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Dear Ms Roberts

Re: The City of London Law Society Revenue Law Committee response to the Discussion Document "Tax Abuse and Insolvency" (the "Document")

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients, from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response has been prepared by the CLLS Revenue Law Committee (the **"Committee"**). A list of the committee members is herewith:-
http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=156&Itemid=469

Q1: Do you agree that HMRC should be tackling this behaviour?

While the Committee is supportive of efforts to counteract abusive behaviour in the context of taxation, each of the proposed approaches outlined in the Document (i.e. transfer of liability and joint and several liability) would essentially allow HMRC to "pierce the corporate veil" in certain circumstances, thereby undermining the limited liability status of the relevant taxpayer. It is the very strong view of this Committee that any measures that result in the erosion of the established principle of limited liability for certain business structures should not be considered lightly and, in particular, should: (i) only be implemented if determined to be absolutely necessary; (ii) only apply in limited circumstances in the context of abusive behaviour; and (iii) be clearly defined and proportionate in nature so as not to jeopardise the UK's reputation as an attractive, stable, and predictable place to do business. This latter sensitivity is of particular relevance in the current political environment given the existing uncertainties surrounding the impact of Brexit.

Based on the information contained in the Document, the Committee is not convinced that the above criteria are met in respect of the proposed approaches (see more detail below) and therefore opposes the introduction of these proposals.

Are there any other forms of abuse of insolvency in relation to tax that ought to be tackled?

The members of this Committee do not represent clients that would participate in activity amounting to what the Committee members would consider to be abuse of insolvency and consider that HMRC is best-placed to identify such practices.

Q2: To what extent do you consider that one of the above approaches could provide a helpful model for tackling the abuses outlined in this document?

It is difficult to provide a meaningful response to this question as the overview of the approaches does not set out the detailed parameters or scope of the proposed measures. As mentioned in our response to question 1, this Committee is generally opposed to the introduction of these proposals but our response to question 3 sets out certain observations on the high-level description of the approaches outlined at paragraph 3.5 of the Document.

Q3. What do you think might be the key issues with applying one of these approaches to tackle the abuses outlined in this document?

We have set out below some observations on the proposed approaches, as described at paragraph 3.5 of the Document.

In summary:

- Whilst the Committee's view is that it is not appropriate to include tax avoidance within the scope of these measures, if it is to be included it is important that the test of what constitutes illegitimate tax avoidance should be set at an appropriate level where there can be no material doubt that these draconian powers should be invoked. We propose that, at least in the first instance, the test should be set at the GAAR level of anti-avoidance. That is to say the provisions should be invoked only where the relevant behaviour could be countered by the application of the GAAR.
- It would also be vital to establish with clarity who would be identified as responsible for the tax.
- Most importantly, liability should be limited to the benefit obtained.
- Finally there should be proper judicial control of the powers through the First Tier Tribunal Tax Chamber and of course appellate courts.

A. Tax avoidance

Our view is that the question of whether an arrangement amounts to "tax avoidance" is inherently too subjective to potentially give rise to the severe outcomes for individuals that are contemplated by the proposed approaches. We draw a clear distinction here between tax avoidance and a scenario involving a *deliberate* underpayment of tax which is attributable to a particular individual – in the latter case establishing that the relevant mischief has occurred will be a far more objective and fact-based question and would presumably leave little to personal judgment and opinion.

It seems to be generally accepted that tax practitioners (including advisers and representatives of HMRC), judges, and members of the business community can hold materially differing views on where the line lies between behaviour amounting to acceptable tax "planning" and non-acceptable tax "avoidance". Certain members of the Committee are also of the view that the general perception of the location of this line has shifted over time (with a general movement towards a more conservative view). The word "avoidance" can have a variety of meanings in different legislative contexts. For example:

1. There are certain sections of the UK tax code that exist under the statutory heading "Tax Avoidance" or "Anti-avoidance" (such as the whole of Part 13 of the Income Tax Act 2007 and section 75A of the Finance Act 2003) which can strictly apply absent any actual tax avoidance motivation (i.e. there is no purpose test inherent in these "anti-avoidance" rules). In this Committee's experience it is fairly common to see genuine commercial arrangements, which involve no abusive tax avoidance drivers, be caught by these sorts of "anti-avoidance" rules.

2. There is a raft of other targeted anti-avoidance provisions framed around a "main purpose" test (i.e. broadly, whether the obtaining of the relevant tax advantage was a "main purpose" of the arrangements). These rules can often be difficult to apply in practice as businesses commonly consider tax implications as part of their wider transaction structuring and would, for example, generally seek to structure their transactions within available tax exemptions (which may involve including steps in the arrangements that are designed to secure this outcome). Such tax structuring may in fact fall squarely within the policy intention of Parliament when making the relevant exemption available, but there may nonetheless be a judgment call to be made as to whether the inclusion of the relevant steps falls foul of the relevant, strictly worded, anti-avoidance provision. We have included an example of this sort of scenario in the appendix with the intention of illustrating the difficulty of including the application of these sorts of provisions within the scope of the "avoidance" that is targeted by the measures in the Document.

3. The UK's general anti-abuse rule ("**GAAR**"), introduced in the Finance Act 2013, was devised with the intention of identifying and counteracting a high threshold of "abusive" tax avoidance. If HMRC is not convinced by our argument that it is inappropriate to include a subjective concept such as avoidance within the scope of the proposed rules, then at the very least we would recommend that the targeted "avoidance" scenarios are restricted to those that would be caught by the GAAR. By way of analogy, the "Penalties for Enablers of Defeated Tax Avoidance" rules (in Schedule 16 to the Finance Act (No.2) 2017) effectively operate to impose penalties on "enablers" only in cases of avoidance that are considered sufficiently abusive to be able to be successfully defeated by the GAAR.

B. Including "avoidance" within the measures – practical impact on Directors and Officers insurance

It is standard practice for companies to obtain Directors and Officers ("**D&O**") insurance, which provides a company's directors and officers with insurance cover against personal liabilities they may incur in carrying out their duties (such as legal action brought against them in their personal capacity for breaches of the Companies Act 2006). The availability and scope of this insurance is often a material factor taken into account by individuals when they are considering whether to act as a director of a UK company – to put it another way, the Committee's large corporate clients would likely struggle to identify suitable candidates for board positions if this insurance were not available to the relevant company's officers, or were not sufficiently comprehensive.

D&O insurance would not typically provide insurance cover against the penalties that could potentially be assessed on directors and officers under paragraph 19 of schedule 24 to the Finance Act 2007 (relating to deliberate underpayment of tax attributable to the individual director) ("**Paragraph 19 Penalties**"); insurers would generally hold the view that any such deliberate action would be within the conscious control of the relevant director and so insurance is not appropriate in these circumstances.

It is unclear what impact the introduction of the measures proposed by the Document would have on the D&O insurance market. If the scope of the measures were to extend to tax "avoidance" (i.e. potentially extend to a scenario in which there may have been no deliberate or conscious wrongdoing on the part of the responsible person), then company directors would presumably expect to be insured against the risk of the relevant (potentially material) liabilities arising from the proposed measures. At the very least, we imagine that this could have a material impact on insurance premiums and it is possible that that the insurance market will be unwilling to extend D&O insurance coverage to what would effectively amount to insurance against UK tax avoidance.

C. Tax evasion

The Committee's understanding is that the term "tax evasion" refers to behaviour that amounts to criminal/fraudulent activity and that this kind of behaviour could never be entered into in good faith and without a criminal intention on the part of the responsible person. As such, the concerns outlined above relating to the inclusion of the subjective concept of "avoidance" within the scope of the proposed measures do not seem relevant.

However, the Committee believes the existing sanctions that can be applied against directors and officers already act as a sufficient deterrent and protection for HMRC in this area (including, for example, existing criminal sanctions and the potential transfer of penalty liabilities in respect of deliberate underpayment of tax in Schedule 24 to the Finance Act 2007).

D. The link with insolvency

The "possible approaches" outlined in the Document on page 11 either:

a) refer to a requirement that there is "a risk that the funds will be lost in insolvency" before liability can be transferred to the relevant responsible person; or
b) state that the joint and several liability could be imposed "in the event that the company could not meet the tax debts".

Neither of these descriptions seems to establish a tight link between the relevant unacceptable behaviour (e.g. the tax avoidance) and the eventual insolvency of the relevant company.

However, the premise of the Document seems to be specifically to counteract deliberate "abuses of insolvency" involving UK taxation rather than simply introduce new general deterrents against repeated non-payment of tax or tax avoidance and evasion. The Document does not appear to be recommending that a responsible person should always be at risk of joint and several liability in respect of successfully challenged tax avoidance transactions if the relevant company just happens to become insolvent (and unable to pay its tax debts) at a later date. As such, we would have expected the description of the possible approaches to outline in more detail and with greater clarity the requisite link between the tax avoidance/evasion/non-payment and the insolvency.

For instance, (using GAAR-avoidance as an example) the "proposed approach" wording could have outlined that the measures would only apply where, at the time the relevant arrangements were entered into, the person responsible:

a) had knowledge (or should reasonably have had knowledge) of a material risk that the arrangements would be the subject of a successful challenge under GAAR; and
b) intended/believed that, in the event of such a challenge, the relevant company would enter into insolvency rather than pay the tax due.

E. Repeated non-payment/phoenixism

While the Committee recognises the unacceptability of the behaviours described as "repeated non-payment" involving insolvency and phoenixism, our view is that any measures designed to counteract these behaviours would need to be very carefully drafted so as not to unintentionally capture certain transaction structures that are commonly adopted in cases of genuine corporate distress or insolvency. It seems consistent with the Government's general policy objectives in the context of companies in genuine financial distress that relevant stakeholders should be assisted in salvaging the viable trading activity from a business through a financial restructuring process without incurring tax liabilities in the process which would result in the "rescued" business being financially unviable or in the restructuring proposal being financially unattractive to the stakeholders.[1]

As HMRC notes at paragraph 2.3 of the Document, most companies will have some tax liability at the point at which they become insolvent. We have set out below a general description of certain arrangements that commonly take place in the context of corporate distress/insolvency situations.

a) HMRC may be a material unsecured creditor in an insolvency/distress situation in which the value of the company (the "**Distressed Company**") "breaks" in the senior secured debt issued by the Distressed Company (i.e. there is insufficient value in the Distressed Company to repay the senior secured debt in full). In these situations, it is generally regarded as commercially acceptable that the junior secured, or unsecured, creditors may receive no value as part of a financial restructuring of the Distressed Company.

b) In situations such as this, in particular where the senior creditors and directors of the relevant company consider that all or part of the Distressed Company's trade could continue to be viable if it were "rescued" from the unsustainable debts, it is common for the directors of the Distressed Company (or the administrators in an insolvent administration process) to agree with the senior creditors that the Distressed Company's viable business can be acquired by the senior creditors (typically through a special purpose acquisition company (the "**Creditor Company**")) in return for the release of all or the relevant portion of the senior debt.

c) The Distressed Company would typically be left with no valuable assets and would have material liabilities (including those owed to HMRC) and so would enter into an insolvent liquidation process. The Creditor Company which has acquired the "good assets" out of the distressed company would continue to operate the sustainable trade, often with all or some of the directors of the Distressed Company becoming directors of the Creditor Company (and often with a new management incentive plan being put in place for their benefit).

d) Where this type of transaction occurs on a "consensual" basis (i.e. outside a formal insolvency process), it is also possible that the majority shareholder of the Distressed Company might be offered a very small equity investment in the Creditor Company in order to incentivise them to cooperate in the implementation of the restructuring.

In the situation outlined above, it is likely that HMRC would form one of a number of material unsecured creditors but of course it is possible that, depending on the circumstances, HMRC could be one of the only material unsecured creditors. In this case, a main purpose of the arrangements would be to "save" the value in the viable business from the unsustainable tax debts.

The Committee notes that the scenario outlined above carries several of the hallmarks of the description of unacceptable phoenixism behaviour at paragraphs 2.11 and 2.12 of the Document. Although this does not seem to be specifically stated in the Document, the policy objective seems to be to prevent abusive phoenixism where the <u>economic interest</u> in the relevant company does not materially change as part of the arrangements. On the facts above, it is clear that the material economic ownership in the business transfers from the shareholders in the Distressed Company to the senior creditors. We would expect this genuine change in economic ownership to be regarded by HMRC as indicative of behaviour that does not amount to abuse of the insolvency system. Further, we do not consider that retaining the

[1] For example, through the introduction in 2015 of the "corporate rescue exemptions" from releases and deemed releases of debts at sections 322(5B) and 361D of the Corporation Tax Act 2009.

same directors in the business should be regarded as a hallmark of abuse – in commercially acceptable scenarios such as that set out above, there should be no disincentive for the appropriately experienced and qualified former directors to continue to support the rescued business.

Possible ways of limiting the scope of the proposals so that only abusive situations are caught by the measures could include:

a) including specific "whitelist characteristics" in the relevant legislation to make it clear that the rules do not operate if these circumstances exist (such as in the case of a material change of economic ownership of the distressed company as part of the "phoenixing" or where the unpaid tax does not represent more than [50]% of the unpaid debts), or make it a condition of the application of the rules that the "phoenixism" does not involve a material change in economic ownership of the relevant company; and

b) a requirement that there must have been proven <u>repetition</u> of the behaviour by the responsible person or in respect of the relevant business before the measures apply (i.e. the relevant responsible person has actually taken part in the same behaviour at least once before, or the business has been "phoenixed" at least once before (and the responsible person is aware of this), in order for the potential liability under these measures to apply).

F. Types of company targeted?

Despite the statement that the proposed approaches are not targeted at any particular size of company, the examples and descriptions in the Document seem to be focussed on smaller-scale, owner-managed businesses. The Committee's view is that, if the measures outlined in the Document were to be introduced, they should be targeted at scenarios where the "persons responsible" (or their connected persons) also have a material economic interest in the relevant company. We would therefore recommend that any such measures are limited in their application to "close companies".

Of course, certain "large" companies will fall within the close company definition and so this approach would not undermine the general statement, made in the introductory wording to the Document, that the proposals do not target companies of "any particular size". However, narrowing the scope of the proposals to close companies would seem to achieve the policy outcomes identified by HMRC and would have the benefit of clearly taking many larger, widely held, UK businesses outside the scope of the rules.

Limiting the potential application of the rules to close companies would not, however, address our concerns about the potential for the measures outlined in the Document to operate to stifle entrepreneurial activity in the UK – small business owners in particular are less likely have the appetite or resource to put themselves at risk of incurring, potentially significant, secondary liabilities.

G. The persons responsible?

The current description of the proposed approaches refers to attaching the relevant liability to "the persons responsible" for the relevant abusive behaviour. The scope of persons who can potentially be caught by the rules would need to be clearly defined in the relevant legislation.

For example, it may be that HMRC's intention would be to limit "the persons responsible" to the sorts of persons who are relevant to the Paragraph 19 Penalties. This list or "persons" includes:

a) a director, manager or secretary of the relevant company; and
b) any other person managing or purporting to manage any of the company's affairs.

Given the severity of the potential application of these measures, the Committee's view is that a very high threshold (of knowledge of the circumstances and intention to commit the abusive behaviour involving insolvency of the taxpayer) would need to be met before the relevant person could be held "responsible" for the abuse and so personally subject to the tax liability in question.

The legislation should make it clear that the measures do not extend to persons with no official management position in respect of the business, such as non-director shareholders.

H. Appropriate level of financial liability in the context?

The general tenor of the Document implies that the policy intention of these measures is to give HMRC additional tools to assist it in recovering the fruits of abusive tax avoidance, evasion or repeated non-payment in circumstances where the existing legal rules relating to insolvency would otherwise make this impossible. The policy intention does not primarily seem to be to introduce a general deterrent for individuals against participating in such behaviours (although this would obviously be an indirect benefit of the rules).

On this basis, it seems appropriate that the extent of the personal liability imposed on the person responsible should be limited to an amount equal to the financial benefit obtained by that individual as a result of their participation in the abusive behaviour. For example, a non-shareholder director who was responsible for an abusive phoenixism scenario should only be liable to the extent of any special bonus/compensation he received that was related to the phoenixism activity over and above his usual remuneration.

This approach seems consistent with several statements/examples in the Document; in particular the first bullet point under paragraph 2.5 which refers to the person responsible "extracting value" from the company and the general statement in paragraph 2.10 that the misuses of insolvency enables the responsible people "to retain the fruits of tax avoidance…". We appreciate that there may be practical issues in tracing and quantifying the relevant benefit in certain circumstances, but we consider this to be an important safeguard in ensuring that the rules are not unduly punitive.

Q4: What views do you have for alternative approaches that could be adopted to tackle the forms of tax abuse outlined in this document?

The Committee notes the following statement in paragraph 3.3 of the Document:

> *If an insolvent company is found to have deliberately underpaid CT and Excise duties (and such actions are attributable to company officers), HMRC can transfer liability of the penalties due in respect of the Excise duties to the insolvent company's directors –* ***<u>but not the Corporation Tax.</u>*** (Emphasis added.)

The Committee's understanding of the scope of Paragraph 19 Penalties is that penalty liabilities in respect of deliberate underpayment of corporation tax <u>can</u> be transferred to officers of a company to whom the deliberate underpayment of corporation tax is attributable (see further Compliance Handbook paragraphs *CH84610, CH81011, and CH81012).*

Q5: What safeguards should apply to ensure taxpayers' rights are protected?

We have addressed our comments on this point in our responses to the other questions, in particular questions 3 and 6.

We would recommend that the exercise of these powers, in particular in the context of tax avoidance, should be subject to appeal to the First Tier Tax Tribunal, the expert tribunal in such matters. In particular the tribunal should have a full decision making responsibility and not merely a supervisory jurisdiction, as for example, in the context of excise duties under Finance Act 1994.

Q6: Do you consider that the above parameters for scoping the measure are appropriate?

Our response to question 3 outlines some initial comments/views on certain aspects of the scope of the proposals.

If HMRC is determined that one of these approaches should be implemented, this Committee urges HMRC to commence with an accurately targeted set of initial provisions, with the potential to widen the scope of the provisions if, in practice, they turn out to be inadequate to counter the types of abuse HMRC is seeking to counteract.

In practice, it will be very difficult for advisers and taxpayers to operate effectively if the rules are too widely drafted. Given the punitive and potentially catastrophic financial impact that these measures could have on individuals and their families, it is of the utmost importance that the rules are clear and that their application would not, for example, include any uncertain aspects (leading to the potential for taxpayers to have to rely on published guidance for comfort that the rules will not apply to them) or involve any element of HMRC discretion (such as, for example, allowing for assessment of a penalty if it would be “just and reasonable” to do so).

Q7: Are there any other safeguards you think should be considered to ensure that genuine insolvencies are not impacted by any proposal to tackle these abuses?

We have generally addressed our comments on this point in our responses to the questions above.

As a closing remark, we note that paragraph 2.2 of the Document refers to the fact that these proposed measures are aimed at tackling the behaviour of a “tiny minority” of taxpayers. In light of the perceived small scale of the abuse, the potential severity of the application of the proposed measures, and the difficulty in crafting legislation that will <u>certainly</u> be sufficiently narrow to avoid attaching liability to individuals in unintended circumstances, the Committee recommends that these proposed measures are not explored further.

Please let us know if you have any questions; we would be happy to attend a meeting to discuss these comments in person if that would be helpful.

Yours sincerely

Chris Bates
Chair, Revenue Law Committee
City of London Law Society

APPENDIX

Illustrative example involving a "main purpose" anti-avoidance provision

As a general comment, it is clear to us from the overall tone of the Document that the sort of scenario outlined in the example below is not the intended target of the proposed measures (for example, we refer to the comments at paragraph 1.7 of the Document). However, we thought it would be helpful to try to illustrate an example of where the proposed rules, even if relatively narrowly drafted (for example, broadly in accordance with our comments at question 3, paragraph D, above), may extend to scenarios outside the limited policy objectives.

All statutory references are to the Corporation Tax Act 2009.

1. A UK trading company is in financial difficulty and needs to undergo a debt restructuring in order to avoid going into insolvency and so that it can continue to operate its trade.

2. The wider commercial deal is that the immediate parent of the UK company will acquire the portion of unsustainable debt from the relevant third party creditors in an arm's length transaction but at a significant discount to the debt's face value; the intention is initially that a cash payment would be made to the relevant third party creditors in consideration for the debt acquisition.

3. Without further structuring, the transaction would give rise to a deemed release under section 361, which would give rise to a tax liability in the UK company of £10 million. The directors of the UK company are aware that, even after the proposed restructuring is effected, the UK company would not be able to meet this tax liability and would go into insolvent liquidation if the liability were to arise.

4. The directors of the UK company consider that the "corporate rescue conditions" in section 361D(4) are met and assume that the corporate rescue exemption in section 361D can therefore be relied upon as an exemption from the deemed release charge.

5. However, on further consideration of the steps required to fall within section 361D, the non-UK tax resident ultimate holding company of the corporate group tells the UK company that it would suffer a material charge under the "controlled foreign company" (CFC) rules in its jurisdiction if the UK company's immediate parent released the UK company from the relevant portion of unsustainable debt (required to fall within section 361D). This CFC charge would be greater than £10 million and so, in practice, relying on the corporate rescue exemption is not possible.

6. The UK company renegotiates with the relevant third party creditors and they agree that the immediate parent of the UK company will issue ordinary shares to the creditors in consideration for the debt acquisition, rather than making the previously planned cash payment (with the value of the shares issued being equivalent to the cash payment they would have received under the alternative cash-pay structure). This transaction structure allows the UK company to benefit from the "equity for debt" exemption from the deemed release charge in section 361C.

7. The UK company's tax advisers advise the UK company directors that they need to consider whether the anti-avoidance provision in section 363A applies. They advise that they consider that there are good arguments to support the analysis that section 363A should not apply on these facts, as the group was free to choose between any available structures for the transaction, and the third-party creditors disposing of their debt for shares have a real interest in acquiring the ordinary shares in the parent (and therefore these shares represent true consideration for their disposal of the debt). Their advice is that the only "main purpose" of the wider arrangements should be viewed as securing a successful arms-length debt restructuring of the UK company in order to enable it to continue its operations and, moreover, that it is highly unlikely that HMRC would seek to apply section 363A in

these circumstances. The directors of the UK company receive this advice and agree to the wider restructuring terms (without their consent the restructuring could not go ahead).

8. However, two years later, HMRC enquires into the transaction and takes a different view as to the "purpose" of the arrangements. HMRC's view is that the switching of the consideration for the debt acquisition from cash to shares was an "arrangement" (or part of an arrangement) that was undertaken with the main purpose of avoiding an amount being treated as released under section 361 (and so section 363A applied and the £10 million tax liability arises in the UK company). The case is litigated but the courts agree with HMRC's analysis on a very technical reading of section 363A.

9. In this case, the directors of the UK company had been made aware that there was a risk that an anti-avoidance provision (section 363A) may technically apply to the proposed transaction (although their tax advisers had advised that it should not) and the directors knew that, if the transaction were successfully challenged on this basis, that the UK company would have been unable to meet the consequent tax liability. We are concerned that this set of facts may fall within the scope of the proposed approaches outlined in the Discussion Document, with the result that the £10 million tax liability could be assessed against the directors in their personal capacity.

10. While we understand that it is unlikely that HMRC would, in reality, have the appetite to actually pursue a challenge under section 363A on these facts (and this understanding is in supported by certain general statements in published guidance), we strongly believe that the UK company directors should not have to rely on their confidence in HMRC's appropriate use of discretion/common sense in order to insulate them from this potential personal liability.

11. In the Committee's view, the arrangements above, viewed in their context, could not be regarded as falling within the scope of the GAAR.