Substance and Form in Practice in the UK

Nikhil V Mehta
Gray's Inn Tax Chambers
nm@taxbar.com
Introduction

- The UK has no general doctrine of substance over form in the tax system

- However, the same effect is achieved by other means in some areas

- There is no "sham" doctrine
UK's Approach to Substance Over Form

• The Courts' approach to tax avoidance has sometimes come close to a substance over form approach, without actually being that

• In current legislation, there are areas where the doctrine has effectively been incorporated

• The new GAAR, which will be introduced from April 2013, will bring the UK closer
Courts

• The *Duke of Westminster's Case*, decided in 1936 by the House of Lords, remains the key authority for rejecting substance

• Nearly 50 years later, we had the equally famous decision in *Ramsay*

• The *Ramsay Principle* has evolved from where it began so that there is, arguably, an old *Ramsay Principle* and a new *Ramsay Principle*
Duke of Westminster

- Covenanted payments in lieu of wages
- In substance, salary
- In form, annuities
  - Form won!
"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable."
Old Ramsay: Lord Wilberforce

• "[Westminster] is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form."
A Slight Diversion: McDowell

In 1985, the Supreme Court applied the Ramsay Principle in India in the McDowell decision. Chinnappa ReddyJ said:
"We think that the time has come for us to depart from the Westminster principle as emphatically as the British courts have done...

In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal ana not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."
New Ramsay

- Arrowtown
- Barclays Mercantile v Mawson
"The driving principle in the Ramsay line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."
Barclays Mercantile: Lord Nicholls of Birkenhead

• "The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction {which might involve considering the overall effect of a number of elements intended to operate together} answered to the statutory description."
Summary of Courts’ Approach Today

- *Westminster* remains good law: the substance of a transaction embodied in a written instrument is to be found by construing the document as a whole.
- *Ramsay* is a rule of statutory construction prescribing a purposive approach (and nothing wider regarding tax avoidance).
- The purposive approach enables the Court to identify the transaction intended to be affected and then to look at the particular facts in the round to see if they fit.
Current Legislation: Principles Based

- Financial products and disguised interest

  - Amount economically equivalent to interest taxed as interest

  - Section 486A et seq. CTA 2009
Current Legislation: Changing the Tax Result

- Repos: sale and repurchase of securities equates, in substance, to a loan at interest

- Shares accounted for as liabilities: S. 521A et seq. CTA 2009

- Disguised Remuneration: taxation of distributions (loans in particular) to employees from employee benefits trusts
The Proposed GAAR

Tax arrangements are nabusiven if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances including:

(a) the relevant tax provisions,
(b) the *substantive results of the arrangements*, and
(c) any other arrangements of which the arrangements form part.

- Counteraction on a just and reasonable basis.
Transactional Implications

- Documentation
- Witnesses (both lay and expert)
- Accounting treatment
- Implementation
Conclusion

In practice:
there is no doctrine of substance over form in the UK, but the best position is if the two coincide in any given set of facts. If they don't, there has to be a good reason beyond the avoidance of tax to justify the divergence. Otherwise, there are several ways in which the transaction may be impugned.
THANK YOU

FIT CONFERENCE —2012