

# Closing 'the Tax Gap'

## Thoughts from a disputes specialist

**B**efore I start, let me come out and declare an interest. In any debate on law reform or behaviour change, I will always be in favour of the approach that does most to minimise unnecessary disputes between taxpayers and HMRC. This means that what I say here is directed towards that goal. Disputes arise frequently enough. It is in no-one's interest to create more.

Experience tells us that there are a few groups of situations in which disputes frequently arise. One group is where – however strong the taxpayer's technical position – HMRC is unable to accept it from a political perspective. There are then three main sub-groups: issues where HMRC has a tenable case and the tax at stake is so great that it feels unable to concede or settle without having really tested the taxpayer's position; arguments that the UK legislation does not operate in accordance with its own terms because of EU law; and actual or perceived avoidance. It is this last category that the *Guardian's* 'Tax Gap' series focused on. Leaving aside the questions of morality, the simple truth is that if we can reduce actual or perceived avoidance, we can reduce disputes. This article explores one feature of the UK system which actively incentivises behaviour that the *Guardian* considers to be avoidance, and argues that 'avoidance' of that sort, and so disputes, can only be reduced if such features are eliminated. Reducing disputes is a good thing on many levels but one very practical point is that, in my personal experience, HMRC's dispute resolution teams risk becoming too stretched to allow for disputes to be adequately resolved. I return to this point in the final paragraphs.

### Avoidance

There has been extensive debate on 'the Tax Gap' and whether it is a legitimate concept. I am going to steer clear of that. I will only say that in my view, the Tax Gap, if it exists, does not extend to matters such as 'debatable allowances'.

*Rupert Shiers, of the Tax Disputes and Investigations team at McGrigors, adds his thoughts to the continuing debate on the 'whys and wherefores' of tax avoidance*

Where a taxpayer's normal business affairs possibly trigger a tax relief, if the taxpayer believes – after any advice – to a 51% standard that those affairs create a right to an allowance, the taxpayer is entitled to claim it. If the taxpayer claims the allowance without that 51% belief, that may be evasion. But otherwise, it is quite absurd to describe a successful claim for those allowances as part of a Tax Gap.

There is no debate on the existence of tax avoidance. There is also no debate, I think, that the prevalence of tax avoidance is triggered by presence or absence of incentives: a sense of unfairness about a tax charge, the availability of pre-packaged artificial schemes, or the presence of a hard-edged boundary in the system where there is a real prospect of crossing from one side to the other without too much trouble. Any one of these will prompt taxpayers to think about avoiding the tax. It is only human to do so. This has all been thrown into sharp relief by the drive for short-term shareholder value (and the equivalent approach for individuals) in the early years of the decade. But the incentives have been there for many years before that.

In this context, perhaps the most effective part of the DoTAS regime as a tool against avoidance has been to change the system which ensured the availability of artificial structures. The incentive to pursue short-term shareholder value at all costs may also be changing, partly as a result of the current climate and partly – for large corporates – because of the way HMRC has approached the 'new relationship'. There remains much that can be said about artificial structures: the role for a 'purpose' test, the need for a GANTIP, and even the question of

whether there are unused tools available to HMRC which could help it produce the 'right' result. But the rest of this piece will focus on the presence of hard boundaries that can be easily crossed. This is really a question, not so much about morality but about whether the tax system is fit for purpose. Boundaries of this sort play a large part in creating what the *Guardian* considers to be avoidance.

### Hard boundaries

The incentive for avoidance created by a hard boundary is simple. Where there is an obvious boundary, a perimeter fence, and one that can be easily scaled, people will try to escape to the greener grass on the other side. The – actual or perceived – ability to escape from one regime to a more benign one will appeal to taxpayers for as long as human nature remains unchanged.

Any tax code is full of 'hard' boundaries, where tax applies differently on the two sides of the boundary: capital/revenue, dividends/interest, resident/non-resident. In a domestic situation, there are typically two ways to disincentivise taxpayers from trying to escape from one side to the other. The first is to make sure that the grass is not greener. When Nigel Lawson equalised the rates of tax applicable to income and capital gains, for the first time in 200 years, for many there was suddenly no incentive to turn income into capital. This was a masterstroke. But that approach is not always possible. The other approach which runs through the tax code is to patrol the boundaries vigorously, sometimes very vigorously indeed.

This is the approach that has been taken – for instance – to the boundary between interest and dividends (and, for some financial transactions, also to interest and

capital gains). Until recently this was also the approach taken in many cross-border situations, but the impact of EC law has been such that it is becoming increasingly difficult for HMRC to do this. The CFC regime and exit charges look close to falling, and if TCGA 1992, s 171 is extended to apply to EU-resident companies, it will become extremely difficult for HMRC to ensure that any corporate capital gains are subject to UK tax.

This means, once again, that there is a hard boundary which can easily be crossed. HMRC, and the *Guardian*, say that there is nothing to be done other than change taxpayer behaviour. Taxpayer behaviour is clearly important. But there is also a crucial role for examining the boundary that taxpayers are flooding across.

### Moving the fence

In a situation like this, to minimise disputes, HMRC must look more closely at whether the boundary is drawn in the right place. I will continue here by examining a single example: corporate residence.

Much of the *Guardian's* series related to profits which were taxed (or not taxed) offshore when – so the *Guardian* would have us believe – everyone knew perfectly well that they 'should have been' taxed in the UK. At a very high level there is some attraction to this approach. But based on the law as it stands today, there is no way for those profits to be taxed here. For those profits to stay 'onshore', the law on which jurisdiction is entitled to tax profits would have to undergo a major overhaul. And while the old rules remain in force, companies will act in accordance with the incentives that those old rules set.

The law on corporate residence is very old. It was developed in Empire days, by the courts, against a background where residence disputes were over whether colonial enterprises could still be taxed in the UK. The intellectual foundations were laid long before the invention of the commercial aeroplane, modern management structures, email, fax, telex, mobile phones or conference calls. The law is vastly outdated today. The residence of a corporate is now almost entirely elective and the tax benefits that can be achieved by moving residence of a company are often disproportionate to the work that has to be done to make that move. If there is a low, unpatrolled, fence with significant benefits on the other side, HMRC cannot be altogether surprised that people try to jump over.

Because we cannot control the quality of the grass on the other side of the fence, and EU jurisprudence prevents the fence



Rupert Shiers

from being patrolled in the way that it might otherwise like, HMRC feels boxed in. I want to say that a solution remains: to move the fence. The law on residence is ripe for review. In today's world, linking taxability to the location of board meetings is anachronistic at best. Particularly for SPVs, there is a coherent view that residence is too easily manipulated.

I cannot propose a complete solution here. One approach would be to retain residence as the connecting factor but establish a much more substance-based approach, possibly relating to how and where the business is actually run on a day-to-day basis. This might demand renegotiation of tax treaties, risks creating substantial uncertainty, and might require an advance multilateral ruling system. Even such a 'day-to-day management' approach could struggle to be meaningful for a truly multinational company, a pure holding company, or one with various different lines of business which are managed independently. This might mean, instead, that it is time to completely change the way in which corporate profits are connected to a particular tax system, abandoning residence and adopting across the board a new model 'source' doctrine. There are problems with reforming things in this way but while the rules remain as they are, the UK (in common with many other jurisdictions) has an obvious, crucially important, unpatrolled, hard boundary in its system: one with significant benefits on the other side and which can be easily jumped.

Corporate residence is just an example. The points here would apply to any similar rule. A rule with these features actively encourages people to jump the fence. And because the fence is

so low, and the grass on the other side so much greener, HMRC then comes under political pressure to challenge whether the jump has been made successfully. The *Guardian* says that the tax at stake in these challenges is part of the Tax Gap. I am not sure that is right. But a low fence of this sort always produces undesirable disputes.

### Conclusion

Given human nature, obvious opportunities will always be exploited. The *Guardian* is probably right that some people's view is that the use of low-tax jurisdictions by corporates 'feels' wrong. But this is behaviour which has been created – at least in part – by residence rules which operate in an extremely formal way. Disputes will continue to arise whenever legislation leaves a gate wide open but HMRC feels politically obliged to slam it on anyone who walks through. Neither HMRC nor the *Guardian* can reasonably argue that taxpayer behaviour is 'naughty', 'evil', or 'wrong' if it simply responds to long-standing, well-recognised structural features of the system.

### Resourcing

I want to finish by coming back to the other point I made at the start. In my view, in the medium term HMRC could significantly reduce the number and length of disputes by increasing the resource it makes available to deal with contested issues. There is increasing evidence from the progress of contentious issues that HMRC's resources are over-stretched. This applies both to the central technical teams and the disputes teams themselves. This overstretching allows taxpayers to take substantial tactical advantages in issues and disputes by controlling the pace of progress and development of the issue.

But, unfortunately, delays and lack of consistent responsiveness from HMRC actually create ill-will on the taxpayer side. In my recent experience, they prompt a desire to take a hard line in the dispute itself, a sense of being 'let down', and even an increased appetite for planning in the future. If the Tax Gap is a genuine concept, HMRC's approach to resourcing and resolving disputes risks – unintentionally – deepening the gap and even causing the edges to crumble away.

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Rupert Shiers is a Partner at McGrigors. He can be contacted on 020 7054 2737 or at [rupert.shiers@mcgrigors.com](mailto:rupert.shiers@mcgrigors.com).