EVEN WITH THE BEST OF MOTIVES: TAX AVOIDANCE AND THE MOTIVE DEFENCE

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5th December this year marks the fifth anniversary of the amendment to the so called “motive defence”, a non tax avoidance defence to liabilities under the transfer of asset abroad provisions, now under sections 720 to 735 ITA 2007. HMRC promised that the new rules would merely “clarify how key elements of the legislation are intended to apply and ensure it works effectively”.[2] In reality however, HMRC used the amendments to introduce a stricter regime for operations after 5th December 2005 while retaining the previous rules for pre-5th December 2005 operations.

The first tranche of cases under the new rules are now presumably working their way to the courts. In the meantime, the case of *Burns v HMRC*[3] has furthered our understanding of the old rules, and of how the old and new rules may differ. This is one of only a handful of cases to consider the motive defence in detail. This article looks in depth at the decision in *Burns v HMRC* and asks what lessons practitioners can learn from it.

The transfer of assets abroad provisions

Before introducing the facts of *Burns v HMRC*, it is worth briefly outlining the scope of the transfer of assets abroad provisions as they now stand.

Broadly, sections 720 to 730 provide for situations where an ordinary UK resident individual would otherwise avoid income tax by means of a transfer of

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2 HMRC explanatory memorandum dated 5th December 2005

3 Burns & Neil v Commissioners for Revenue and Customs (2009) SpC 728

assets, as a result of which, alone or with any associated operations, income becomes payable to persons resident or domiciled outside the UK. Where as a result of that transfer or associated operations the ordinary UK resident individual has power to enjoy any income of such persons, that income is chargeable to income tax as if received by the individual in the UK.

Sections 731 to 735 provide for such transfers or associated operations where the UK resident individual is not a transferor (for example beneficiaries of a non-resident trust). The individual is chargeable to income tax on the benefit, to the extent that it can be franked by the amount of income arising to the non-resident.

The motive defence is an important check on this transfer of assets regime. As discussed, the defence operates under two similar but distinct sets of rules; for pre-5th December 2005 transactions (the “Pre-2005 Rules”) and post 4th-December 2005 transactions (the “Post-2005 Rules”). There are also specific provisions where relevant transactions span the 5th December 2005 division.[4]

The onus is on the taxpayer to show that their situation falls within either of two conditions: Condition A or Condition B. If he discharges this obligation, none of sections 720 to 735 ITA 2007 can render the relevant income taxable as his. Under the Pre-2005 Rules, Conditions A and B are:

- Condition A: that the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

- Condition B: that the transfer and any associated operations were (a) genuine commercial transactions, and (2) were not designed for the purpose of avoiding liability to taxation.[5]

The Post-2005 Rules expands on these definitions as follows:

- Condition A: it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

- Condition B: (a) all the relevant transactions were genuine commercial transactions and (b) it would not be reasonable to draw the conclusion,

4 Section 740 ITA 2007

5 Section 739 ITA 2007

> from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.[6]

Burns v HMRC

The Burns v HMRC case involved a family which had moved to Jersey and, in particular, the two daughters of the family, who, when they were aged 18, transferred two income producing UK properties into Jersey companies owned by them.

At the time of the transfers both girls were Jersey resident and domiciled. Both loved horses and indeed at least one of them had ambitions to represent Great Britain at the Olympics. The girls' horse riding ambitions required that they spend increasing periods of time in the UK competing and within six years of the first transfer they were both UK tax resident.

The two tax advantages allegedly sought to be achieved by the transactions were:

- A limitation of the UK charge to income tax. The girls would have been subject to the higher rate income tax rate, whereas the non-resident company was subject to a lower rate of taxation. The Special Commission accepted that it was Revenue practice not to pursue non-UK resident individuals for higher rate income tax. However, once the girls become UK tax resident (which HMRC argued was foreseeable at the time of the transfers) no such concession could be expected.

- The capital transfer tax advantage of ensuring that the girls directly owned assets with a foreign situs (shares in a Jersey company) rather than UK situs real property. The same principle would now also apply to Inheritance tax.

The transactions were arranged by the girls' parents. Their mother contended that the main purpose of the transfers was to divorce ownership of the properties (which remained with her daughters) from management; with responsibility for the management of the properties in the hands of the parents who were the directors of both companies. She also claimed that the transfers were intended to protect her daughters' property interests from unsuitable boyfriends.

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6 Section 737 ITA 2007

The girls further explained that they had no interest in business or finance and went so far as to say that as long as ‘we had enough money to look after our horses and do what was important to us; we didn’t particularly want to know what was going on’.[7] Their primary defence, in effect, was that they had no purpose at all in effecting the transactions and so tax avoidance cannot have been a purpose.

The girls claimed the benefit of Condition A (as they had no purpose in effecting the transactions) and Condition B (as, even if there were some tax avoidance purpose in effecting the transactions, the main purpose was to divorce ownership from management, which qualified the transactions as having a commercial purpose) of the motive defence, which was at the time of the transfers contained in section 741 TA 1988.

Is the motive defence subjective?

HMRC has consistently disputed whether, under the Pre-2005 Rules, the “purpose” of the transactions should be judged subjectively.

HMRC set out their view in Tax Bulletin 40 of April 1999.[8] This states that “if a transaction involves tax avoidance, that is considered by the Revenue to be at least one of its purposes even if the transferor did not form the subjective intention of avoiding tax”. It seems that HMRC based this argument on a quotation from Crown’s Counsel in *IRC v Willoughby* which was described by Lord Nolan as “generally helpful”[9] (although Lord Nolan made this comment while considering the meaning of tax avoidance, rather than the subjectivity or otherwise of the defence).

HMRC’s interpretation was dismissed in the subsequent cases of *Beneficiary v IRC*[10] and *Carvill v IRC*.[11] This issue was considered briefly again in *Burns v HMRC*, where the Special Commissioner helpfully accepted that the concept of purpose is subjective and not, as HMRC had long argued, a concept which can be ascertained from the objectively ascertained effect of the transaction.

7 (2009) SpC 728 17

8 It also appeared in Revenue Interpretation 201.

9 [1997] 1 W.L.R. 1078

10 [1999] STC (SCD) 134

11 [2000] STC (SCD) 143, 148

Note that this decision will only apply to the Pre-2005 Rules. One of the most significant aspects of the Post-2005 Rules is the move away from a subjective purpose test. This is achieved by the insertion of the words "… it would not be reasonable to draw the conclusion, from all the circumstances of the case…" into Conditions A and B. This denotes a predominately objective purpose test (except that it is subject an additional provision which requires that the intentions and purposes of any person who designs, effects of advises on the relevant transactions).[12]

From whose perspective should the purpose be ascertained?

The Commission accepted the appellants' argument that they personally had no purpose in effecting the transactions; they had just signed what they had been given. However, in a quite radical step, the Special Commissioner then took into account the purposes of the appellants' parents on the basis that the transfers were made at their behest.

Nowhere in the Pre-2005 Rules does it mention the possibility of attributing to the person who undertakes the transaction the purpose of another person. Even the extended provisions of the Post-2005 Rules do not allow the purposes of another family member who is not the architect of the transactions to be taken into account.[13]

So why was the Special Commissioner so keen to find against the appellants? Fortunately he tells us, saying that he was "heavily influenced" by the fact that one of the asserted purposes put forward by the appellants was "largely undermined in cross-examination and rather suggests that it cannot have been a genuine reason in the first place, but rather one devised to explain the transfer and to support an argument that [the motive] defences could be invoked".[14]
The Special Commissioner also professed to be "mildly influenced" by the suggestion that the main adviser (an English solicitor practicing in Jersey) was just "the family's Jersey adviser" despite the fact that he had "the greatest

12 Section 737(5) ITA 2007

13 One of the additions to the Post-2005 Rules is that it specifically permits the purposes of others to be considered. Section 737(5) provides that in determining the purposes for which the relevant transactions for Conditions A or B were effected the intentions and purposes of the person who, designs, effects or provides advice in relation to the transactions is taken into account. This would presumably include advisers such as lawyers and accountants, but should not on the face of it include other related parties such a family members (as was the case in Burns v HMRC).

14 (2009) SpC 728 52

reputation for the very type of tax planning alleged by HMRC to have influenced the parties".[15]

The courts have generally taken the view that, if a person relies wholly on his advisers and executes documents without having properly understood the proposals put to him, the purpose of the advisers can be attributed to him.[16] [17]
The significance which the Special Commissioner in *Burns v HMRC* placed on the appellants' tax advisors is a reminder that even if a person has understood the proposals put to him, the adviser's identity (and their instructions and advice to the extent that these are disclosed) may be used to ascertain the subjective purpose of the relevant transactions (or indeed the objective purpose under the Post-2005 Rules).

Tax avoidance or mitigation?

Helpfully the Special Commissioner in Burns v HMRC also touched on the distinction between tax mitigation and tax avoidance.

The question of whether a taxpayer has conducted tax avoidance (which would fall foul of the motive defence) or merely tax mitigation has historically proven a difficult distinction to draw. The starting point is the statement of Lord Nolan in *IRC v Willoughby* which defined tax avoidance as "a course of action designed to conflict with or defeat the evident intention of Parliament".[18]

The potential breadth of this test is clear from the decision in *Beneficiary v IRC*. This case concerned a settlor who transferred substantial cash assets from the UK to Jersey to be held by a Jersey trust (thereby placing those assets outside the scope of UK inheritance tax). The Special Commissioner noted that the transfer was no different in effect from switching the funds from a Sterling account into a foreign currency account at the same bank, which would also have been protected from UK inheritance tax. As such, this practise was not "tax avoidance" but "tax mitigation" as it simply took advantage of an express relief.

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15 Ibid 55

16 IRC v Pratt 57 TC 1 at 47

17 HMRC had interpreted this rule rather more widely, considering that "the role of advisers is taken into account in assessing the purpose of the transaction"; apparently regardless of the role of the taxpayer themselves. (This statement was admittedly made within the context of HMRC's view that the motive test was objective.)

18 [1997] 1 WLR. 1078

This decision should be read in light of the statement in *Carvill v IRC* which warned that:

> "it is not enough to say that if you find a relieving provision then it is the evident intention of Parliament that the taxpayer should be entitled to use it whatever the circumstances…[the taxpayer] must be using, rather than misusing, the relieving provision in a way consistent with Parliament's evident intention"[19]

For a distinction between "use" and "misuse" a further "economic consequences" test has evolved. This originates from the Privy Counsel case of *IRC v Challenge Corporation Ltd* where Lord Templeman distinguished tax mitigation as where:

> "the taxpayer's tax advantage is not derived from an "arrangement" but from the reduction of income which he accepts or the expenditure which he incurs… The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."[20]

In *IRC v Willoughby* Lord Nolan interpreted that the test to mean that the taxpayer "genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option."[21]

On considering this issue, the Special Commissioner in *Burns v HMRC* dealt first with the income tax advantage (namely that the non-resident company was subject to income tax at a lower rate than the higher rate payable by UK resident individuals). The Special Commission found as a matter of fact that the appellants (or rather their parents and advisers) had foreseen that they would become ordinarily UK tax resident soon after the transactions were effected. The transfer of property from an (albeit not yet) ordinarily UK tax resident to a non-resident person to reduce income tax without any change in ultimate beneficial ownership is exactly the sort of structuring which the transfer of assets abroad provisions are designed to prevent. By definition, this was therefore held to be tax avoidance.

More interestingly, was the Special Commission's analysis of the capital transfer tax and inheritance tax advantage. He began by accepting that:

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19 Para 91

20 [1987] 2 WLR 24

21 [1997] 1 WLR. 1079

> "if a non-domiciled person arranged to hold foreign situs, rather than UK situs, assets, and then died, no tax advantage would have been sought. Thus if a UK house was sold, and a French house purchased, that would simply be a case of genuinely changing the assets held, and were some section 739 [now section 720 ITA 2007] point to hinge on whether the change was effected for the purpose of avoiding UK tax, the answer would be that it was not."[22]

This is well covered ground as the stated examples include a clear element of "economic consequences" for the transferor. A further example offered by the Special Commissioner was:

> "if UK bank deposits were withdrawn and deposits placed elsewhere, then again, that would be a pure investment switch, and not a step the purpose of which would involve the purpose of achieving a UK tax advantage."23

This statement should presumably state that moving bank deposits is not a step the purpose of which would involve the purpose of achieving UK tax **avoidance**. Clearly moving bank deposits outside of the UK can achieve tax advantages (as was the case in Beneficiary v IRC).

The Special Commissioner's analysis of where to draw the line between tax avoidance and mitigation is worth stating in full:

> "Indirectly retaining a UK real property, and simply achieving the technical change in status by putting the property into a non-UK resident company in a case where one of the purposes is to achieve the potential Inheritance Tax advantage, implicit by effecting those steps, does seem to me to cross the border between mitigation and tax avoidance. This is because it has involved no real change of investment, as in the two previous examples, but the retention of the UK property, accompanied by a step to change the normal tax consequences of that."[24]

On the facts of this case, the Special Commissioner therefore concluded that the transfer of an interest in UK real property to a Jersey company, with no change in ultimate ownership or control, was deemed tax avoidance.

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22 (2009) SpC 728 59

23 Ibid

24 Ibid

Presumably, the Special Commissioner's reference to a "no real change of investment" test was intended as a paraphrase of the "economic consequences" test in *IRC v Willoughby*. However, it has been questioned whether this analysis is in fact consistent with the "economic consequences" test and whether this new terminology is picked up on in later decisions remains to be seen.[25] In the meantime, HMRC will no doubt take this decision as a carte blanche to attack similar arrangements using offshore companies.

Meaning of "commercial" transactions

Condition A provides for situations where avoiding any liability to taxation, however incidental, was not the purpose, or one of the purposes, of the relevant transactions. Condition B, meanwhile offers a safe haven for genuine commercial transactions were there is **some** element of tax avoidance underlying the transactions. Previously, HMRC argued that this test should be interpreted such that tax avoidance was not a "significant purpose". This issue was considered in *Carvill v IRC*, where the Special Commissioner concluded that the correct interpretation was that tax avoidance not be the "main purpose" (there is probably little practical difference between these interpretations).[26]

It should be noted that the "main purpose" test in Condition B of the Pre-2005 Rules is rather more narrowly construed under the Post-2005 Rules, where transactions may not be more than "incidentally designed for the purpose of avoiding liability to taxation".[27]

To rely on the "main purpose" test in Condition B, taxpayers must show that the relevant transactions were "commercial". Under the Pre-2005 Rules this term is undefined, although *Carvill v IRC* gives some guidance.[28] In that case, the Special Commissioner considered that a transaction can be described as commercial if it "implements or facilitates a business end" or is "in furtherance

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25 See for example, James Kessler and Amanda Hardy, 'Hurdles to jump', Tax. 2009, 163(4194), 164-167

26 [2000] STC (SCD) 143 89

27 Section 737(4)(b) ITA 2007

28 Ibid 87

of commerce (i.e. a trade or business)”.[29]

Certainly the term would not embrace transactions with an element of bounty, such as transfers to family trusts, even if these represented sound financial planning. Accordingly, in *Burns v HMRC* the alleged purpose of transferring the property interest in order to protect if from “the aspirations and bad influence of unwelcome boyfriends”[30] was dismissed as clearly not a commercial purpose.

More interestingly, in *Burns v HMRC* was the Special Commissioner’s treatment of the appellants’ argument that the main purpose of transferring their property interests to Jersey companies was to divorce ownership from management. While this argument was ultimately dismissed on the facts (as it emerged that the management of the properties was in fact never dealt with by either of the directors of the two companies), the Special Commissioner noted that he was far from convinced that the separation of management from ownership was going to succeed in establishing that the transactions were bona fide[31] commercial even if the argument had not collapsed. As this comment shows, the scope of transactions which may be considered as “commercial” for the purposes of the Pre-2005 Rules is limited and excludes many arrangements which would surely be considered as “commercial” under the word’s ordinary meaning.

It is also worth noting that under the Post-2005 Rules an even more restrictive definition of “commercial transactions” is now set out in section 738 ITA 2007. This definition expressly excludes making or managing investments where the parties are connected or are not dealing at arm’s length (as was the case in *Burns v HMRC*).[32]

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29 Ibid. Note that HMRC has previously taken the view that under the Pre-2005 Rules the term “commercial transactions” should “only apply to transactions in the furtherance of trade or business, and not to the making or managing of investments”. This view which excludes “the making or managing of investments” seems difficult to justify within the context of the Pre-2005 Rules, particularly when such investment is made in furtherance of a trade or business.

30 (2009) SpC 728 43

31 There is little practical distinction between the terms “genuine” under the ITA 2007 and “bona fide” which applied to the motive defence when it was at section 741 ICTA 1988 (as was in force at the time of the relevant transactions in Burns v HMRC).

32 Section 738(4) ITA 2007

Conclusion

Judges tend not to have much sympathy with a person if they think they are having the wool pulled over their eyes. They will make sure that they reach the 'right' decision even though it may well set a precedent which may seem unfair in another case – as is often said 'hard facts make bad law'. The apparent tightening up of the Pre-2005 Rules by the Special Commissioner in *Burns v HMRC* can possibly be ascribed to this trend. The attributing of a third party's (in this case the parents) purpose for effecting the transactions seems in particular to be an extension to the rules.

The lesson for practitioners is to ensure that a transaction's purpose is clearly defined and documented from the outset. Clearly, tax avoidance should not be one of the purposes and, if possible, the transactions should be conducted on commercial terms as set out in section 738 ITA 2007. The interpretation of both of these terms remains heavily fact specific and thought should be given as to how to structure each transaction to allow for the strongest possible justification in each case. In the *Burns v HMRC* case, if the parents had in fact taken a role in managing the property investment (as was contended as the main purpose of the transfers) their argument could not have been dismissed so easily.