CONTROLLED FOREIGN COMPANY - motive test - captive insurance - whether main purpose of transaction with the captives was to obtain tax reduction - no - whether main reason for the existence of the captives was to achieve a reduction of tax by diversion of profits from the UK - yes -Taxes Act 1988 s.748(3)

THE SPECIAL COMMISSIONERS

ASSOCIATION OF BRITISH TRAVEL AGENTS LIMITED - Appellant
- and -
THE COMMISSIONERS OF INLAND REVENUE - Respondents

Special Commissioner: DR JOHN F AVERY JONES CBE

DR NUALA BRICE

Sitting in London on 2-6, 9-13 September, 14-16 October, 4, 19, 21, 22 November 2002

Giles Goodfellow and Richard Vallat of counsel instructed by Simon Bunce, ABTA legal department for the Appellant

Elizabeth Gloster QC and David Ewart instructed by the Solicitor of Inland Revenue for the Respondents

NOT FOR PUBLICATION

DECISION

1. This is an appeal by the Association of British Travel Agents Limited (ABTA) against 11 Directions made by the Board of Inland Revenue applying the controlled foreign companies legislation in section 747 onwards of the Taxes Act 1988 to the profits of two captive insurance companies for periods ending 30 June 1995 to 30 June 1999 for both companies and in addition for the period 6 May 1994 to 5 May 1995 in respect of one of them. It is now accepted that for the periods up to 30 June 1996 both companies followed an acceptable distribution policy. Accordingly, we are concerned only with the periods ended 30 June 1997, 1998 and 1999. The issue in relation to those years is whether the Appellant can satisfy what is generally known as the motive test to prevent the controlled foreign companies legislation from applying; it is common ground that all the other conditions for the application of that legislation are satisfied. The Appellant was represented by Mr Giles Goodfellow and Mr Richard Vallat, and the Respondent Commissioners of Inland Revenue by Miss Elizabeth Gloster QC and Mr David Ewart.
2. We had 13 ring binders of documents including witness statements from 12 witnesses, all of whom gave evidence.

Introduction

3. ABTA is well known for what is popularly known as the ABTA promise, which is that the travelling public is protected against failure of ABTA members in relation to travel arrangements. It also covers ABTA tour operators against failure of ABTA travel agents who have taken money from the public and not passed it on to the tour operator. The promise has been held to be legally binding: *Bowerman v ABTA,* Court of Appeal, 21 November 1995 (unreported).
4. ABTA is a trade association whose members comprise both tour operators and travel agents. Their interests are opposed in that each wants a larger share of the customer's expenditure, and consequently each group does not want to subsidise ABTA's expenditure on the other. Within each class of member there are also potential conflicts between the interests of large and financially secure companies and smaller and less financially secure specialist ones with the former not wanting to subsidise the ABTA promise for the latter, and the latter depending on the ABTA promise for their credibility. It is the ABTA promise that keeps the tour operators, travel agents and members of different sizes of each group together. ABTA's committee structure is such that members of all sizes are represented. The ultimate decision maker is the National Council on which both tour operators and travel agents are represented. Each of them has a separate council, the Tour Operators' Council (TOC) and the Travel Agents' Council (TAC) at which the main business affecting each group is conducted. Council members are in business and their work for ABTA is voluntary and intermittent. There is a full time secretariat.
5. ABTA's articles of association provide that tour operator members must have in force a bond or other security in such form and amount as is acceptable to TOC. They must also have contributed to the premium for a current insurance policy approved by TOC (in the November 1997 articles, of an amount approved by the National Council) for the purpose of providing further cover if the bond or other security proves inadequate to secure their liability. Contributions to the premium are proportionate to turnover shown in their latest audited accounts. For travel agent members the TAC may require any member to provide security for the protection of the Travel Agents' Fund by bond, guarantee or other security in such form and such amount as the TAC considers necessary. Failure to do so entitles TAC to terminate the travel agent's membership. Contributions to the Tour Operators' Fund or Travel Agents' Fund may not exceed half the membership subscription.
6. From 1991 tour operators which included air travel in their travel arrangements were bonded through the Air Travel Organisers' Licensing (ATOL) scheme. The ABTA promise therefore covers only other ("non-licensable") activities of tour operators. Large tour operators have their own bonding and insurance arrangements through the Tour Operators Study Group which are approved by ABTA and accordingly these members are excluded from the matters considered in this case. Other tour operators conducting non-licensable activities provided a bond to ABTA for 10 per cent of their non-licensable turnover. The bond guarantees to ABTA the member's obligations to its customers under the ABTA promise. Bonds were obtainable from banks which required security and charged about 1 per cent of the value of the bond per annum, and from insurance companies on an unsecured basis which cost about 6 to 7 per cent of the value of the bond per annum. Travel agent members also provided bonds but based on 2 to 3 per cent of turnover.
7. ABTA took out insurance against liability in excess of the bonds. The insurance was funded by a levy from members for that purpose which was

based on the member's turnover. ABTA also maintains internal funds, the ABTA Travel Agents' Fund and the ABTA Tour Operators' Fund, funded by levies from members which, under the articles of association, cannot exceed 50 per cent of the member's subscription. Thus on the failure of a member the funds that are available to meet the ABTA promise to the customer are first the bond, next the shortfall insurance, then the relevant internal fund, and lastly ABTA's general funds. From the tax point of view, the income of the internal funds were treated as ABTA's trading income. The amounts of the contributions received from members in each year, less the amounts of claims paid out in that year, were treated as ABTA's trading profits. If the amount of claims paid out in any year exceeded the amount of contributions, then the balance was treated as a trading loss of ABTA which ABTA could set against its other profits or carry forward in the normal way. The same of course applied to payments out of ABTA's general funds.

8. In the early 1990s there was a high rate of failures among both tour operators and travel agents. Levies were made for the internal funds of £1.5m in 1991, £1.4m in 1992 and £600k in 1993. The following table shows the amount of claims and the source of funding of those claims in respect of tour operators (the corresponding figures for travel agents are given in the table in paragraph 31 below) for the ABTA promise. The figures are in £000.

	1991	**1992**	**1993**
Bonds	6,735	1,447	3,629
Insurance	2,000	936	2,992
ABTA funds	5,420	0	0
Total	14,155	2,383	6,621

9. The effect of claims both in respect of tour operators and travel agents on ABTA's financial position was serious. In the 30 June 1991 accounts its reserves fell by 60 per cent from £3.688m at the end of the previous year to £1.459m.
10. In March 1991 following publicity about the very high level of failures of members, ABTA approached the Department of Trade and Industry about its position saying that as a result of the latest levy it was still able to meet its obligations. Mr Edward Leigh, Parliamentary Under-Secretary of State at the DTI, was concerned about this and asked them to provide up-to-date accounts verified by auditors. These were duly provided and confirmed ABTA's solvency. Advice was also taken from Peat Marwick McLintock which we did not see but was understood to be slightly more favourable than the auditors' opinion. The DTI telephoned to say that they were satisfied. It was made clear in these discussions that government funding would not be available.
11. With effect from 23 December 1992 the Package Travel, Package Holidays and Package Tour Regulations 1992 (SI 1992/3288) (the Regulations) provided that if tour operators were members of an approved body having appropriate insurance with an approved insurer in the EU, tour operators were required to provide a bond of 10 per cent of turnover; if not, they were required to provide a bond of 25 per cent. Because of its having shortfall insurance ABTA was an approved body, approval being given formally on 12 February 1993. The consequences for ABTA if they were

not able to renew the shortfall insurance in 1993 were therefore serious: they would cease to be an approved body under the Regulations and their tour operator members would be required to provide a bond of 25 per cent of turnover, which most of them could not afford to do.

12. ABTA was at the same time tightening up on reporting by members and investigating their financial position. This was expected to reduce the number of failures in the long term but there were doubts about how much effect this would have in the short term. In fact the changes (and perhaps the improved economic situation) had an immediate effect and ABTA's reserves at 30 June 1992 were restored to the 1990 level of £3.1m.
13. About this time there was also a proposal for a Travel Protection Association (TPA) under which all bodies providing travel would arrange for each customer to pay £1 to a fund operated by a company limited by guarantee to protect the public against failures of tour operators and travel agents. It was expected that firm proposals would be available by the end of 1992. The TAC approved the principle of the proposals in February 1993. The time of establishment of such a fund was then thought to be about two years in the future. The possibility of this being brought forward to coincide with the ABTA shortfall insurance renewal in May 1993 was considered but rejected. Fairly detailed proposals were available in March 1993 by which time it was thought it would start in the second half of 1993. By April 1993 it looked as if a start in 1994 was now likely. Different views were held about whether TPA would ever happen. Mr Fleming (Chairman of TOC) was among those who thought it would happen. The problem of ABTA securing the obligations of tour operators was therefore at the time thought by many to be a short-term issue. In fact the proposal did not succeed and was abandoned in September 1993 after the tour operators' captive had been set up.
14. Subsequently ABTA investigated its own consumer levy scheme under which the travelling public would buy ABTAsure stamps. Nothing came of this proposal.

Tour operators

15. Difficulties had been experienced in renewing the shortfall insurance in 1992. The Commercial Union refused to quote. By the beginning of 1993 it was becoming clear that insurance might not be available at all on the May 1993 renewal. In March 1993 it was estimated that under the current insurance policy, insurers would have received a premium of £750,000 and paid claims of £2.5m in the current year for tour operators. Since many of the bonds were also provided by insurance companies it was expected that renewal of these would also become difficult for members. This problem became particularly serious by March 1993 and the TOC had to extend time for renewal of bonds. On the renewal of the shortfall insurance in May 1993 the terms offered by the market contained very little insurance with the premium virtually being equal to the cover after a substantial excess. These were unacceptable to TOC who resolved on 6 May 1993 to reject the quotation. Before this decision was made, invoices had been sent out to tour operator members to collect £1.7m, being the first instalment of the contribution to the expected premium.
16. The possibility of modifying the ABTA promise was also considered and rejected. This left ABTA with two alternatives for tour operators: a fund within ABTA, and captive insurance. The alternative of doing nothing, resulting in 25 per cent bonding by tour operators was clearly unacceptable. An in-house fund would (or at least it was thought by some to) require a change in the Articles if contributions were payable (as had

insurance premiums been in the past) on a basis other than a percentage (with a maximum of 50 per cent) of subscriptions; the articles provided for contributions to insurance premiums to be in proportion to turnover. Some people, including Mr Dunscombe (Chief Executive), thought that there would be a problem with obtaining the necessary majority because on a poll larger members had more votes and essentially they would be paying to provide cover for weaker members. Others thought that such a change would be possible as the fund would merely be a replacement for the existing shortfall insurance with contributions being collected on a similar basis as a proportion of turnover.

17. The idea of a captive had been considered in 1991 for the travel agents' side and rejected at the time. Some papers obtained then were re-circulated to the National Council in February 1992. The secretariat obtained some further information about captives from Willis Corroon Group in a letter of 17 May 1993. A meeting of the National Council on 19 May 1993 set up a working party of five TOC members and Mr Chandler (Head of Finance) to study the captive route. A letter was sent on 24 May 1993 to tour operator members who were then due to contribute to the premium for the insurance stating that the options of an in-house fund and a captive were being considered on the basis of tax and administrative cost. An enclosure explained that no refunds of the money collected for external insurance would be made. Willis Corroon gave further illustrations for a captive on 27 May 1993 and attended a presentation on 2 June 1993 to the working party, which was attended by Mr Fleming (Chairman of TOC), Mr Perez (Chairman of the Bonding Administration Committee), Mr Dunscombe (Chief Executive), two members of the internal legal department and Mr Malacrida (Chantrey Vellacott, ABTA's auditors). Mr Malacrida records in his note of the meeting that the captive proposal was unattractive: premiums were £4.3m over 3 years for cover of only £1m in years 1 and 2 and £3m in year 3. The minutes of the meeting record that an in-house fund lasting for two years until TPA was expected to be in place, with the balance being distributed to the members at the end of year 2, was therefore the preferred option. Mr Malacrida was asked to write a paper on the tax implications of each proposal. All the witnesses from the Secretariat agreed that they took advice on tax before deciding on a course of action; it would be surprising if they did not. The meeting also resolved to recommend calling an EGM on 7 July to amend the articles and in the event of the resolution failing the second option of a captive was agreed with Willis Corroon to be asked provide an amended proposal. The fact that money had been collected on account of premiums for external insurance did not play any part in the decision.
18. On 8 June 1993 Willis Corroon came up with an amended proposal which included a profit participation under which if claims did not exceed 20 per cent of the premium 75 per cent of the premium was returned to ABTA and thence to the contributing members, with a sliding scale for claims of a greater percentage. Mr Dunscombe reported to the National Council on 9 June that this appeared to have advantages over the cash fund including the return of a proportion of the premium and reduced tax costs. This is puzzling because, as Mr Dunscombe accepted, the internal fund proposal included a refund of the balance of the fund after two years and so the captive proposal was now the same in this respect, rather than the refund being an advantage of the captive. However, it is clear that the amended proposal for a captive had advantages over the original proposal for a captive as the amended proposal included a return of premiums which the original proposal did not. The Council asked the working party to reconvene and consider the alternatives further. Willis Corroon gave some slightly revised figures on 11 June.

19. Mr Malacrida wrote a 17 page report on 11 June 1993 comparing the two alternatives. He did this on the basis of figures for two years. The fund was assumed to remain in being at the end of this period but the report stated that moneys could be returned when the fund was wound up, presumably referring to TPA taking over. The captive proposal was also on a two-year basis but the report showed both the effect of a return of a proportion of the premiums to ABTA and by ABTA to the contributing members under the profit participation, and the remaining profit being distributed to ABTA at the end of that period. Three examples were given. In the example where the funds were £2.5m and the claims £1.5m each year, members pay £4,275K with the fund and £3,193K with the captive, a difference of £1,082K or 25 per cent less. Mr Malacrida in his evidence gave us the split between the two years by correcting the figures prepared by the Respondent which Miss Gloster put to him, which was expanded by him in a schedule handed in later. These show that in both cases the year 1 contribution is £2.5m; the year 2 contribution is £1,775 for the fund and £1,350K for the captive (the reason is that the fund is made up to £2.5m, but the captive premium is a pound for pound contribution where claims exceed £150K which results in the fund at the beginning of year 2 being £2.655m); and there is the return to members of the profit commission of £657K for the captive. This difference in contributions is represented by £428K additional tax with the fund and £650K additional funds after tax remaining in ABTA with the fund (the difference in total is due to rounding). His conclusion was that the captive was a tax-efficient long-term vehicle, and the in-house fund was best suited to a short-term situation.
20. The working party comprising Mr Fleming (Chairman of TOC), Mr Dunscombe, Mr Malacrida and a member of the internal legal department met on 14 June 1993. The note of the meeting records that Mr Fleming had spoken to Mr Perez, who was unable to attend, on Saturday 12 June 1993 but that Mr Perez had not seen the report as he did not have a fax machine at home. The working party resolved to pursue the captive route further "as there was little difference between the net cost to ABTA members of either scheme, whereas from a cash flow point of view the reserve fund meant that tax liabilities would fall due earlier." We have difficulty in understanding this as Mr Malacrida's figures showed a considerable difference in the cost to members. Willis Corroon were to be asked to produce a revised quotation taking into account eight listed points, which they did on 16 and 17 June 1993. One of the changes was that the profit commission could result in 95 per cent of the premium being returned to members. On 18 June, Mr Fleming sent a fax to Mr Parker (ABTA Treasurer) saying that "One of the main advantages that had emerged during our discussion vis-a-vis a captive as opposed to self funding is tax savings." Mr Malacrida revised the figures in his report on 21 June incorporating the latest Willis Corroon figures. He records a telephone conversation with Mr Fleming on 23 June:

    "I summarised my conclusions, which were that the captive insurance route had cash flow advantages to the members, in that the amounts that would be required in year 2 would be significantly lower than in the reserve fund, as there would be no need to provide additional funds to pay for the tax liabilities. Similarly, the members would have the certainty of knowing the amount coming back to them under the captive route when the policy period expired, whereas with the reserve fund this could only come back to the members should ABTA's responsibility for shortfall cover be taken over by someone else."

In cross-examination Mr Fleming, who Mr Chandler (Head of Financial Services) regarded as the best-informed member of the working party, said that he understood the cash flow advantage to be the tax difference. Mr Dunscombe and Mr Chandler in their evidence distinguished between the two. It seems to us, with the benefit of seeing Mr Malacrida's split of the figures for the two years summarised in paragraph 19 above, that there are two separate items affecting how much and when the members have to pay which might be described as cash flow: the tax benefit (which mainly affects the members' contributions at the beginning of year 2) and the profit commission (which results in a payment to members at the end of year 2), that were not always kept separate in people's minds. Mr Dunscombe and Mr Fleming advised the TOC about the proposal on 24 June summarising the advantages of the captive as "cash flow/tax." After discussion, the TOC recommended the captive route on 24 June and the National Council approved it on 30 June.

Tour Operators Limited

21. The captive, ABTA Insurance Company (Guernsey) Limited (Tour Operators Limited) was set up on 13 July 1993 and the first board meeting took place on 19 July 1993. It was authorised by the Guernsey Financial Services Commission on 28 September 1993. The proposal was for a 24 month policy with a limit of £2.5m cover and a premium of the same amount of which £125,000 was paid to ABTA as brokerage (which was taxable in its hands) and put back into Tour Operators Limited as part of the capital of £225,000 (non-deductible). The Guernsey authority required a higher capital of £427,500 than Willis Corroon had expected. The additional amount was provided by a letter of credit secured on a blocked bank account of ABTA. At the end of year 1 a further premium was payable to restore the fund to £2.5m. The business plan included a profit participation resulting in a maximum return of 95 per cent of premiums. Additional capital was £100,000 paid in cash and £202,500 provided by a letter of credit. In order to comply with the Regulations requiring insurance with an EU insurer, the policy was fronted by Reliance National Insurance Company (UK) Limited for the first £1.5m for each year, meaning that Reliance National reinsured the whole of its risk with the captive on the same terms in return for a fee of £75,000. In order to protect itself, Reliance National required that premiums were required to be held in a trust fund. Considerable delays occurred in setting this up. In January 1994 this had still not been done and Reliance National said that they did not then consider themselves on risk and would return the premium if the trust deed were not completed. Mr Perez was unaware of this problem when he became a director in February 1994. The trust deed was never dated so we do not know when it was completed. The fronting policy was not signed until 17 June 1994 and no earlier cover note was produced. On day 13 of the hearing we were shown for the first time a copy signed by Tour Operators Limited of the reinsurance agreement between Reliance National and Tour Operators Limited, although without stating the date when it was signed. In addition to the cover fronted by Reliance National, Tour Operators Limited provided direct insurance to ABTA for a further £1m for each year, and its liability also covered the fronting policy being inoperative. We were given a copy of the cover note for the direct insurance on day 13 of the hearing. This is dated 20 October 1994 and relates to insurance starting on 1 July 1993.
22. The board of Tour Operators Limited consisted of Mr Harwood (Guernsey Advocate), Mr Ford of Lloyds Bank plc also resident in Guernsey and Mr Dunscombe. Mr Dunscombe was replaced by Mr Perez in February 1994.

Mr Ford was replaced by Mr Cutts-Watson between the meetings in February and June 1996 and he was replaced by Mr Niven who was Mr Ford's successor at Lloyds Bank on 15 October 1996. Mr Monk (Head of Finance) regularly attended board meetings. The board met in Guernsey and considered a quarterly report by the managers, Willis Corroon Management (Guernsey) Limited. The board determined the terms of the policies and the terms of their renewal.

23. A summary of the policies issued by Tour Operators Limited and their results are as follows:

Policy years	**13.7.93 to 31.3.96**	**Year to 31.3.97**	**Year to 31.3.98**	**Year to 31.3.99**	**Year to 31.3.00**
Cover	2,500,000	2,500,000	1,500,000	1,500,000	1,500,000
Premiums	2,900,000	1,750,000	850,000	600,000	500,000
Fronting fee	(75,000)				
Brokerage	(205,000)				
Claims	(301,000)	(46,312)	(227,786)	(30,164)	(173,373)
Profit commission	(1,916,975)	(1,225,000)			
Underwriting commission	401,848	478,688	622,214	569,836	326,627
Accounts profit (Year to 30 June following end of policy)	669,123	588,767	728,637	695,768	507,657

24.

25. The first policy initially covered the period from 1 July 1993 to 30 June 1995. The policy was extended for a further 12 months resulting in the profit commission being deferred for this period. The policy provided for a maximum profit commission of 70 per cent of the premium, not 95 per cent as in the business plan. The premium for the extension was £400,000, being the amount estimated to be required to make the capital and reserves up to £2.5m. Fronting was not required for the extension because the Regulations had been changed from 24 June 1995 by the Package Travel, Package Holidays and Package Tours (Amendment) Regulations 1995 (SI 1995/1648) to allow insurance with Guernsey companies. The termination of the fronting policy which was not extended triggered payment of the profit commission of £411,975. At ABTA's request the extended policy was terminated prematurely on 31 March 1996 to make it easier to include the figures in the ABTA accounts. We have shown the first policy as extended and terminated prematurely as a single policy in the table above. In all cases, the amount of the premium is that necessary to bring the capital and reserves up to the amount of the cover. The policy covering the period to 31 March 1997 was the last to contain profit commission. In previous years it had been paid out and then returned as premium. Mr Monk (Head of Finance, succeeding Mr Chandler) did not see any point in continuing it. The accounts profit comprises the underwriting profit shown in the table plus investment income less expenses.

26. Claims by customers of failed members are made to ABTA and are investigated by them. This investigation also determines whether there is

a claim under the policy. Tour Operators Limited rely on ABTA's investigations of claims. ABTA are able to pay claims from an imprest account of the captive containing £10,000 without prior approval of the captive. The claim is notified to the captive at the same time as the payment is made.

27. Before the extension of the first policy in March 1995 Mr Monk recorded in a paper for TOC that "Clearly, the main benefit of leaving the risk within the Captive will be the retention of any future profits. Additionally any remittance back to the UK can remain under our control which will have important tax implications." At the TOC on 9 March 1995 he is recorded as saying that the captive was proving to be an excellent long-term investment and that the did not foresee any need to consider any distribution of funds at least for the time being.
28. It should be pointed out that the part of the expected cash flow advantage to members of the refund of the profit commission was not realised. The way the captive was in fact operated was that any return of premiums on account of profit commission was made to ABTA and not redistributed to members. The profit participation was used towards funding the next premium. Mr Monk kept a memorandum account showing that the tour operator members as a class benefited from the return of premiums but strictly they became part of ABTA's general funds. Effectively therefore the captive operated in exactly the same way as an in-house fund would have done. This was inevitable once TPA had been abandoned and the captive was a continuing entity.
29. It will be seen from the table that claims were very low compared to the experience before the setting up of the captive. Some people, like Mr Monk, had taken a pessimistic view of future claims in the light of past experience; others were hoping for some improvement because of better supervision by ABTA of members' accounts. Everyone was surprised that the improvement was so great, which can probably be attributed in part to the improved economic situation.
30. Mr Hopkirk (Willis Corroon, London), who was keen to earn what would have been substantial brokerage, tried to obtain quotes from insurers in the market. On the 1995 renewal one company showed some interest but declined to quote. He did not recall obtaining quotations in 1996 but said that he would have asked around unofficially. In 1997 indications were obtained from 8 insurers in the market. In 1998 two indicative quotes were obtained. In every case the rate paid to the captive was better than these quotes.
31. Mr Gilkes (the Revenue's expert witness on insurance) criticised the lack of care with which the policies were constructed, such as the absence of a definition of profit for profit commission purposes. He also criticised the removal of the profit commission in the later policies as not being an arm's length transaction. When dealing with a wholly-owned subsidiary some informality might be expected. The intention of the parties seems to have been reasonably clear and did not give rise to any dispute. Because ABTA owned the captive and the profit participation was returned to pay the next premium, it made no difference to ABTA (except the calculation of the dividend to satisfy the acceptable distribution policy) whether it existed. We are surprised, however, that the fronting insurer stated that it was not on risk as late as January 1994 (although this may have been a statement made to force the completion of the trust agreement) and did not sign the first policy until 17 June 1994, and that the cover note for the direct insurance in excess of the cover in the fronted insurance was not signed until 20 October 1994. Tour Operators Limited was apparently at risk for the fronting insurer's liability until the Reliance policy was issued but no cover note for that insurance was issued until more than 15 months

into the policy period. In the end this made no difference to anyone as the fronting policy when it was finally signed took effect from the beginning of the policy period. All the witnesses with experience of insurance said that a delay in the issue of policies was the norm. However, we do not believe that delays such as Tour Operators issuing a cover note on 20 October 1994 for cover starting on 1 July 1993 is normal. They way in which the early documentation was handled does no credit to those involved but ultimately is not relevant to our decision.

Travel agents

32. Travel agents were experiencing the same problems as tour operators in the early 1990s. The following table shows the total amount of claims paid by ABTA and the sources from which those claims were met. The figures are in £000.

	1991	**1992**	**1993**
Bonds	2,265	2,050	2,314
Insurance	1,000	1,218	1,047
ABTA funds	1,298	300	333
Total	4,563	3,568	3,694

33. The travel agents' class had, as has been mentioned, begun to look at the possibility of using a captive in 1991. A presentation was made to a Working Party of the TAC, although at that time it was expected that the captive would be to be able to reinsure the risk from the start, but nothing came of the proposal. They also decided to look at an optional bond replacement scheme in December 1991 but decided not to pursue it because of the unpredictability of the claim levels. Mr Malacrida also raised the possibility that this would amount to unauthorised insurance, a view which was supported by the Head of Legal Services as recorded at a TAC meeting in January 1992. Mr Malacrida suggested that the possibility of using a captive be explored further.
34. As with tour operators, it became clear by early in 1993 that it would be impossible to obtain insurance for travel agents' failures from the market at acceptable rates. In March 1992 it was estimated that the insurers would in the current policy year have taken a premium of £440,000 and paid out claims of £1.6m in respect of travel agents. At the same time travel agent members were finding difficulty in obtaining bonds from insurance companies. From early 1993 consideration was given to ABTA self-insuring travel agents through a scheme called Travel Agents' Bond Replacement Scheme (TABRS) to replace the requirement to obtain a bond. Originally this was intended to be compulsory, except for members with turnover exceeding £50m, in order to avoid selection resulting in all the bad risks being in TABRS and those who were a good risk obtaining bonds in the market. The cost would be a flat rate for all members plus a charge based on turnover. By March 1993 the proposal had changed so that, while the compulsory flat rate part continued, the turnover charge had become a voluntary optional alternative to bonding because substantial members would not agree to join such a scheme as they could obtain bonds more cheaply in the market. A special meeting of the National Council in March 1993 suggested that the idea of a captive should

be revived. In April 1993 the TAC resolved on an optional, rather than a compulsory, fund. By May 1993 it was proposed again that it should be mandatory, which the TAC then approved. Various drafts for a compulsory scheme were considered during 1993. A scheme with a compulsory flat rate charge plus an optional charge based on turnover was approved by TAC on 8 September 1993. The National Council had endorsed the scheme in principle on 15 September 1993 leaving it to the TAC to settle the details.

35. Mr Monk presented a further paper to the TAC on 13 October 1993, which was approved in principle. The paper envisages an in-house fund, but at the meeting he recommended that, as the income would attract corporation tax, a captive should be used, which the committee approved if it were practicable. Mr Monk saw as a problem that if ABTA took in sums based on the risk it might be carrying on unauthorised insurance. Others did not agree and outside legal advice had been taken in March 1993, of which Mr Monk was unaware, that this was not the case. It seems that, while Mr Monk maintained this view, he did not do anything to prevent the TABRS proposal going ahead and this was not a reason for choosing the captive. Travel agent members were informed by letter of 19 October 1993 that the new scheme would run from 1 January 1994 without saying that it was to be run by a captive. On 27 October 1993 the National Council approved TABRS and the use of a captive on the basis of Mr Monk's advice. Mr Malacrida met Mr Monk on 3 November and the former notes that the reason for the scheme being off-shore was to keep tax on the funds at a minimum. Mr Malacrida was instructed to review the business plan of TABRS. The National Council was informed on 25 May 1994 that the new captive had been formed. Mr Monk was trying to obtain permission from the Guernsey Insurance Commissioner that the insurance should run from 1 January 1994.
36. The business plan provided for a 3 year policy from 1 January 1994 with the sum assured limited to 125 per cent of net premiums subject to a maximum of £7.5m (incorrectly stated as £7.5bn in the first three policies). The actual premium could not be determined in advance since it depended on how many travel agent members decided to join the voluntary element of the scheme. ABTA was to receive brokerage of 20 per cent of the premium. In other words if the premium is 100, ABTA receives 20 as brokerage, puts this back as capital (paying tax on the brokerage income on the way and not obtaining a deduction for the contribution to capital), the net premium is 80 and the sum assured is 125 per cent of 80 equals 100, being the capital plus the net premium. The business plan did not set out the profit participation but the first policy provided a sliding scale with nothing returned if claims were 70 per cent of the premium to 30 per cent returned if claims did not exceed 10 per cent of the premium, which is a different and less generous scale from the policies issued by Tour Operators Limited.
37. On 6 July 1994 the National Council approved the scheme but asked Mr Malacrida to review the business plan. His note of a telephone conversation with Mr Monk records that he was to provide an objective assessment of whether the captive proposals were viable, contrasting them with an in-house fund. His report dated 1 September 1994 runs to 27 pages. Unlike his report for the tour operators' captive, he assumed continuation of both the captive and the in-house fund for an indefinite time, comparing them for the three-year period of the first policy, pointing out that they differed only in their taxation treatment. This was illustrated by figures based on three different scenarios. The figures were such that in none of the three cases was there any profit commission return of premiums. Apart from necessary differences such as higher expenses in

the captive, the comparison shows that the two proposals are identical except for the tax. He points out that residual funds are higher with the captive as funds build up tax-free. This is illustrated by a schedule assuming no claims and ignoring investment income, showing the fund reducing from 1000 to 670 after tax at the end of the first year with an internal fund, and remaining at 1000 with a captive. The conclusion of the Report was:

"We consider that given the new procedure for monitoring members' accounts, claims should be better contained, enabling funds to build up, indicating that the establishment of a captive insurance company is preferable in the long term interest of continuing with ABTA's Scheme of Financial Protection for members of the Travel Agents Class."

38. That report was put before the TAC on 7 September 1994 which recommended proceeding with the captive to the National Council, which also had the report before it when it approved the proposal on 14 September. The minutes of the National Council refer to detailed questions being posed by members and refer to seven points that were discussed. Mr Fleming (then Chairman of TOC, who was familiar with Tour Operators Limited) is recorded as speaking in favour. Mr Thompson (member of TAC and National Council) agreed that TAC and the National Council approved the proposal in the basis of Mr Malacrida's report, including therefore the tax benefits identified in the report.

Travel Agents Limited

The travel agents' captive, ABTA Travel Agents Insurance Company Limited (Travel Agents Limited), was set up on 6 May 1994. Permission was given by the Guernsey insurance authority to back-date the cover to 1 January 1994. The following summarises the results of the policies issued by Travel Agents Limited.

	1994-1996	**1997**	**1998**	**1999**
Premiums	10,939,120	3,300,121	3,235,725	2,657,352
Brokerage	(1,560,000)			
Claims	(5,823,884)	(2,001,624)	(681,714)	(997,062)
Profit commission	(916,698)			
To P&L	2,638,538	1,298,497	2,554,011	1,660,290
Accounts profit (year to following 30 June)	2,900,802	1,748,498	3,079,611	1,588,940

39. The first policy was originally for 1994 and 1995 which was extended for a further year on the same terms. No figure has been stated in the table for

the cover as this is always 125 per cent of premiums so that the premium will ensure that maximum liability under the policy equals the capital and reserves of the captive. Profit commission was payable under the first policy. Brokerage was not payable from 1 January 1997, although from the accounts it appears that payment of brokerage ceased during 1996. The 1999 policy is reflected in the profits of the captive to 30 June 1999 so far as investment income is concerned but not as to the underwriting profit. The reason why the profit in the year ended 30 June 2000 is less than the underwriting profit on the 1999 policy is that an underwriting loss on the first six months of the 2000 policy was recognised in the accounts. The accounts profit comprises the underwriting profit shown in the table plus investment income less expenses. The claims handling procedure was the same as for Tour Operators Limited except that the amount of the imprest account was £100,000 until 30 June 1995 and thereafter £250,000. It will be seen that while claims are higher than for Tour Operators Limited, Travel Agents Limited has been more profitable that anyone would have predicted at the start in the light of past figures.

40. The board of Travel agents Limited consisted of Mr Harwood, Mr Ford and Mr Freudmann (Chairman of TAC). Mr Ford was replaced by Mr Cutts-Watson between the meetings in February and June 1996 and he was replaced by Mr Niven who was Mr Ford's successor at Lloyds Bank on 15 October 1996. Mr Freudmann was replaced by Mr Bath on 10 September 1998. Mr Monk regularly attended board meetings. The board met in Guernsey and considered a quarterly report by the managers, Willis Corroon Management (Guernsey) Limited. The board determined the terms of the policies and the terms of their renewal.

41. As with Tour Operators Limited, Mr Gilkes criticised the careless way the policies has been written by this captive, for example that the maximum potential cover is stated in the policies up to 1997 as £7.5bn instead of £7.5m, and the absence of a definition of profit for the purpose of calculating profit commission. We consider that the intention of the parties was reasonably clear and a certain degree of informality might be expected between a parent company and its wholly-owned subsidiary.

Review of both captives

42. When the law changed in 1995 to increase the acceptable distribution policy from 50 per cent to 90 per cent, which affected the captives from the 30 June 1997 period Mr Monk and Mr Malacrida gave consideration to restructuring the captives. Mr Malacrida wrote a draft paper on 25 September 1997 relating to Travel Agents Limited which was expanded in the final version of 1 December 1997 to cover both captives. The paper considered the possibility of re-establishing an in-house fund for travel agents. In making a comparison between various options the only points made about reverting to an in-house fund were the taxability of surpluses in the in-house fund and the deductibility of claims paid, the saving on costs of operating the captive, and that it would have no effect on ABTA's general reserves. Mr Monk appreciated the tax benefits of not making the change. The paper concluded that even with the 90 per cent distribution the captives would still have sufficient reserves unless there was a large underwriting loss. It also stated that ABTA would be unlikely to pass the motive test. Although a working paper based on this report was discussed at a meeting attended by Mr Reynolds and Mr Perez (then a director of Tour Operators Limited) on 5 December 1997 it does not seem to have been put before any committee. But no doubt it would have been if they had considered that there were issues to be decided. Mr Reynolds and Mr Perez were therefore the brains of ABTA for this purpose in deciding to

continue with the captives, subject to further consideration being given to restructuring Travel Agents Limited so that ABTA members had control of it without being entitled to dividends (nothing came of this proposal).

The statutory provisions

43. We turn now to the statutory provisions. Section 748(3) provides:

(3) Notwithstanding that none of paragraphs (a) to (e) of subsection (1) above applies to an accounting period of a controlled foreign company, no apportionment under section 747(3) falls to be made as regards that accounting period if it is the case that--

(a) in so far as any of the transactions the results of which are reflected in the profits arising in that accounting period, or any two or more transactions taken together, the results of at least one of which are so reflected, achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal or it was not the main purpose or one of the main purposes of that transaction or, as the case may be, of those transactions taken together to achieve that reduction, and

(b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom,

and Part IV of Schedule 25 shall have effect with respect to the preceding provisions of this subsection.

44. The following provisions of Schedule 25 are relevant to the interpretation of section 748(3)(a).

"16(1) The provisions of this Part of this Schedule have effect for the purposes of section 748(3)

(2) Any reference in paragraphs 17 and 18 below to a transaction-

(a) is a reference to a transaction the results of which are reflected in the profits arising in an accounting period of a controlled foreign company; and

(b) includes a reference to two or more transactions taken together, the results of at least one of which are so reflected.

17(1) A transaction achieves a reduction in United Kingdom tax if, had the transaction not been effected, any person--

(a) would have been liable for any such tax or for a greater amount of any such tax; or

(b) would not have been entitled to a relief from or repayment of any such tax or would have been entitled to a smaller relief from or repayment of any such tax.

(2) In this Part of this Schedule and section 748(3) 'United kingdom tax' means income tax, corporation tax or capital gains tax.

18. It is the main purpose or one of the main purposes of a transaction to achieve a reduction in United Kingdom tax if this is the purpose or one of the main purposes--

(a) of the controlled foreign company concerned; or

(b) of a person who has an interest in that company at any time during the accounting period concerned."

45. The Appellant needs to satisfy both limbs of section 748(3) in order to succeed. The two limbs serve two different purposes. Paragraph (a) is concerned with whether the purpose of a transaction is reducing tax, and therefore considers whether there was a different purpose; paragraph (b) accepts the genuineness of the transaction but considers whether the reason for the existence of non-resident entity was the reduction in tax caused by its being non-resident, and therefore concentrates on whether the same result could have been achieved using a UK resident vehicle.

Paragraph (a) of section 748(3)

46. In summary, paragraph (a) operates by first identifying a transaction the results of which is reflected in the profits of the CFC. Next, it asks whether there would be a reduction in United Kingdom tax if the transaction had not been effected. Lastly, it asks whether one of the main purposes of either the CFC or those with an interest in it in entering into the transaction was to obtain that tax reduction. We shall deal with each of these in turn. Mr Goodfellow contended that we should approach the legislation in the light of the mischief set out in the consultation document in CFCs of December 1982. The legislation in its final form is different from the draft legislation in that document and we are reluctant to place much reliance on the document.

Identification of "the transaction"

47. By paragraph 16(2) of Schedule 25 a transaction for this purpose is a transaction the results of which are reflected in the profits arising in an accounting period of the CFC. Miss Gloster identifies the transaction as the payment of the premiums to each of the captives. She contended that the unilateral act of paying the premium was a transaction, in the same way that a dividend is considered to be a transaction in securities for section 703, see *IRC v Laird* [2002] STC 722. Alternatively she identifies the transaction as entering into the policies, so that other financial results directly flowing from this, such as claims and profit commission, are taken into account. Mr Goodfellow identifies the transaction as the entering into of the policies coupled with the contributions of the members to the payment of the premiums, either as a tripartite arrangement, or as two related contracts. So far as Travel Agents Limited is concerned he points out that all of the premiums were funded by the members. The members' contributions to Tour Operators Limited were as follows: year ended 30 June 1997 nil; 1998 £55,675; 1999 £39,074 (the reason for the low contributions is that we understand that only new members had to contribute in those years). Miss Gloster contends that as ABTA is insuring its own liability and as there is no contractual relationship between the

member and the captive, the members' contributions are not part of the same transaction as the payment of the premium.

48. Since paragraph (a) of section 748(3) must be satisfied in relation to any transaction that is reflected in the profits of the CFC which has the effect of reducing tax, it is not a question of identifying a correct transaction but applying the provision to all transactions that are put forward as being relevant. We consider that on the ordinary meaning of language paying a premium can be a transaction, as can be the entering into of a policy. In both cases the results are reflected in the profits of the CFC. On the question whether the contributions to the premiums are part of the same transaction as entering into the policy, as Mr Goodfellow contends, we do not consider that it is in relation to tour operators. The articles provide that a tour operator member is someone who has inter alia contributed to the premium based on a proportion of turnover on an insurance policy approved by the TOC (October 1995 articles) or of such total premium as approved by the National Council (November 1997 articles). There is no promise to contribute as such. The premium paid by ABTA is not the total sum contributed by tour operator members; in each of the years under appeal the premium was far larger than the members' contributions, and in one year there was no contribution at all. The members' contribution was separately determined by TOC or National Council and related only to new members in the years under appeal. Accordingly we consider that there are two separate transactions: the premium paid by ABTA and the contribution towards the premium paid by the member. The position is different for travel agents. The articles provide that the TAC may require a travel agent member to provide security for the Travel Agents' Fund whether by bond, guarantee or any other kind of security in such form and for such amount as the TAC shall consider necessary. ABTA does not contract with Travel Agents Limited to pay a particular premium but the policy specifies the basis on which members contribute, consisting of a flat rate charge paid by all travel agent members plus a charge based on a formula for those travel agent members who wish make such payment in lieu of posting a bond. The total sums are kept in a separate account and then passed on by ABTA to Travel Agents Limited as a premium. Insurance premium tax is invoiced to the members in addition to the premium and paid by ABTA to Customs and Excise on behalf of the captive, thus demonstrating to the members that they were contributing to the premium. The total cover is 125 per cent of the premiums. In other words, the premium paid by ABTA to Travel Agents Limited is not a separate transaction between them but a transaction necessarily involving the member who decides whether to contribute a sum in addition to the flat rate charge or take out a bond. While agreeing with Miss Gloster that ABTA is insuring its own liability and that there is no contractual relationship between the member and Travel Agents Limited, in our view in the circumstances the payment by the member to ABTA which ABTA pays on in full to Travel Agents Limited is a single transaction. The results of it are reflected in the profits of Travel Agents Limited.
49. We shall therefore proceed on the basis that each of the following is a relevant transaction: (a) payment of the premium by ABTA to Tour Operators Limited, (b) ABTA entering into the policy with Tour Operators Limited, (c) payment by the members to ABTA and by ABTA to Travel Agents Limited of a premium referable to those members, (d) payment by the members to ABTA and the entering into by ABTA of the policy (instead of merely the payment of the premium) with Travel Agents Limited referable to those members. These are referred to below as transactions (a), (b), (c) and (d) respectively. There is no doubt that each of these transactions is reflected in the profits of the relevant captive.

50. We must also consider the alternative definition in paragraph 16(2) of Schedule 25 that the transaction consists of two or more transactions taken together the results of at least one of which are reflected in the profits. This provision is puzzling because it is alternative to the single transaction and it does not make clear who decides whether to apply the provision to the single or the composite transaction, and how one decides whether two transactions are to be looked at together. With a composite transaction one of the components must be a transaction of which the results are reflected in the profits of the CFC which will therefore be capable of being counted as a transaction in its own right. It may be that the purpose of the provision is to deal with the possibility of the transaction reflected in the profits not being the one that reduces the tax, or the relevant person having a purpose in relation to both but not to one component separately. Nothing turns on the distinction in this case. Mr Goodfellow accepts that the provision must be satisfied both in relation to a transaction as well as any composite transaction. While we do not consider that the payment of the tour operator member's contribution to the premium paid to Tour Operators Limited is part of the same transaction as the payment of the premium, we shall treat this as a composite transaction consisting of both aspects, one of which, payment of the premium by ABTA to Tour Operators Limited, is reflected in the profits of Tour Operators Limited (transaction (e)). Since there was no contribution by members in the year ended 30 June 1997 it is identical to transaction (a) for that year and this transaction is applicable only to the two succeeding years. Transaction (f) is the same but looking at the composite transaction as the entering into the policy by ABTA (instead of merely the payment of the premium) and the contribution to the premium by the members. For the same reason as for transaction (e) for the year ended 30 June 1997 transaction (f) is identical to transaction (b) and this transaction occurs only in the two succeeding years.

Whether there is a reduction in tax

51. The next step is to determine whether each of these transactions achieves a reduction in tax. This is explained in paragraph 17.
52. When read with paragraph 16, paragraph 17 must be read as starting: "A transaction the results of which are reflected in the profits arising in an accounting period of a controlled foreign company achieves a reduction." and separately as starting: "Two or more transactions taken together, the results of at least one of which are so reflected achieve a reduction.". One must assume that the transaction had not been effected and then ask whether someone would have been liable to more United Kingdom tax (paragraph 17(a)) or a reduced relief from such tax (paragraph 17(b)). The only tax in issue here is corporation tax. We interpret paragraph 17 as meaning that one does a calculation of ABTA's tax position with, and without, the transaction, taking into account differences flowing directly from the transaction, but not any differences that would be necessary for ABTA to continue to operate in a similar way. This is because the hypothesis is that the transaction had not been effected; nothing else can be put in its place (in contrast to paragraph (b) of section 748(3) which looks at what it is reasonable to suppose would have been put in the place of the CFC).
53. Where the transaction is the payment of the premium the only adjustment is to assume that the premium had not been paid. Similarly, where the transaction is entering into the policy the tax reduction is the difference between the tax on the receipts and payments directly flowing from the policy. The consequences of not entering into the policy are that ABTA

neither pays the premium nor obtains the benefit of claims under the policy so that it will not be refunded for the claims made against it under the ABTA promise, and it will not receive any other benefits under the policy such as profit commission. Mr Goodfellow contended that one should also take into account any consequential reductions such as that if because it did not pay premiums on a suitable insurance ABTA would cease to be an approved body for the Regulations and tour operator members would therefore be required to post bonds of 25 per cent of their turnover, as a result of which many would cease to be members, or that in order to remain an approved body ABTA would have to pay higher premiums to an outside insurer. Miss Gloster QC contended that only matters directly flowing from cutting out the transaction could be included. We do not consider that such matters should be taken into account. The hypothesis is solely that the transaction did not take place and one must be able to calculate the reduction of tax with certainty to determine whether or not it is minimal. For the same reason we ignore dividends paid to ABTA out of profits of the CFC since they do not flow directly from the payment of premiums or entering into the policy, and are the subject of separate decisions by the directors.

54. If transaction (a) had not been effected the Appellant's tax would clearly be increased since the premium is fully deductible in computing the Appellant's profits. The same is true of transaction (b), the only difference being that in all three years ABTA would have had no receipt from the claims on the policy and in the year ended 30 June 1997 the profit commission of £1,225,000 would be taken into account. Transaction (c) is different; the tax position is the same if it had not been effected since the receipt from members and payment of the premiums by ABTA cancel out. Transaction (d) takes into account other benefits received under the policy, such as payment of claims and profit commission and brokerage. If transaction (d) had not been effected there would be a decrease in ABTA's tax the claims paid would be decductible without a corresponding receipt under the policy. We therefore proceed on the basis that the transactions that achieved a reduction in tax are transactions (a), (b), and composite transactions (e) and (f), all of which relate to Tour Operators Limited. In each case the reduction is clearly more than minimal. The following table extracts the figures from the accounts of the captives.

	Tour Operators			Travel Agents		
	1997	1998	1999	1997	1998	1999
Premium	1,750,000	850,000	600,000	10,939,120	3,235,725	2,657,352
Contribution from members	0	55675	39074	10,939,120	3,235,725	2,657,352
Profit commission /brokerage	1,225,000			2,476,698		
Claims	46,312	227,786	30,164	5,823,884	681,714	997,062
Reduction of tax on:	1,750,000	850,000	600,000	0	0	0

Transaction (a)/(c)						
Transaction (b)/(d)	478,688	622,214	569,836	Increase	Increase	Increase
Transactions (e)	1,750,000	794,325	560,926			
Transaction (f)	478,688	566,539	530,762			

55. *The purpose test*

56. We have to determine whether the main purpose or one of the main purposes of each of the transactions was to obtain *that* tax reduction. In the case of the composite transactions (e) and (f) we have to consider the main purpose of the transactions taken together. Paragraph 18 specifies whose purpose is relevant: here the relevant purpose is ABTA's. By purpose is meant the aim that the person was trying to achieve by entering into the transaction: was one of the main purposes the reduction in tax that would have occurred if the transaction had not been entered into, or were the main purposes something else? Mr Goodfellow contends that where the transaction is a tax-deductible payment, as in transaction (a), or a tax-deductible payment in excess of a taxable receipt, as in transaction (f), it cannot logically both have a main purpose of reducing tax, and be wholly and exclusively expended for the purposes of the trade within section 74 of the Taxes Act 1988. *Ransom v Higgs* [1974] STC 539 in relation to the *Kilmorie* appeal is an example of a tax avoidance purpose precluding a payment from being deductible. Miss Gloster QC contends that the transaction is not making a tax-deductible payment in general but the payment of the premium to the captive. She makes the comparison between not paying the premium and having an in-house fund, which is the choice actually made by ABTA in relation to both captives. She contends that one can have a business purpose and a purpose of reducing tax, for example when taking tax advice. If this were not the case paragraph (a) of section 748(3) would never apply.

57. We consider first Miss Gloster QC's contention that because ABTA chose the captive rather than an in-house fund taking tax into account, one of the main purposes of the transaction consisting of the payment of the premium was to achieving that reduction, that is the reduction in tax caused by paying the premium compared to not paying the premium. It seems to us that that is different from the statutory hypothesis. The difference can be seen if the transaction which one has to assume had not been effected is the payment of the premium to Tour Operators Limited. One might think that not paying the premium leaves ABTA in a similar position to having an in-house fund. But the position is not the same when the hypothesis is applied separately to each accounting period. In the first year under appeal, the year ended 30 June 1997, tour operator members made no contribution to the premium paid by ABTA to Tour Operators Limited of £1.75m. Cutting out the premium does not leave one in the same position as an in-house fund: the fund would be £1.75m, while the captive had funds (after payment of the premium) of £2.5m and provided cover of that sum, and so the level of cover would not be the same. The difference is even more extreme in relation to travel agents if the transaction consists both of the contribution by the member to ABTA and the payment of the identical amount by ABTA to Travel Agents Limited.

Cutting out that transaction does not leave ABTA with an in-house fund; it leaves it with no funds at all out of which to pay claims arising from the default of travel agent members. The test asks whether it was a main purpose of ABTA in carrying out the transaction to obtain the tax reduction of the difference between paying the premium and not paying the premium. The tax reduction compared to not entering into the transaction was never considered by ABTA. If they had not paid the premium, they would have paid claims under the ABTA promise which were tax deductible, and in the case of travel agents they would have needed to collect funds from travel agent members. The choice they made was between an in-house fund for which there would be a deduction for claims paid, and a captive for which there would be a deduction for premiums paid. They had a real purpose in making that choice, and hence for paying the premium to Tour Operators Limited rather than having an in-house fund, but that is not the purpose the Act is addressing, which is the tax reduction caused by the difference between not paying the premium and paying it.

58. We therefore prefer Mr Goodfellow's approach. The test is whether there was a main purpose of achieving that tax reduction. If paragraph (a) does not apply because the purpose was commercial, that is what the test is trying to determine, and no doubt why the taxpayer also has to comply with paragraph (b).
59. As we have said ABTA never considered simply not effecting the transactions in isolation and accordingly never had a purpose directed to that reduction *i.e.* the tax reduction resulting from effecting the transaction. Accordingly we find that ABTA did not have a main purpose (or indeed any purpose at all) of obtaining that reduction. While it is possible to have an unconscious purpose, as in *Mallalieu v Drummond* [1983] 2 AC 861, this can occur only when the purpose is an obvious one, like the purpose of clothes being to provide warmth and decency. It cannot be applied to a tax reduction based on a statutory hypothesis which nobody could have considered. Accordingly we find that there was no unconscious purpose either. Our interpretation of paragraph (a) is clearly of importance and in case we are wrong we make findings of fact on the basis of Miss Gloster's contention under the heading *Alternative findings of fact* below.
60. We make no distinction between the purpose of the payment of the premium and the purpose of entering into the policy. One cannot find a purpose of a payment isolated from what was obtained by making the payment. We find that the answer to the question of what were the main purposes of ABTA in relation to the payment of premiums in transaction (a), the two elements of composite transaction (e) taken together, the entering into of the policy in transaction (b), and the two elements of composite transaction (f) taken together, is that the only purpose was to obtain the insurance cover which for tour operators was required in order for ABTA to remain an approved body which it needed to be to maintain the ABTA promise. That was the purpose in the minds of those responsible for the transactions both originally when the captives were formed and in the years under appeal. The tax reduction as between entering into the transaction and not doing so is an effect of the transaction, as it would be in respect of any deductible payment, not one of the main purposes that ABTA was trying to achieve. Paragraph (a) of section 748(3) is therefore satisfied.
61. In case we are wrong in finding that no reduction in tax took place for transactions (c) and (d) on the basis that we should not have taken the contributions from members into account, we would have made exactly the same finding of fact in relation to those transactions for Travel Agents

Limited. The purpose was to enable travel agent members who were unable to purchase bonds in the market to provide security to ABTA to enable it to continue to meet the ABTA promise.

Alternative findings of fact

62. In case we are wrong in our interpretation of paragraph (a) we shall also make findings of fact based on the real-world choice between the in-house fund and the transaction of paying premiums or entering into the policy. In other words, rather than looking at what purpose ABTA was trying to achieve by paying the premiums to the captives (or entering into the policies with the captives) we ask ourselves was a main purpose of choosing the captives rather than an in-house fund to achieve the reduction in tax between the two routes?
63. For tour operators the two alternatives were considered in a relatively short time during which ABTA had no insurance in place from 8 May 1993 and was accordingly in breach of the Regulations. During this time the captive proposals were constantly evolving. On 9 June 1993 Mr Dunscombe was recommending the captive on the ground of the return of premiums, whereas the basis of the meeting on 2 June was that the cash fund was to last two years with a return of the fund at the end of the period. (It may be that ABTA had no power to distribute the balance of the fund to the contributing members but the report, which had input from the legal department, assumed that it could. We believe that if the contributions were obtained on the basis of a formula that returned contributions not paid in claims this could have been achieved.) Mr Malacrida's report did not show the effect of the winding up of the fund, whereas it showed the effect of the return of a proportion of premiums under the profit participation arrangement and the distribution of the profits of the captive to ABTA at the end of 2 years. The return of a proportion of the premiums was assumed to be repaid to the members. Although ABTA is prohibited from distributing anything to its members it was presumably thought that if ABTA collects a sum in order to fund premiums which under a formula in the policy results in a return of part of the premium, ABTA would be obliged to return the excess to the members. As with the proposal to distribute the in-house fund on its termination, it does not matter if that is right in law or not because that is the basis on which the decisions was made.

(a) The tax and cash flow differences

64. The comparison made in the report shows that the members paid far less over the two years with the captive. Three examples were given. In the example where the funds were £2.5m and the claims £1.5m each year, members pay £4,275K with the fund and £3,193K with the captive, a difference of £1,082K or 25 per cent less. As we have already stated Mr Malacrida's breakdown of the figures in his report show that in both cases the year 1 contribution is £2.5m; the year 2 contribution is £1,775 for the in-house fund and £1,350K for the captive (the reason is that the fund is made up to £2.5m, but the captive premium is a pound for pound contribution where claims exceed £150K which results in the fund at the beginning of year 2 being £2.655m); and there is the return to members of the profit commission of £657K for the captive. This difference in contributions is represented by £428K additional tax with the fund and £650K additional funds after tax remaining in ABTA with the fund (the difference in total is due to rounding).

65. If one uses the same example to make a comparison eliminating the different assumption about who retains the surplus, by assuming that the profit commission is not returned to the members and accordingly all funds remain within ABTA, we calculate that the additional cost to members of the in-house fund becomes £425K and the additional tax paid by the fund becomes £171K with the timing difference that some tax (£355K) is paid in the first year and some in the second year (£120K) by the fund, and all the tax (£304K) is paid in the second year with the captive. The difference in funds remaining in ABTA would be £350K more with the fund. We should make clear that the parties have not seen these calculations and they may contain errors.
66. A reader of the report would not detect the effect of the earlier payment of tax with the internal fund because the report gives a figure for the two years together. The stated conclusion that the captive was better in the long-term and the internal fund in the short term, although true, does not really come out from the report because the comparison was on the basis the internal fund continuing and the captive ceasing after two years. It seems to us that a decision in favour of the captive was inevitable given the comparison in the report; the members paid over £1m less over two years with the captive. It was a comparison between the members receiving a return of the surplus at an uncertain time in the future with the in-house fund, with nothing shown in the calculations for this, and the members receiving a return of a proportion of the premium of £657K at the end of two years. Looking at the reasons expressed for adopting the captive, Mr Fleming, who was the only member (as opposed to the secretariat) at the second working party meeting on 16 June, was aware of the cash flow difference but not aware of the details. He was unable to explain to us why the TOC had made the choice; it was a committee decision which was influenced by numerous factors of which the advice received was one. When giving evidence he did not keep separate the effect of tax and the profit commission. We are left with the best contemporary evidence being Mr Malacrida's note of his telephone conversation with Mr Fleming on 23 June quoted in paragraph 20 above explaining that the advantage of the captive was the lower cost to members in year 2 because of the lack of a tax charge, and the certainty of the profit commission return of premiums at the end of year 2 compared to distribution of the in-house fund only on TPA taking over. This must have been Mr Fleming's understanding at the time. Mr Fleming was effectively the brains of ABTA in recommending the captive to the TOC on 24 June and thence to the formal decision of the National Council on 30 June. The advantage recorded in the TOC minutes for 24 June 1993 as "cash flow/tax" is in line with this. The cash flow advantage is first the lower payment by members at the beginning of year 2 (£1,350K for the captive and £1,775K for the fund in the example in paragraph 62 above), the amount of which is largely determined by tax (£355K paid by the fund and nothing paid by the captive in the example, although the funds are not made up to the same figure at the start of year 2 in the case of the fund and the captive), and secondly the profit commission paid to members at the end of year 2 (£657K in the example) in comparison to the in-house fund which was distributed only on its winding up which was not included in the figures. The importance of the profit commission was noted by the TOC on 24 June 1993 when deciding that no return of premiums should be made to members who had terminated their subscriptions before the end of the two years. It is also demonstrated by a note made by Mr Malacrida of a meeting between Mr Dunscombe and Willis Corroon on 6 July 1993 which refers to the objective of minimising the overall costs to members by ensuring the greatest possible refund to

them in year 3. Mr Dunscombe and Mr Chandler both said in evidence that they regarded this aspect as important. This is not surprising because many tour operators were in financial difficulties and keeping liabilities of members to a minimum must have been in the minds of committee members of ABTA in choosing to follow the captive route. By the time of this decision everyone seems to have forgotten the original proposal for a 2 year internal fund with the surplus distributed to members, or circumstances had changed so that this was no longer in people's minds, perhaps because of changed perceptions about the likelihood of TPA.

67. The profit commission was much less important in relation to Travel Agents Limited. Mr Malacrida's report did not show any such refund to members, although it was part of the travel agents' captive proposal but not the in-house fund. The profit commission in the early policies issued by Travel Agents Limited was much less generous than Tour Operators Limited: if claims were less than 10 per cent of the premium the return of premiums was 30 per cent for the former and 70 per cent for the latter, with corresponding differences for other levels of claims. We find that this consideration played no part in deciding in favour of the travel agents' captive. The only advantage of the captive was the tax advantage identified by Mr Monk and quantified by Mr Malacrida which Mr Thompson agreed formed the basis for the decision by TAC and the National Council to adopt the captive proposal.
68. When the captives were reviewed in 1997 after the acceptable distribution policy was increased to 90 per cent Mr Malacrida's report again examined an in-house fund for travel agents. When that report was considered Mr Reynolds and Mr Perez did not have it referred to any committee. We deduce that the purpose of the captives had not changed. We do not regard it as significant that Mr Malacrida did not think that the motive test was not satisfied. That would not prevent it from being satisfied. In particular we do not think it demonstrates that ABTA did not have commercial purposes in relation to the transactions with the captives.
69. Although Mr Dunscombe, Mr Fleming, Mr Monk, Mr Thompson and Mr Malacrida, did not consider tax to have been the reason for the choice, they agreed that tax was at least an important consideration in the decision. The tax savings of a captive are those identified by Mr Malacrida's two reports, that for a given size of fund members will have to pay more to make the fund up to that amount in the second and subsequent years in the case of an internal fund by the amount of the tax on the surplus in the fund in the previous year. The investment income within the internal fund will similarly pay tax. He also identified a tax disadvantage of the captive that where ABTA received brokerage that was taxable and when it reinvested the brokerage as share capital that was non-deductible. There is another aspect which he did not identify that if the capital of the captive is lost (which will be the last part of the loss), that amount forms part of the deductible payments for an internal fund, but there is no tax relief for it with a captive, the amount paid up as share capital being capital expenditure. There will, however, be a capital loss on liquidation of the captive.
70. We were shown some reports from the travel press, one of which, Travel Weekly 30 June 1993 stated that "An offshore company was chosen to avoid UK taxation on the reserves, which will be held separately from ABTA's own £3.5m funds." Mr Dunscombe explained that there were oral briefings after every National Council, TOC and TAC meetings. We do not pay much attention to these press reports in determining ABTA's purpose. Obviously if they originated from statements made by ABTA they would be important but Mr Dunscombe said that often they contained information given by committee members and misunderstandings that arise when oral

briefings are given. For example, the writer of the quoted passage seems to have thought it necessary to say that the captive's reserves were held separately from ABTA's, which does not demonstrate much understanding of the separate personality of the subsidiary. Another report, Business Insurance of 24 April 1995, quotes Mr Monk as saying "We chose Guernsey for tax reasons, basically. It has very beneficial tax advantages. I suppose we could have chosen any tax haven really, but Guernsey seemed to fit the bill." We are not convinced that this is really a direct quote and Mr Monk did not arrive until 26 July 1993 and so had no direct personal knowledge of why Guernsey was chosen for Tour Operators Limited, although he did for Travel Agents Limited.

(b) The differences other than tax and cash flow

71. We turn to consider differences other than tax and cash flow between an in-house fund and the captives. These are extremely similar in their effect. Both collect funds which represent the maximum liability and there is no element of insurance in the sense of sharing risks. The main differences put forward at various times were first, that the in-house fund might represent unauthorised insurance; secondly, that liabilities relating to a class of member could be ring-fenced within a captive; thirdly, in relation to tour operators, money had been collected in advance from members for payment of premiums to an external insurer; fourthly, that an in-house fund would require an EGM to change the articles to enable funds to be collected on a basis different from a percentage of subscriptions; and fifthly, if there were claims on a fund early in a year there might be a requirement to top the fund up during the year which would not apply to insurance. We shall examine each of these in turn.
72. On the first, whether an internal fund amounted to unauthorised insurance, Mr Malacrida and head of Legal Services were initially of the view that an internal fund did amount to unauthorised insurance, Mr Monk remained of that view but did nothing to stop the investigations of an internal fund on that ground. External legal advice was obtained in March 1993 that it was not unauthorised insurance. The DTI were involved with the proposals at various times and never suggested that this was a difficulty. Neither of Mr Malacrida's papers comparing the two captive proposals with internal funds mentions this. We find that, although this point was in the mind of some of the persons concerned, it was not regarded as a reason for adopting the captive route.
73. The second difference, ring-fencing of liabilities, was part of the original proposal for an in-house fund. The proposal stated that the money would be held in a trust account which was intended to have this effect. While this might have affected the tax treatment, no consideration was ever given to this. Accordingly we find that this was not a reason for deciding in favour of the captives.
74. The third difference, that money had been collected from tour operators to pay premiums on external insurance, which might have made it easier to use them for paying premiums to the captive (strictly in part to the fronting insurer), was accepted by Mr Dunscombe as not being a reason for choosing the captive route. We accept this.
75. The fourth difference, that amendment to the articles would, or might, be necessary for an internal fund, may have played a small part in the choice. Mr Chandler did not consider that any amendment was necessary. Mr Dunscombe was concerned that as larger members, who were more financially secure, had more votes on a poll they might successfully oppose it. The tour operators' working party on 2 June 1993 did recommend the internal fund but at the same time backed the captive as a

second choice if the resolutions were not passed. While some people may have been more concerned than others about the possibility of the resolution not being passed this does not seem to have been a major factor in the decision, which was in favour of the captive on the perceived merits of the proposal, rather than because the alternative of an in-house fund was not likely to succeed. Accordingly we find this is not a difference between the two proposals.

76. The fifth difference was mentioned by Mr Malacrida and is probably a difference, depending on the terms on which a fund is set up, but so far as we can see it did not feature in the decision about the choice between the two routes.
77. In the light of our consideration of these non-tax factors, we find that the only one which played a serious part in the choice of the captive was the return of premium under the profit participation in relation to tour operators only. Since the profit commission applied only to Tour Operators Limited and only for the year ended 30 June 1997 by which time it was clear that no payment was being made to members, it is not necessary for us to make any findings on the relative importance of it.

(c) Whether tax was a main purpose of the choice of the captives over an in-house fund

78. This leaves tax and the lower net contributions caused by the profit commission as the factors that we find influenced the decision in favour of the captive. If we had to decide what was actually in the minds of ABTA in making the original decision in favour of a captive for tour operators we would probably decide that the tax reduction was not a main purpose. The tax difference was a timing difference in a calculation based on a two year comparison under which all the profits of the captive were distributed either as profit commission to the members (which could be as much as 95 per cent of the premium) or as dividend to ABTA. From the members' point of view the profit commission was much larger than any tax difference and the benefit of it was then expected to be received by the members. It was the lower cost to the members that influenced their decision. But this point does not have to be decided since by the first year under appeal it had become clear that TPA would not occur and so the basis of the two year comparison made by Mr Malacrida no longer applied; both the captive and the in-house fund would be regarded as long-term choices. Mr Fleming though that he probably appreciated that this would be the result of TPA not going ahead at the time. Also, although the profit commission remained in the first year under appeal it was clear that it was not being distributed to members but used as part payment of the next premium, and in subsequent years there was no profit commission so that the funds remained in the captive. Therefore the significance of the difference caused by the different amount of funds remaining in the in-house fund or in the captive had disappeared, leaving only the tax difference. Probably by the start of the first year under appeal, nobody asked what the purpose of paying the premium (or of the policy) was; the captive just continued. Asking the question whether obtaining the tax reduction between the captive and an in-house fund was a main purpose in each of the years under appeal, the only possible answer is that it was, even though this may have been an unconscious purpose. Mr Malacrida's paper of 1 December 1997 considered the merits of reverting to an in-house fund for travel agents. The only advantage of doing so identified was the saving of costs of operating the captive; the disadvantages were tax.The decision to continue Travel Agents Limited in the periods ended 30

June 1998 and 1999 was therefore a conscious one in which the purpose of obtaining the tax reduction was one of the main purposes.

79. So far as Travel Agents Limited is concerned there was a decision to go ahead with TABRS and a separate decision to operate it through a captive proposed by Mr Monk for tax reasons. Mr Malacrida's report quantified the tax advantage of the captive. Mr Thompson agreed that TAC and the National Council adopted the captive proposal on the basis of Mr Malacrida's report. Virtually the only difference between the two proposals was tax. Mr Monk agreed that nothing had changed since then. In December 1997 Mr Reynolds and Mr Perez considered Mr Malacrida's report that considered the possibility of an in-house fund for travel agents and decided against it. There was therefore a conscious decision to continue made during the year ended 30 June 1998, the reason for which continued to apply in the year to 30 June 1999. The only purpose for the choice was a tax purpose. Applying this alternative interpretation we find that one of the main purposes in choosing the captive route for travel agents in the years under appeal was to obtain the reduction in tax between the two routes.

Paragraph (b) of section 748(3)

80. We set out again the statutory provision:

"(3) Notwithstanding that none of paragraphs (a) to (e) of subsection (1) above applies to an accounting period of a controlled foreign company, no apportionment under section 747(3) falls to be made as regards that accounting period if it is the case that-

(a) .

(b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom,

and Part IV of Schedule 25 shall have effect with respect to the preceding provisions of this subsection."

81. Paragraph 19 of that Schedule provides:

"19(1) The existence of a controlled foreign company achieves a reduction in United Kingdom tax by a diversion of profits from the United Kingdom in an accounting period if it is reasonable to suppose that, had neither the company nor any company related to it been in existence--

(a) the whole or a substantial part of the receipts which are reflected in the controlled foreign company's profits in that accounting period would have been received by a company or individual resident in the United Kingdom; and

(b) that company or individual or any other person resident in the United Kingdom either--

(i) would have been liable for any United Kingdom tax or for a greater amount of any such tax; or

(ii) would not have been entitled to a relief from or repayment of any such tax or would have been entitled to a smaller relief from or repayment of any such tax.

(2) For the purposes of sub-paragraph (1) above, a company is related to a controlled foreign company if--

(a) it is resident outside the United Kingdom; and

(b) it is connected or associated with the controlled foreign company; and

(c) in relation to any company or companies resident in the United Kingdom, it fulfils or could fulfil, directly or indirectly, substantially the same functions as the controlled foreign company.

(3) Any reference in sub-paragraph (1) above to a company resident in the United Kingdom includes a reference to such a company which, if the controlled foreign company in question were not in existence, it is reasonable to suppose would have been established."

82. In paragraph (b) of section 748(3) one has to find what it is reasonable to suppose would have happened if the captives had not existed. The problem here is not that the alternatives do not exist in the real world, but that the hypothesis on which it is based, that the captives did not exist, is not something likely to occur in the real world, and so nobody is likely to have thought about what they would have done if it had occurred. The closest to the hypothesis ever occurring might be that Parliament passed an Act saying that one may not insure with a non-resident captive. The question is then what would it be reasonable to suppose that ABTA would do in such circumstances. It is therefore irrelevant that nobody considered the particular alternatives.
83. The first issue for paragraph (b) is whether the existence of the CFC achieves a reduction in UK tax by the diversion of profits from the UK, to which we shall refer in short as a tax reduction by diversion of profits. A tax reduction by diversion of profits occurs if it is reasonable to suppose that had the captives (and any other related non-resident company) not existed, the whole or a substantial part of the receipts reflected in the accounts of the captives would have been received by a UK resident company or individual who would have been taxable on them. The relevant receipts which are reflected in the profits of the captives are the premiums and the investment income.
84. When Mr Goodfellow opened the case his skeleton said that the Revenue should set out what alternative they claimed it would be reasonable to suppose would exist. We took the step of asking Miss Gloster QC to open the Revenue's case on this paragraph before any evidence was called. She outlined three possibilities: first, a UK resident company approved for insurance purposes in the UK; secondly, a Guernsey incorporated but UK resident company approved for insurance in Guernsey; and thirdly, a UK incorporated company managed and controlled in Guernsey (and UK resident by virtue of its incorporation) approved for insurance in Guernsey. Mr Goodfellow said he was prejudiced by the late introduction of the second and third possibilities but we consider that he was able to deal with these in his evidence. If another case involving a hypothetical alternative arises we would favour that any direction given before the hearing should require the alternatives to be specified.

85. Since the hypothesis prohibits the existence of a non-resident company connected or associated with the captives, the choices are: (a) insurance with a UK resident independent insurer, (b) insurance with a non-resident independent insurer, (c) insurance with a UK resident captive, (d) an in-house fund. Mr Goodfellow contends that (a) would have applied for tour operators and that ABTA would have left travel agents to obtain bonds in the market; Miss Gloster QC contends for (c) or possibly (d). She contended primarily that one could not assume that the payments had not been made at all, but if that were wrong the investment income would still be received by ABTA. We cannot find anything to say that any transactions must still take place; the hypothesis is that the receipts which are reflected in the controlled foreign company's profits would have been received by UK resident. This could occur if the transactions did not occur and ABTA retained the funds. We can ignore (b) as there is no evidence that non-resident independent insurers would be more suitable than resident ones. We deal with the remaining possibilities starting with the one which we consider it most reasonable to suppose would have been adopted if the captive had ceased to exist. In all the cases where it is reasonable to suppose that the receipts would have been received by a UK resident it would have been taxable on them.

In-house fund

86. We consider that we should start with (d) as this is the comparison with the captives which ABTA in fact made. Mr Goodfellow's objections to an in-house fund are: (1) that the hypothesis is that the captives do not exist and therefore their funds do not exist either and so ABTA would have to collect £2.5m, (2) it would be difficult to persuade members to contribute to a fund building up surpluses from which they could never benefit, (3) a cash fund did not provide a known budgetable cost for each year of membership, (4) ABTA might have been carrying on unauthorised insurance, particularly in relation to travel agents who paid a contribution based on the risk (5) a cash fund does not isolate creditors of each class of member, whereas with two captives a creditor has a direct claim against the insurer under the Third Parties (Rights Against Insurers) Act 1930.
87. In our view: (1) the statutory hypothesis does not say that the funds in the CFCs cease to exist, but merely that the CFC ceases to exist. In construing a statutory hypothesis

"For my part I take the correct approach in construing a deeming provision to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction." (*Marshall v Kerr* [1995] 1 AC 148, 164 E)

The policy and purpose of the fiction is to ask what it is reasonable to suppose would have happened if the captives ceased to exist and could not be replaced by a non-resident associate. Treating the funds as not existing would be absurd and is not clearly within the purposes of the fiction, which is to avoid having a non-resident associated company; (2) we agree that surpluses in the captive can be used more generally within ABTA but in fact members did not receive any distributions from the profit commission or dividends paid by the captives, so that the effect on

members was much the same, (3) while this is true if there had been a deficit in the captive the members would have been required to contribute to it; the only difference is that contributions would be during the year with an in-house fund and in the following year's premium with a captive, (4) while this was Mr Monk's fear they had, unknown to him, obtained legal advice that they would not be carrying on insurance business as defined in section 95 of the Insurance Companies Act 1982, on the basis that the guarantee contract was merely incidental to their other business, which seems reasonable advice, (5) we agree that this is a difference.

88. Standing back and considering these differences, while it is undoubtedly the case that an in-house fund is not identical to insurance with a captive, we consider that the differences are not so substantial that if ABTA were forced not to have a captive, it is reasonable to suppose that they would have adopted this route, particularly as they nearly adopted it in the beginning. The premium and investment income would have been received by ABTA, in the case of the premium by retention of funds.

UK resident captive

89. Alternative (c) undoubtedly involves insurance and therefore regulation somewhere. Miss Gloster QC relied on either UK regulation under the Insurance Companies Act 1982 or Guernsey regulation coupled with various combinations of UK residence, namely (i) Guernsey incorporation and UK management and control, (ii) UK incorporation and Guernsey management and control, (iii) UK incorporation and management and control.

UK management and control with Guernsey incorporation and insurance authorisation

90. Starting from where they were, the closest alternative is (i) involving continuing with Guernsey regulation and incorporation and merely moving the management and control to the UK.
91. Mr Goodfellow set out his reasons why this route would not have been chosen. These are (1) that it was not suggested to ABTA or its advisers, (2) this was not used by anyone before 1997 and since then only on rare occasions, Mr Harwood (Guernsey advocate and director of both captives) mentioning his involvement with only two such companies, (3) it was used only to obtain a UK tax advantage, (4) there are serious doubts whether the route is effective in UK law, in separating out the insurance transactions from the management and control when the only business of the companies was captive insurance.
92. In our view (1), (2) and (3) are not surprising as the need for UK residence is a statutory hypothesis not something that one actually meets, (4) this combination is occasionally used and so far as we are aware its operation is not disputed in either jurisdiction. Insurance authorisation depends on where the effecting and carrying out of contracts of insurance occurs (see *Re a company (No.007816 of 1994)* [1997] BCLC 685), which concentrates on the policy; management and control depends on where the highest level decisions relating to the whole business of the company are made. We accept that where the only business of the company is to effect one policy each year and carry out its terms, this is a very thin dividing line. Mr Harwood originally accepted that there were no fundamental problems to this proposal but later said that because of the danger that such a company might be carrying on unauthorised insurance

business in the UK he would not be willing to serve as a director. Mr Falla (Willis Corroon, Guernsey) explained that the method of operating the few captives which were UK resident was for the board to meet in the UK and for an underwriting committee making all the underwriting decisions to meet in Guernsey. In the light of the evidence that such companies exist we do not accept that this route was impossible. Practical operation of the companies would have been just as practical, if not easier, as Mr Perez and Mr Freudmann (as directors) and Mr Monk (as the person in attendance representing ABTA) normally travelled to Guernsey for board meetings. Faced with the actual situation of not being able to use a non-resident captive we consider that ABTA would take advice as to how to structure a captive which was resident in the UK but where the underwriting decisions were made in Guernsey.

93. Accordingly we find that it is reasonable to suppose that this is a course that ABTA would have adopted, though less likely than an in-house fund.

UK incorporation and Guernsey management and control

94. If UK residence were obtained by UK incorporation (remembering that paragraph 19(3) allows one to consider whether it is reasonable to suppose that a company is formed), Mr Goodfellow raised the following additional objections to the ones raised above: (1) there were no known examples of this type of captive, the only foreign incorporated authorised companies being UK insurers who want to write Guernsey business, (2) while a letter from Diane Colton, Deputy Director of Insurance in Guernsey, said that incorporation outside Guernsey was not a bar in itself, the attitude to an actual case was not known; Mr Harwood said that it was doubted whether the Royal Court of Guernsey could wind up a foreign company which might make the regulator more careful about authorisation of a foreign incorporated company, (3) under the UK-Guernsey double taxation agreement "a company shall be regarded.as resident in Guernsey if its business is managed and controlled in Guernsey" so that by virtue of section 249 of the Finance Act 1994 UK residence would be disapplied if the UK incorporated captives were managed and controlled in Guernsey.

95. In our view: (1) this is not surprising as there is no problem in having a Guernsey incorporated company; it is the hypothesis that takes this possibility away, (2) while it may have been harder to obtain authorisation there is no evidence to suggest that it would have been impossible, (3) this is not the occasion to decide a difficult point of interpretation of the agreement; it is sufficient to say that even if Mr Goodfellow is right the problem can be overcome by applying for exemption from Guernsey tax when it is common ground that the agreement will not apply. While normally a company would not do this if the result would be to pay UK tax instead of Guernsey tax, here the hypothesis requires that the company be UK resident and that is a way of achieving that result without also paying Guernsey tax.

96. Standing back, we consider that it is reasonable to suppose that this route would have been adopted, though it is less likely than the previous possibilities.

UK incorporation and management and control and UK insurance authorisation

97. The position is complicated and the first issue is what class of insurance business it is. The Appellant's expert, Mr Shackerley-Bennett, was told that it was class 14:

"Effecting and carrying out contracts of insurance against risks of loss to the persons insured [ABTA] arising from the insolvency of debtors of theirs [ABTA's] or from the failure (otherwise than through insolvency) of debtors of theirs [ABTA's] to pay their debts when due."

98. We agree with Miss Gloster QC that this seems inapplicable. The claim against ABTA is by a customer of an insolvent member without the member being a debtor of ABTA. She contended that it was class 15(a):

"Effecting and carrying out-

(a) contracts of insurance against risks of less to the persons insured [ABTA] arising from their having to perform contracts of guarantee entered into by them."

99. The ABTA promise is a contract of guarantee entered into by ABTA. Mr Goodfellow did not address us on the point. Our tentative conclusion, as this is not a suitable forum to decide points of insurance law, is that Miss Gloster is right. Mr Shackerley-Bennett took us through the basis on which authorisation is granted. On the basis of normal authorisation requirements for Class 15, there being no regime for captives in the UK and virtually no UK authorised captives, a required minimum margin is calculated, to which must be added an additional discretionary margin which Mr Shackerley-Bennett put at 1.5 times the required minimum margin. The following table summarises the figures in £000.

	Tour Operators			Travel Agents		
	1997	1998	1999	1997	1998	1999
Total required margin based on actual results	780	780	780	1498	1440	1365
Total required margin based on forecast figures	788	780	780	1733	1950	2168
Shareholders' equity	1145	1873	2569	4644	6392	9471
Technical reserves	643	600	503	366	928	666

100. On the basis of this evidence we find that the two captives did have sufficient reserves in all years under appeal to have qualified for authorisation.

101. Mr Goodfellow's contentions why this route would not have been chosen were (1) ABTA would not have been able to use the funds within TOL and TAL to obtain authorisation for a new company, (2) even if one did take those funds into account the extent of the assets would not have been known in time to achieve authorisation by 1 July 1996, (3) the running costs would have been much greater, (4) without the benefit of

hindsight it would not have been clear that the results would justify the increased cost, (5) there are hardly any UK authorised captives, (6) TOL would have insured in the market, (7) TAL's rates would have become uncompetitive because of the increased costs.

102. In our view (1) we disagree for the reasons set out in paragraph 85 (2) since we are dealing with a hypothesis we do not consider that we should take account of matters such as the time it would take to obtain authorisation, which in varying degrees will apply to all the possible alternatives, (3) and (4) we do not consider that the additional costs estimated by Mr Shackerley-Bennett to be £80,000 to obtain authorisation, £15,000 per qualified director, and £70,000 annual operating costs (including £5000 for claims which might be avoided as ABTA investigate claims against it anyway), would have made this route uneconomic. These figures need to be considered in the lightof the accounts profit of Tour Operators Limited in 1997, for example, of £588,000 and of Travel Agents Limited of £1.7m, (5) we accept that this increases the uncertainty but not that it means that this route is not possible, (6) we deal with this below, (7) we doubt this in the light of the figures quoted above.

103. Our conclusion is that it is just reasonable to suppose that this route would have been adopted, but it is less likely than the alternatives considered above.

UK independent insurer (tour operators)

104. Mr Goodfellow contended that for tour operators insurance in the UK market is the only route that would have been adopted.

105. Looking at the results of the two captives by 31 March 1996, before the beginning of the first year under appeal, for tour operators ABTA had paid premiums of £4,650,000, received profit commission of £3,141,975 and had made accounts profits of £439,865. We do not find it credible that ABTA would have paid premiums in the insurance market, probably of a greater amount, with no hope of any return if claims experience had continued to be similar. We do not find it reasonable to suppose that they would have adopted this route.

Do nothing (travel agents)

106. Mr Goodfellow contended that ABTA would have been left travel agents to obtain bonds in the market. For travel agents, by 31 December 1996 (which is after the start of the first year under appeal but much of this was already known) members had paid premiums of £10,939,120, ABTA had received profit commission of £916,698 and had made accounts profits of £2,900,802. We do not find it credible that ABTA would have given up this source of income in favour of external providers of bonds. We do not find it reasonable to suppose that they would have adopted this route.

The reason for the existence of the CFCs

107. Having decided that it is reasonable to suppose that had the captives not been in existence the receipts of the captives the results of which are reflected in their profits in each accounting period would have been received by a UK resident who would have been taxable on them, there is accordingly what we have called for short a tax reduction by diversion of profits. The final question is whether the main reason or one

of the main reasons for the existence of the captives in each accounting period was to achieve that tax reduction by diversion of profits.

108. Mr Goodfellow contended that, like paragraph (a), on the ordinary meaning of the words this was a subjective test; Miss Gloster QC contended that it was objective. She points to the absence of any equivalent to paragraph 18 setting out who must have the reason. She relies on the distinction between purpose and reason considered in *Brady v Brady* [1989] 1 AC 755, 779-80 *per* Lord Oliver:

".it is important to distinguish between a purpose and the reason why a purpose if formed. The ultimate reason for forming the purpose of financing an acquisition may, and in most cases probably will, be more important to those making the decision than the immediate transaction itself. But 'larger' is not the same thing as 'more important' nor is 'reason' the same as 'purpose'. If one postulates the case of a bidder for control of a public company financing his bid from the company's own funds-the obvious mischief at which the section [s.151 Companies Act 1985] is aimed-the immediate purpose which it is sought to achieve is that of completing the purchase and vesting control of the company in the bidder. The reasons why that course is considered desirable may be many and varied. The company may have fallen on hard times so that a change of management is considered necessary to avert disaster. It may merely be thought, and no doubt would be thought by the purchaser and the directors whom he nominates once he has control, that the business of the company will be more profitable under his management than it was heretofore."

Mr Goodfellow explained the absence of any equivalent to paragraph 18 by saying that its purpose was to enlarge the scope of the persons whose purpose is relevant for paragraph (a) only.

109. We consider that a reason for doing something is subjective. The passage quoted from *Brady* looks at the purchaser's reasons in the sense of the motive prompting the action (that the business will be more profitable under the purchaser's management), as opposed to the purpose it is sought to achieve (obtaining control of the company), both of which are subjective. The difference is that the reason precedes the action and the purpose looks to what it is hoped to achieve by the action. In determining the common test in tax legislation whether a transaction is effected for bona fide commercial *reasons* one asks what reasons were in the taxpayer's mind for effecting the transaction. Such a requirement is often coupled with a purpose (or object, which seems to be the same) test, as in the following examples:

".unless the exchange or scheme of reconstruction in question is effected for bona fide commercial *reasons* and does not form part of a scheme or arrangements of which the main *purpose,* or one of the main *purposes,* is avoidance of liability to capital gains tax or corporation tax." (section 137 Taxation of Chargeable Gains Act 1992)

"unless he shows that the transaction or transactions were carried out either for bona fide commercial *reasons* ., and that none of them had as their main *object*, or one or their main *objects*, to enable tax advantages to be obtained." (section 703(1) Taxes Act 1988)

The distinction made in *Brady* fits these examples. The bona fide commercial reason is what prompted the action, and the avoidance of tax (or tax advantage) is what it is hoped to achieve by the action. It also fits section 748(3). In paragraph (a) the purpose is applied to a tax reduction which it was hoped to achieve by the transaction (and which must have actually been achieved to a more than minimal extent for the provision to apply); in paragraph (b) the reason is applied to two existing facts: the existence of the company and a tax reduction by diversion of profits computed by comparison with an objectively determined alternative, not something which it is hoped to achieve. We consider that the draftsman was using the distinction between purpose and reason because of the difference in nature between the tests in the two paragraphs rather than to indicate whether or not reason was subjective.

110. Are there any indications that "reason" is not intended to be subjective? First, does the absence of an equivalent to paragraph 18 indicate that the draftsman did not intend paragraph (b) to be wholly subjective? Or, as Mr Goodfellow suggests, does it indicate that the reason for the company's existence must be found in the minds of those controlling the company, who could do something about whether it existed or not, so that the paragraph 18 extension of the people with the relevant purpose to the company itself and any person having an interest in the company would not be appropriate? We agree with Mr Goodfellow's analysis. No equivalent to paragraph 18 is necessary; it is obvious whose reason it must be. Secondly, the reason test applies to a tax reduction by diversion of profits which is determined objectively by asking what it is reasonable to suppose would happen if the company had not been in existence. Mr Goodfellow points out that the object test in section 703 quoted above is applied to "tax advantage" which is determined at least in part by comparing what was done with a hypothetical way of achieving the same result but paying more tax, which may not have been considered by the people involved. We agree that a purpose test can be applied to an objectively determined alternative; if the taxpayer had a different purpose he can satisfy the test without having considered the hypothetical alternative. Thirdly, the subject matter of the test is the company's existence in an accounting period. In practice we can assume that those controlling companies do not ask themselves in every accounting period why the company exists. Companies that serve some purpose continue to exist without anyone asking why. Here the reason can apply to inaction rather than action. If a wholly subjective test were applied in such a case, a taxpayer can satisfy paragraph (b) by saying that it never considered the reason for the existence of the CFC in the particular accounting period and therefore one of the main reasons for its existence cannot be the obtaining of the tax reduction by diversion of profits. We do not think this can be what Parliament intended.

111. The only way the test can be applied in such a case is therefore to ask ourselves whether either ABTA did consider, or, if they did not give any consideration to the question, a reasonable person knowing all the circumstances would consider, that one of the main reasons for the existence of the captives in each accounting period was to achieve the tax reduction by diversion of profits. We have found in paragraph 77 that ABTA's purpose in choosing Travel Agents Limited rather than an in-house fund was the tax reduction between the two. Nothing changed between the setting up of that company and the years under appeal. Accordingly, at least one of the main reasons in the mind of ABTA for the existence of Travel Agents Limited in the years under appeal was to achieve the tax reduction by diversion of profits. Even if the matter were not consciously

considered in the years under appeal the same reasons as before continued to apply and we come to the same conclusion objectively. In addition, in December 1997 Mr Reynolds and Mr Perez considered Mr Malacrida's report that included the possibility of re-establishing an in-house fund for travel agents and decided against it. The only advantage of an in-house fund identified in that report was the saving of costs of operating the captive; the other considerations were the tax disadvantage. One of the main reasons for that decision was therefore to achieve the reduction of tax by diversion of profits. There was therefore a conscious decision to continue Travel Agents Limited made during the year ended 30 June 1998, the reason for which continued to apply in the year to 30 June 1999 because nothing had changed by the later year.

112. In relation to Tour Operators Limited we have already decided in paragraph 76 that by the time of the first year under appeal one of the main purposes, even if an unconscious one, of choosing the company rather than an in-house fund was to obtain the tax difference between the two choices. The same applies to the existence of the company as opposed to having an in-house fund in the years under appeal for which we find that one of the main reasons was to achieve the tax reduction by diversion of profits. Even if the matter were not consciously considered in the years under appeal the same reasons as before continued to apply and we come to the same conclusion objectively.

113. The other alternatives involving UK resident captives which we have found it is reasonable to suppose would have been adopted were never considered by ABTA. Accordingly we adopt an objective test and ask whether we can infer that a main reason for the existence of the captives in the years under appeal was to achieve the tax reduction by diversion of profits between the existence of the captives and the other alternatives. We infer that this was one of the main reasons. A UK resident captive would achieve exactly the same result but without the tax benefits.

114. Accordingly if a subjective test is applied the Appellant has not shown that paragraph (b) is satisfied in relation to an in-house fund, which is the only alternative actually considered by ABTA. In so far as the matter was not considered in the years in question we reach the same conclusion objectively. Iin relation to all the alternatives which we find that it was reasonable to suppose would be adopted looking at the matter objectively we consider that one of the main reasons was to achieve the tax reduction by diversion of profits. The same result could be achieved in several ways without using a non-resident company. Accordingly, on either basis we find that the Appellant has not shown that paragraph (b) is satisfied.

115. Our decision in principle is that:

a. The Appellant has demonstrated that paragraph (a) of section 748(3) is satisfied in relation to the periods ended 30 June 1997, 1998 and 1999;
b. The Appellant has not demonstrated that paragraph (b) of section 748(3) is satisfied in relation to the periods ended 30 June 1997, 1998 and 1999;
c. Accordingly the appeal is dismissed in relation to the periods ended 30 June 1997, 1998 and 1999;
d. The appeal is allowed by consent in relation to the periods ended 30 June 1995 and 1996.

116. In accordance with section 56A(2) of the Taxes Management Act 1970 we hereby certify that our decision involves a point of law relating wholly or mainly to the construction of an enactment that has been fully argued before us and fully considered by us. This means that if both

parties consent, and if the leave of the Court of Appeal is obtained, the Appellant may appeal from our decision directly to the Court of Appeal.

117. We should like to make a final comment. This was the first time the motive test has been litigated, and we should like to consider whether any lessons can be learned. The case was originally listed for 10 days but the final total was 17 (although two of them were half days only). Of this 11 days were spent hearing oral evidence of witnesses. If our decision on the interpretation of paragraph (a) of section 749(3) is correct little of this evidence assisted us. Even when considering the alternative of whether the choice made between an in-house fund and a captive had a tax purpose most of the evidence was provided by the documents of which Mr Malacrida's notes of meetings were particularly helpful. Particularly when the events of nine years earlier are concerned this is to be expected. With our rules providing that the winning party pays his own costs we consider that we should be more proactive in keeping costs to a minimum. The appellant in a case such as this has to prove a negative and will consider it necessary to call all possible witnesses so that it cannot be said that a witness it did not call might have had a tax purpose. If another case on this test arises it is for consideration whether the Tribunal should take the opportunity to consider in advance whether it considers such witnesses are necessary. We appreciate that this may be difficult to achieve in practice but, even if it meant that witnesses were called at a separate second hearing, we should like to see in another case whether any savings of time and costs could be achieved.

DR JOHN F. AVERY JONES

DR NUALA BRICE

SPECIAL COMMISSIONERS

SC 3106/01

Authorities cited but not referred to in the decision

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