GAAR ADVISORY PANEL

Redacted and sub-panel approved version of the Opinion Notice issued on 28 May 2019

Subject Matter: Distribution. Loan or advance to participator. Arrangements conferring benefit on participator. Extraction of value by shareholders via joint acquisition by company and its shareholders of a second hand bond, and use of gilt option, additional contribution and "cooling off" rights.

Taxes: Income Tax and amount chargeable as if it were Corporation Tax.

Relevant Tax Provisions: Chapter 2 of Part 23 Corporation Tax Act 2010, especially sections 1000 and 1020; section 383 Income Tax (Trading and Other Income) Act 2005; Chapters 3 and 3A of Part 10 Corporation Tax Act 2010.

Opinion: the entering into of the tax arrangements is **not** a reasonable course of action in relation to the relevant tax provisions; and the carrying out of the tax arrangements is **not** a reasonable course of action in relation to the relevant tax provisions.

Opinion Notice

This opinion notice is given pursuant to paragraph 11 of Schedule 43 to the Finance Act 2013 ("FA 2013") by a sub-panel consisting of three members of the GAAR Advisory Panel (the "Panel") in the referral by HMRC dated 15 March 2019 relating to A Ltd ("the Company").

The sub-panel received written material from HMRC under paragraph 7 Schedule 43 FA 2013 and representations under paragraphs 4 and 9 Schedule 43 FA 2013 made jointly on behalf of Mr B ("Mr B") and the Company.

1. *Reminder of what the sub-Panel's opinion notice is to cover*

"An opinion notice is a notice which states that in the opinion of the members of the sub-panel, or one or more of those members—

(a) the entering into and carrying out of the tax arrangements is a reasonable course of action in relation to the relevant tax provisions—

(i) having regard to all the circumstances (including the matters mentioned in subsections (2)(a) to (c) and (3) of section 207), and

(ii) taking account of subsections (4) to (6) of that section, or

(b) the entering into or carrying out of the tax arrangements is not a reasonable course of action in relation to the relevant tax provisions having regard to those circumstances and taking account of those subsections, or

(c) it is not possible, on the information available, to reach a view on that matter,

and the reasons for that opinion." (paragraph 11(3) Schedule 43 FA 2013)

"For the purposes of the giving of an opinion under this paragraph, the arrangements are to be assumed to be tax arrangements." (paragraph 11(4) Schedule 43 FA 2013)

2. *Terms used in this opinion and parties to the arrangements*

2.1. This reference relates to the Company, a UK company.

2.2. At the material time Mr B was a 60% shareholder and a director of the Company; Mrs C and Mr D were each 20% shareholders of the Company. Mr B, Mrs C and Mr D are together referred to as "the Shareholders". Mr B entered into the transactions described below on his own behalf and as bare trustee for Mrs C and Mr D. References in this opinion to Mr B are to him acting on his own behalf and on behalf of Mrs C and Mr D.

2.3. Mr B and the Company are together referred to as "the Taxpayers".

2.4. Separate references to the Panel were made in relation to Mr B and the Company. We are issuing today opinion notices relating to both of the two references.

2.5. The Taxpayers' representations under Schedule 43 FA 2013 were composite representations made on behalf of both of the Taxpayers.

2.6. "IFA Letter" means the letter of 14 May 2014 written by Mr B to an independent financial advisor ("the IFA")**.**

2.7. "Mirror Option" means the option with risks mirroring the Option entered into by the manager of the Offshore Bond with a third party different from the counterparty to the Option to hedge the Offshore Bond portfolio's post novation exposure under that Option. We assume that the Offshore Bond manager paid £250,000 for the Mirror Option. This assumption is consistent with what we have been told about the accounts treatment of the Company's investment in the bond.

2.8. "Offshore Bond" means the bond established and sold by the Scheme Protagonists being a second-hand life assurance policy bond with a surrender value of £253,807.11 and able to accept additional contributions in cash or in specie.

2.9. "Option" means the "out of the money" option sold on 1 July 2014 by Mr B for a premium of £250,000 under which Mr B is liable to pay the counterparty £5m in gilts if the US$ per GBP spot rate has touched at or below one predetermined barrier level or at or above another predetermined barrier level before the 10 July 2014 expiry date.

2.10. **"Scheme Protagonists"** means, in relation to the arrangements, the promoters, administrators, scheme tax advisers, initial purchaser of the Offshore Bond and their associates or any of them.

2.11. When we refer to "Guidance" we mean the GAAR Guidance approved by the Panel with effect from 15 April 2013.

3. Earlier similar case

3.1 The arrangements entered into by the taxpayers in this case are similar (but not identical) to the arrangements entered into by the taxpayers in the "extraction of value using a second hand bond, gilt options, additional contributions and 'cooling off rights " case on which a sub-panel of the GAAR Advisory Panel opined on 12th April 2019 (the "Earlier Similar Case"). The opinions relating to the Earlier Similar Case are published on the GAAR Advisory Panel opinions page on the GOV.uk website**.**

3.2 We come to the same conclusion in this case as the sub-panel did in the Earlier Similar Case, and do so for similar reasons.

4. *Outline of the arrangements*

4.1. *Acquisition by Mr B of interest in Offshore Bond (30 June 2014)*

a) The joint acquisition by the Taxpayers of the Offshore Bond for £272,500, Mr B contributing £1,000 and the Company contributing £271,500.

4.2. *Sale by Mr B of the Option (1 July 2014)*

a) Sale by Mr B of the Option to a third-party counterparty.
b) The Option entitles Mr B to a premium of £250,000 and carries a 5% chance on expiry of requiring Mr B to make a £5m gilt settlement to the option counterparty.

4.3. *Additional investment into Offshore Bond (1 July 2014)*

a) Mr B agrees to make an additional contribution into the Bond of £1,000 and, by way of novation, the Option including the right to receive the £250,000 premium.
b) Mr B had statutory cancellation rights ("cooling off" rights) giving Mr B the right for 30 days after he received the statutory notice advising him of his rights (crucially after the maturity position of the option is known) to reverse the novation.
c) The manager of the Offshore Bond enters into the Mirror Option.

4.4 Expiry of the Option (10 July 2014)

a) The Option expires out of the money so there is no obligation to make a payment in gilts under the Option but an entitlement (at that stage) for the Offshore Bond manager to receive the £250,000 premium.
b) Mr B exercises his "cooling off" cancellation rights and the payment of £1,000 and the novation of the Option including the right to receive the premium are reversed; Mr B is now entitled to receive the £250,000 premium.
c) The Mirror Option expires, and the Mirror Option premium of £250,000 is paid; the Offshore Bond reduces in value by £250,000.
d) The Offshore Bond is now effectively worthless, and the Company's assets have been reduced by £271,500 (see 4.1 above).

5. *Summary of substantive result of the arrangements*

5.1. Mr B has paid out £1,000 for his share in the Offshore Bond and receives £250,000 in the form of a premium under the Option.
5.2. The Company's assets reduce in value by £271,500, representing the price it paid for its share in the Offshore Bond which becomes worthless as a result of the arrangements.
5.3. Under the arrangements taken as a whole as they were and were intended to be implemented the Shareholders have not taken any material financial risk and the Company has not been in a position to make a profit.

6. *The tax advantage*

6.1. HMRC's position is that the arrangements allow the Company to pass value to the Shareholders without the Company or the Shareholders bearing the tax cost that would normally be associated with such a transfer.

7. *Tax results argued for by the taxpayer*

7.1. The Taxpayers argue Mr B acquired a gilt option from a third party and hedged the downside risk through the Offshore Bond.

7.2. The Taxpayers argue the £250,000 premium is exempt from both income tax and capital gains tax under legislative provisions dealing with financial options and gilts.

8. *The likely comparable transaction*

8.1. The effect of the arrangements is the extraction of value by the Shareholders from the Company.

8.2. The extraction is achieved by exploiting:

a) Mr B's no cost ability (thanks to the cooling off right on the additional contribution to the Offshore Bond) to reverse the novation of the Option including the right to the Option premium and so become entitled to a premium of £250,000;

b) the manager of the Offshore Bond's agreement to accept, without appropriate compensation for the Offshore Bond for the risk assumed as a result of the novation and cooling off right, the novation of the Option as an additional contribution to the Offshore Bond and at the same time enter into the Mirror Option so on exercise of the cooling off rights a loss of £250,000 arises to the Company (via the £250,000 reduction in value of the Offshore Bond portfolio as a result of the payment of the premium for the Mirror Option).

8.3. Given the substantive result of the arrangements and lack of separate significance of any of the individual elements comprising the arrangements, in our view the most likely comparable commercial transaction is a dividend or other cash distribution of £250,000.

9. *What are the principles of the relevant legislation and its policy objectives?*

9.1. The overall scheme of the distributions legislation is that distributions, as defined in Chapter 2 of Part 23 CTA 2010 (*Matters which are Distributions*), when received by individual members of the distributing company are subject to income tax (section 383 ITTOIA 2005).

9.2. Subject to exceptions, none of which we regard as relevant in this case, any dividend or other distribution out of the assets of a company in respect of the shares in the company is a distribution (section 1000(1) CTA 2010).

9.3. Section 1000(1)B CTA 2010 requires the distribution to be "in respect of shares in the company". We are of the view in this case that the "in respect of shares in the company" condition is satisfied. The £250,000 benefit that flows from the Company to the Shareholders is received by Mr B on his own behalf and as bare trustee for the other Shareholders.

9.4. The Company is a "close company" and each of the Shareholders is a "participator" in the company. Where a benefit, which is not a distribution, is conferred by a close company on a participator, participator benefits legislation applies to bring the benefit into charge to tax.

9.5. Where a close company is party to tax avoidance arrangements under which a benefit is conferred on an individual who is a participator in the company, a charge is made on the company "as if it were an amount of corporation tax". The charge is on the value of the benefit (section 464A CTA 2010). No charge arises where the individual is charged to income tax on the benefit, for instance under the distributions legislation (section 464A (2)).

9.6. Where a close company makes a loan or advance to an individual who is a participator, tax becomes due from the company "as if it were an amount of corporation tax" (section 455 CTA 2010). Tax is charged on the amount of the loan or advance. Relief is given when and if the loan is repaid (section 458 CTA 2010).

9.7. Where the necessary conditions are met section 779 ITTOIA 2005 and section 115 TCGA 1992 exempt the premium on options like the Option from income and capital gains tax. The scheme of the legislation is

a) for financial options entered into otherwise than in the course of a trade to be within the capital gains rather than income regime; and
b) for gains relating to options over gilts to be exempted from being chargeable gains.

10. *Does what was done involve contrived or abnormal steps (section 207(2)(b) FA 2013)?*

10.1. This is a "packaged deal" – with all the elements being carefully crafted to fit together to give the desired result of a predetermined amount of money or money's worth being extracted from the Company by its shareholders.

10.2. Commerciality is lacking:

a) The Company is in a position under which at best (if the Options require a gilt settlement to be made) it suffers a loss of about £17,500 and otherwise makes a loss of about £271,500;
b) The Shareholders are in the position that at worst they lose £2,000 (if the Option requires a gilt settlement to be made) and otherwise make £249,000;
c) the manager of the Offshore Bond accepts the novation of the Option notwithstanding the expectation that (when coupled with the Mirror Option and cooling off of the novation of the Option) the result of those transactions will be the £250,000 reduction in the value of the Offshore Bond portfolio; and
d) Because of Mr B's cooling off right, and the 95% chance that the Option would expire out of the money, it was overwhelmingly likely that the Company would lose about £271,500 and the Shareholders make £249,000.

10.3. Our view on the lack of commerciality is consistent with the IFA Letter in which Mr B made it clear that he was acquiring an interest in the Offshore Bond and entering into the Option *"primarily for fiscal rather than investment purposes".* It is also consistent with the advice from an independent financial adviser that the Taxpayers, from an investment perspective, should not proceed given their limited investment experience with the products in question.

10.4. We have considered Examples D13 and D14 from the Guidance. Example D13 is an example of a transaction where every element of the transaction is contrived and abnormal. Example D14 is an example of a transaction where limited amounts of uncertainty were present and were priced at market rate but which, in the overall context of the transaction had no real commercial function.

10.5. Taken together, and having regard to the likely comparable transaction, the highly complex steps are contrived and abnormal.

11. *Is what was done consistent with the principles on which the relevant legislation is based and the policy objectives of that legislation (section 207(2)(a) FA 2013)?*

11.1. The principles and policy objectives of the legislation referred to in section 9 above are to charge tax on a cash (or cash equivalent) benefit received by a participator from a close company. In a case like this the benefit can fall into one of three categories:

a) a dividend or other distribution, or
b) a benefit associated with a tax avoidance arrangement to which the company is a party, or
c) a loan or advance.

11.2. In our view the most likely comparable commercial transaction given the risks assumed by the Taxpayers and the desired financial outcome is a £250,000 dividend or other cash distribution paid by the Company to the Shareholders on the Option settlement date.

11.3. In our view, contrived and abnormal steps have been adopted to avoid the tax consequences of the most likely comparable commercial transaction.

11.4. Looked at in isolation the Option satisfies the conditions necessary for the premium to be received free from income tax and capital gains tax. The Taxpayers in effect seek to argue that the Option should be looked at as a standalone starting point. The Taxpayers say in representations Mr B "*wished to hedge the contingent downside to his option transaction. The hedge was structured through the purchase of an offshore life policy held jointly by [the Taxpayers].*"

11.5. In our view the Option was never intended to, and could never, exist in isolation in this case. The Option would only ever be entered into by Mr B as part of the arrangements package. We note that the immediate novation of the Option into the Offshore Bond enabled Mr B to avoid having to provide the £5million margin payment which would have been required if the novation had not taken place.

11.6. Accordingly, it would be inappropriate for the tax principles applying to the arrangements as a whole to be determined by reference to how the Option would, in isolation, be taxed.

12. *Is there a shortcoming in the relevant legislation that was being exploited (section 207(2)(c) FA 2013)?*

12.1. We do not consider that the arrangements seek to exploit any specific shortcoming in any particular piece of legislation.

13. *Does the planning result in:-*

(i) **an amount of income, profits or gains for tax purposes which is significantly less than the amount for economic purposes, or**

(ii) **deductions or losses for tax purposes which are significantly greater than the amount for economic purposes, or**

(iii) **a claim for the repayment or crediting of tax which has not been and is unlikely to be paid**

and, if so, is it reasonable to assume that such a result was not the intended result when the relevant tax provisions were enacted (section 207(4) FA 2013)?

13.1. The planning, if successful, results in an amount of income or profits for tax purposes being significantly less than the amount for economic purposes.

13.2. The Shareholders receive £250,000 and argue the corresponding amount of income, profits or gains for tax purposes is zero.

13.3. This is not the intended result of the distributions legislation.

14. Was what was done consistent with established practice and had HMRC indicated its acceptance of that practice (section 207(5) FA 2013)?

14.1. HMRC has said there is no relevant established practice and that it has not indicated its acceptance of the tax planning represented by the arrangements.

14.2. However, the Taxpayers argue the contrary based on correspondence running from February 2009 to January 2015 between the Scheme Protagonists and HMRC on the requirements for disclosure under Part 7 FA 2004 ("DOTAS") of the generic scheme and its predecessor scheme.

14.3. The Taxpayers' representations state: *"HMRC did not consider that entering into the arrangements would generate a tax advantage. Even if this view was objectively incorrect, [the Taxpayers] having been made aware of the position adopted by HMRC in relation to DOTAS, it must be the case that entering into the transactions could reasonably be considered to be a reasonable course of action to take."*

14.4. We have considered the DOTAS correspondence provided to us by the Taxpayers and are unable to draw from that correspondence the conclusion that HMRC had for the purposes of section 207(5) FA 2013 "indicated its acceptance" that no tax advantage arose from the arrangements.

14.5. HMRC wrote to indicate that they had decided not to pursue the matter any further but gave no reason for that decision. We do not accept that, even if HMRC agreed that the arrangements were not disclosable under DOTAS, this would necessarily, without something express, represent acceptance that the underlying arrangements did not involve a tax advantage. There are other reasons why HMRC may have chosen not to pursue its DOTAS argument. For example, there are other conditions that must be met for an arrangement to be caught by DOTAS.

14.6. We have also considered whether, even if the DOTAS correspondence falls short of the test in section 207(5), it nevertheless gives the Taxpayers reasonable grounds for believing that the transactions constitute a reasonable course of action. We do not believe that it does. It is apparent from the correspondence that HMRC had difficulty understanding what the arrangements were designed to achieve. In the correspondence we have seen the Scheme Protagonists do not clearly explain that the arrangements would be used to extract value from a company without a tax charge. Nor does HMRC give any clear indication that, having understood what the arrangements were designed to do, in their view they did not give rise to any tax advantage or were otherwise acceptable to HMRC.

14.7. We note that the engagement letter provided to the Taxpayers by the Scheme Protagonists in May 2014 expressly warned that the Scheme Protagonists *"offer no guarantee that any tax planning strategy will be successful."*

14.8. We are of the view that the Taxpayers have not established the existence of favourable established practice in relation to "no tax advantage" or HMRC's acceptance of that practice or that the DOTAS correspondence in some other way gives the Taxpayers reasonable grounds for believing that the arrangements are a reasonable course of action.

15. Discussion

15.1. This is a packaged scheme designed to produce a particular economic outcome, namely the tax-free transfer of a pre-determined amount of value from the Company to its Shareholders.

15.2. The arrangements are designed as a package and should be looked at as a whole. Taken as a whole the arrangements involve contrived and abnormal steps and the Shareholders accept the arrangements are fiscally rather than investment driven.

15.3. In our view the most likely comparable commercial transaction, given the risks assumed by the Taxpayers and the desired financial outcome, is a £250,000 dividend or other cash distribution paid by the Company to the Shareholders on the Option settlement date.

15.4. We note that the Option included a market condition based on the US/UK exchange rate, which was designed to have a 95% chance of producing the desired outcome.

15.5. A market condition involving only an 85% chance of success was built into the arrangements in Example D14 of the Guidance (again based on the US/UK exchange rate). The Guidance records that "*the artificial market condition (called "market change" but in fact meant no change) contingency and the fact that a purchaser of the note would readily be found meant that on a realistic view of the facts the scheme would proceed as planned i.e. to create the loss. This is what participants understood, expected and paid fees for. It is clear that the substantive tax result (a large tax loss) is not consistent with the principles or policy objectives of the relevant tax provisions*." We consider that similar reasoning applies here, particularly given the even smaller chance of failure of the market condition in this case.

15.6. Against the background of clear legislative intent in the distributions legislation it cannot be correct for one element, here the Options, in a composite abnormal and contrived arrangement to be looked at in isolation.

15.7. The Taxpayers argue the GAAR is intended to apply "*where the parameters of sensible and proportionate tax planning are not impinged upon*" [sic]. This is a case that involves neither sensible nor proportionate tax planning. We do not agree with the Taxpayers' claim they were adopting an *"acceptable method of tax mitigation"*. The Taxpayers submit that " *'back to back' transactions are an acceptable method of tax mitigation. Thus in the context it is submitted that the transactions under consideration (in particular the options [sic] written by [Mr B] and the also [sic] the hedging or back to back element provided through the policy) are capable of reasonably being considered to be a reasonable course of action to take."* We do not agree. While the Option and Mirror Option may have had a similar effect to back to back transactions while they were held by the Offshore Bond, the Offshore Bond with its cooling off right which enabled Mr B to extract the right to the Option premium from the Offshore Bond when, as expected, the Option expired out of the money leaving the Company and Offshore Bond to lose value went well beyond a back to back transaction or acceptable method of tax mitigation.

15.8. In our view neither the entering into nor the carrying out of the steps in this case amounts to a reasonable course of action in relation to the distributions legislation.

15.9. For the reasons given above, we are not swayed by the arguments raised by the Taxpayers to the effect that they adopted a reasonable course of action, including in particular arguments based on HMRC's decision not to pursue their DOTAS enquiries into whether the generic scheme was disclosable and those based on judicial authority that the arrangements were not abusive.

15.10. The circumstances set out in section 207(2)(a) and (b) FA 2013 and section 207(4)(a) FA 2013 point towards both the entering into and the carrying out of the scheme as not amounting to a reasonable course of action in relation to the relevant income tax provisions:

a) the substantive results of the steps taken are not consistent with the principles on which the underlying distributions legislation is based;
b) the means of achieving the intended result relies on creating an abnormal and contrived package that, exploiting a regulatory "cooling off" right, produces the desired movement of value from the Company to the Shareholders; and
c) the overall tax outcome is that £250,000 of income, profits or gains funded by the Company is intended to be received by the Shareholders tax free.

16. Comment

16.1. We have not been provided with the distributable reserves position of the Company in July 2014. To the extent under our likely comparable transaction the dividend or other cash distribution is unlawful, we would expect that amount to be treated as a loan or advance to a participator for the purposes of section 455 CTA 2010, or as an untaxed extraction of value for the purposes of section 464A CTA 2010.

17. Conclusion

Each of the sub-Panel members is of the view, having regard to all the circumstances (including the matters mentioned in subsections 207(2)(a), 207(2)(b), 207(2)(c) and 207(3) FA 2013) and taking account of subsections 207(4), 207(5) and 207(6) FA 2013, that:

a) the entering into of the tax arrangements is **not** a reasonable course of action in relation to the relevant tax provisions; and
b) the carrying out of the tax arrangements is **not** a reasonable course of action in relation to the relevant tax provisions.