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Miller's Tales IV

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This time around, the cases are about the transactions in securities legislation, at ICTA 1988, ss 703 *et seq*. The legislation for income taxpayers is now found in ITA 2007, ss 682 *et seq*.

Trevor G Lloyd v HMRC SpC 00672

Mr Lloyd owned 38.2% of the share capital of Prosaw Ltd, a company manufacturing machine tools. Prosaw Holdings Ltd owned another 38.2% of Prosaw, as well as some preferred shares. Prosaw Holdings was owned by Mr Lloyd, Mrs Lloyd and The Lloyd Family Trust. The remaining shares of Prosaw were held by Messrs Crick and Jenner, who were directors of the company and were eventually intended to hold one third of the shares of Prosaw each.

To achieve this, in December 2002 Mr Lloyd sold his Prosaw shares to Prosaw Holdings for £275,000, funded by a dividend of £312,500 that had been paid by Prosaw to Prosaw Holdings in the same accounting period. The combination of retirement relief and taper relief mean that Mr Lloyd paid only £6,392.40 in tax on the disposal. It was common ground that this represented a tax advantage in comparison to Mr Lloyd being paid a dividend of £275,000 instead.

After an 'earn-out period', in 2005 Prosaw bought back most of its share capital from Prosaw Holdings for £600,000, so that Prosaw was owned one third each by Messrs Crick and Jenner and one third by Prosaw Holdings. The Special Commissioner, Dr John Avery Jones, was asked to consider whether the sale of shares by Mr Lloyd was for *bona fide* commercial reasons and whether the main object, or one of the main objects, of the sale was to enable the tax advantage to be obtained for the purposes of ICTA 1988, s 703.

Mr Lloyd contended that the transactions had been carried out for wholly commercial reasons, to arrive at the three equal shareholdings in Prosaw by 2005. HMRC argued that this could just as easily have been achieved by Prosaw buying back shares from both Mr Lloyd and Holdings in 2005 and that the 2002 transaction had been detrimental to the interests of Messrs Crick and Jenner, as the company's assets had been reduced by the £312,500 dividend paid to Holdings in 2002.

The Special Commissioner reminded us 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'. He reminded us of the *obiter dictum* of Fox J in *Clark v IRC* [1978] STC 614, at page 624: 'In deciding that [whether the transaction was carried out for *bona fide* commercial reasons], one must, I think look at the transaction in the context of all the circumstances which gave rise to it.'

Looking at the current transaction in the round, Dr Avery Jones said: 'The transaction had the advantage that Messrs Crick and Jenner saw that something was being done then towards the ultimate end. Retaining their services was important to Prosaw's business and was a commercial reason. 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 Messrs Crick and Jenner 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.'

He also noted, however, that he believed that the structure had been Mr Lloyd's original idea, with input from his tax adviser to obtain the best tax result. He said: 'I consider that it was more likely that the transaction was a joint effort with Mr Childs [the tax adviser] seeing the tax benefits of the transaction and the appellant seeing some commercial benefit'.

On this second question, Dr Avery Jones noted that the transaction had to be structured the way it was (and, indeed, when it was) in order for Mr Lloyd to be able to claim retirement relief. Clearly, this represented a tax advantage, as a result of which Mr Lloyd only paid £6,392.40 in tax on the disposal, rather than income tax on a dividend of £275,000. So the Special Commissioner found that 'The tax advantage cannot be said to be an effect rather than an object of the transaction. I find that the tax advantage was one of the main objects of the transaction.'

Comments

This case is interesting in reminding us, once again, that there are two questions to answer with these transactions. In determining whether a transaction is being carried out for *bona fide* commercial reasons, we must look at the transaction subjectively, as well as in its proper context. In the case of Mr Snell (see *Snell v HMRC* [2006] All ER (D) 336, discussed in Miller's Tales, *The Tax Journal*, Issue 900, 10 September 2007), this meant that selling his shares was for *bona fide* commercial reasons. In Mr Lloyd's case, the Special Commissioner went a little further and said that Mr Lloyd's subjective reasons for structuring the transaction were paramount, not the objective question of whether the transaction was actually commercial. In other words, mirroring *CIR v Brebner* 45 TC 705, it is the purpose, not the effect, which counts.

However, the fact that both the purpose and the effect of the transaction was to give Mr Lloyd a large sum of tax-free cash was sufficient for the Special Commissioner to find that the tax-free cash was a main object of the transaction, so that Mr Lloyd's appeal against the s 703 counteraction notice had to fail.

Snell & Snell v HMRC SPC 00699

Mr and Mrs Snell and their family held almost all the issued shares of PA Snell & Co Ltd, a house-building company. Their sons also each held a single share. In 2000 Mr and Mrs Snell were considering retirement. They had a number of concerns, mainly about how to pass the company on to the sons while not passing on any commercial risks relating to previous work done, so that the sons would benefit from future profits of the trade. Obviously, Mr and Mrs Snell were also keen to be able to enjoy the fruits of their previous labour.

The transactions that took place were that the shares of PA Snell & Co were sold to a new company, Snell Group Ltd, formed for the purpose. The consideration was an issue of ordinary shares in Snell Group Ltd on a one-for-one basis, an issue of 8.5% non-voting preference shares with a nominal value of £650,000 to each of Mr and Mrs Snell, and a payment of £50,000 cash to each of Mr and Mrs Snell. The trade of PA Snell & Co was then transferred to PA Snell & Sons Ltd, a new company that was a wholly owned subsidiary of Snell Group Ltd, and PA Snell & Co was dissolved.

As the transaction was developed, a number of clearances were sought from HMRC. Originally, the cash element was to be £180,000 each, which would have qualified for retirement relief in 2000/01. Since the Section 707 Clearance Team had not responded in time, the clearance was modified so that the cash element was £137,000 each, the amount that would have qualified for retirement relief in 2001/02. Clearance under ICTA 1988, s 707 (now ITA 2007, s 701 for income tax purposes) was refused.

In the words of the case report, the tax adviser 'then attempted to find out what level of cash payment the Inland Revenue would accept was too small to attract a ICTA 1988, s 703 notice but, not surprisingly, the compliance unit official concerned was not prepared to state a figure.' Haven't we all had that conversation?

In the event, the figure of £50,000 each was chosen. I infer from the report that this amount was chosen as being a relatively small proportion of the total consideration (£100,000 out of £1.4 million, about 14%), with a view to arguing that this was such

a small amount that it could not possibly be a 'main object' of the transaction.

HMRC raised notices under s 703(1) (now ITA 2007, s 698(2) for income tax purposes), which were the subject of the appeal. Mr and Mrs Snell had to demonstrate that 'the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of managing investments, and that none of them had as their main object or one of their main objects, to enable tax advantages to be obtained' (see s 703(1), now ITA 2007, s 685 for income tax purposes).

The Special Commissioner found that the shares were sold for *bona fide* commercial reasons, being to permit Mr and Mrs Snell to retire in due course while the business continued, and so that they could enjoy the fruits of their previous hard work over the years. This part of the decision is very much in line with the decision in *Snell v HMRC* (mentioned above).

But it was clear that one of the objects of the transaction was to obtain some tax-free cash, covered by retirement relief, for Mr and Mrs Snell. So the Special Commissioner had to consider whether this was a main object of the transaction. In his view, the cash element was a main object of the transaction.

First, he noted that neither £100,000 cash nor the £12,500 tax saved by each of Mr and Mrs Snell was trivial or *de minimis*, although this was not sufficient to make the tax saving a main object of the transaction.

Second, he found that the cash element was not ancillary to the main transaction. Had it been a merely ancillary element, it could not have been a main object. The reasoning is not clear on this point, but the case report implies that the cash payment had been an element of the transaction from the beginning and that the various iterations of the mechanism had been designed to maximise the potential for tax-free cash, so it would be difficult to argue that getting some tax-free cash wasn't a main object of the transaction.

The Special Commissioner concluded for HMRC, noting: 'By the time the transaction occurred the cash payment had been decided upon and it does not cease to be one of the main objects of that transaction just because there is another more important object. Mr and Mrs Snell made a conscious decision to obtain cash and indeed they chose the highest figure that their advisers were then recommending. That is in my opinion significant when judging the importance of that object within the transaction.'

Comments

I find it interesting that one of the main arguments here was that a mere 14% of the consideration cannot be a main object of a transaction. Under other circumstances, this argument might have succeeded, as such a relatively small amount might well be ancillary to the main transaction. But it is clear in this case that the advisers had been trying throughout to ensure that Mr and Mrs Snell were able to access some of the value of the company in the form of tax-free cash. And that is sufficient to make the cash element a main object of the transactions, even if it is not a major component of the transaction consideration. Once again, we separate the purpose from the effect, but this time to the detriment of the taxpayers.

As an aside, while the structure apparently prevented the commercial liabilities of PA Snell & Co being passed on to the sons, nothing in the case report explains how (or whether) the companies were in fact given to the sons.

Conclusions

The theme in these two cases is that they both involve a Special Commissioner's finding that there was a tax avoidance motive, even though the main transactions were carried out for *bona fide* commercial reasons. In both cases the Special Commissioner was persuaded by the underlying facts of the transactions and by the correspondence. And, indeed, in both cases there had been substantial discussion with HMRC before the transactions were carried out.

The practical point is that it is difficult to successfully argue that there is no tax avoidance motive when the underlying correspondence (particularly with HMRC) suggests the opposite!

And there's more… Nicolas John Harding v HMRC [2008] EWCA Civ 1164

I commented on this case in the first Miller's Tales. Mr Harding had sold the shares in his company in return for loan notes that were not qualifying corporate bonds (QCBs), due to a currency conversion clause. This clause was time-limited and expired before the bonds were redeemed. Mr Harding claimed that this meant that they were QCBs at the time of the

disposal, due to the lapse of the relevant clause. HMRC has now won in the Court of Appeal (as it did in the High Court, as noted in Miller's Tales II).

In my first review of the case, I concentrated on the issues related to the operation of TCGA 1992, s 137(1), the *bona fide* commercial reason test and the avoidance of tax test. This seems like a good time to consider the technical aspects of the case, which were the subject of the court cases.

The Special Commissioner, Charles Hellier, considered whether the non-QCB status of the bonds at issue was sufficient to make them permanently non-QCBs, in contrast to Mr Harding's arguments that the bonds were non-QCBs when issued but had become QCBs when redeemed, thus falling completely outwith the scheme of capital gains tax (before the relevant amendments to TCGA 1992, ss 116 and 132).

Mr Hellier decided that the terms of issue of the bonds determined the status of the bonds for all time. He considered the matter 'finely balanced' but said that the interpretation that best fit the intention of the legislative framework, including that a security must have a degree of permanence, was one that 'focuses on the formal terms of the security rather than those which are effective at any particular time'. He backed this up with an explanation as to how other ephemeral terms of a loan note could 'leave an after-taste, a shadow on the later value of the security', which made it clear to him that the intention of the legislation was to ensure that loan notes with these 'other bells and whistles' were intended to be within the capital gains regime, while 'plain vanilla' bonds were to be excepted from that regime and taxed elsewhere.

In the High Court the arguments were largely based on the wording of s 117, the relevant part of which reads:

> '(1) For the purposes of this section, a “corporate bond” is a security, as defined in section 132(3)(b)
>
> '(a) the debt on which represents and has at all times represented a normal commercial loan; and
>
> '(b) which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling.'
>
> HMRC argued for the purposive approach to statutory interpretation and 'submitted that the anomaly arising from the wholesale escape from tax of all gains (including rolled-over gains) which had accrued by the time of the lapse of the currency option was so great as to compel a search for an alternative construction to that contended for by Mr Harding, even if Mr Harding's case reflected more precisely the literal meaning of the words in the [s 117(1)(b)] condition'.

Briggs J accepted that a literal interpretation of the legislation gave the result contended by Mr Harding. But he preferred HMRC's purposive approach, noting that 'it plainly avoids the glaring anomaly, and no counter-mischief has been suggested' and saying that 'I find it impossible to believe that the draftsman who framed the [s 117(1)(b)] condition, or Parliament when it passed it, consciously intended to [give the result which a literal interpretation of the words used would give]'. So he concluded that the only interpretation of the statute that could reasonably be said to reflect the will of Parliament was one whereby all terms of a loan note, whether lapsed, current or not yet effective, were to be taken into account in determining whether it was a QCB or a non-QCB for tax purposes.

In the Court of Appeal, Counsel for Mr Harding argued that the words of the legislation could not bear the meaning imposed on them by Briggs J in the High Court. Section 117(1)(b) refers to the security, which is a 'bundle of rights', and if a term has lapsed, it is no longer part of that bundle of rights.

HMRC argued that the security, referred to in s 117(1)(b), is a wider term than the debt on that security, referred to in s 117(1)(a). So, while on Mr Harding's argument it was correct that the debt could no longer be converted into another currency, the currency conversion clause was still a term of the security, even if that term had lapsed.

Lord Justice Lawrence Collins gave the judgment in this case. He considered that the distinction between the security and the underlying debt was not relevant, but that the key was the use of the word 'provision' in the phrase '… in respect of which no provision is made for …' in s 117(1)(b). In essence, the security contained provision for the conversion, even if there was a time when that provision was no longer exercisable.

This is very similar to the reasons for the Special Commissioner's decision, that the correct interpretation 'focuses on the formal terms of the security rather than those which are effective at any particular time'.

Comments

The technical aspects of this case are particularly interesting, in that all the judgments have been based on a perceived intention of Parliament. All the judgments have considered the history of the legislation and its historical context, even though that context has changed over time.

And the judgments have also made it clear that the intention of Parliament is paramount, even if giving effect to that intention means overriding the plain words of the legislation.

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