regarded as entirely normal.

This is not criticism because we, observers of the tax system, know how truly awful it is and are not in the least surprised that there are two or more alternative interpretations which can be made in respect of any legislation, and nor that there should be a potential difference of opinion before the final "right" view of the law is reached.

In comparison, professionals, who almost by definition, must be less than the best of the best on a general basis, are required regularly to be right and in addition, if they are not, they suffer the financial penalties for being negligent. This must be right because otherwise the system could not operate. We are so used to this process that it seems entirely beyond comment that a judge can reach a "wrong" view of the law and that this is only to be expected but that, on the whole, a professional cannot do so and if he does, he is negligent with all the expected financial consequences.

This is all strange but it is part of life. Opinions have to be right in order to enable taxpayers to operate in spite of the complexity of the UK tax system. It is interesting then

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in this context to review the High Court and Court of Appeal decisions in *Grimm v Newman and Another* ([2002] STC 84 and [2002] STC 1388). These cases considered whether or not a professional was negligent in respect of certain advice. One can imagine at least two tests for whether or not such advice is negligent:

- One test is that advice is negligent if it is wrong.
- It would be plausible to argue that advice was not negligent if it was the standard of advice that a court could have accepted. Therefore, to take an extreme example, if advice was given and, on appeal, at least one court thought that the advice was correct, that advice could not be negligent even if the decision of the ultimate court was that the advice was incorrect. This returns to the issue that there should not be a higher standard of care imposed on a professional than on a member of the judiciary. However "fair" or not this plausible approach might be, it cannot be accepted, since it would mean that advice could not be relied on to a sufficient extent.

Firstly he agreed that it was not necessary to decide whether or not the advice was correct and secondly he agreed that there was negligence because there was a significant likelihood that the Inland Revenue would claim tax and would succeed. In particular:

> *"… Mr Grimm's case did not depend simply on the contention that Mr Newman's advice was wrong in law. The alternative contention was that, whatever the courts might ultimately have held to be the correct position in law, there was a significant likelihood that the Inland Revenue would claim tax, and would succeed. Implicit in that, as I read it, is the allegation that Mr Newman should have been aware of that risk, and taken it into account in his advice to his client. That alternative formulation expresses the practical reality that, whatever the position in strict law, most people prefer to avoid a battle through the courts with the Revenue; and they expect their tax advisers to take reasonable steps to protect them from such an outcome."*

It is only clear in Sir Andrew Morritt V-C's judgement in the Court of Appeal that advice can only be

Correct advice could be negligent if it was the kind of advice which was likely to be challenged by the Inland Revenue and with a significant chance of success

Grimm v Newman raises a third potential test for determining negligence:

- The High Court decision found negligence existed on the following grounds without determining whether or not the advice was correct:

> *"In my judgement, a reasonably skilful and careful accountant tax adviser, with the same specialism as the first defendant, would have recognised in 1991 that a scheme, by which assets representing income were paid to the taxpayer's wife and applied by her in the purchase of property jointly acquired with the taxpayer and intended be occupied by them, ran a high risk of being challenged by the Revenue and stood a significant prospect of giving rise to a charge to tax on a constructive remittance by the taxpayer."*

Carnwath LJ in the Court of Appeal decision in *Grimm v Newman* agreed with the High Court on the third test.

negligent if it is incorrect (ie. it is not possible or at least more difficult for advisers to be negligent if the advice is correct). Therefore, although the final decision was that correct advice was not negligent, the issue was and is to some extent still in the balance because at least two out of the four judges in the High Court and the Court of Appeal held that correct advice could be negligent if it was the kind of advice which was likely to be challenged by the Inland Revenue and with a significant chance of success.

It is the judicial view that advice can be negligent even if correct if it is the kind of advice which the Revenue are likely to challenge and with a significant chance of success which is fascinating. It is easy to understand why there is such a difference of view on such a basic point. The Carnwath LJ view is:

> *"The issue is not whether the advice would ultimately have been upheld, because that is not what happened. The issue*

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is whether a reasonably skilful adviser, in Mr Newman's position, should have recognised the risk of what in fact occurred, and have advised his client accordingly."

The Sir Andrew Morritt V-C view is almost the opposite:

"Nevertheless it is not possible to avoid a decision on whether or not the advice from Mr Newman was correct in law for that was and is precisely the issue between the parties. Further if the accuracy of the alternative scheme is relevant, which it is, then a decision on the soundness, as a matter of law, of the original advice is necessary too."

Depending upon which view is adopted, it leads to complete difference in the nature of tax advice. It is considered that the view of Sir Andrew Morritt V-C has to be the correct one.

Firstly, if advice can be negligent because the advice given is liable to be challenged by the Inland Revenue and the Inland Revenue had a significant chance of success, this would gain taxpayers nothing. Every tax opinion would immediately be qualified to state that the Inland Revenue may challenge the advice given and may have a significant chance of success perhaps with the effect that the tax advice could never be negligent.

Therefore, that (i.e. the ability to rely on professional opinions) which is currently the only thing sustaining business operations in the awful complexity of the UK tax world would immediately be taken away. In addition, it should be noted that the division of the Inland Revenue which investigated Mr Grimm was the Special Compliance Office. If other practitioners experience is like the author's, there are few things which the Special Office will not challenge.

By way of example, in a recent case where the Special Office obtained a Section 20BA TMA 1970 notice against the author in order to obtain a file and where the author and his client particularly wanted to hand over the file, the Special Office charged the author with contempt of court. What had happened was that the order obtained by the Special Office was defective so that the author had been unable to hand over all his file. The author actually suggested how the order could be reworded so that all the file could be handed over and in the meantime handed over that section of the file covered by the existing order.

The Special Office immediately alleged contempt of court because part of the file was not handed over and it had to be pointed out to them that that was the part of the file not covered by the existing order and could they please amend the order as requested. This good natured badinage, in the author's experience, is not abnormal when dealing with the Special Office, and so to make the likelihood of challenge by the Special Office, one half of a test of negligence is absurd. The other half of this test is the significant likelihood of success.

This half, if this test were applicable, would make life even more difficult. What percentage likelihood of success makes it a significant chance of success? Perhaps it is easiest to deal with this by sleight of hand. We can look at what the Inland Revenue says about when it will claim tax. Both Code of Practice 11 (Enquiries into tax returns by Local Tax Offices) and Code of Practice 14 (Enquiries into company tax returns) contain the legend:

"We want you/companies to pay the right amount of tax: no more, no less. We will do everything we reasonably can to help you make sure that this happens."

This legend is to some extent stating the obvious of what should be the case. On this basis, the Inland Revenue would never claim tax in any circumstances if it did not think that it had a significant chance of success.

The third comment.

The final comment is that all tax advisers are aware of four golden rules in giving tax advice. These are:

- Never backdate documents;
- never destroy engrossed documents;
- always make all material disclosure; and
- always tell the truth.

The first three rules are probably variations of the last. A euphemism can be the most dangerous breach of the final rule because it easily disguises a lie. If someone says that they have been economical with the truth and this, of course, has been frequently said, the comment can appear acceptable but it remains the fact that the full truth has not been told. In this context, one can refer as a starting point to the comment of Lord Diplock in *Fothergill v. Monarch Airlines Ltd* ([1981] AC 251 at 279).

"The constitutional functions performed by courts of justice as interpreters of the written law laid down in Acts of Parliament is often described as ascertaining 'the intention of Parliament'; but what this metaphor, though convenient, omits to take into account is that the court, when acting in its interpretative role, as well as when it is engaged in reviewing the legality of the administrative action, is doing so as mediator between the state in the exercise of its legislative power and the private citizen

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for whom the law made by Parliament constitutes a rule binding upon him and enforceable by the executive power of the state. Elementary justice or … the need for legal certainty demands that the rules by which the citizen is to be bound should be ascertainable by him (or, more realistically, by a competent lawyer advising him) by reference to identifiable sources that are publicly accessible."

What at first sight is alarming about the metaphor "the intention of Parliament" is that it is a euphemism. One thing of which the author is certain is that Parliament understands the present UK tax system and, if it does not understand it, it cannot have intended it. It may be that the UK tax system is out of control in that it is made up of so many parts that no one controls it. By way of example, did anyone in the UK ever intend for European law to override UK domestic tax law in the way in which this has happened?

There was and is an analogy to a similar issue in literary criticism. The Romantic school of literary criticism which assessed literature on its imagination and originality became caught up with determining the intentions of the author.

Therefore the criticism of a piece of literature which was valued for its imagination and originality involved the examination of the author's intention from which the imagination and originality emanated. It was only in the twentieth century with, for example, "The Verbal Icon" by Wimsatt and others that this reference to the intention of the author became known as "the intentional fallacy" and references to the intentions of authors were abandoned. It was recognised that it was hopeless, in the case of literature, to refer to the intentions of an author because this was a bottomless pit. The author, for all the literary critic may know, may want to lie.

Therefore it became the orthodoxy for literary criticism to assess a piece of literature by reference to the literature alone without reference to the intentions of the author. It is therefore interesting to note that the courts before *Pepper v Hart* ([1992] STC 898) had adopted almost the same position as twentieth century literary critics although using a different form of words.

Literary critics cut the ties with the author's intentions concentrating on the literature alone and expressed any reference to the author's intentions as the intentional fallacy. The courts concentrated on the words of legislation alone but described this exercise as interpreting the intention of Parliament as expressed in the words it used. *Pepper v Hart* has of course relaxed the above approach where:

- Legislation is ambiguous or obscure or leads to absurdity;
- The material relied on consists of one or more statements by a minister or other promoter of the Bill together if necessary with such other Parliamentary material as is necessary to understand such statements and their effects; and
- The statements relied on are clear.

The author remains sure however that the metaphor that the courts are interpreting the intention of Parliament in literal terms is a euphemism. However, the law is different from literature.

Therefore the reference to the intention of Parliament by the courts is the expression of the ideal of Parliamentary democracy which, while it continues, is the only source of validity for taxation. Therefore the fault is not with the courts for retaining the ideal but with Parliament for failing to live up to it.

Conclusion

In conclusion, what is the best way out of the mess? Oddly the first step in the right direction has started to be taken in the form of Clauses 290 to 302 Finance Bill 2004 although not in their present form.

The fact that, subject to regulations, a promoter has to notify arrangements within a prescribed period from the date on which the promoter "first becomes aware of any transaction forming part of the proposed arrangements" is far too onerous and ineffective. A promoter who has an idea in the bath becomes immediately locked into the notification process.

It also decelerates the application of Clauses 290 to 302 because, provided that the promoter was aware of a transaction forming part of the proposed arrangements before 18 March 2004, there is no need for notification.

Therefore the present stock of tax plans remains outside the scope of notification. Clauses 290 to 302 Finance Bill in a sensible form would however represent a first step in the right direction. The writer, in his next ten years of practice, looks forward to seeing these objectives achieved.

The remaining steps to a solution are a Parliament or a committee of Parliament which does intend what it legislates, a reasonable amount of stability in legislation over a reasonable period of time and probably five to ten years hard work with no glory. They should enable there to be greater stability in tax law with less need for tinkering.

Nicholas Noble, Field Fisher Waterhouse

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Printed by Riverside Press
ISSN 1361-3472
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