Tolley's Tax Digest

Income Tax: Transactions in Securities

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Practical, expert guidance covering:

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- Income Tax Act 2007 s 685 conditions;
- Relevant case law including *Cleary*, *Greenberg*, *Joiner* and *Wiggins*;
- the fundamental change of ownership test;
- the motive test;
- the consequential income tax advantage;
- clearances;
- counteraction;
- appeals;
- and much more.

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1 Introduction

The transactions in securities legislation has been with us for over 50 years now, having been enacted originally in Finance Act 1960. And, despite many changes in the tax system over the years, it remains as relevant as ever, with tax rates on gains probably remaining materially lower than the rates on income.

Following Finance Act 2010 there are now separate transactions in securities regimes for income tax and corporation tax. This *Tax Digest* only covers the transactions in securities legislation for income tax purposes, which applies from 24 March 2010.

For details of the regime for corporation tax purposes, see *Tax Digest* Issue 92.

For details of the pre-FA 2010 regime for both income tax and corporation tax, see *Tax Digest* 81.

1.1 Structure of the legislation

The essence of the regime is to allow HMRC to counteract an income tax advantage arising from one or more transactions in securities in certain circumstances. The tax advantage must arise as a result of transactions in securities with tax avoidance motives, where the necessarily widely-drawn conditions are satisfied. However, there are 'escape clauses' or negative filters; further conditions which, if satisfied, prevent HMRC from taking counteraction measures.

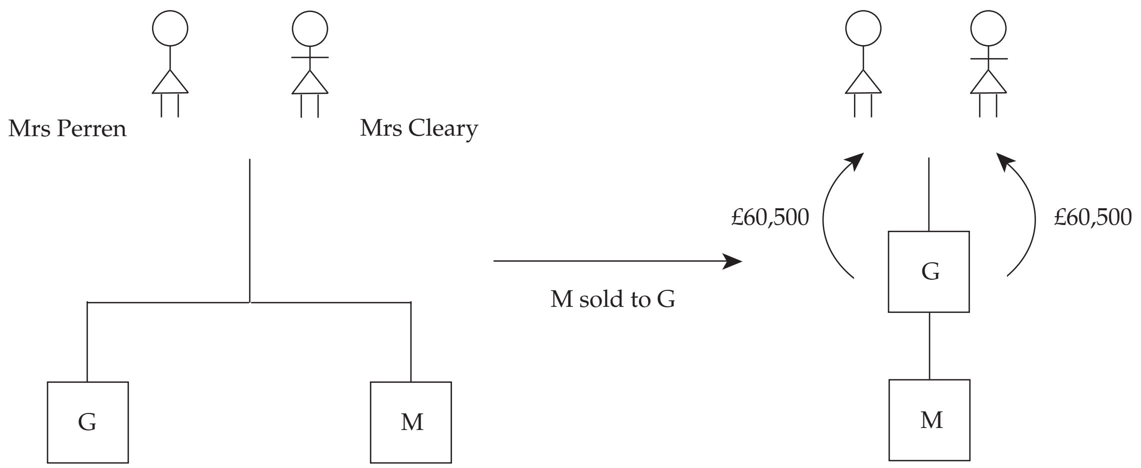
1.2 History

One of the most important things to remember about this legislation is that it was enacted five years before the capital gains tax legislation that we are now very familiar with, and two years before the first attempt at taxing short-term gains (in 1962). So many of the tax avoidance schemes that developed at that time were geared towards turning income profits, taxable at rates up to 98% in some cases, into capital gains that were not taxable at all.

Below are two examples of avoidance schemes that were practised prior to the enactment of this legislation in 1960, and which it was designed to stop.

See **Example 1** below.

Example 1: *CIR v Cleary, CIR v Perren* (44 TC 399)



Mrs Cleary and her sister, Mrs Perren, each owned 50% of the shares in each of G Ltd and M Ltd. G Ltd had accumulated distributable profits in excess of £180,000. If those profits had actually been paid out as dividends to the sisters, the amounts paid out would have been liable to both income tax and to surtax.

Instead, M Ltd was sold to G Ltd for £121,000, each sister receiving £60,500.

Absent the provisions for taxing certain transactions in securities as if the relevant consideration had been distributed as a dividend, the sisters would have received the £60,500 each as a capital gain and there would have been no tax to pay.

The impact of the 1960 legislation is that the sisters were caught by the transactions in securities rules (under Circumstance D of the rules as originally enacted – see *Tax Digest* 92) and the £60,500 was taxed on each of them as if it had been received as a dividend.

Example 2: *CIR v Greenberg* (47 TC 240)

L Greenberg Ltd was owned by Mr Greenberg and his son, Henry. The company was very profitable and in 1958 it was considered likely that the company would make at least £20,000 profits over the next five years. As in the *Cleary* case, dividends would have been taxed at very high rates, so the Greenbergs entered into a forward stripping arrangement, instead.

First, the Greenbergs subscribed for £100 of new preferred shares in the company, carrying preferred dividends amounting to £20,000 over the five years. The shares were then sold to Finsbury Securities Ltd., a company of share dealers, for £20,100. The intention was that the Greenbergs would have a £20,000 tax-free capital gain. Finsbury Securities would receive £20,000 preferred dividends over the five years and, as share dealers, they would also be able to claim tax deductions for both the cost of the shares of £20,100 and the loss in value of £20,000.

In the event, Finsbury Securities did not get the deduction they anticipated. This was denied under earlier legislation, although it would almost certainly have been denied under Circumstance B of the transactions in securities rules as originally enacted – see *Tax Digest* 92.

And the tax position for the Greenbergs was also caught, this time by Circumstance C of the rules as originally enacted – see *Tax Digest* 92.

During the 1950s Parliament enacted a number of statutory provisions aimed at specific tax avoidance devices, such as bond-washing. But there was still a constant stream of tax mitigation schemes, as can be seen from the examples throughout this *Tax Digest*. Many of these, such as bond-washing and dividend strips, were based on converting income chargeable to income tax into capital receipts not chargeable to tax at all, as there was no capital gains tax until 1965. Eventually, very general anti-avoidance legislation was introduced as FA 1960 s 28, effective from 6 April 1960, which was rewritten for income tax purposes in Finance Act 2010.

The legislation is still relevant, 50 years after its enactment, as capital gains tax rates have often, as now, been lower than tax rates on income. At the time of writing (January 2013), for example, for individuals, the main capital gains tax rate is 28%, whereas the income tax rate can be up to 50% (reducing to 45% for 2013/14). For companies, many chargeable gains are exempt (under the substantial shareholdings exemption, for example), while the main rate for corporate profits is 24% for FY 2012, reducing to 22% for FY 2013.

1.3 Current legislation

The income tax legislation is at ITA 2007 Ch 1 Pt 13, ss 682-713, and the rules described in this *Tax Digest* have effect in relation to income tax advantages obtained on or after 24 March 2010.

1.4 Interpretation

When this legislation was first enacted, the approach taken by the courts was to interpret the words of the legislation as widely as possible, in order that they might be effective as anti-avoidance rules. In *IRC v Greenberg* (47 TC 240) Lord Reid said:

> '…on the face of it any single act done by one person alone is a transaction in securities if it is one "relating to securities". This is a vague phrase, but I do not see how to stop short of giving to it a very wide meaning.'

And:

> '…if the courts find it impossible to give very wide meanings to general phrases the only alternative may be for Parliament to do as some other countries have done and introduce legislation of a more sweeping character.'

Lord Wilberforce, in *IRC v Joiner* (50 TC 499), noted that these rules require:

> '… a different method of interpretation from that traditionally used in taxing Acts … the scheme of [these provisions], introducing as they did a wide and general attack on tax avoidance, required that expressions which might otherwise have been cut down in the interest of precision were to be given the wide meaning evidently intended …'

More recent cases may have eroded this principle of interpretation of the transactions in securities rules. For example, in *CIR v Laird Group plc* ([2003] STC 1349), Lord Millett noted that in early cases involving this legislation, such as *Greenberg* (above), *Parker* (43 TC 396) and *Joiner* (50 TC 449), it was contended by the taxpayers that the rules were aimed only against tax avoidance by dividend-stripping, asset stripping or bond washing. The need for the courts to adopt a wide approach to interpretation was thus aimed only at this narrow point. Lord Millett held that line of argument to have become unmaintainable following the decisions in those cases and that 'that horse has been dead for nearly 30 years'.

In the more recent case of *Marcus Bamberg* (TC00618), the First-tier Tribunal followed this approach, saying that 'in the most recent case of *IRC v Laird Group plc* … the House of Lords approached the interpretation of the [transactions in securities legislation] as a matter of the ordinary meaning of language'.

In some ways, the argument may be said to be moot, on the basis of the rules having been rewritten in a more targeted fashion for income tax purposes by FA 2010, so that there is less need for a wide interpretation of the rules when the target is clearer from the way they have been recast. However, many of the definitions and parts of the Conditions are identical to the old rules, or very similar to them, so the question of interpretation is still a live point, in my view. Certainly, within the context of the narrower focus, which is clearly delineated by the new legislation itself, it seems logical to assume that the courts will continue to interpret the legislation as widely as necessary.

In any case, the legislation itself clearly requires a wide interpretation in some areas. For example, the definition of 'transaction in securities' in ITA 2007 s 684(2) is worded very widely. The term includes 'transactions of whatever description, relating to securities' and, in particular the purchase, sale or exchange of securities, the issuing or securing the issue of new securities, applying or subscribing for new securities or altering or securing the alteration of the rights attached to securities.

2 The main rule

The current regime described here has effect in relation to income tax advantages obtained on or after 24 March 2010. This means that the legislation could potentially apply where the transactions in securities took place before that date, so long as the tax advantage arises on or after it.

2.1 The main rule

The main rule, ITA 2007 s 684(1), reads as follows:

'(1) This section applies to a person where -

a) the person is a party to a transaction in securities or two or more transactions in securities;

b) the circumstances are covered by section 685 [the specific conditions for the legislation to apply] and not excluded by section 686 [the fundamental change of ownership test];

c) the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage; and

d) the person obtains an income tax advantage in consequence of the transaction or the combined effect of the transactions.'

Where ITA 2007 s 684 applies, HMRC is entitled to consider counteracting the tax advantage, as detailed below. We will now look at some of the components of ITA 2007 s 684(1) in more detail.

2.2 The burden of proof

Under these rules, it is clear that the burden of proof falls on HMRC to establish that the conditions of ITA 2007 s 684(1) are satisfied. Probably the most important impact here is the requirement for HMRC to prove the taxpayer's motive, as discussed at **4.1** below.

3 Party to a transaction in securities – ITA 2007 s 684(1)(a)

3.1 Party to a transaction

The person against whom HMRC can take counteraction must be a person who was party to a transaction in securities. It may be possible for a taxpayer to successfully argue that the rules do not apply in cases where they were not themselves party to any transactions in securities. For example, if the trustees of a settlor-interested trust carry out a transaction in securities but the tax advantage accrues to a beneficiary to whom the trust's assets are later distributed, that beneficiary may not have been party to the transaction in securities and hence would not be caught by these rules.

The phrase 'party to the transactions' is a narrowly focused phrase and doesn't obviously permit a wide interpretation. For example, if a person devises a transaction, or benefits from it, that does not necessarily make them party to it.

This is a new test, introduced by FA 2010, so there is no jurisprudence on the point that is specific to this legislation.

3.2 What is a transaction in securities?

As we have seen, the legislation is all about transactions in securities. So what actually is a 'transaction in securities'?

The expression 'transaction in securities' is widely defined (as noted above), in ITA 2007 s 684(2). It includes 'transactions, of whatever description, relating to securities, and in particular—

- the purchase, sale or exchange of securities;
- issuing or securing the issue of new securities;
- applying or subscribing for new securities; and
- altering or securing the alteration of the rights attached to securities.'

'Securities' for these purposes includes shares and stock, and an interest of a member of a company that is not limited by shares (ITA 2007 s 713). Some commentators also consider that a participator loan account, such as may arise on incorporation of a sole or a partnership business, might constitute a security for these purposes, and hence be open to counteraction.

The examples in the legislation are not exhaustive, which is why the list is introduced with the word 'includes'. Various combinations of events and actions have been considered to fall within the definition, even though a layman might not consider them to be transactions in securities. For example, in *CIR v Greenberg* (47 TC 240) (see **Example 2**), it was decided that a dividend followed by a payment of the same amount as an instalment of capital together constituted a transaction in securities (even though the courts declined to decide whether the dividends alone were transactions in securities). And in *Williams v IRC* (54 TC 257) it was held that loans by a company to individuals who subsequently acquired the company were transactions in securities, even though the loans were not securities in the normal sense of the word.

3.2.1 Company liquidation

It was clear when the legislation was introduced that Parliament did not consider that a liquidation was a transaction in securities. The Attorney-General at the time said that a 'liquidation is not a transaction in securities any more than the payment of a dividend on shares' (HC Official Report 25 May 1960, col 511). However, it soon became clear that, if a liquidation were not a transaction in securities, there was a potential lacuna in the legislation. In 1962 the words 'the combined effect of the transaction or transactions and the liquidation of a company' were added, indicating that the draftsman also did not consider that a liquidation was a transaction in securities. That said, this wording does not declare a liquidation to be a transaction in securities for the purposes of this legislation and indeed these words were omitted from the rewritten income tax rules.

HMRC's practice was not to apply the legislation to an ordinary liquidation, with no other elements. But there have been exceptions, as in **Example 3**.

Example 3: *CIR v Joiner* (50 TC 449)

A company was put into liquidation and the assets were distributed to the shareholders according to an agreement made between them before the liquidation. The trade was transferred to a new company and other assets were distributed to the shareholders, as capital receipts.

A tax advantage therefore accrued to the shareholders, as they had managed to extract assets from the company in capital form, while leaving the trade in a company. Their defence was that the tax advantage arose only from the liquidation, which was not a transaction in securities.

The courts decided that the pre-liquidation shareholders' agreement was a transaction in securities as it varied the rights of the shareholders in respect of their shareholdings, so the tax advantage arose as a result of the combined effect of the shareholders' agreement – a transaction in securities – and the liquidation of the company, and was squarely within the terms of the legislation as it then stood. It is interesting to speculate about whether the taxpayers would win under the current rules, which do not refer to the liquidation, but the better view is that HMRC would be able to demonstrate that the tax advantage arose as a consequence of the transaction in securities, i.e. the shareholders' agreement.

Notably, the courts declined to decide whether the liquidation per se was a transaction in securities. However, we might also see this decision as an example of the courts taking a wide view of the correct interpretation of this anti-avoidance legislation.

3.2.2 Payment of a dividend

As noted in **3.2.1**, above, the Attorney-General in 1960 said that a 'liquidation is not a transaction in securities any more than the payment of dividend on shares'. But such a statement in Parliament does not necessarily make it so and this question was considered in *Greenberg* (see **Example 2**). The issue here was that all the preliminary transactions in securities – the subscription for preferred share capital and the sale of those shares to the dealers – had taken place before 6 April 1960, when the legislation first came into force. However, the dividends were to be paid in tranches, as the profits were made and became distributable, so the only 'transactions' that occurred after 5 April 1960 were the dividends.

Fortunately for the Revenue, the payments of capital to the Greenbergs were also to be made in tranches, following the receipts of the dividends by the dealers. The courts decided that a dividend and the subsequent payment of an instalment of capital together constituted a transaction in securities. Again, we might see this as another example of the courts taking a wide view of the interpretation of this legislation. But the court stopped short of deciding whether a dividend per se was a transaction in securities.

Nevertheless, many people clearly took the view that a dividend was a transaction in securities, purportedly following *Greenberg*. For example, the judgment in *Marwood Homes No 3 v IRC* [1999] STC (SCD) 44 explicitly states that all parties agreed that the dividends were transaction in securities.

The position was finally resolved in *Laird Group plc v IRC* (75 TC 399). The company acquired all the share capital of S Ltd, a UK company carrying on a similar trade, and arranged that S Ltd paid a dividend of £3 million to Laird. Due to the operation of the (now repealed and unlamented) ACT regime, this allowed Laird to claim a repayment of corporation tax. HMRC contended, inter alia, that the tax advantage arose from the dividend, which was a transaction in securities. The House of Lords decided that there was no material difference between a distribution of profits in a liquidation and a distribution by way of dividend, as in either case this merely gave effect to the rights attached to the shares. Neither form of distribution was a 'transaction relating to securities'. Their Lordships asked rhetorically why a distribution to shareholders by a company that is still active and continuing to trade or carry on business should be a transaction in securities while a distribution to shareholders by a company that is being wound up is not? In other words, why should the intended continued activity of the company determine whether distributions in respect of shares should be a transaction in securities? The House of Lords felt that there was no reason for a difference and, therefore, upheld the company's view that a dividend is not a transaction in securities.

4 The conditions – ITA 2007 s 684(1)(b)

The transactions in securities rules only apply if either condition A or condition B in ITA 2007 s 685 is met. Given the relatively straightforward language used, it is appropriate to set out the legislation in full.

4.1 Conditions A and B

Condition A is that, as a result of the transaction in securities or any one or more of the transactions in securities, the person receives relevant consideration in connection with:

(a) the distribution, transfer or realisation of assets of a close company;

(b) the application of assets of a close company in discharge of liabilities; or

(c) the direct or indirect transfer of assets of one close company to another close company,

and does not pay or bear income tax on the consideration.

The most obvious target of Condition A is transactions such as that in the *Cleary* case (**Example 1**), where it was established that the sale of one company to another fell within the very similar descriptions of transactions that were in the pre-FA 2010 rules.

Condition B is that:

(a) the person receives relevant consideration in connection with the transaction in securities or any one or more of the transactions in securities;

(b) two or more close companies are concerned in the transaction or transactions in securities concerned; and

(c) the person does not pay or bear income tax on the consideration (apart from this Chapter).

4.2 Relevant company

The transactions in securities rules only apply to close companies, or to companies that would be close if they were UK resident (ITA 2007 s 713). Transactions in securities involving publicly-listed companies will therefore usually be outside the scope of the legislation, regardless of where the companies are listed.

In *IRC v Garvin* [1981] STC 344 it was held (under the old rules which had a different definition of 'relevant company') that the company must be a relevant company at the date of the relevant distribution of profits. This is probably still good law, so the test applies at the time of the relevant transaction(s) in securities.

This may be advantageous to taxpayers in private equity transactions where the private equity investor is part of a UK listed group. In a number of cases, HMRC has conceded that transactions in securities involving such investors cannot be caught by this legislation, as the company being transferred is controlled by a listed company that is not close, so the transactions in securities rules cannot apply.

Note that this test also makes it clear that a company does not have to be UK resident to be a relevant company, when it refers to a company that would be close were it UK resident.

4.3 Relevant consideration

For cases within (a) or (b) of Condition A, 'relevant consideration' means consideration which:

- is or represents the value of:
  - assets which are available for distribution by way of dividend by the company; or
  - assets which would have been so available apart from anything done by the company;
- is received in respect of future receipts of the company; or
- is or represents the value of trading stock of the company.

In these cases, the consideration is referring back specifically to the company whose assets are transferred, distributed, realised or applied in the discharge of liabilities (see **3.2.3**). This is a restriction on the scope of the rules but is unlikely to be of practical significance in most cases.

Relevant consideration will not include a return of sums paid by subscribers on the issue of securities, even if under the law of the country in which the company is incorporated assets of that description are available for distribution by way of dividend.

For cases within (c) of Condition A or within Condition B, 'relevant consideration' means consideration which consists of any share capital or any security issued by a close company and which is or represents the value of assets which:

- are available for distribution by way of dividend by the company;
- would have been so available apart from anything done by the company; or
- are trading stock of the company.

In this case, where non-redeemable shares are issued as relevant consideration, the legislation only applies so far as the share capital is repaid (on a winding up or otherwise). But any distribution made in respect of any shares on a winding up or dissolution of the company is to be treated as a repayment of share capital.

It is important here that the relevant consideration in the form of shares or securities must represent assets available for distribution by the company issuing them (see **3.2.3**).

In all cases, consideration includes both money and money's worth.

4.3.1 Form of consideration

In most cases, the consideration will be recognisably a payment of a tax-free sum or the receipt of assets (money's worth). But this is not a sine qua non for the legislation to apply. In *Williams v IRC* [1980] STC 53 the taxpayers were the shareholders of a property company, K Ltd, which had made a substantial profit. Following a complex sequence of transactions, including a distribution of profits by K to a new parent company, a third company made interest-free loans to the shareholders of the original company. It was held that the loans had been received by the taxpayers in connection with the distribution of the profits by K Ltd, demonstrating that the loans were themselves to be considered as 'consideration' for the purposes of this legislation.

If Condition A (c) or Condition B are in point, the relevant consideration has to be in the form of securities (i.e. shares or stock, ITA 2007 s 713) and it is those securities that have to represent the amounts available for distribution or the trading stock, so that this must refer to the issuing company.

If the relevant consideration in these cases is in the form of non-redeemable share capital, the transactions in securities rules can only apply when is repaid, on a winding up or otherwise, such as in a reduction of capital under CA 2006 s 641 (ITA 2007 s 685(7)). Any distribution in a winding up is treated as a repayment of share capital for these purposes.

4.3.2 'In connection with'

Conditions A and B only apply if consideration is received free of tax in connection with the distribution, transfer or realisation of assets of a relevant company, etc. (Condition A) or in connection with the transaction(s) in securities (Condition B). The phrase 'in connection with' is satisfied by a less definite causal link than the phrase 'in consequence of' in ITA 2007 s 684(1)(d): it involves a relationship between things one of which is bound up with or involved in or having to do with another.

There are a number of examples of this in the jurisprudence. In *Anysz v IRC* [1978] STC 296 a scheme was effected to extract a development profit from a property company, K Ltd. The scheme included the exchange by the taxpayers of their shares in K Ltd for shares in an investment company, P Ltd and a dividend from K Ltd to P Ltd. The Special Commissioners found that the purpose of the share exchange was to enable K Ltd to be stripped of its assets by the subsequent dividend, so the receipt by the taxpayers of the shares in P Ltd was 'in connection with' the payment of the dividend by K Ltd to P Ltd.

Similarly, In *Williams v IRC* (see above), it was held that the loans had been received by the taxpayers in connection with the distribution of the profits by K Ltd.

4.3.3 Assets available for distribution

Since the consideration for the sale of the shares of a company will usually come from a purchaser, it is clearly not necessary that the consideration giving rise to a tax advantage should come directly from the company itself. All that is necessary is that the consideration can be shown to represent reserves or assets of that company.

The statute refers to assets available for distribution by the company, but the company referred to is different depending on which type of relevant consideration applies.

If we are looking at Condition A (a) or (b), the relevant consideration refers back to the company whose assets are transferred, distributed, realised or applied in the discharge of liabilities. In *Cleary* (**Example 1**) the shares of M were sold to G and the courts decided that the consideration paid by G to Mrs Cleary and Mrs Perren represented the distributable reserves of G, the purchaser company, which would otherwise have been able to distribute the £121,000 to the sisters. The courts also held that the payment of £121,000 by G was a transfer of assets, so the *Cleary* transaction would satisfy Condition A (a) with the consideration representing the distributable reserves of G.

Another, equally valid (in my view) approach is to say that the amounts paid by G for the shares of M represented the value of the distributable reserves of M, so that it is the reserves of M that are in point. And the transfer could be seen as the realisation of the value of M, so also falling within Condition A (a).

It is also clear from the judgment in *Addy v IRC* [1975] STC 601 that capital distributions are not excluded from counteraction. In that case a company reconstruction was followed by the distribution of revenue and capital reserves in the liquidation of the original company.

4.3.4 Apart from anything done by the company

The requirement that the consideration represents assets available for distribution can be helpful, in that this generally means that the anti-avoidance legislation cannot be invoked in respect of a company that has no distributable reserves at the time of a relevant transaction in securities, perhaps through being loss-making, or because reserves have already been distributed up to shareholders. In such cases, any consideration cannot represent distributable reserves.

However, it was necessary to ensure that the legislation could not be circumvented by artificially reducing a company's reserves. For example, in *IRC v Parker* (43 TC 396), a company made a bonus issue of debentures, by capitalising reserves. Some years later the debentures were redeemed. The House of Lords held that the redemption of the debentures was a transaction in securities and a distribution of profit and that there was a tax advantage because, but for something done by the company (i.e. the reduction of reserves by capitalisation into the bonus issue), the consideration could have been received by way of dividend.

HMRC has also invoked this proviso in circumstances where a commercial transaction that caused a reduction of reserves was not itself a taxable transaction (**Example 4**).

Example 4: Pension contribution.

A company made a large payment to the director's pension fund, so that the company claimed a tax deduction but the pension fund did not bear tax on the receipt. Subsequently, the company was to be subject to a management buy-out, and one of the purchasers was the director concerned.

Clearance under TA 1988 s 707 was refused, in part because an element of the consideration was considered by the inspector to represent an amount that would have represented the distributable reserves of the company, but for the fact that that amount had been contributed to the pension fund.

Generally, HMRC does not object where the reserves have been reduced by a taxable transaction, such as the payment of a dividend to the shareholders.

What is less clear is HMRC's attitude where a deduction is not available, perhaps because the contribution is to an EBT, rather than an approved pension fund. There is still a reduction of the reserves available for distribution but, absent the tax deduction, HMRC might not find this so offensive.

Example 5: *Marcus Bamberg* TC00618

This is a recent case that turned partly on whether something had been done by the company to reduce its distributable reserves, when it transferred a trade to a company with a large deficit on reserves.

Mr Bamberg owned a profitable trading company with about £2m of reserves. There was a completely independent company, WCL, which had a deficit on reserves of £15m and a liability to repay loan stock of the same amount. TTEL acquired the shares of WCL for £2 and Mr Bamberg personally bought the loan stock for £237,000.

Initially, TTEL (the trader) made loans to WCL (now its subsidiary). Most of the amounts loaned were then used to repay part of the loan stock. As this was a tax avoidance scheme, the repayments were considered by the Tribunal to be susceptible to counteraction as amounts representing the distributable reserves of TTEL (under the pre-FA 2010 rules).

Subsequently, however, the trade of TTEL was hived down to WCL. As a result, the combined reserves were substantially negative (around £12m) and WCL was unable to pay dividends. However, the profits generated from trading were used to repay the loan stock, instead. HMRC argued that there would have been distributable reserves in TTEL, had the hive down not taken place, but the Tribunal said that the rule looks at the company making the payments, which was WCL. Their analysis was that 'the hypothesis extends to a company's action in making its available assets into non-available assets; it does not extend to making one company's non-available assets into a different company's available assets by saying that the assets would have accrued to the latter company but for the hive-down. The fact is that the profits after the hive-down did not accrue to TTEL and they never were available assets to TTEL to which that company has done something to make into non-available assets'.

4.3.5 In respect of future receipts

This provision only applies to consideration under (a) and (b) of Condition A.

Previously I have suggested that this provision applies where the consideration is in the form of deferred cash, such as loan notes or redeemable shares. It appears, however, from an informal conversation, that this is not actually HMRC's view of this provision, although the person concerned did not know what this is meant to cover!

4.3.6 Deferred consideration

Deferred consideration is caught by the legislation, just like any other form of consideration. Where the consideration is in the form of loan stock or debentures (both of which would normally be securities for the purposes of the transactions in securities legislation), HMRC has frequently stated in correspondence that counteraction will only be considered at the time the securities are redeemed, and any counteraction would be by reference to the distributable reserves of the company at that time. This would be consistent with the premise that the legislation is aimed at transactions that generate cash representing a company's reserves, not merely its receipts.

Conversely, immediate counteraction might be considered where the securities are convertible to cash in the short term. In particular, this is likely to apply where the instruments are short-dated loan notes, redeemable shortly after issue. HMRC has been known to take a similar view of bank-guaranteed loan notes, too, as the bank guarantee means that the loan notes can be effectively be converted to cash in the short term, by using them as security for personal loans. In HMRC's view this looks like a receipt of consideration in money's worth.

In practical terms, if the later redemption of loan notes or shares is part of a shareholder exit from the company, HMRC will often decide against counteraction.

4.3.7 Is or represents the value of trading stock

This form of consideration is exemplified in *CIR v Wiggins*.

Example 6: *CIR v Wiggins* (53 TC 639)

The company's trade was that of picture framers and, having bought a batch of old pictures for the frames, it was discovered that one of the pictures was a very valuable painting by Poussin, potentially worth £130,000. Had the picture been sold as part of the trade, income tax would have been due at a high rate. Instead, there was a reconstruction and the trade was transferred from the original company, Wiggins, to a new company.

Wiggins was then sold for £44,447, with the painting, to a third-party purchaser as a capital transaction. It was held that this was a tax avoidance scheme and that the consideration received by the shareholders represented the trading stock of the company that was sold.

The reason for the discrepancy between the value of the painting and the disposal proceeds of the company is the very high rates of tax involved. Essentially, if the company had sold the painting for £130,000, the company would have paid tax on the trading profit and a distribution of the remaining proceeds would have been subject to both income tax and surtax. So the lower price for the 'tax-free' sale of the company itself was based on a sharing of the overall tax benefits.

Unfortunately for the shareholders, the counteraction was based on the £44,447 received, so that they paid both income tax and surtax, having already given up the bulk of the proceeds on the basis of the anticipated tax savings. So this case demonstrates something of a double whammy for the taxpayers.

Transactions to which this provision applies are generally rare (perhaps due to the deterrent effect?)

4.4 Conditions A and B and relevant consideration

To round up this section, let's look at some common transactions to see if they can fall within Conditions A or B. In each case, we do not consider whether there is a tax advantage, whether it is intended, and so on. We are just looking at Conditions A and B.

In each case, however, the individuals concerned are party to the transaction in securities, do not suffer income tax on the transactions but are, instead, potentially chargeable to capital gains tax at a lower rate than income tax.

Example 7: sale of private company

Ms Baez owns all the shares of Diamonds & Rust Ltd, a jewellery retailer. The company is profitable and has distributable reserves of £4m, trading stock worth a further £1m and the goodwill is valued at £3m. She accepts an offer from Zimmerman Ltd, wholly owned by Robert Zimmerman, to buy Diamonds & Rust Ltd for £8m cash.

This would appear to potentially satisfy Condition A (a), as a realisation of the assets of a close company (following *Cleary*, see **Example 1**), as the consideration could be said to represent the distributable reserves, the trading stock and the future receipts, i.e. the goodwill.

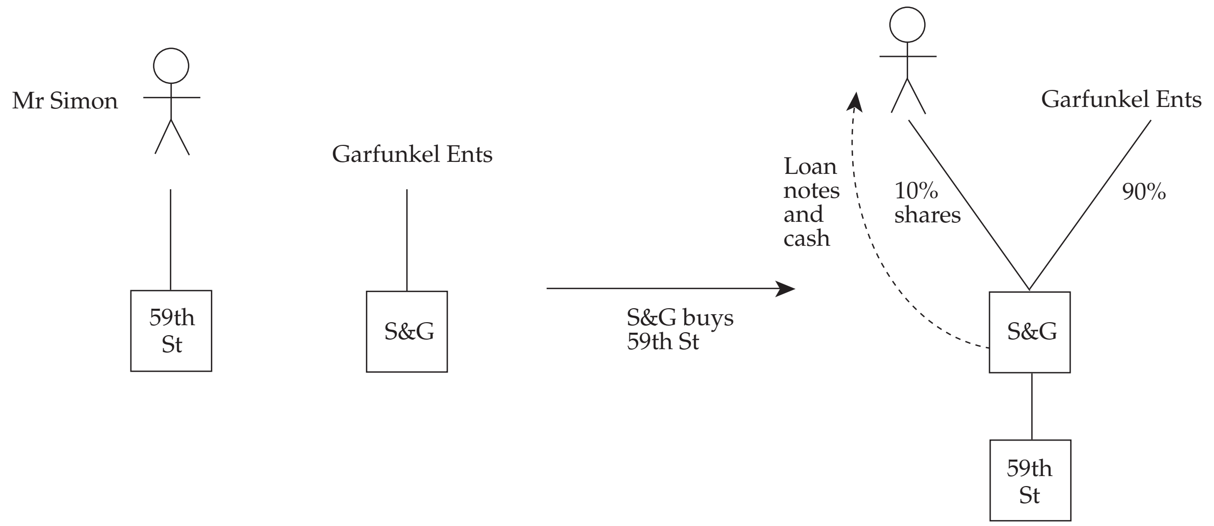
It could also satisfy Condition B, as two close companies are involved, but the consideration is cash, not securities, so there is no relevant consideration. Of course, Zimmerman Ltd might have paid part of the consideration in the form of loan notes or shares, in which case Condition B might also be in point.

This does not mean that the transaction is necessarily open to counteraction, as there is no suggestion of a tax avoidance motive in selling the company (ITA 2007 s 684(1)(*c*), see **6** below). Furthermore, Ms Baez is likely to satisfy the fundamental change of ownership test (ITA 2007 s 686, see **5**, below).

Another example might involve a private equity investment. See **Example 8** on the following page.

As regards the consideration in the form of loan notes and securities issued by Simon & Garfunkel Ltd, Condition B might apply, but only if Simon & Garfunkel Ltd is a close company, which is itself dependent on whether Garfunkel Enterprises Plc is a close company. (This is because Garfunkel Enterprises Plc controls Simon & Garfunkel Ltd and a company under the control of a company that is not a close company cannot

Example 8: Private equity transactions



Mr Simon owns 100% of the shares of 59th Street Ltd, a successful trading company, which is now worth £20 million and has distributable reserves of about that amount. As the business is expanding, he realises that he needs substantial external financing to fund the expansion. Garfunkel Enterprises Plc, a private equity firm, agrees to provide funds. The deal is structured so that Garfunkel Enterprises sets up a new company, Simon & Garfunkel Ltd, funded with £60,000 equity and a £19.94 million debt. Simon & Garfunkel Ltd. then buys 59th Street Ltd for £5 million cash, issuing Mr Simon with £40,000 share capital, so that he owns 40% of Simon & Garfunkel Ltd, and issuing him £10 million in loan notes, to be paid off over 10 years.

Does the transaction satisfy either Condition A or B?

So far as Condition A is concerned, we know that HMRC see this transaction as structurally similar to the transaction in the *Cleary* case (**Example 1**), and consider it to involve 'the distribution, transfer or realisation of assets of a close company'. The relevant consideration might be said to represent the reserves of 59th Street Ltd, so Condition A (a) is in point in respect of the proceeds, whether cash, loan notes or shares.

Condition B does not apply to the cash consideration, as this requires relevant consideration to be in the form of securities.

itself be a close company (CTA 2010 s 444). So if Garfunkel Enterprises Plc is not close, nor is Simon & Garfunkel Ltd.) Furthermore, the relevant consideration, i.e. the loan notes or shares issued by Simon & Garfunkel Ltd, would have to represent the distributable reserves of Simon & Garfunkel Ltd, which seems unlikely as this is a new company, set up for the purpose of this transaction, and it doesn't have any reserves.

As regards the loan notes, on the basis that they are potentially relevant consideration for the purposes of Condition A (a), if HMRC is considering counteraction under the transactions in securities rules, they may take the view that they will look at the distributable reserves of Simon & Garfunkel Ltd and 59th Street Ltd at the time that the loan notes are redeemed (see **4.3.6**).

As regards the shares, the proviso at ITA 2007 s 685(7) (see **4.3.1**) does not apply where the shares are issued as relevant consideration for a transaction within Condition A (a) or (b). So there is no restriction on HMRC trying to counteract a tax advantage, if appropriate in this case, in respect of any consideration received in the form on non-redeemable share capital.

4.5 Repayment of share capital

In Condition A (a) and (b), the references to assets do not include the return of amounts subscribed for securities, even if under the law of the country in which the company is incorporated these amounts are available for distribution by way of dividend (remember that the company does not have to be UK resident, see **4.2**). In other words, where the assets distributed, transferred, realised or applied in discharge of liabilities are actually the return of share capital subscribed or the redemption of loan stock, Condition A (a) and (b) are not satisfied.

This provision has been referred to as the 'foreign law clause' and held to apply only to non-UK companies for many years, as a result of an obiter in *IRC v Hague* (44 TC 619) where Cross J said that 'Those words were apparently directed to the case where the law of the country in which the company was incorporated provides that the capital of the company can be distributed as income'. The legislation may indeed have been directed at such companies, but it clearly did not explicitly exclude UK companies from its scope and many commentators have assumed that it could apply to a UK company, such as, for example, an unlimited company distributing its share capital.

In any case, UK unlimited companies were able to return their capital even in 1960, and the provision also applies to amounts subscribed for loan stock, which has also always been redeemable (obviously). So there has never been any legal justification for the proposition that this only applies to non-UK companies.

Furthermore, with changes to UK company law over the years, there is no longer any justification (if there ever really was) for assuming that this provision only applies to non-UK companies. This was accepted by the First-tier Tribunal, in *Marcus Bamberg* (**Example 5**), where the redemption of loan stock was held to fall into this exclusion (although this finding was not helpful to Mr Bamberg's case).

This issue is currently very relevant, as changes to company law mean that a private company can now reduce its capital (i.e. repay amounts subscribed for its shares) fairly easily (Companies Act 2006 ss 641 et seq.) So a company with substantial share capital now has a choice between returning some of that capital to shareholders and paying them dividends out of distributable reserves, and I have seen a number of these cases since the enactment of the new company law.

Whether or not there is a tax avoidance motive, I believe that the clause means that a repayment of capital cannot satisfy Condition A (a) or (b), as the assets being distributed, transferred, realised or applied in discharging liabilities clearly do represent the amount subscribed for the share capital and, therefore, the transactions in securities legislation cannot apply. Unfortunately, HMRC has not yet accepted this technical position. (For completeness, a reduction of capital cannot satisfy Condition A (c) or Condition B) as both of these require the involvement of more than one close company and consideration in the form of securities.)

An interesting question is whether the exclusion of amounts subscribed applies to the word 'assets' in the description of the relevant consideration, too, such as 'assets available for distribution'. Prima facie, the exclusion only applies to the word 'assets' in Condition A (a) and (b), not in the description of relevant consideration. However, in the pre-2010 legislation the exclusion was worded so as to apply both to the assets distributed etc. and to the assets referred to in the description of the consideration. No substantive change in legislation was intended in this area at the time of enactment of the 2010 rules, so there is an argument for a purposive approach, taking into account the history of the legislation, such that the exclusion applies to the word 'assets' in the description of the relevant consideration, too.

4.6 Interaction between Conditions A and B

There is scope for considerable overlap between Conditions A and B. Firstly, any relevant consideration under Condition B would also be relevant consideration under Condition A. And a transaction within Condition B, which necessarily involves more than one close company, will potentially be caught by (c) of Condition A, for example.

Under the pre-FA 2010 rules, Circumstance E (which is similar to Condition A(a) and (b)) was a subset of Circumstance D (which is similar to Condition A(c) and Condition B), so that any transaction within Circumstance E was also within Circumstance D. In *CIR v Williams* (54 TC 257) it was decided that Parliament had clearly intended the Circumstances to catch different transactions, not to allow two bites of the cherry for the Inland Revenue. Therefore, a transaction under Circumstance E could not also fall into Circumstance D.

Despite the clear similarities between Conditions A and B and Circumstances D and E, it is not clear whether HMRC will be able to take cases under alternative Conditions in overlap cases, or whether the Tribunals and courts will effectively invoke the spirit of *IRC v Williams*. The answer is probably that we will have to wait and see, although my instinct is that the structure of the legislation, requiring either of the Conditions to be present, would be read by the judiciary as permitting HMRC to consider either or both Conditions in most cases.

Similarly, there is scope for overlap between (a) and (c) of Condition A. If we look at the *Wiggins* case (**Example 5**, above), there is a transfer of assets from one company to another, which is both a transfers of assets (a) and a transfer of assets from one close company to another (c). In theory, both provisions could apply. However, a transaction within Condition A (c), where the consideration is in the form of shares, is potentially protected from counteraction where the shares are non-redeemable, as the transactions in securities rules only apply if the share capital is repaid (on a winding up or otherwise). So, if the transaction is within Condition A (a) it is not protected by this proviso but if it is within Condition A (c) it is protected.

Following the spirit of Williams, it seems reasonable to suppose that Parliament intended transactions within Condition A (c) to have this protection, so where there is an overlap, Condition A (c) would have priority.

5 The fundamental change of ownership test – ITA 2007 s 686

The second leg of ITA 2007 s 684(1)(*b*) – after satisfying Condition A or B – is the fundamental change of ownership test at ITA 2007 s 686. If a transaction satisfies the test, i.e. if there is a fundamental change of ownership, the transactions in securities legislation cannot apply. For example, we would expect Ms Baez in **Example 7** to be able to satisfy that test, as she is selling all the shares of her company.

In the fundamental change of ownership test, if 75% of the ordinary share capital of a company (carrying at least 75% of the rights to distributable profits and 75% of the total voting rights in the company) changes hands as a result of the transactions in securities, the transactions in securities legislation does not apply (even if the transaction is carried out for tax avoidance purposes).

The person (or persons) who beneficially owns the shares after the transaction must not be connected with the person who sold them and must not have been connected in the two years prior to the transaction. The ownership of the shares by an unconnected person must continue for at least two years, so that it is not possible to get out of the provisions by a short-term change of ownership.

For these purposes, ITA 2007 s 993 is assumed to apply in determining whether persons are connected. This is not totally clear, however, as ITA 2007 s 993 is prefaced by the words 'This section has effect for the purposes of the provisions of the Income Tax acts which apply this section'. Nothing in ITA 2007 Chapter 1 Part 13 specifically applies ITA 2007 s 993 for the purposes of the transactions in securities legislation!

The fundamental change of ownership test is an empirical test, as HMRC consider that they would almost invariably have given clearance in the past when 75% of the shares of a company were disposed of to an unconnected person. As well as simple sales of companies, this filter may apply to MBOs and secondary buyouts where, typically, the management team hold less than 25% of the shares (as in **Example 8**, after the transaction). They would swap their existing shares for shares in a new company set up by the new venture capitalist owners but would also receive some cash. If the management shareholders are not connected with the new venture capitalist owners, the fundamental change of ownership rule should apply to exclude the buyout from this legislation.

There is an important caveat to this rule, which HMRC has been keen to emphasise: the 75% test is a clear safe harbour, but this does not mean that transactions where less than 75% of the share capital changes hands are somehow tainted and will be subject to counteraction. All that it means is that any transactions that do not satisfy the fundamental change of ownership test will need a clearance application in the normal way. And in most normal cases, where there is no intention to avoid income tax, it is likely that clearance will be granted.

Example 9: Selling a company

Fred owns 100% of Ginger Ltd. As part of his retirement planning, he decides to sell part of his holding to his friend Busby. Fred and Busby are not related and are not otherwise connected per ITA 2007 s 993. Therefore, if Fred sells at least 75% of his shares to Busby, the fundamental change of ownership test suggests that Fred cannot be subject to counteraction under the transactions in securities rules, even if he is deliberately avoiding income tax as a result of the transaction, falls within one of the Conditions, and so on.

There is a slight twist to this: ITA 2007 s 993(7) says that persons are connected with each other if they are acting together to secure or exercise control of a company. So, if Fred and Busby now run Ginger Ltd together, this would suggest that they become connected as a result of the transaction in securities. Since they have become connected within two years, does this mean that the fundamental change of ownership test is automatically failed in such cases? This cannot be the right answer, as this would render the fundamental change of ownership test completely unusable in most private equity cases, for example, and would therefore only apply in cases where the vendor is not acting together with the other shareholder(s) to control the company (such as in **Example 7**).

A possible technical analysis is that the fundamental change of ownership test looks at the connection between the parties at the time of the transaction, only. So, at the time of the transaction, Busby is not connected with Fred, and the test is satisfied, and the fact that Fred and Busby may now become connected is not relevant.

6 The motive test – ITA 2007 s 684(1)(c)

The legislation only applies if 'the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities or any of the transactions in securities, is to obtain an income tax advantage'.

Under the pre-2010 rules, there was also a requirement that the transition or transactions in securities have a genuine commercial purpose or be in the normal course of making or managing investments. In rewriting the legislation, HMRC did not consider that a commercial purpose test would 'significantly improve the clarity or simplicity of the legislation'. However, HMRC's strong view is that the existence of commercial reasons for carrying out a transaction are a major factor in demonstrating that tax avoidance was not a main purpose of the transactions.

It is not clear whether HMRC takes the same attitude to cases where it can be shown that the transactions in securities were carried out in the normal course of making or managing investments, although it is hard to see why not.

6.1 The burden of proof

As noted above (see **2.2**), HMRC is required to prove that the conditions of ITA 2007 s 684 are satisfied.

In particular, this means that HMRC has to prove that 'the main purpose, or one of the main purposes, of the person in being a party to the transaction in securities, or any of the transactions in securities, is to obtain an income tax advantage'. Under the old rules the onus was on the taxpayer to establish that there was no tax avoidance motive, and it is hard to prove a negative. So the current income tax rules should make it harder to HMRC to take marginal cases, such as those where the commercial reasons for a transaction were not clear.

In practical terms, where HMRC believes that an income tax advantage was intended, they may use their new information powers under FA 2008 Sch 36. For practical (and legal) purposes it is therefore as important as ever to retain all relevant documentation relating to the transaction and the purposes behind it, so as to be able to refute any suggestion that the avoidance of income tax is a main purpose of the transaction. But it remains HMRC's responsibility to make their case, not the taxpayer's to prove the negative.

6.2 Whose intention?

While individuals might have commercial purposes or might wish to avoid tax, it is a trite point that a company does not have a mind and cannot have a purpose of its own. This point was made in *Brebner* (43 TC 705) where Lord Pearce said that:

'The "object" which has to be considered is a subjective matter of intention. It cannot be narrowed down to a mere object of a company, divorced from the directors who govern its policy or the shareholders who are concerned in and vote in favour of the resolutions … the company, as such, and apart from these, cannot form an intention.'

In *IRC v Addy* [1975] STC 601, a case involving a liquidation, Mrs Addy argued that she could not have had a tax avoidance motive, as she was not party to the decision to liquidate and took no part in the operations of the business, being only a minority shareholder. Mr Justice Goff in the High Court found this to be of no relevance, 'because what has to be applied is a subjective test of the intention of those in control'. He went on to suggest that 'those in control' might also include the professional advisers who had dreamed up the scheme. This theme was approved of in *Marwood Homes*, where the decision included the statement that the intention to be looked at is that of '… those who governed the policy of the company in the area where the transaction or transactions in question fall. This may involve looking at the intention of the directors, or the shareholders or, where appropriate, the professional advisers'.

This latter point causes some concern in that, if the advisers of a company are 'governing the policy of the company' in any area, it may be that they are acting as more than mere advisers and may be shadow directors. This should not be the case (and may even contravene company law), and perhaps a better formulation is that in some cases a company's policy is directed by the directors or shareholders but under the guidance of the advisers.

To reiterate, two principles are established by these decisions. First, as a company cannot have an intention, it is necessary to look at the intention of those making policy for the company, usually the directors or the shareholders. Second, ignorance of the scheme is not a defence for such as minority shareholders. If the intention of the scheme is to avoid tax, then the anti-avoidance provisions can apply, even if individual shareholders have no such intention (this is similar to decisions based on the *Ramsay* doctrine, too).

6.3 Tax avoidance motive

The test here is that that the main purpose, or one of the main purposes of the person in being party to the transaction(s) in securities, or any of them, is to obtain an income tax advantage. So it is not just about tax avoidance being the only reason for entering into the transactions, the test is also about whether tax avoidance was the one of the major motives behind the transactions, as opposed to being wholly ancillary.

As noted, there is no longer a requirement for there to be a commercial motive for the transactions in securities. However, HMRC have made it clear that they consider the commercial drivers to be as important as ever and, in practice, it is best to operate (wherever possible) as if the commercial reason test were still in place.

We are fortunate in having some cases with identical or nearly identical facts that can be contrasted to show the interaction between tax avoidance purposes and commercial purposes.

Example 10: *Marwood Homes Ltd*

Marwood Homes, a member of a group of companies, was making heavy losses. In addition the group wished to consolidate the building and maintenance division, of which Marwood Homes formed part. A series of transactions was carried out and, in due course, the Inland Revenue challenged these and raised counteraction notices. The Special Commissioners noted that the tax advantage was very much in the mind of those who decided to undertake the transaction but that it would be wrong as a necessary consequence to draw the inference that one of the main objects of the transactions had been to obtain that tax advantage (following *Brebner*). The Commissioners found a decision to be very finely balanced indeed but concluded on balance that it was not the subjective intention of those in control of Marwood Homes that a main object of the acquisition by Marwood Homes of the four subsidiaries was to enable a tax advantage to be obtained (reported in *Marwood Homes v CIR (No 1)* 1997 SCD 37).

The Inland Revenue required the case to be reheard by the Tribunal constituted under TA 1988 s 706 (now abolished). On the re-hearing by the Tribunal, reported in *Marwood Homes v CIR (No 3)* (1999) SCD 44, new evidence was produced, including a note of a meeting convened to discuss a letter to be sent to the Inland Revenue requesting a clearance (under what is now ITA 2007 s 701). The note stated that much of the meeting was spent 'beefing-up' the commercial rationale for the transactions. The Tribunal decided that this meant that the transactions had a main purpose of avoiding tax, effectively because they inferred that there was not originally an adequate commercial reason for the transactions. In their decision, the Tribunal stated that:

' … if one or more of the specified transactions can be explained as having its main objective (or one of its main objectives) the obtaining of a tax advantage, the obtaining of that tax advantage may disqualify the transactions … from the bona fide commercial limb of the escape clause.'

The Tribunal held that the transactions were only rational if the tax advantage was taken into account, and the obtaining of that advantage was the main reason, if not the only reason, for the transactions in question. The company was not entitled to the protection of the escape clause.

The key point in this case is that the evidence seen on re-hearing the case clearly demonstrated that the commercial bona fides for the transactions were secondary to the desire to reduce the tax burden on the Marwood Homes group, so that the escape clause was not available.

The *Marwood Homes* case is also an important demonstration of the need to take proper care in correspondence between advisers and clients. Meeting notes in the terms described in the evidence in *Marwood Homes* can clearly be prejudicial in legal hearings, even if what was actually meant was something far more innocent. Given HMRC's powers to require information (see below reference), it must be assumed that every document relating to a transaction, except those covered by legal professional; privilege, may be seen by an inspector considering counteraction.

Example 11: The *Lewis* and *Sema Group* cases

In *Lewis (Trustee of Redrow Staff Pension Scheme) v IRC* [1999] STC (SCD) 349 and the very similar case of *IRC v Trustees of the Sema Group Pension Scheme* [2003] STC 95, the trustees of exempt pension schemes took advantage of an offer by the company to buy back its own shares. In both cases the transactions represented in large part a distribution (under TA 1988 s 209(2)(*b*), now CTA 2010 s 1000(1)B) and the trustees claimed and received a tax credit in respect of those distributions. Subsequently, HMRC claimed that a tax advantage had been obtained by the sale of the trustees' shares back to the companies instead of selling them on the open market, where there would not have been a claimable credit.

In *Lewis*, the Special Commissioners accepted the claim by the trustees that the purchase was made in the ordinary course of making and managing investments. There was a requirement to reduce the pension fund's holding of shares in Redrow plc to 5% or less, in order that the company could be floated, and the trustees did not wish to incur the costs and extra work which would have been involved if they had sold their shares in the course of the flotation. Although the trustees were aware of the tax benefit, this was not a main object of the sale of the shares, it was merely 'the cherry on the cake'.

In contrast, in *Sema Group*, the trustees decided to accept the buyback offer at a price below what they had paid, because a material part of the consideration would be treated as a distribution and the associated tax credit payable to the exempt fund would give the trustees an aggregate profit on the investment. While the Special Commissioners again found that the trustees were acting in the ordinary course of managing investments, they also found one of their main objects of the sales had been to enable tax advantages to be obtained, so the Revenue's counteraction was valid.

The key implication in these decisions is that the escape clause is not available if the transaction would not have been carried out if there were no tax advantage.

Many of the published decisions, such as the original *Marwood Homes* decision, have made it clear that taxpayers are entitled to take tax into account in their decision making, without such considerations necessarily tainting the transactions with a tax avoidance motive. Indeed, commercially it would be remiss of the directors of a company not to take tax into account in making their decisions. In *CIR v Brebner* (see below), it was noted that the legislation requires a distinction between the purpose of a transaction and its effect. Thus, just because the effect is a reduced tax burden it is not open to HMRC to necessarily infer that this was the purpose of the transaction. As Lord Pearce, in the House of Lords, said:

> 'Admittedly, an object of the carrying out of the broad scheme by way of the resolutions was a tax advantage. But that which had to be ascertained was the object (not the effect) of each interrelated transaction in its actual context, and not the isolated object of each part regardless of the others.'

6.3.1 Conclusions

Overall, there are no hard and fast rules in this area, and each case must be viewed on its own merits.

The contrast of the *Sema Group* case with *Lewis* suggests that tax is a main motive for a transaction if the transaction would not have taken place without the tax advantage. This may be an extreme statement of the position. It is perhaps fairer to say that the escape clause may still be available in finely balanced cases, such as *Marwood Homes No. 1*, perhaps, where a positive tax outcome helps to tip the balance towards carrying out a transaction, or carrying it out in a particular way.

But where a transaction would clearly not have been carried out, as in *Sema Group*, where the outcome would have been commercially unfavourable without the payable tax credit, then it is more likely that HMRC will challenge the application of the escape clause and, perhaps, more likely that a Tribunal or court will agree.

Furthermore, *Brebner* tells us (and HMRC) very clearly that purpose and effect must not be confused. Just because there is a tax advantage does not automatically mean that that advantage is a main purpose of the transaction(s).

6.4 Commercial purpose test

As noted above, HMRC still considers that the commercial reasons for carrying out transactions are of major (if not paramount) importance. The point is that genuine commercial transactions should not be susceptible to counteraction, so long as those transactions were not entered into for tax avoidance reasons. This is clear from a reading of the Standing Committee debates on FA 1960 s 28 and, despite the major change in the legislation in 2010, the position on this score remains the same.

So this section looks at some of the factors involved in considering the commercial drivers behind transactions in securities.

The question of what is a genuine commercial reason has been considered a number of times by the courts, although each case is decided on its own merits and views have changed as taxpayers and their advisers become more sophisticated. **Examples 12** and **13** are cases where a genuine commercial reason was accepted for the transactions. They are useful cases but, perhaps because business people and their advisors are nowadays more sophisticated and better informed about tax, if these cases were to be heard today, it is possible that the Tribunals or courts would concentrate on the tax saving and find that there was a tax avoidance motive.

Example 12: *IRC v Brebner* (43 TC 705)

The taxpayer and five others were the main shareholders in a public company trading as coal merchants. A take-over bid was made for all the shares of the company at a price of 40s 6d, well in excess of the then market price of 25s per share. The taxpayer and five principal shareholders formed a group to oppose the take-over bid for two reasons. They had interests in fishing companies which bought coal on favourable terms from the company. Further, the bidder intended to liquidate the company and the appellants did not wish to see employees lose their jobs. Eventually, in February 1959 the group offered to acquire the shares of the other shareholders at 45s per share, an offer which most shareholders accepted.

To finance the purchase £108,000 was borrowed from a bank on a joint and several undertaking by the group and on condition of early repayment. It was intended from the outset that cash should be extracted from the company to pay off the bank loan though that consideration did not affect the price offered. The company's share capital was therefore increased, partly from the revenue reserve, and the increased share capital was then reduced by a capital (hence tax-free) repayment.

On appeal against counteraction, the main contention of the taxpayer was that the transactions were entered into for bona fide commercial reasons and did not have as one of their main objects the avoidance of tax. The Revenue contended that the extraction of cash had the gaining of a tax advantage as its main object. The courts found for the taxpayer. In a seminal speech, Lord Upjohn, in the House of Lords, said:

'My Lords, I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out—one by paying the maximum amount of tax, the other by paying no, or much less, tax—it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special

Commissioners to decide upon a consideration of all the relevant evidence before them and the proper inferences to be drawn from that evidence.'

He further stated that whether a main object is to obtain a tax advantage is a subjective matter of the intention of the parties. This is often the intention of the taxpayers, but it suffices if it is the intention of those in control of carrying out the relevant transaction (see **6.2** above).

Brebner demonstrates the importance of separating the cause and effect of a transaction (or series of transactions) in securities. Just because there is a tax advantage does not mean that the obtaining of that advantage was the (or a) main purpose of the transactions.

Example 13: *Clark v IRC* [1978] STC 614

One of the shareholders of a private investment company, Robin Clark, also ran a commercial farm. The opportunity arose to purchase a neighbouring farm which could be run profitably with the taxpayer's own. In order to finance the transaction, he sold his 50% of the company to another family company (similar to the *Cleary* transaction, **Example 1**).

The Special Commissioners found that there were good commercial reasons for acquiring the farm and it followed that the sale of the shares was also carried out for bona fide commercial reasons but that those reasons were too remote from the activities of the company to qualify for the escape clause.

The High Court overturned this decision on the basis that the Special Commissioners had misdirected themselves in law and that the commercial reasons for the transactions did not need to be connected with the taxpayer's interest in companies concerned in or affected by the transaction. The High Court did not have a problem with the Special Commissioners' finding of fact, that the transaction was carried out for bona fide commercial reasons, only with the finding in law, which was inconsistent with the finding of fact. The legislation did not concern itself with whose commercial reasons were in point, only with the existence of bona fide commercial reasons at all.

In similar contexts, it has been accepted that retention of family control of a private company and its business can be a genuine commercial reason (*IRC v Goodwin*, *IRC v Baggley* [1975] STC 173, CA, [1976] STC 28). The courts accepted that the prosperity of a business could depend in part on the very fact that it was an old established family business and continued as such under family control and management, both in the context of company–customer relationships and of the employer-employee relationship.

These cases also demonstrate that the reasons for the transactions are essentially questions of fact for the First-tier Tribunal to determine. Where the Tribunal finds that the objects of transactions are genuinely commercial and that the obtaining of a tax advantage was not a main object, it is not open to the Upper Tribunal or the courts to overturn the finding of fact unless it is a finding which the First-tier Tribunal, properly instructed in the law, could not reasonably have made.

It is also clear that a genuine commercial reason for a transaction does not imply that the transaction itself has to be a commercial one, as we see from the *Trevor Lloyd* case.

Example 14: *Trevor G Lloyd v HMRC* (SPC 00672)

Mr Lloyd sold his 38.2% holding in a private trading company to a company that he owned jointly with his wife and a family trust. The commercial reason he gave was that this was part of a scheme to ensure that the other two (unrelated) directors of the trading company would each hold one third of the shares of the trading company.

HMRC argued that there were simpler commercial ways to achieve that end result, so the transaction could not have been carried out for bona fide commercial reasons. The Special Commissioner said that his first question was 'whether the Transaction was carried out for bona fide commercial reasons; it is not whether it was a bona fide commercial transaction, which is more objective ... The fact that it seems to me today that the Transaction was unnecessary does not mean that the Appellant did not believe that it was, or that [the other directors] did not regard it as a step showing that the ultimate end was being pursued. Accordingly I find that the Transaction was carried out for bona fide commercial reasons.'

6.5 In the ordinary course of making and managing investments

This was the other escape clause, alongside the genuine commercial reason, and the two are of course perfectly compatible, as the *Sema Group* and *Lewis* cases show. Given the comments HMRC has made about the continued validity of the commercial purpose test, it seems reasonable to suppose that the same view would apply in cases where it can be shown that the transactions in securities were carried in the ordinary course of making or managing investments.

Example 15: *Clark v CIR* revisited

After finding in favour of the taxpayer, Robin Clark, that there was a bona fide commercial reason for the transactions, the Special Commissioners were also required to look at the similar transactions carried out by Colin Clark, Robin's brother. Colin sold his shares as he didn't want to be left with 50% if Robin had sold his 50%, and also because selling the shares together might achieve a better price. Colin had no specific need for the funds and would not have sold had Robin not been selling his shares.

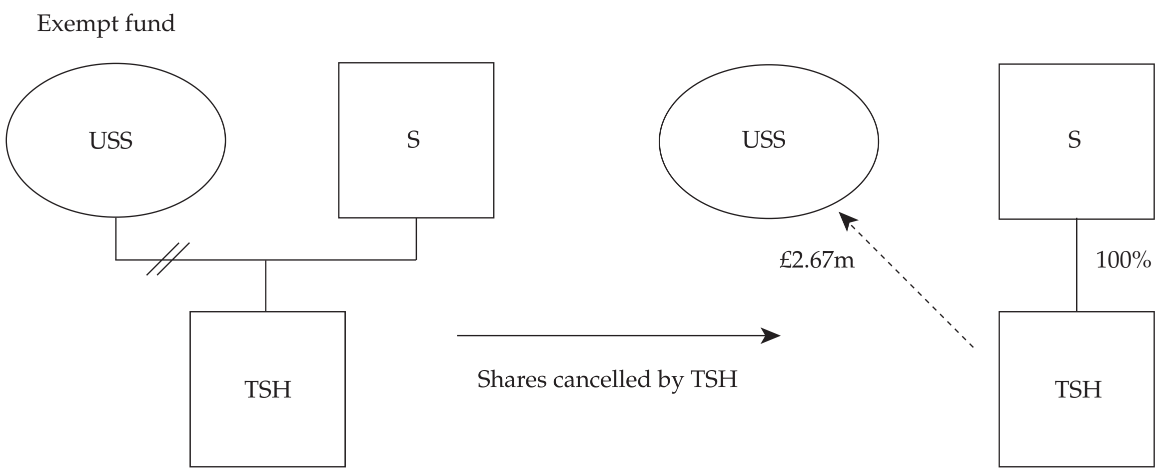
The Special Commissioners held that the sale of Colin's shares to another family company was done in the ordinary course of making and managing investments, so that the escape clause applied to Colin, too, and the Revenue's counteraction was not valid. In effect, while the circumstances were unusual, he was protecting the value of his investment in the best way possible, by realising the investment and reinvesting the proceeds.

See also Example 16, below, which looks at the meaning of `ordinary course', of making or managing investments.

Conversely, in *IRC v Wiggins* 53 TC 639, the sale of the picture-framing company was described by the Special Commissioners as not having been in the ordinary course of making and managing investments, as 'none of the Appellants was ordinarily concerned in making or managing investments'.

See **Example 16** below.

Example 16: *IRC v Universities Superannuation Scheme*



USS, a charity, invested large sums of money in a property development project, part of which was in the form of shares in TSH, the company carrying out the development. USS had a put option whereby it could require S, the majority shareholder of TSH, to buy the shares for a sum that represented 7.5% of the profits of the development. When the option was exercised, the amount payable would have been £3,517,000.

S suggested, instead, that the TSH shares held by USS should be repurchased by TSH for £2,662,750 (see diagram). For tax purposes, most of this sum was treated as a distribution (under TA 1988 s 209(2)(*b*), now CTA 2010 s 1000(1) B) and, as an exempt fund, USS was able to claim a payment of the associated tax credit (under rules that have since been repealed). The tax credit was £854,250, which meant that USS's total receipt was £3,517,000.

So, economically the transaction left TSH as a wholly-owned subsidiary of S, but £854,250 of the consideration was effectively funded from the Exchequer. Not surprisingly, HMRC refused the repayment and invoked the transactions in securities rules.

One of the arguments USS put forward was that the transactions in securities rules could not apply as the transaction was in the ordinary course of making or managing investments. The Special Commissioner said 'USS took the transaction out of the ordinary course of making or managing investments and substituted a transaction which was in my judgment not ordinary. On the evidence before me I find that the second transaction … was not carried out for bona fide commercial reasons or in the normal course of making and managing investments.'

6.5.1 Conclusions

There are a number of broad themes arising from the decided cases about genuine commercial reasons and the ordinary course of making or managing investments.

- Just because a transaction or series of transactions generates a tax advantage, does not of itself mean that the tax advantage was a main purpose of carrying out the transactions (*Brebner*).
- There is no rule that requires a connection between the commercial reason for the transaction(s) and the activity of the company whose shares or securities are being transacted in (*Clark*).
- A genuine commercial reason for carrying out a transaction is distinct from the question of whether a transaction is itself commercial (*Trevor Lloyd*).
- There is no escape for transactions in the ordinary course of making or managing investments where the parties concerned do not habitually make or manage investments (*Wiggins*).
- But this escape clause may apply, even for unusual circumstances, so long as the transaction is itself ordinary (cf. *Colin Clark* and *USS*).

7 The consequential income tax advantage – ITA 2007 s 684(1)(d)

7.1 What is an income tax advantage?

There is a simple calculation in ITA 2007 s 687 that allows us to measure the quantum of the tax advantage. The rule requires a comparison of the capital gains tax paid (if any) in respect of the transaction(s) in securities with the income tax that would have been payable by the person potentially obtaining an income tax advantage, if the relevant consideration had been a qualifying distribution by the close company. Any amounts that the close company would have been unable to distribute lawfully are left out of account. This is best illustrated by an example.

Example 17: Measuring the income tax advantage

During 2012 Bob sells 50% of the shares in his company to a family trust, as part of a tax avoidance scheme, and receives £1m consideration. He pays £100,000 CGT, as entrepreneurs' relief is available. Had he received a distribution of £1m, he would have paid tax of £361,111 (at the top tax rate for dividends). Therefore, there is an income tax advantage of £261,111.

If the company had only had distributable reserves of £500,000, the tax on a distribution of that amount would only have been £180,556. The other £500,000 of consideration is left out of account as the company could not have made a lawful distribution of this amount. Therefore, in this case, the income tax benefit to Bob is £80,556.

If the company did not have any distributable reserves, no lawful distribution could have been made and there would have been no income tax advantage in this case.

This approach to measuring the tax advantage enshrines in legislation what most practitioners had always considered to be the case. However, prior to the FA 2010 changes, HMRC would not confirm that this is the limit of the extent to which counteraction can be applied. More importantly, we now have a simple computational tool for calculating whether there is a tax advantage, which should reduce the number of pre-transaction clearance applications.

Arguably, this is not just a computational tool, it is also a negative filter, as the transactions in securities rules only apply if there is an income tax advantage. If, following the computational rules in ITA 2007 s 687, there is no income tax advantage, the transactions in securities rules do not apply. Similarly, if the income tax advantage is small in comparison to the commercial or other advantages, this helps to establish a prima facie case that the income tax advantage was not a whole or main purpose of the transaction(s) in securities.

7.2 In consequence of

Very few cases have considered in detail the question of whether a tax advantage has arisen 'in consequence of' a transaction in securities.

On one level, in order for a company to be able, for example, to sell shares or to receive a dividend, it must have acquired those shares in the first place. Whether the acquisition was by subscription, by purchase or by barter (e.g. a share-for-share exchange), this initial acquisition is usually going to be a transaction in securities. But is that transaction in securities one to which the anti-avoidance legislation can apply? That is, does the subsequent tax advantage arise in consequence of it? In general terms, the answer must be that it does not, unless it is itself part of the tax avoiding arrangements.

Indirect authority for this position is found in *Laird Group plc v IRC* [2003] STC 1349 where the company acquired a new subsidiary for normal commercial reasons. The subsidiary was able to pay a dividend in circumstances that gave rise to a tax advantage and Laird had been aware of this at the time of the purchase. However, the Tribunal held inter alia that the dividends were not paid in consequence of the original acquisition of the subsidiary.

In *IRC v Garvin* [1981] STC 344 there was a complex series of transactions and the House of Lords considered the similar words 'in consequence of a transaction whereby'. Lord Russell of Killowen said that:

> '… to treat the word [whereby] as introducing the concept that all that is required is that the transaction should be a causa sine qua non of the subsequent abnormal dividend goes in my opinion too far.'

Although the context is slightly different, this is further indirect judicial authority for the proposition that just because the legislation cannot apply if a person does not own shares does not mean that the initial acquisition of those shares is a transaction in securities in consequence of which a tax advantage arises. Indeed, in many cases the original acquisition of shares will have been for wholly commercial reasons (as in *Laird Group*), often years before there was any question of carrying out any tax planning.

In general, therefore, the phrase 'in consequence of' should normally be taken to mean that both the tax advantage and the transaction(s) in securities must be part of the arrangements that HMRC might find offensive.

8 Clearances

Given the concerns of Parliament in 1960, the legislation was enacted with the facility for taxpayers ascertain in advance whether the HMRC is satisfied that no counteraction is required. This facility for 'clearance' is now found at ITA 2007 s 701.

8.1 Form and content of the application

The application must be in writing (which includes email or fax, see below) and must give full details of the transactions to be carried out. Statement of Practice 13/1980 has some helpful information about the form and information required in any clearance application.

As a practical point, it is vital that the initial clearance application is complete in all material respects in order to avoid HMRC asking for further information, thus restarting the 30-day clock (see **8.5**). Equally important is clarity in the clearance application. The best letters are those that tell the story clearly, concisely and logically, so the inspector has all the information required to grant a clearance without further ado. A badly-written letter invites queries and therefore creates delay.

While clearance applications should be comprehensive, it is frequently the case that the final details are not decided until relatively late in the process. In such a case, it is preferable to make a clearance application earlier rather than later, also making a point of detailing the area(s) where decisions are yet to be finalised, together with the likely outcome. If the final decisions are materially different from what was originally advised to HMRC, a supplementary letter may be required to get final sign-off. Strictly, such a letter is a new application for clearance, but in circumstances like this the inspector will usually expedite the clearance on the basis that there are only minor differences to consider.

Although the legislation refers to transactions carried out by the applicant, it is important that the application includes details of any associated transactions carried out by others which might affect the relevance of the anti-avoidance provisions.

The application should as far as possible keep separate the transactions in securities (which should be listed in numbered paragraphs), the background information and evidence of bona fide commercial reasons or of the factors which indicate that the transactions will be carried out in the ordinary course of making and managing investments.

8.2 Disclosure

Should an application later be found not to have fully disclosed all the relevant facts, ITA 2007 s 702(4) provide that inadequate disclosure makes any clearance void.

The importance of this was highlighted in the Special Commissioner's decision in the capital gains case of *Harding v HMRC* (SpC 608). Mr Harding had applied for and been granted a pre-transaction clearance. But the clearance application had failed to mention the crucial aspects of the transaction that made it attractive for tax planning purposes. As the Special Commissioner said, the 'letter to the Revenue was, to be charitable, wholly inadequate for its purpose'.

This case emphasises that it is vital to give HMRC all relevant information when applying for a clearance, otherwise that clearance is void. At least if a clearance is refused, a transaction can be restructured to try and achieve a better result. But a transaction that has been carried out under an invalid clearance is irrevocable.

8.3 Meaning of a clearance

ITA 2007 s 702 tells us that a clearance requires HMRC to notify an applicant if the Commissioners of HMRC are satisfied that no counteraction should be taken, given the facts and circumstances that have been disclosed. Where HMRC have given a clearance they are precluded from taking counteraction under ITA 2007 s 698 in respect of the transactions notified in the clearance application. However, the clearance does not extend to arrangements which include the notified transactions along with other transactions not included in the application. Hence the importance of full disclosure of any associated transactions.

Unlike clearances under, say, the capital gains reorganisation provisions (TCGA 1992 s 138, for example), such clearances do not specifically state that the Board is satisfied with the commercial reasons for the transaction, and so on. This can be helpful, as it allows applications for clearance to be made either on the basis that the transactions are carried out for commercial reasons and not to avoid tax – the more usual escape clause – or where the taxpayer would like confirmation that the transactions do not technically fall into the provisions, perhaps because there is no transaction in securities, or neither of the Conditions is present.

8.4 How to apply

Clearances are dealt with by the HMRC Clearance and Counteraction Team, which also deals with, inter alia, clearances under the following provisions:

- CTA 2010 s 1091 (demergers);
- CTA 2010 s 1044 (company purchase of own shares); and
- TCGA 1992 ss 138 and 139 (company reconstructions).

Most of the comments here will be relevant to clearance applications under other provisions, too, so should be taken as being of general use.

Applications for clearance under any of the relevant statutory provisions should be sent to:

Clearance and Counteraction Team (Anti-Avoidance Group)
SO528
PO Box 194
Bootle
L69 9AA

Tel 020 7438 7474
Fax 020 7438 4409

Applications can also be sent by e-mail to reconstructions@hmrc.gsi.gov.uk or by fax to 020 7438 4409, as well as by post. However, only one method should be used to avoid confusion and double counting of applications.

If the transaction is market sensitive, it should be marked as such when posted, faxed or emailed. HMRC regards information that could affect the price of a stock market quoted company and information concerning the financial affairs of well-known individuals as sensitive in this context.

There is a great deal of helpful information available from the HMRC website about clearances, particularly:

- http://www.hmrc.gov.uk/cap/ which explains about a number of areas where advice and clearances may be available;
- http://www.hmrc.gov.uk/cap/#12 which gives details about clearances under, inter alia, ITA 2007 s 701; and
- Statement of Practice 13 of 1980 (SP13/80) which is strictly about demerger clearances under CTA 2010 Chapter 5 Part 23 but which has some helpful information about the form and information required in any clearance application. This can be found at http://www.hmrc.gov.uk/agents/sop.pdf which has all the Statements of Practice on one Acrobat document.

Practitioners and taxpayers should read this guidance carefully whenever they are making an application for clearance under any of the statutory provisions.

In general, HMRC will deal with simple applications as quickly as possible, usually within a few days of receipt, and there will be no separate acknowledgment of the application. HMRC will only issue a formal acknowledgement of an application if HMRC does not expect to deal with the application within a few days of receipt. This may happen if the team is particularly busy or if the case is complex and requires more detailed thought. A letter of acknowledgement does not mean that HMRC is concerned about the application and wants to refuse clearance. It is just letting applicants know that their response may take a little time.

If you are enquiring about the progress of an application or making general enquiries, you may call HMRC on 0207 438 7474. But the website suggests that you allow ten days after receiving an acknowledgement before you contact HMRC to check progress.

8.5 Timing of clearances

The legislation gives HMRC 30 days to give a substantive response to a clearance application, either be giving a decision or by requesting further information. If they request further information, the application technically lapses if that information is not supplied within 30 days. In practice, HMRC does not usually take this point and will reconsider the original application whenever the new information is received. After all, if it takes more than 30 days to supply the further information, the applicant can simply make a completely new application, including the further facts requested by the inspector. The decision must then be given within 30 days of HMRC receiving the information.

Given this timescale, it is important to consider clearance applications earlier rather than later when considering transaction timetables, to ensure that there is plenty of time to obtain clearance for a transaction before it is carried out. It is also important because it is not possible to rely on HMRC being willing to expedite a clearance for an imminent transaction, particularly at busy times when there are other clearance applications that may be getting close to the 30-day deadline.

If, exceptionally, HMRC fail to give a decision within 30 days of the application (or of the provision of further information) it should not be assumed that no counteraction can be taken. However, I am not aware of HMRC ever failing to give a substantive repose within the statutory 30 days.

Note that clearance applications can be made after the transaction has been carried out, as well as before, although one would generally assume that best practice would always be to seek clearance before carrying out a transaction.

8.6 Urgent applications

The most important thing about an urgent application is that it be clearly marked as urgent at the top of the front page of the letter. When clearance applications are initially received, they are allocated a reference number and passed to an inspector to deal with in date order. So no one will see a statement that the application is urgent at the end of the letter or hidden in the explanatory text until the inspector reads the letter in detail.

In my experience, the Clearance and Counteraction Team will always do its very best to comply with reasonable requests for urgent clearances, but it is also important to be aware of the other pressures on inspectors to process all applications within the 30-day time limit, particularly at busy times. So make sure your application really is urgent before taking this approach. If taxpayers or practitioners constantly demand quick turn-around times on what are essentially non-urgent cases, this is likely to be to the detriment of their relationship with the Clearance and Counteraction Team. This could make life very difficult for an adviser who regularly applies for clearance on behalf of clients.

Also, remember that inspectors are human too! There is nothing more annoying than being begged for an urgent clearance when it is clear that the transaction had been under consideration for some considerable time and the clearance application could and should have been made much earlier in the process.

8.7 Refusal of clearance

The legislation does not require HMRC to explain why an application for clearance has been denied. However, as a matter of practice, an applicant is always informed as to the area(s) of concern. This allows taxpayers to correspond with HMRC if clearance has been denied, in order to see if HMRC's concerns can be allayed. In practice, HMRC is usually willing to consider further comment or to opine on changes to the structure with a view to being able to grant clearance, whether on the originally proposed transaction or on a transaction that is less 'offensive'. Remember, however, as always, that HMRC's latitude is limited and also that their ability to respond swiftly is likely to depend upon how busy the inspectors are.

There is no formal route of appeal against a refusal of clearance by HMRC, in contrast to the procedure for demerger clearances (CTA 2010 s 1091) or capital gains (TCGA 1992 s 138 et seq.)

The refusal of a clearance does not automatically mean that counteraction will be taken, but it is not the practice of HMRC to refuse clearance unless, on the information available, they would expect to give serious consideration to taking counteraction if the transactions were to be carried out as described in the clearance application.

9 Compliance

9.1 Interaction with self-assessment

Counteraction under the anti-avoidance provisions requires a notice to be issued by the Board of HMRC. As a result, liability (or potential liability) under the provisions cannot be a matter for self-assessment. This was confirmed in Tax Bulletin 46, which states explicitly that there is no requirement to self-assess liabilities under this legislation. Taxpayers are invited, however, to mention on their return any correspondence with HMRC about the provisions.

By the same token, the normal self-assessment time limits do not apply to the anti-avoidance provisions, which have their own longer time limits for seeking information from taxpayers and for counteraction.

9.2 Information powers

There are no longer specific information powers for the transactions in securities legislation. ITA 2007 s 703 and TA 1988 s 708 were both repealed by SI 2009/2035 on 13 August 2009 as no longer necessary. Instead, HMRC can now use the wide-ranging information powers in FA 2008 Sch 36.

10 Counteraction

We all fervently hope that none of our clients will be subject to counteraction under these provisions. However, it clearly happens occasionally, so it is important to be aware of the process and of your clients' rights and obligations throughout.

The process of counteraction consists of a number of stages. Before all of these, of course, HMRC will have gathered the information required for making a decision about counteraction. They will either have used the information powers under FA 2008 Sch 36 or they will have got the information they need from a clearance application under ITA 2007 s 701.

10.1 Preliminary notification

Once all the information has been gathered and a decision made that counteraction is probably required, HMRC must issue a notice under ITA 2007 s 695. This is a preliminary notification that the person concerned is liable to counteraction and that a counteraction notice ought to be served.

This preliminary notification must specify the transaction or transactions concerned. Under the pre-FA 2010 rules there was no requirement to state which of the Circumstances was present or why HMRC considers that counteraction may be appropriate, and no such requirement has been introduced in respect of the Conditions in the post-FA 2010 rules.

In *Balen v IRC* [1977] STC 148 the Revenue notified the plaintiff that they had reason to believe that TA 1988 s 703 might apply in respect of certain specified transactions which they listed. The notification did not specify HMRC's reasons for their opinion. The plaintiff argued inter alia that the preliminary notification was null and void on the basis that natural justice dictates that a party against whom an allegation was made should have clear notice of the case he had to meet.

The court decided that the notification that is now under ITA 2007 s 695 was merely a triggering mechanism to put the taxpayer on notice that the Inland Revenue required an explanation. There was no reason why fairness should demand that the Inland Revenue should be compelled at the outset to do more than specify those transactions which had excited their interest or to tie themselves to making good a particular case when by statute they were not obliged to make any case at all. The notification followed literally the words of the statute and specified with sufficient precision the transactions in respect of which the taxpayer's contentions were invited, and was unobjectionable.

Given the similarities between the new regime and the old, particularly the fact that the mechanics of the regime were not changed by FA 2010, it is assumed that *Balen* remains good law and that a preliminary notice under ITA 2007 s 695 is not required to state which of the Conditions is present or why HMRC considers that counteraction may be appropriate.

There is no formal appeal against a preliminary notification, so strictly the taxpayer must follow the prescribed statutory declaration procedure. However, even at this late stage, it is to be hoped that the Clearance and Counteraction Team will be prepared to discuss their concerns about the transactions with the taxpayers, in order to reach an appropriate resolution.

10.2 The statutory declaration

ITA 2007 s 696 requires the taxpayer to oppose the notification by a statutory declaration. I note in passing that there is no obvious policy reason why the statement of opposition to the preliminary notice should be by statutory declaration.

The statutory declaration must 'state the facts and circumstances' whereby the taxpayer does not believe that they are liable to counteraction. It must be sent to the officer of HMRC who issued the preliminary notification, within 30 days of the issue of that notification.

If HMRC takes no further action, the person ceases to be liable to counteraction.

10.3 Submission to the First-tier Tribunal

If HMRC still wishes to proceed with a counteraction notice after receiving a statutory declaration from the affected person, the inspector is required to send to the First-tier Tribunal a certificate to that effect, along with the statutory declaration (ITA 2007 s 697). HMRC may also send a counter-statement, which one assumes will explain why they wish to proceed with the counteraction and why HMRC disagrees with the taxpayer's statutory declaration. There is no requirement for HMRC to let the appellant see this counter-notice.

The function of the Tribunal in this respect is to take into account the declaration and the counter-statement and to determine whether there is a prima facie case for proceeding. If the Tribunal decides that there is no prima facie case for proceeding, HMRC cannot take counteraction.

HMRC has no right of appeal against the decision of the Tribunal. However, that decision only applies to the transactions that were the subject of that decision. HMRC is still entitled to consider counteraction in respect of arrangements which include some or all of the specified transactions if they also include one or more other transactions.

Strictly, the Tribunal has no authority to seek or consider information not in those documents, nor may the taxpayer or the Board address further arguments to them. This was challenged in *Wiseman v Borneman* (45 TC 540) as being contrary to natural justice, such that the taxpayer should be given the opportunity to deal with the counter-statement or to address the Revenue's arguments. The House of Lords unanimously dismissed the taxpayer's appeals, on the ground that the procedure laid down by statute was not in all the circumstances unfair to the taxpayer. However, a majority of their Lordships indicated that in the proper circumstances the Tribunal had power, if it saw fit, to take appropriate steps to eliminate any unfairness in an exceptional case where material has been introduced of such a character that it would be unfair to decide upon it ex parte. That said, I am not aware of ever seeing this obiter tested in any later cases.

10.4 Formal notice of counteraction

Where a notification has been issued to a taxpayer and either he has not made a statutory declaration or the Tribunal has found a *prima facie* case for proceeding, ITA 2007 s 698 requires the HMRC officer to issue a formal notice of counteraction. The legislation does not appear to give the inspector any discretion at this stage.

The counteraction notice must specify the adjustments which are to be made to counteract the tax advantage and the basis on which they are made. The adjustments permitted are limited to the following (ITA 2007 s 698(4)):

- an assessment;
- the nullifying of a right to repayment;
- the requiring of the return of a repayment already made; or
- the calculation or recalculation of profits or gains or liability to income tax or corporation tax.

Anecdotally, it is understood that all counteraction in the last ten years or so has been by way of assessment.

Once again, there is no requirement for the notice to specify the Condition that applies or the grounds for HMRC's view that counteraction is required.

The HMRC officer will arrange for any necessary assessments or amendments to assessments to be made. No assessment may be made more than six years after the year of assessment to which the tax advantage relates.

11 Appeals

When a notice of counteraction has been issued to a taxpayer, he has the right to appeal within 30 days, under ITA 2007 s 705. The appeal may be on the grounds that the legislation does not apply to him in respect of the transaction or transactions in question, or that the proposed adjustments are inappropriate.

11.1 Internal review

Since the counteraction notice is an appealable decision, the taxpayer is also entitled to request HMRC to review the decision to issue the notice, or HMRC may of their own accord offer a review. This is under the new statutory internal review process detailed in TMA 1970 ss 49A-49I.

If the taxpayer requests a review HMRC will then have 30 days to give their 'view' and a further 45 days to conduct the internal review and issue a decision on whether to uphold the counteraction notice. If HMRC offer a review of their own accord, they will just have the 45 days to conduct the review. The taxpayer would then have a further 30 days to notify an appeal against the counteraction notice to the First-tier Tribunal.

Of course, if the individual or company concerned does not want an internal review, they can simply make the appeal directly to the First-tier Tribunal, within 30 days of the counteraction notice (see **11.2**).

11.2 Appeal to the First-tier Tribunal

The procedure as regards an appeal is in general similar to that for an appeal against an assessment. The general principle is that the appeal will be heard by the First-tier Tribunal. There is scope in certain circumstances for appeals to be transferred directly to the Upper Tribunal, but this is not discussed in detail here, as it is assumed that almost all appeals against counteraction notices will be dealt with by the First-tier Tribunal. If you are involved in a case where it is suggested that the appeal should be heard by the Upper Tribunal, you are advised to seek advice from a tax litigation specialist (as, indeed, you should in any appeal to either Tribunal).

Appeals to the First-tier Tribunal are categorised according to their complexity. The categories are 'default paper', 'basic', 'standard' or 'complex (a full discussion of these categories is beyond the scope of this Tax Digest but readers might like to read the booklet Making an Appeal, available at http://www.tribunals.gov.uk/tax/Documents/MakinganappealWEB.pdf. Default paper hearings usually do not require a hearing, and an appeal against a counteraction notice is unlikely to fall into this category. Basic cases only require an informal hearing and, again, an appeal against a counteraction notice is unlikely to fall into this category. So appeals against counteraction notices are most likely to be categorised as standard or complex.

As noted above, HMRC will not have previously been required to share any of its concerns with the taxpayer. The exact level of disclosure by HMRC will depend on the category to which the case is allocated. As most cases involving the transactions in securities legislation will fall in the 'standard' or 'complex' categories, the taxpayer will be provided with a Statement of Case setting out HMRC's case. The taxpayer will then be able to file a 'reply' addressing the issues raised in this.

On an appeal, the Tribunal has the power to affirm, vary or cancel the counteraction notice under ITA 2007 s 698 or to affirm, vary or cancel any assessment made in accordance with that notice. However, appealing against the notice does not affect the validity of anything done in consequence of that notice pending determination of the appeal. So it is necessary to make a separate appeal against any assessment which may have been made as part of the counteraction.

There is no appeal from a determination by the Tribunal on a question of fact, only on a point of law.

11.3 Appeal to the Upper Tribunal

After a determination by the First-tier Tribunal, the taxpayer or HMRC officer may declare dissatisfaction with the determination on a point of law. They may, within 56 days of the determination, request leave to appeal to the Upper Tribunal. If permission is not given by the First-tier Tribunal, a request for leave to appeal can be made to the Upper Tribunal within one month of the First-tier Tribunal refusing permission to appeal.

While appeals to the Upper Tribunal are pending, tax must be paid in accordance with the determination of the First-tier Tribunal. If the amount payable is reduced by the order of the Upper Tribunal, the tax, and interest determined by the Tribunal, must be repaid. If the amount due is increased, HMRC must issue a notice of the further amounts to be paid. Payment is then due within 30 days of the date the notice is issued.

11.4 Appeal to the Court of Appeal and the Supreme Court

Appeals against a decision of the Upper Tribunal lie to the Court of Appeal, with permission from the Upper Tribunal or the Court of Appeal Appellate Committee. Similarly, appeals to the Supreme Court require the permission of the Court of Appeal or of the Supreme Court Appellate Committee.

11.5 Scotland and Northern Ireland

The new unified tribunals system applies to the whole of the UK. However the (English) Court of Appeal usually only hears appeals on English matters. The legislation requires the Upper Tribunal to determine which of the Court of Appeal in England and Wales, Court of Session in Scotland or Court of Appeal in Northern Ireland is the most 'appropriate' to hear the appeal and to send the appeal there. Appeals from any of these courts go to the Supreme Court.

12 The future of the legislation

The Government and HMRC remain committed to eradicating what they see as tax avoidance. It seems likely, therefore, that these provisions will remain in force for some time to come, particularly while the rates of tax on some gains remain lower than those on income. While some changes in the legislation would be desirable – particularly streamlining the process for counteraction and introducing a right of appeal against refusals of clearance under ITA 2007 s 701 – changes in the short-term seem unlikely.

Notes

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