GAAR ADVISORY PANEL

Anonymised and sub-Panel approved version of a representative Opinion Notice issued on 7 August 2019

This is the anonymised version of one of a number of substantially similar opinion notices issued on 7 August 2019 to taxpayers in respect of whom referrals were made by HMRC on 2 May 2019. The accompanying Common Schedule applies to each opinion.

Subject Matter: Extraction of cash/value from a company by its directors/shareholders. Employee Shareholder Shares.

Taxes: Income Tax, Capital Gains Tax.

Relevant Tax Provisions: Taxation of Chargeable Gains Act 1992, especially Part 7; Income Tax (Trading and Other Income) Act 2005, especially Part 4; Corporation Tax Act 2010, especially part 23.

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 2 May 2019 relating to taxpayer Mr A.

The sub-Panel received written material from HMRC under paragraph 7 Schedule 43 FA 2013 and from Mr A representations under paragraphs 4 and 9 together with further information the sub-Panel requested under paragraph 10(2).

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 taxpayer Mr A.

2.2. At all material times Mr A and the other Taxpayers owned 100% of the shares in and were directors and employees of the Company.

2.3. We are issuing today opinion notices in similar terms in relation to each Taxpayer in respect of whom a similar referral was made to the Panel on 2 May 2019.

2.4. "Common Schedule" means the common schedule forming part of this opinion notice. The Common Schedule also forms part of each opinion notice issued today to other Referred Taxpayers.

2.5. The definitions used in section 1 of the Common Schedule apply throughout this opinion notice.

3. *Common Schedule*

3.1. The Common Schedule covers:

a) the outline of the arrangements;
b) the summary of the substantive results of the arrangements;
c) the tax advantage;
d) the results argued for by the taxpayer;
e) contentious facts;
f) the principles of the relevant legislation and its policy objectives;
g) the circumstances, and in particular the matters mentioned in subsections (2)(a) to (c) and (3) of section 207 FA 2013 and the matters mentioned in subsections (4) to (6) of section 207 FA 2013; and
h) discussion on reasonable course of action.

4. 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.

Common Schedule

This is the common schedule forming part of each opinion notice issued on 7 August 2019 to Referred Taxpayers (as defined below).

5. *Terms used in this schedule*

5.1. "Taxpayers" means the small number of shareholders in the Company (being more than four) (and each is a "Taxpayer").
5.2. "Referred Taxpayers" means each Taxpayer in respect of whom a referral was made to the GAAR Advisory Panel on 2 May 2019.
5.3. "ES C Shares" means the Class C shares in the Company (being the shares entitled to the substantive economic value of the Company once the Hurdle has been met).
5.4. "ES Share(s)" means share(s) satisfying the conditions for relief under the ES Shares Legislation.
5.5. "ES Shares Legislation" means the provisions, at the relevant date, of sections 236B – 236G TCGA 1992 and section 385A ITTOIA 2005 which in effect provide that no charge to tax arises on a repurchase by a company of ES Shares.
5.6. The "original shareholding" means the shares held by the Taxpayers prior to the Day 15 share reorganisation.
5.7. "Adviser" means the adviser to the Taxpayers and the Company on the arrangements.
5.8. The "Hurdle" means the performance hurdle linked to the net asset value of the Company and included in the terms of the ES C Shares.
5.9. The "Partnerships" means the partnerships associated with the Company's business.
5.10. When we refer to "Guidance" we mean the GAAR Guidance approved by the Panel with effect from 15 April 2013 and from 30 January 2015.
5.11. The financial index used is based on 100 being the aggregate amount the Company pays to the Taxpayers on the repurchase of the ES C Shares.

5.12. The day count used is based on Day 0 being the day HMRC writes to Adviser accepting the ES C Shares valuation.

6. *Outline of the arrangements*

6.1. *Pre-January 2014 position*

i) The Company is wholly owned by the Taxpayers.
j) Each Taxpayer is a director and employee of the Company.
k) Each Taxpayer is a member, with other Taxpayers, of at least one of the Partnerships.
l) Adviser suggests a restructuring involving the extraction of value via ES C Shares.

6.2. *Pre-share reorganisation position*

a) In early 2014 the Taxpayers gave up their interest in the Partnerships.
b) On 29 May 2015 Adviser writes to HMRC requesting a valuation of the proposed ES C Shares.
c) Net asset value of the Company at the end of December 2014was 73 with the May Company estimate of 89 at the end of September 2015.
d) On 7 September 2015 HMRC writes to Adviser accepting the proposed ES C Shares values (based on a net asset value hurdle of 91).
e) On 11 September 2015 Adviser contacts HMRC to say additional income and costs had arisen since the initial valuation and proposed the net asset value hurdle be increased to 96.
f) In early October 2015 (Day 0) HMRC writes to Adviser accepting the valuation based on that revised information and the new hurdle.

6.3. *Share issue and Employee Shareholder Agreement*

a) On Day 15 Company resolutions are passed effecting the following:
    (i) the existing £1 ordinary shares in the Company are each sub-divided into 100 ordinary shares of £0.01 each;
    (ii) new articles of association are adopted;
    (iii) each of the Taxpayers' holding of £0.01 ordinary shares is re-designated, so that after the re-designation each of the Taxpayers holds shares in two new class A and B shares; and
    (iv) the directors are authorised to allot Class C shares (the ES C Shares).
b) The share rights mean that once the Hurdle of 96 is reached the rights attaching to the Class A and Class B shares (effectively the

original shareholding) pass into the Class C shares (new ES Shares).

c) On Day 15 each of the Taxpayers signs an employee shareholder agreement. That agreement includes:
    (i) acknowledgment that the Taxpayer is giving up certain employment rights;
    (ii) recording that the ES Shares are being allotted in return for entry into the employee shareholder agreement and that the Taxpayer has provided no other consideration for the shares; and
    (iii) recording the value of the ES Shares, in each case at less than £25,000.

6.4. *Share repurchases*

Within a period of a few days ending on day 90:

a) the Hurdle is met,
b) the Taxpayers resign as directors of the Company,
c) the Company repurchases the ES C Shares for an aggregate of 100.

7. *Summary of substantive result of the arrangements*

7.1. On the Hurdle being met, effectively all the economic value held by the Taxpayers via their original shareholding moves into the ES C Shares held by those same Taxpayers.

7.2. On the repurchase of their ES C Shares each of the Taxpayers receives their share of the Company's accumulated and undistributed profits, those profits having been generated in the main prior to Day 0.

8. *The tax advantage*

8.1. HMRC's position is that the Taxpayer seeks to extract their share of the 100 of value from the Company without suffering income tax or capital gains tax consequences.

8.2. In particular HMRC maintain the ES Shares exemption is not available on the Day 90 repurchase of the Taxpayer's ES C Shares.

9. *Tax results argued for by the Referred Taxpayers*

9.1. The Referred Taxpayers argue they are entitled to the ES Shares exemption on the repurchase of their ES C Shares.

9.2. The Referred Taxpayers argue they not only satisfy the ES Shares conditions but that their planning is consistent with the policy objectives of the ES Shares Legislation.

9.3. Accordingly, the Referred Taxpayers have an exemption from capital gains tax and income tax on the sale proceeds they receive, and otherwise in respect of the ES C Shares are subject to an income tax charge only on the difference between the agreed value of their ES C Shares and £2,000.

10. *The arrangements – contentious facts*

10.1. *Employee incentive*

a) HMRC argues that given each of the Taxpayers already bore the opportunities and risks of ownership through their original shareholding *"there was no need to issue Shares to incentivise [the Taxpayers]".*

b) HMRC argue in addition that given the fact the Taxpayers had ceased active work, the *"issuing of the [ES C Shares] could not have been to incentivise a better performance."*

c) The Referred Taxpayers argue they all remained employees and the ES C Shares were *"designed to encourage the [Taxpayers] to continue their activities for as long as possible…"* and that the incentive was created *"by virtue of the tax-exempt status of the [ES C Shares]".*

d) The Referred Taxpayers go on to argue that the relevant date to consider the impact of this issue for GAAR purposes is the date of the design of the arrangements rather than the date of the issue of the ES C Shares.

e) In considering our opinion we started by giving no weight to the above HMRC arguments. Having reached our conclusion on that basis we make no further comment on the respective positions taken above by the parties.

10.2. *Valuation*

a) HMRC asserts that the Taxpayers *"were allotted shares with a performance hurdle that appeared to have already been achieved"* and elsewhere that HMRC *"does not agree that the valuation of the [ES C Shares] at the point of allotment was necessarily correct or that we are bound by the agreed valuation".*

b) The Referred Taxpayers maintain the Hurdle had not been achieved at the date the shares were allotted and that the valuation is a correct valuation.

c) In considering our opinion we have ignored any alleged defect in the implementation of the arrangements and in particular we do not regard whether or not the Hurdle had been met on or before the date of issue of the ES C Shares as relevant to reaching our conclusions. We have therefore assumed that the Hurdle had not been met by the relevant date and that the valuation confirmation provided by HMRC on Day 0 stands.

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

11.1. In owner managed companies a choice is given to the taxpayer on how profits can permanently be extracted. The overall scheme of the cash extraction legislation allows a choice as to how those profits can be distributed – cash remuneration, dividend, share repurchase or a combination. The legislation further allows a choice as to when profits are distributed.

11.2. Given different tax results arise from the choices available, one would expect (particularly where large sums are involved) there to be financial planning and it is not unreasonable for that financial planning to be driven by a desire to take the benefit of the choice on offer with the lowest tax cost.

11.3. Subject to the satisfaction of certain conditions, the ES Shares Legislation provides the potential for favourable tax treatment via a share repurchase.

11.4. The ES Shares Legislation provides an exemption from capital gains tax and income tax on the repurchase of the ES Shares. In addition, no income tax is chargeable on the first £2,000 of share value received when the ES Shares are allotted.

11.5. As a threshold condition, the ES Shares Legislation applies to *"a share acquired in consideration of an employee shareholder agreement and held by an employee"* (section 236B(3) TCGA 1992).

11.6. Section 236C(1) provides, in effect, that the ES Share *"is exempt if, and only if, the total value of qualifying shares acquired by the employee does not exceed £50,000."*

11.7. Section 263D provides for the ES Shares not to be exempt if the shareholder or a connected person has a material interest in the Company. That test requires that there be no relevant material interest within the 12 months preceding the acquisition of the ES Shares (section 236D(2)).

11.8. The legislation was introduced as part of a wider policy to introduce a new *"'employee shareholder' employment status to reduce regulatory burdens on business… [and] is intended to support take-up of the new 'employee shareholder' status."* (Tax Information and Impact Note]

11.9. The legislation was aimed at *"enabling growing companies to attract and retain talented and entrepreneurially minded individuals by offering the opportunity for a potentially significant tax-free gain on shares in the company"* [Public Bill Committee]

11.10. Section 205A of the Employment Rights Act 1996 introduced "employee shareholder" status from 1 September 2013 for new and existing employees who give up employment rights in return for shares in their employer and where the conditions set out in that section are met. This definition is adopted in the ES Shares Legislation.

11.11. It is clear to us that the legislation explicitly and implicitly keys off the employee shareholder agreement. The legislation anticipates that the employee will be giving up rights (see section 236G TCGA 1992 which treats the relinquishing of employment rights as not being the disposal of an asset) but does not require that the rights being given up are in fact valuable.

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

12.1. In looking at this factor we will start by looking separately at each of the key steps.

12.2. <u>*Giving up interests in the Partnerships*</u>

a) The ES Shares Legislation has a material interest condition (section 236D TCGA 1992). That condition must be met at the date of issue of the ES Shares.

b) Giving up their interests in the Partnerships in this case is not a contrived step but simply an obvious planning necessity.
c) This material interest condition does mean, however, a period of 12 months had to pass before the ES Shares could be issued to the Taxpayers.

12.3. *ES C Shares held for only a short period*

a) From date of issue of the ES C Shares to their date of repurchase was less than three months.
b) ES Shares are typically designed to be held for an extended period. Abusive arrangements involving ES Shares are likely to include, as a feature, a short holding period.
c) While we do not give particular weight here to the short holding period as a potential indicator that the arrangements may be abusive, we note that the feature is consistent with what we would expect in abusive arrangements.

12.4. *Reorganisation of the Company's share capital*

a) Reorganising share capital (including the creation of new classes of stock with class rights tailored to individual shareholders) to facilitate the issue of company shares to employees is not abnormal.
b) Although the creation of these new tailored classes of stock is in a general sense contrived, in the context of the ES Shares Legislation it is likely that in many cases a new class of share will need to be created. That is an inevitable consequence of legislation where ES Shares are grafted onto a company's existing shares.
c) Accordingly, we do not consider the issue of ES C Shares of itself to be an indicator that the arrangements may be abusive.

12.5. *Inclusion of the Hurdle in the ES C Shares terms*

a) It is both abnormal and contrived to include a hurdle the intended result of which is to move effectively all the value from one class of share held by a company's shareholders to another newly created class of share held by those same shareholders.
b) Using numbers from the balance sheets provided to HMRC with the May 2015 valuation request:
    i. the draft balance sheet of the Company as at the end of December 2014 shows net current assets of 73;
    ii. the projected position of the Company at the end of September 2015 is 89.
c) Irrespective of how quickly the valuation could be agreed and the shares issued, the intended effect of meeting the Hurdle would be to move current value (of at least 73) from the taxable original shareholding to exempt ES Shares.
d) We recognize that the use of a hurdle mechanism as part of an incentive arrangement will in many ordinary situations not, of itself, be abnormal. However, given the terms of the hurdle and the context of overlap between shareholders generally and holders of the ES Shares this is not an ordinary situation.
e) We regard the terms of the Hurdle abnormal and contrived and a strong indicator that the arrangements may be abusive.

12.6. To the extent the various steps were seeking to put the Taxpayers in a position in which they could access the favourable ES Shares Legislation for future profits the share reorganisation may have been contrived, but is not an indicator of abuse. However, including a hurdle mechanism to access historic profits is contrived and an indicator of abuse.

13. *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)?*

13.1. The principles and policy objectives of the legislation referred to in section 7 above suggest that, were no attempt made to move profits made prior to the ES C Shares allotment out of the original shareholding and into those shares, the ES Share exemption would have been consistent with the principles and policy objective of the ES Shares Legislation.

13.2. Engineering a situation in which the Taxpayers give up existing economic rights, being rights on their original shareholding that accrued before the employee shareholder agreement was signed, and moving those rights into the ES C Shares is a strong indicator that the arrangements are abusive.

13.3. In our view the most likely comparable commercial transaction is a repurchase of the Taxpayers' original shareholding for the consideration paid under the arrangements. There may need to be a share reorganisation ahead of the share repurchase to ensure for instance that the Company remains in existence. We recognize the cash could equally have been extracted by way of dividend.

13.4. In our view, the adoption of the Hurdle as a mechanism to move effectively all accrued value to the ES C Shares, and to pass value out of the original shareholding, is contrived and adopted to avoid the tax consequences of the most likely comparable commercial transaction.

13.5. We have not been provided by the Referred Taxpayers with probabilities of the Hurdle being met. We do have a statement that they *"do not agree … that the [Hurdle] had already been met (or was very likely to be met) at the time of the issue of the ES C Shares"*.

13.6. We accept for the purposes of this opinion that there was, at the date of issue of the ES C Shares, a level of uncertainty as to whether the Hurdle would be met, and if met when it would be met. This does not alter our view that the Hurdle mechanism is a strong indicator that the arrangements are abusive.

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

14.1. It is highly unusual for a company with more than four shareholders to have existing shareholders and holders of newly issued ES Shares being one and the same.

14.2. It is probably not surprising that this particular scenario was not dealt with in the legislation. In our view, had the drafter considered this scenario we would have expected the legislation to have included an anti value-shifting provision to bolster the ES Shares £50,000 initial value limit.

14.3. That approach by an informed drafter would also have been consistent with section 205A(1)(d) of the Employment Rights Act 1996 under which an employee "*is an "employee shareholder" if - ... the individual gives no consideration other than by entering into the agreement.*"

14.4. We consider the arrangements, and in particular the Hurdle, seek to exploit this shortcoming in the ES Shares Legislation.

14.5. The subsequent changes made to the ES Shares Legislation may reflect an uptake of the exemption amongst a group of taxpayers different to the group envisaged when the legislation was enacted, but that does not mean there was a shortcoming for the purposes of section 207(2)(c) FA 2013.

15. *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)?

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

15.2. The ES Shares Legislation provides an exemption from capital gains tax and income tax on the repurchase of ES Shares and therefore a mismatch with the economic position. However, that favourable mismatch arises only where the ES Shares Legislation exemption applies.

15.3. If the arrangements are contrived and not consistent with the policy objectives of the ES Shares Legislation, then it would not be reasonable to assume exemption was the intended result in a comparable share repurchase transaction.

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

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

16.2. The Referred Taxpayers say that details of the rights on the ES C Shares, including details of the Hurdle, were included in the Taxpayers' valuation request. *"We would have expected HMRC to engage on the valuation if it thought that the design of the [ES C Shares] was abusive."*

16.3. We do not regard HMRC's lack of engagement on abuse at the time of the valuation as a material indicator that the arrangements might not be abusive.

17. Discussion

17.1. The legislators of the ES Shares Legislation may not have had in mind the Taxpayers, given the company ownership structure, and value, as worthy recipients of the exemption. However, that does not make steps taken by the Taxpayers to access the ES Shares exemption automatically an unreasonable course of action.

17.2. The exemption for ES Shares was introduced to benefit an employee shareholder but not just any employee shareholder. Employee shareholder for the purposes of the ES Shares Legislation is defined in section 205A of the Employment Rights Act 1996. Compared with an ordinary employee, an employee shareholder's employment rights are more limited. For shares to benefit from the ES Shares Legislation exemption, the employee shareholder must acquire their ES Shares "*in consideration of [their entering into] an employee shareholder agreement*".

17.3. The further information provided to us shows that (on a conservative view) over 73 of the 100 the Taxpayers received on the share repurchase relates to value the Taxpayers already had through their original shareholding. On the Taxpayers' May 2015 estimate that rises to about 89 at the end of September 2015.

17.4. What the Referred Taxpayers are in effect seeking to do here through the Hurdle is to backdate the issue of the ES Shares to a time when neither the employee shareholder agreement had been signed nor could the material interest condition be satisfied and to sidestep the £50,000 limit on value.

17.5. The Taxpayers' position is unusual in that there are more than four shareholders, all of whom are also key employees. Each shareholder/employee is in the same economic position (save for tax) whether or not the ES Shares are issued. Each shareholder under the arrangements is simply moving their entitlement to their share of the Company's underlying profits from a left hand (taxable) pocket to a right hand (tax exempt) pocket.

17.6. A company with similar overlap and four shareholders would not qualify at all under the ES Shares Legislation. The higher the number of shareholders, the less likely it is there will be an absolute overlap between existing shareholders and holders of new ES Shares. Where the overlap is not absolute it is likely that the £50,000 limit and the "no consideration" conditions in the underlying legislation will as a matter of practice prohibit the holder of the ES Shares from accessing existing profits.

17.7. In considering this case the following extracts from the Guidance have been of particular help:

> *C5.7.7 … there may be legislative provisions where the principles and policy are not clearly discernible, or may not be fully developed. For example in a case where the drafter had simply not considered the possibility of certain participants in a particular type of transaction being resident outside the United Kingdom.*

C5.7.8 In such cases the main focus of the enquiry as to whether the arrangement was a reasonable course of action in relation to the relevant tax provisions will move to the considerations set out in [ss207(2)(b)] (contrived or abnormal steps) and (c) (exploiting shortcomings in the relevant legislation) [FA2013].

C5.9.1 Directing attention to the consideration of whether arrangements are intended to exploit any shortcomings in the relevant tax provisions is based on the recognition that the drafting of particular tax rules may lead to unanticipated consequences. This may be because the tax rules have a defect that was not apparent to the drafter, or the drafter may not have contemplated that a particular type of transaction could be carried out (whether to come within the rules or to keep outside them).

17.8. We have considered all the circumstances. Each of the particular circumstances set out in section 207(2)(a), (b) and (c) 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 and capital gains tax provisions:

a) the substantive results of the steps taken are not consistent with the principles and policy objectives on which the underlying ES Shares Legislation is based;
b) the means of achieving the intended result relies on an abnormal and contrived net asset value hurdle built into the rights of the ES C Shares so that effectively all current value can be passed out of the Taxpayers' original shareholding into the ES C Shares held by those same Taxpayers;
c) the arrangements exploit a shortcoming in the legislation as the particular circumstances of overlapping existing shareholders and holders of new ES Shares had not been contemplated by the drafter, and if it had been contemplated anti value-shifting provisions would have been included to prevent exploitation; and
d) the overall tax outcome is that the proceeds of sale of the ES C Shares (a substantial proportion of those proceeds representing value "owned" by the Taxpayers before the ES C Shares were issued, and indeed before the Taxpayers made their valuation request) are intended to be taxed in a different way to the way in which comparable transaction share repurchases are ordinarily taxed.