# The 'commerciality' issue in tax planning

After the recent Westmoreland and Citibank cases, Mohammed Amin of PricewaterhouseCoopers assesses the current boundaries of acceptable tax planning.

When is tax planning liable to be struck down for lack of commerciality? Two cases decided within the past six months have cast new light on this question.

Before discussing their implications, it is worth revisiting the leading case, which is the 1984 House of Lords decision in Furniss (Inspector of Taxes) v Dawson.

The taxpayers wanted to sell two companies without paying tax. They set up an Isle of Man company, Greenjacket, and achieved the sale in two stages, as indicated in *Figure 1*. The share-for-share exchange to Greenjacket should have been non-taxable, as should have Greenjacket's onward sale, because it had acquired a market value base cost on the initial exchange. The House of Lords decided that the transfer to Greenjacket was an inserted step, with no commercial purpose. Accordingly, it re-wrote the transactions for tax purposes as in *Figure 2*. The deemed direct sale by the original shareholders to the ultimate purchaser was fully taxable. To get to the finishing position, the original shareholders were then deemed to use their cash proceeds to subscribe for newly-issued Greenjacket shares.

The new cases show that the limits of the Furniss v Dawson doctrine are narrower than the Inland Revenue would like.

### *Macniven (Inspector of Taxes) v Westmoreland Investments (WIL)*

WIL was a defunct property investment company, indirectly held by the Electricity Supply Pension Scheme. As indicated in *Figure 3*, a circular flow of cash enabled WIL to convert an accrual for interest expense of about £50m into a £50m realised management expenses loss carried forward. This enabled WIL to be sold for £2m, for the benefit of its management expenses carry forward. Neither party's financial position changed, since the accrued interest was paid using money from a fresh loan from the same shareholder.

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The Inland Revenue argued that WIL had not really 'paid' the interest as required by ICTA 1988 s.338. The House of Lords found for the taxpayer. In doing so, it put an entirely new gloss on the Furniss v Dawson doctrine:

- where concepts draw their meaning from commercial life, then the transaction is exposed to being re-written for tax purposes if there are inserted steps that lack a commercial purpose. 'Disposal' was held to be a commercially defined word, rationalising the Furniss v Dawson decision that the real 'disposal' was from the shareholders to the ultimate purchaser; and
- where concepts were purely juristic – that is, legally defined, as opposed to commercial – then the Furniss v Dawson doctrine was not applicable. In WIL's case, concepts like 'payment' were held to be purely juristic, so the Inland Revenue was unsuccessful in pleading Furniss v Dawson to argue that WIL had not 'paid' the interest.

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How does the taxpayer decide whether his or her planning involves commercial concepts or juristic concepts? One helpful pointer is to see if there is an express statutory definition. If there is, then the concept is probably juristic. Some of the most important legislation affecting treasurers is that relating to foreign exchange, derivatives and corporate debt. It is filled with new statutorily defined concepts such as qualifying assets and qualifying liabilities (foreign exchange), financial instruments and qualifying payments (derivatives), loan relationships and relevant discounted securities (corporate debt).

In the light of the Westmoreland case, there seems to be limited risk of planning relying on such concepts being impacted by Furniss v Dawson. Unfortunately, the converse is not so simple. 'Payment' is not statutorily defined but is a juristic concept as per the House of Lords. The absence of a statutory definition does not necessarily mean that you are dealing with a commercial concept. You also need to consider how much judicial guidance there is regarding a concept's meaning, looking particularly at non-tax cases.

### *Griffin (Inspector of Taxes) v Citibank Investments*

This decision of the High Court is final, as the Inland Revenue has decided not to appeal. It is an important reminder that you must tax the transaction the taxpayer has actually carried out – and not some fictitious equivalent transaction.

Citibank had capital losses, so capital gains would be tax free, while interest income would be taxable. It accordingly made use of the options box structure. The fundamental concept is illustrated in *Figure 4*.

The investor enters into four European (exercisable only on the terminal date) options. A call option is purchased at 20 and another sold at 30. Simultaneously, a put option is purchased at 30 and one sold at 20. Overall, the investor has a certain fixed outcome of 10 on these numbers. If risk free arbitrage is to be prevented, the aggregate net acquisition cost of the positions must be less than 10, with the guaranteed gain being equivalent to interest over the life of the options.

Citibank entered into its option contracts with a fellow company which was an options trader. The two calls required by the 'box' were combined into a capped call option on the FTSE 100 index, and the two puts combined into a floored put option on the FTSE 100 index. It paid an aggregate £150m to purchase the two option contracts, and realised some £165m on expiry. The Inland Revenue sought to tax the gain of £15m as income rather than as a capital gain sheltered by capital losses. The scope to use options in this way has been eliminated by intervening legislation.

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The Courts appreciated that the transactions carried out were economically equivalent to Citibank depositing £150m and receiving interest of some £15m on maturity of the deposit. However, this was of no assistance to the Inland Revenue.

It is well established that if there are two ways of achieving a particular commercial goal, the taxpayer is entitled to choose the route that costs the least amount of tax (Vestey v IRC). The Inland Revenue could not tax Citibank as if it had made a bank deposit, since it hadn't. The Inland Revenue also tried arguing that the contracts were not option contracts, in particular because together they carried no risk. This argument also failed, since the ISDA documentation used was clearly that of options not bank deposits.

Many transactions have equivalent economic consequences, but different tax consequences, for example:

- a fixed rate borrowing repayable with all interest rolled up as a final bullet payment is equivalent to a zero coupon bond issued at a discount;

*FIGURE 1*

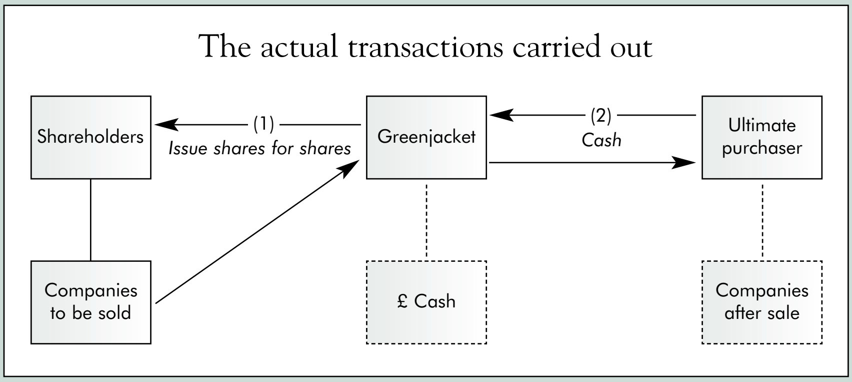



*FIGURE 2*

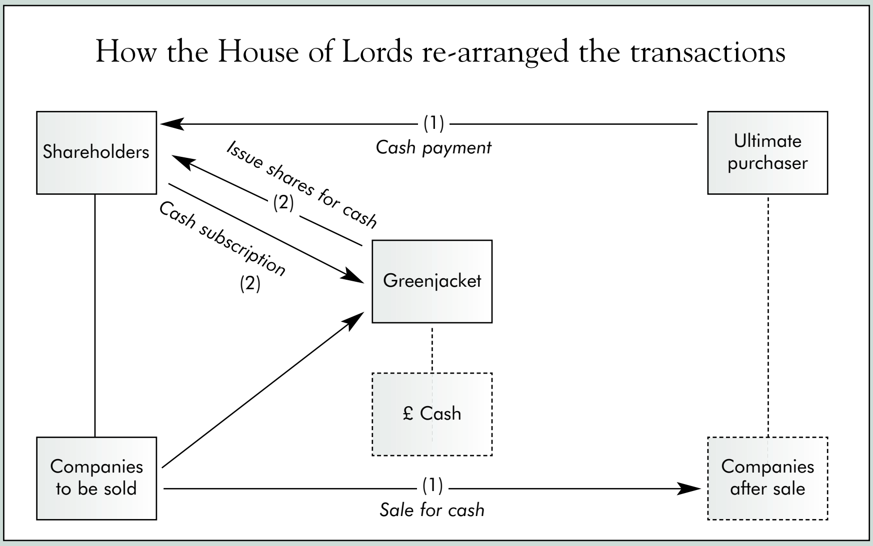
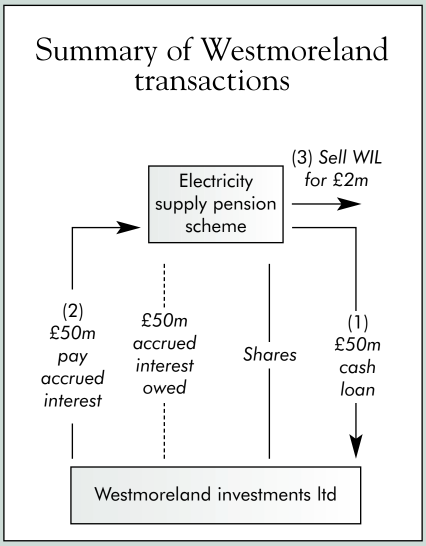



*FIGURE 3*

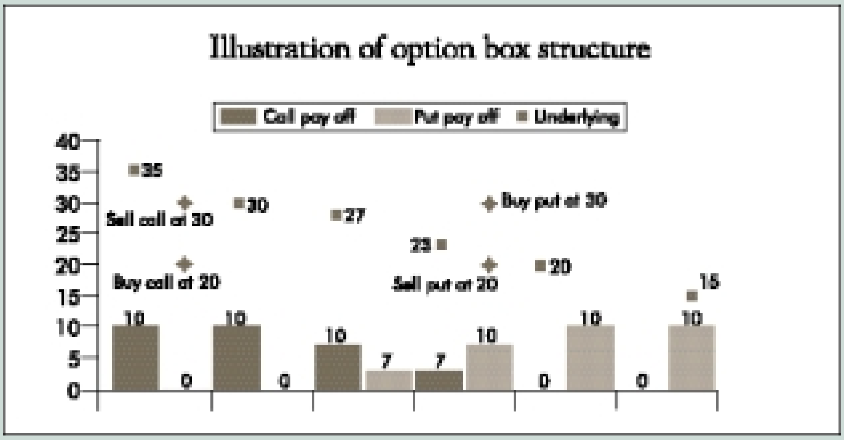


- a forward sale of euro for sterling is equivalent to borrowing euro while depositing sterling, at fixed interest rates with the interest payable on the closing date;
- a currency swap contract is equivalent to two back to back loans in the respective currencies; and
- an interest rate swap is equivalent to a series of forward rate agreements. (*See Modern Alchemy by the author with Jeremy Rayner in The Treasurer, November 2000*).

***Tax planning concepts***

Where possible, tax planning should seek to rely on juristically, not commercially, defined concepts, to minimise the Furniss v Dawson risk. In the areas of greatest interest to treasurers, (foreign exchange, derivatives and debt) the Parliamentary Draftsman may have done a disservice to the Inland Revenue by providing new statutorily defined concepts to replace concepts from the commercial world.

*FIGURE 4*




The Inland Revenue is widely believed to have resisted the introduction of a General Anti Avoidance Rule (GAAR) when this was mooted two years ago. If it continues to lose landmark cases before the Courts, it may develop a new enthusiasm for a GAAR. ■

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