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Chasing a moving target

By Vanessa Houlder

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The heat is being turned up on one of the most esoteric and lucrative corners of the tax world. Tax authorities are eyeing banks' structured finance teams, many of which use aggressive tax planning in a significant minority of their transactions.

In the UK, these concerns led to a crackdown earlier this summer, when the Treasury clamped down on a billion-pound tax loophole used to cut the cost of loans.

The banks and their large clients came under more scrutiny from the British tax authority this month. They were forced to divulge more information at an earlier stage about their tax schemes, under a tougher disclosure regime that requires any plan intended to be confidential to be divulged to Revenue & Customs.

Tax authorities are also gaining new insights into tax-driven structured finance as a result of the creation of a joint task force in 2004 by the UK, US, Canada and Australia set up to co-operate in tackling "abusive tax schemes".

The tax authorities are scrutinising deals that involve "arbitraging" differences between the tax regimes and rates of different countries. This is a problem for all tax administrations, which have no authority outside their borders, but it is particularly acute for those, such as the UK and US, with open capital markets.

Earlier this summer, the issue was also raised in the US when Mark Everson, commissioner of the Internal Revenue Service, urged the Senate Finance Committee to examine the different tax treatment of hybrid debt/equity securities in the US and abroad. These securities are used to avoid tax because they are structured in a way that means they are treated as debt in the US and equity abroad.

Some trends are moving in the tax authorities' favour. The fall-out from the Enron scandal and the introduction of the Sarbanes-Oxley Act on corporate governance has led to more sophisticated internal controls on structuring financing. Revenue & Customs' disclosure regime, originally introduced in 2004, helped it devise a raft of measures aimed at specific structured finance schemes in the 2005 and 2006 Budgets.

The large advisory firms say that their tax businesses are increasingly focused on finding tax benefits from business restructuring, such as reconfigurations of supply chains, rather than more artificial schemes devised primarily for tax purposes.

Yet legislating against tax-driven deals has proved difficult for the government. Like squeezing a balloon, the problem does not go away. It merely pops up somewhere else. For example, Revenue & Customs has long grappled with avoidance opportunities stemming from the different tax treatment of capital and income. By structuring a transaction in a way that converts income into a capital gain, tax planners aim to defer tax bills – in many cases indefinitely.

A succession of Budgets have clamped down on this activity – first by stamping out transactions of this sort settled in cash and, more recently, those settled in shares. But there are signs that investors are now looking at other assets that can generate a secure, interest-type return taxed on a capital basis, such as property.

The scale of the profits generated by tax-driven deals mean that tax authorities will continue to be vigilant. Richard Murphy of the Tax Justice Network, a campaign group, who recently undertook a detailed analysis of an inter-bank transaction, says that billions of pounds of banks' own capital can be used in these deals.

But the tax authorities are obliged to take a cautious approach to ensure that their anti-avoidance measures do not have unintended consequences for the capital markets.

John Cullinane, president of the Chartered Institute of Taxation, says: "The Revenue is concerned that its anti-avoidance rules should not inadvertently hit areas of structured finance that are not tax-based, where London is the leading centre in Europe."

But there is a widespread feeling that the tax-driven structured finance experts will find new ways to get ahead of the tax authorities.

Louise Higginbottom, a partner of Norton Rose, the legal firm, thinks that the present mood of caution will not last for long. "At present, the recent spate of avoidance legislation and the new disclosure rules have given advisers pause for thought. However, as the new regimes become more familiar, it is likely that new transactions will emerge."

Bill Dodwell, a partner of Deloitte, professional services firm, also expects tax-driven structured finance to prove its resilience: "It is getting tough. There is a little less going on than there was. But it has not died down or gone away."

vanessa.houlder@ft.com