I wrote last year about the expected introduction of the UK’s first ever general anti-abuse rule (“A GAAR is born”). This year my musical point of reference is more contemporary, but the subject is essentially the same: what makes the difference between acceptable tax mitigation and unacceptable tax avoidance?

The question is hardly a new one, but never before has it had the same public profile.

In the UK, Parliament’s Public Accounts Committee has been an enthusiastic inquisitor of several famous US multinationals, notably Amazon, Google and Starbucks; and a Committee of the House of Lords has suggested the system for taxing multinationals is in such disarray that consideration should be given to a unitary tax (such as the Common Consolidated Corporate Tax Base favoured by the European Commission) or a destination-based tax (though that sounds a bit like VAT and, in a world with burgeoning numbers of Chinese and Indian consumers, might not work to the UK’s advantage anyway).

The same issue has been taken up at an international level. The Lough Erne Declaration, made by the G8 in June 2013, called for greater tax transparency; and a month later the OECD published its Action Plan on Base Erosion and Profit-Shifting (conveniently abbreviated as “BEPS”). Then in September it was reported that the European Commission had begun an informal investigation into assurances on tax treatment which it believed had been given to various multinationals by Ireland, Luxembourg and The Netherlands.

But I should like to focus on the UK’s domestic rules targeting “abuse” and “avoidance”, where talk has already turned into action. The UK has its first ever GAAR and HM Revenue & Customs (“HMRC”) have mooted specific amendments to the most important of the UK’s “targeted anti-avoidance rules” (“TAARs”).

Seven degrees of separation
Few would dispute that there are difficult issues here, even for those with rather more expertise in matters of taxation than some of the politicians who commonly pronounce on the subject. In a piece published in 2004 by Law Quarterly Review, Lord Walker (then a serving member of the Judicial Committee of the House of Lords) distinguished no fewer than seven degrees of tax avoidance, viz: (i) using a relief; (ii) finding a gap (e.g. turning income into capital, in the days when capital gains were not subject to tax); (iii) exploiting (or abusing) a relief; (iv) “anti-avoidance karate” (by which Lord Walker meant taxpayers turning anti-avoidance legislation to their advantage); (v) “unnatural assets or transactions”; (vi) pre-ordained transactions (a reference to the approach taken by the House of Lords in Furniss v Dawson (1984), a case I discuss below); and (vii) “dodgy offshore schemes”.

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Curiously, the GAAR guidance published in April 2013 (a joint effort by HMRC and a special panel assembled for this specific purpose) also suggested a seven-fold scale, but most of its elements are quite different. They are as follows (each with an example also drawn from the guidance):

(a) straightforward legislative choice (selling shares rather than assets);

(b) long-established practice (allowing shareholders in a listed company to choose whether to receive income or capital on a return of value);

(c) situations where the law deliberately sets precise rules or boundaries (granting an option rather than making an immediate sale, to defer CGT);

(d) standard tax planning combined with some artificiality (finance leasing where the funds are effectively returned to their provider – as in BMBF v Mawson, a leading decision of the House of Lords from 2004);

(e) transactions that are demonstrably contrary to the spirit of the law (a novel way of remunerating employees);

(f) exploiting a shortcoming in anti-avoidance legislation (methods of circumventing rules designed to tax as debt equity that has the economic characteristics of debt); and

(g) contrived arrangements producing a tax result wholly at odds with the legal effect and economic substance of the underlying transaction (the Mayes case from 2011, which involved a very convoluted scheme and could be seen as the proximate cause of the introduction of the GAAR).

The guidance concludes that category (d) begins to stray into GAAR territory. If it had been considering Lord Walker’s list, I suspect the guidance would alight on category (iii) or perhaps even category (ii) – which, if nothing else, is an illustration of the shift in thinking in this area in recent times.

But from a policy perspective, there are really only three categories to consider: schemes that are sufficiently wicked to merit application of the GAAR; those which are not abusive, but should nonetheless be countered by specific anti-avoidance legislation; and those which represent unobjectionable tax planning. With that categorisation in mind, I will devote the rest of this chapter to an examination of the GAAR as now enacted and then a discussion of the generic form of targeted anti-avoidance rule favoured by HMRC and the improvements that might be made to it.

THE GAAR

The UK’s GAAR was brought in by Finance Act 2013 (“FA 2013”) and will apply to any arrangements entered into on or after 17 July 2013. In its essentials, the legislation hardly differs from the draft that I discussed last year. The critical part is set out in subsections (1) to (4) of section 207 FA 2013 and reads as follows:

“(1) Arrangements are 'tax arrangements' if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements.
(2) Tax arrangements are ‘abusive’ if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including:

(a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,

(b) whether the means of achieving those results involves one or more contrived or abnormal steps, and

(c) whether the arrangements are intended to exploit any shortcomings in those provisions.

(3) Where tax arrangements form part of any other arrangements regard must also be had to those other arrangements.

(4) Each of the following is an example of something which might indicate that tax arrangements are abusive:

(a) the arrangements result in an amount of income, profits or gains for tax purposes that is significantly less than the amount for economic purposes,

(b) the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes, and

(c) the arrangements result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid,

but in each case only if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted.”

Other jurisdictions that have equivalent rules focus on abuse or artificiality; see the discussion in last year’s chapter. But the UK’s GAAR, following an approach suggested by Graham Aaronson QC, does not even attempt to identify the defining characteristic of unacceptable arrangements. The word “abusive” appears, but only as a defined term. It comes down to this: do the arrangements constitute a “reasonable course of action”?

I am still amazed that a Parliamentary draftsman was willing to adopt such a vacuous test. Happily, other parts of the GAAR are more satisfactory. The requirement that the arrangements “cannot reasonably be regarded” as a reasonable course of action is not a bad way of indicating that the GAAR is only meant to catch the outer reaches of tax planning; HMRC appear to have accepted that the GAAR should not be seen as a “broad spectrum antibiotic” and should only apply to “egregious” or “abusive and artificial” schemes. (These were all terms used in the original GAAR report or HMRC’s response to it.)

A similar test is used in other UK legislation. For example, the word “house” is defined in section 2(1) of the Leasehold Reform Act 1967 as including “any building designed or adapted for living in and reasonably so called”. In the Court of Appeal hearing of a case from 2008 (Grosvenor Estates Ltd v Prospect Estates Ltd), Mummery LJ noted that this test was satisfied only if “nobody could reasonably call the building a house”, and added this: “Within the limits of reasonableness, different minds can reach different conclusions which are not obviously wrong”.

The list of criteria in section 207(2) FA 2013 is also sensible, though there is no indication how many “bad” factors must be present before the GAAR can apply. Section 207(3) is helpful too: the wider context may rescue otherwise
“bad” arrangements. Taxpayers will hope that this provision encourages the courts to take a more lenient view of tax scheming which facilitates a commercial objective, an approach that they were willing to take when considering one of the UK’s oldest TAARs – see the discussion of the Brebner case below.

Taxpayers will also take some comfort from a few innovative features of the wider GAAR package. An Advisory Panel has been established, without HMRC membership, which will be asked to give its view in any case where HMRC wish to apply the GAAR; although that view will not be binding, it will plainly not be easy for HMRC to convince a court that a course of action “cannot reasonably be regarded” as reasonable if the Panel considers that the GAAR should not apply. And as noted above, extensive guidance has already appeared and here too the contribution from experts outside HMRC has been considerable.

GAAR guidance
But the guidance, though clear and balanced, inevitably reflects the void at the heart of the GAAR. It includes 32 examples, spread across the range of taxes covered by the GAAR, and indicates that 19 of the 32 would be regarded as abusive. Few would disagree with the conclusions reached. But there is no consideration of borderline scenarios, such as where an arguably artificial tax “trick” is inserted into a commercial transaction.

_Furniss v Dawson_ would be an ideal test case. The Dawsons were going to realise a substantial gain on selling a company. So they implemented a simple two-stage transaction to ensure that the gain arose offshore. First, they inserted an Isle of Man company (“IoMCo”) as the immediate owner of the target, through a share-for-share exchange designed to qualify as a tax-free reorganisation. On the same day IoMCo then sold the target.

I think most tax practitioners – and many at HMRC – would accept that such a simple scheme was not “egregious” or “abusive and artificial”. But it is less clear to me that the GAAR as drafted would not apply. (The actual decision of the House of Lords was that, in a “preordained series of transactions” such as this, the initial transfer to IoMCo could be disregarded as an inserted step with no commercial purpose. As I noted in last year’s introductory chapter, it is doubtful whether the UK’s highest court would reach the same decision today; the factual recharacterisation that it involved would seem to go beyond accepted principles of statutory interpretation.)

The GAAR guidance also struggles to make very much of the criteria in section 207(2) FA 2013. In three instances the schemes involve a contrived or abnormal step but are not “abusive”, and in two cases the schemes do not involve exploitation of legislative shortcomings but are nevertheless “abusive”. But in all 32 of the examples, the answer to section 207(2)(a) gives you the overall conclusion: schemes whose substantive results are consistent with the relevant legislative principles and policy objectives are not “abusive”, and vice versa.

So one might think it was only section 207(2)(a) that really mattered. If so, anyone attempting to determine whether the GAAR will apply in any particular case has remarkably little to go on.

The central problem with any general anti-abuse rule or principle is taxpayer uncertainty. Asking as the central question whether arrangements constitute “a reasonable course of action” almost seems designed to maximise this problem. I suggested last year, when the legislation was still in draft form, that instead the arrangements should have to be both artificial and (actually) abusive, two concepts which have been the subject of much judicial consideration in the context of other jurisdictions’ tax legislation. But I do not object to the phrase “could reasonably be regarded” as a test of egregiousness. Indeed, the hole at the heart of the GAAR could readily be filled if a simple definition were added, to state that arrangements constitute “a reasonable course of action” if and only if they are not abusive (or, perhaps better, if they “do not constitute an abuse of the relevant tax provisions”).
Of course, in the real world the prospects of any amendment to the GAAR in the immediate future are vanishingly remote. One can only hope that the measured approach taken by HMRC in the course of consultations over the GAAR will continue. If so, most UK corporates should have little to fear.

THE TAARS

By contrast, the UK’s numerous targeted anti-avoidance rules are very much a live concern and the most important of these is currently the subject of another HMRC consultation.

“Transactions in securities”

It is helpful to start here with a little history. The template for most of the TAARs that are potentially relevant to a corporate taxpayer was established by a piece of anti-avoidance legislation introduced in 1960, dealing with “transactions in securities”. There were two main targets: artificial “dividend-stripping” and “bond-washing”, and arrangements which sought to turn taxable income into what was at the time non-taxable capital.

The regime included complex provisions intended to identify the kinds of transaction that were in scope. But it was recognised that innocent arrangements could also be caught. So the legislation included an escape clause which applied if the taxpayer could show that the transactions were entered into for “bona fide commercial reasons” and that “none of them had as its main object, or one of its main objects, [securing] a tax advantage”.

This formulation gave the courts no clue how to determine whether, when transactions had a commercial purpose as well as a tax purpose, that tax purpose was “one of the main objects”. But in practice this did not matter very often. Where transactions sought to avoid a tax charge in the specified circumstances, or to create a tax loss, it was in most cases obvious that the escape clause did not apply.

Of course, there were exceptions. I have already mentioned the House of Lords’ decision in Brebner (1967). Here, the taxpayers implemented arrangements which allowed them to take profits out of a company they controlled in capital form, thus avoiding a significant tax charge. But they used the funds to repay a loan which it was accepted had been taken out for a good commercial reason connected with the survival of the company’s business. The court held that this justified the arrangements which had turned income into capital, and it was not appropriate to look at those arrangements in isolation.

The escape clause was also considered in a case called Sema which was heard by the Court of Appeal in 2003. A pension scheme had invested in a listed company which offered to buy back some of its shares. As the law then stood, the buy-back generated a tax credit for the pension scheme which entitled it to a payment from the Revenue. The tax credit payment turned what would otherwise have been a sale at a loss into a profitable investment and the scheme’s asset manager decided to participate in the buy-back on its behalf.

The fact-finding tribunal determined that securing the tax credit had been a main object of the transaction under which the shares held by the pension scheme were sold back to the company. In the High Court, the judge observed that a tax purpose which was merely incidental to a commercial purpose – “icing on the cake” – would not constitute a main object or purpose. HMRC have occasionally suggested that any object which is more than incidental must be a main object, but the judge’s comments do not justify such a conclusion.
Interest deductions
So it was far from clear when a tax purpose would be “one of the main objects” of the relevant transaction or transactions, but the nature of the “tax advantages” targeted by these rules meant that this only caused serious uncertainty in limited circumstances.

The same could hardly be said when an “unallowable purpose” rule was introduced as part of a new corporate debt regime in 1996 and used essentially the same formulation. The rule applies if securing a tax advantage (for the borrower or another party) is the main purpose, or one of the main purposes, for which a company makes or remains a party to a borrowing. That purpose is then an unallowable purpose and the rule denies deductions for so much of the interest (or other finance cost) as “on a just and reasonable apportionment is attributable to the unallowable purpose”.

The rule is now contained in sections 441 and 442 of the Corporation Tax Act 2009 (“CTA 2009”) but it is better known by its original statutory incarnation – paragraph 13 of Schedule 9 to the Finance Act 1996 – and I will refer to it as “paragraph 13” below.

The difficulty with paragraph 13 is that the definition of “tax advantage” (also taken from the transaction in securities regime) includes a standard interest deduction; there is no requirement that the benefit should be contrary to the relevant statutory purpose. So a tax advantage will accrue from any corporate borrowing.

What then if an acquisition is funded by debt rather than equity because of the accompanying interest deductions? Or taking this one step further, what if the debt is part of an internal reorganisation one result of which is the introduction of the debt, or if the company borrows intra-group in order to pay a dividend to another group member?

The problem was spotted at the time. The Government’s solution was a Ministerial Statement in Parliament which said that HMRC would not apply paragraph 13 to standard financings that were not “structured in an artificial way”.

One curious result of the uncertainty appears to have been a reluctance on the part of HMRC to litigate paragraph 13. HMRC have certainly threatened to apply the provision on many occasions, including to arrangements which clearly fell within the scope of the Ministerial Statement. But it was not until 2011 that there was any judicial consideration of paragraph 13, in a case called *Explainaway*. Indeed there is yet to be a case with precedent value in which HMRC have asserted that the interest deductions are themselves the relevant “tax advantage”. So the attitude of the higher courts remains to be tested.

Capital allowances
There has however been some judicial discussion of the threshold for establishing that securing a tax advantage is “a” main object or purpose, albeit in the context of other legislation. I have already mentioned *Sema*, in which the High Court said that securing the tax advantage must be more than “icing on the cake”. And a case heard by the Upper Tribunal in 2013, called *HMRC v Lloyds TSB Equipment Leasing (No 1) Ltd*, devoted 22 pages to the question.

*Lloyds Leasing* concerns the availability of capital allowances (tax depreciation for capital expenditure) under a ship leasing arrangement. This required that the ship was “let on charter in the course of a trade which consists of or includes operating ships by a person who is … resident in the United Kingdom…”. The (Japanese) shipping operator introduced a UK subsidiary as the immediate charterer of the ship and thereby satisfied this requirement. But the policy intention was to provide tax relief only to *bona fide* UK shipping operations and the regime therefore included a rule denying allowances if “the main object, or one of the main objects” of the charter (or of any related transaction) was to secure the capital allowances.
Despite the quite different statutory context, *Lloyds Leasing* comes a little closer to the central problem in paragraph 13, because it concerns a set of rules designed to provide precisely the tax benefit – in this instance, capital allowances – that is the subject of the TAAR. And that may help to explain why the First Tier Tribunal (“FTT”) found in favour of the taxpayer, even though the introduction of the UK subsidiary as charterer appears to have been something of an afterthought.

It was accepted that the insertion of the subsidiary into the arrangements had both a tax purpose and a commercial purpose. The Upper Tribunal agreed with HMRC that the tax purpose could be “a main object” even if the commercial object was more important. But that would not be the case if commercial considerations were “paramount”.

*Lloyds Leasing* is also a good illustration of another crucial point regarding the application of the UK’s anti-avoidance rules. The FTT will hear any witnesses and is the primary arbiter on issues of fact; and that will include any enquiry into motive.

There is an intriguing suggestion in *Lloyds Leasing* that the Upper Tribunal, being an “expert appellate tribunal” rather than an “ordinary court”, may have a greater role in factual matters than does the High Court. But the general position, established many years ago in a case called *Edwards v Bairstow*, is that any appellate court or tribunal should only interfere with a finding of fact if is so unreasonable as to constitute an error of law; as a Court of Appeal judge has put it, the conclusion must be “so unreasonable that no reasonable tribunal, properly construing the statute, could have reached it?” So the decision of the FTT is very likely to carry the day when HMRC are arguing that a motive test applies, particularly if this is framed subjectively – asking about the actual purpose of the relevant party – rather than as an objective test of the kind that has begun to appear more recently (“it is reasonable to conclude that ...”).

The difficulty of satisfying the criterion established by *Edwards v Bairstow* should perhaps be a further source of comfort for taxpayers worried by the GAAR, as it again shows the wide scope for differing views that are nonetheless reasonable.

In *Lloyds Leasing* itself, one of the two judges in the Upper Tribunal thought that the conclusion in the FTT was indeed insupportable. The other judge made it pretty clear that he too would have reached a different decision on the facts, but he was not persuaded that the FTT’s view was sufficiently unreasonable as to be wrong in law. As the second judge had the casting vote, the FTT’s decision was upheld. However, the case will shortly be heard by the Court of Appeal, so there may be a further twist in the tale here.

**HMRC consultation**

TAARs based on a similar “main purpose” test are scattered throughout the UK’s corporate tax code and they have been the subject of several reviews by HMRC. In particular, HMRC published in July 2009 a “discussion document on the simplification of unallowable purpose tests” which analysed their existing use and asked whether a template could be developed for any that might be introduced thereafter.

The results of this consultation were published some months later, but the exercise had little practical impact. As an example, the review determined that such tests should be subjective, not objective, and should look at the purpose of the relevant party or parties, not of the arrangements; yet the threshold test in the GAAR violates both those principles, as it asks whether “it would be reasonable to conclude that obtaining a tax advantage was the main purpose, or one of the main purposes, of the arrangements”.
The issue has now resurfaced in the context of a review of the rules governing the corporate taxation of loan relationships (corporate debt) and derivative contracts. The regime for the taxation of derivatives includes a rule modelled on paragraph 13 and a consultation document published by HMRC on 6 June 2013 suggested among other things that the two tests should be merged.

That would I think be fundamentally misguided. The tax outcome of a derivative is normally uncertain at the outset, but there can be arrangements which seek to ensure (for example) that, once the swap is clearly "in the money", no tax is paid on the resulting profit. It makes sense, therefore, to ask whether the tax result has been skewed in this way.

As I have already noted, the position is quite different for corporate debt, which will always give rise to a "tax advantage" as defined. It is perhaps no accident that the derivatives TAAR came before the courts some years before paragraph 13. In the case Prudential v R&C Commissioners (2008), the High Court considered a scheme which sought to obtain a substantial net deduction by characterising part of the payments due to the company under a swap as a (non-taxable) premium received for entering into the contract. The main purpose test was found to apply.

Redrafting paragraph 13
In my view, therefore, far from merging the two tests, they should be separated in substance as well as form by amending paragraph 13 to reflect the fact that a "tax advantage" is inherent in any corporate borrowing.

The simple answer would be to switch to asking whether securing the tax advantage is "the sole or main purpose" of the borrowing. This would follow the approach used for another TAAR designed for a tax regime where a tax benefit is intrinsic to the regime. The UK's CGT participation exemption, mentioned at the start of this chapter, does not apply if obtaining the exemption is "the sole or main benefit that could be expected to arise" from the relevant arrangements.

HMRC may feel that this would take them back to the formulation in what is now section 443 CTA 2009, a provision which has proved to be of very limited use. But that is because it was aimed at "egregious" schemes of the kind exemplified by a case called Cairns v MacDiarmid (1983), where the taxpayer sought to claim a deduction for a year's interest even though he only had the benefit of the loan principal for four days and incurred no net expense – in other words, schemes that would now be a suitable target for the GAAR. It is other elements of section 443, not the "sole or main benefit" criterion, that restrict its application.

If HMRC are determined to stick with a test based on "a main purpose", they could instead expand paragraph 13 so that it distinguished between "good" and "bad" tax advantages.

The drafting of the GAAR suggests some possible indicators. Thus paragraph 13 could be stated to apply by reason of the tax advantage naturally associated with the debt only if there is a significant divergence between the tax and economic consequences of the loan (and of any other arrangements of which it forms part). Such a divergence has been recognised by the House of Lords as characteristic of the difference between "tax mitigation" and "tax avoidance". In IRC v Willoughby (1997), Lord Nolan said this:

"The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be incurred by any taxpayer qualifying for such reduction in his tax liability."
The same idea is reflected in paragraphs (a) and (b) of section 207(4) FA 2013, part of the central text of the GAAR quoted above.

The draftsman could as an alternative look for inspiration to section 207(2), requiring that the debt in question should form part of arrangements which include "one or more contrived or abnormal steps", or which "are intended to exploit any shortcomings" in the corporate debt code. But that would increase the appearance of overlap with the GAAR and would be less well targeted on the essential characteristic of a "bad" tax advantage in this context.

As currently drafted, paragraph 13 can also apply where the debt itself is unobjectionable but it funds a tax scheme; indeed, that was the position in the Explainaway case, noted above, which saw the first judicial consideration of the rule (as an adjunct to the court’s support for HMRC’s main contention, which was aimed at the scheme itself rather than the borrowing).

It is not clear to me why the rule should operate in this way. HMRC could surely rely on the GAAR or, to the extent necessary, a TAAR focused on the tax advantage arising out of the scheme itself. But if this feature of paragraph 13 is regarded as important from a policy perspective, it could be retained alongside the change that I am suggesting.

Finally, paragraph 13 can be triggered because the borrower is trying to secure a tax advantage for another person. The obvious example is a loan which forms part of arrangements designed to access trapped losses in another group member; the UK allows losses arising in any particular year to be "surrendered" for use against profits accruing in the same year to a company that is part of the same group, but brought forward losses cannot be used in this way.

A transaction of this kind in fact appears as the first example in the GAAR guidance. The commentary states that it is consistent with the principles behind and policy objectives of the relevant tax rules and is therefore not "abusive". However, it also includes the following cryptic observation:

"Subject to a loan not having an unallowable purpose within s441 CTA 2009, HMRC has indicated its acceptance of such arrangements."

It is not clear in what circumstances HMRC believe the unallowable purpose rule should nonetheless apply. In my view, this should only be the case if one of the two further tests set out above is also satisfied – that is, where there is a significant divergence between the tax and economic results, or (possibly) where the arrangements include a contrived or abnormal step or are designed to exploit shortcomings in the legislation. But this, too, is a policy question which can be determined as a separate matter.

CONCLUSION

The x factor will necessarily remain elusive; certainly, I cannot pretend to have identified it here. But I do believe it should be possible to reduce the vagueness of much of the UK’s tax legislation aimed at abuse and avoidance, with a consequent reduction in the uncertainty that is the main drawback of all such legislation.

I fear we cannot hope for any improvement in the drafting of the GAAR, at least in the short term, so we are stuck with a test which asks whether the relevant arrangements constitute a “reasonable course of action”; they need not in fact be abusive. However, there seems a fair chance that in practice its application will for some years to come be confined to schemes that merit one of the descriptions commonly used by the proponents of the GAAR; “egregious” or “artificial and abusive” were much used when the GAAR was under development, and “aggressive
avoidance" is a current political favourite. If that is how HMRC operates the GAAR, the responsible corporate taxpayer should have little to fear.

It remains to be seen what changes will be made to the "main purpose" test in the corporate debt regime, and whether there will be any fresh thinking in relation to the numerous provisions that are similarly drafted. Here the key is I think to recognise the difference between parts of the tax code that naturally give rise to reliefs and those that do not: anti-avoidance rules should be more narrowly targeted in the first context than in the second. The TAARs are a much more pressing concern for UK companies than the GAAR, so any progress on this front would be of real practical benefit.

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This article first appeared as the introductory chapter to The International Comparative Legal Guide To: Corporate Tax 2014, published by Global Legal Group Ltd, London