GAAR ADVISORY PANEL

Redacted and sub-panel approved version of the Opinion Notice issued on 25 January 2019

Subject Matter

Individual claiming relief for film-related trading losses. Individual taxable on income generated by original arrangements. Attempt to avoid income tax on future income. Arrangements splitting the sale of a member's LLP Capital Account (effectively the benefit of his future drawings from the LLP) from the sale of the member's residual interest in the LLP.

Taxes

Income tax.

Relevant Tax Provisions

Sections 796 to 803 Income Tax Act 2007.

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 29 August 2018 relating to taxpayer Mr X.

The sub-panel received written material from HMRC under paragraph 7 Schedule 43 FA 2013 and representations from Mr X under paragraphs 4 and 9 Schedule 43 FA 2013.

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 case relates to taxpayer, Mr X.

2.2. In addition to Mr X this case also involves:

a) a limited liability partnership of which Mr X is a member (the "LLP");
b) the promoter of the LLP, and proposer and arranger of the subsequent sales of LLP capital accounts and LLP interests, (the "Promoter");
c) the non-resident purchaser of LLP member capital accounts (the "Capital Accounts Purchaser"); and
d) the non-resident purchaser of LLP member interests (the "LLP Interest Purchaser").

2.3. By "LLP Drawings" we mean drawings derived from LLP profits.

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

2.5. Statutory references without a statute are to the Income Tax Act 2007.

3. *Background to the arrangements*

3.1. The LLP members' agreement is drawn up on 4 September 2006. The LLP is financed by its members with the purpose of "acquiring and exploiting a portfolio of qualifying British film".

3.2. On 7 February 2007 Mr X obtains and uses a capital account contribution loan from a UK bank to introduce capital of about £1million to the LLP.

3.3. Mr X's obligation to the lending bank is secured on his LLP interest.

3.4. The LLP uses member capital contributions to enter into a sale and leaseback arrangement with a film studio. Under that arrangement lease rentals, guaranteed through deposit arrangements with the lending bank, are payable to the LLP until at least 18 March 2022.

3.5. The sale and leaseback arrangements generate a large loss in the LLP in the 2006/2007 tax year and Mr X sets the majority of his share of the loss against other income in that tax year.

4. *Outline of the arrangements*

4.1. Mr X, along with other investing members of the LLP, is provided with a note from the Promoter dated 19 June 2013 and titled "Proposed refinancing of members capital contribution loans from either (A) the proceeds from sale of members' capital accounts or (B) the proceeds of a limited recourse loan".

4.2. On 11 December 2013 Mr X enters into an agreement with the Capital Account Purchaser for the sale of his LLP capital account (being in essence his future LLP Drawings).

4.3. The sale takes place on 20 March 2014. The sale price is about £600,000, with the maximum recoupable LLP Drawings being about £750,000. The Capital Account Purchaser takes security over Mr X's future LLP Drawings. The Capital Account Purchaser acquires the economic benefit of Mr X's future LLP Drawings. Mr X retains the legal entitlement to his future LLP Drawings and to his LLP interest.

4.4. On 7 May 2014 the LLP board passes a resolution permitting LLP members to sell or gift all or part of their LLP interest to a third party.

4.5. On 7 May 2014 the LLP board appoints the Promoter to seek a buyer for member interests in the LLP.

4.6. On 30 June 2014 the LLP board considers the Promoter's shortlist of five potential offers for the purchase of the controlling interest in the LLP.

4.7. On 18 July 2014 the LLP board approves the sale of certain members' LLP interests to the LLP Interest Purchaser.
4.8. On 31 July 2014 a sale and purchase agreement is drawn up between the LLP Interest Purchaser and the LLP capital account selling members (including Mr X).
4.9. The consideration payable by the LLP Interest Purchaser to each selling member is £1 and each selling member is (according to the Promoter's summary of indicative terms) required to make a £40,000 contribution to the LLP to which the LLP Interest Purchaser has the right following the sale.

5. ***Summary of substantive result of the arrangements***

5.1. Mr X makes a tax enhanced financial investment in 2007.
5.2. Prior to the sale of Mr X's capital account:

a) Mr X has an interest in the LLP and an outstanding bank loan;
b) Mr X has an entitlement to LLP Drawings, arising from lease rental payments; and
c) Mr X's LLP Drawings are applied in paying down his bank loan.

5.3. In March 2014 Mr X exits his substantive financial investment and associated borrowing by selling his capital account (being in essence his future LLP Drawings) to a third party for market value and applying the proceeds towards repaying his borrowings.
5.4. Mr X retains an interest in the LLP that has a negative economic value. The Promoter received five offers of purchase for the retained LLP interest. Each offer, as a condition of sale, required a monetary contribution by the selling LLP member.
5.5. In July 2014 Mr X disposes of his negative value LLP interest.

6. ***The tax advantage***

6.1. HMRC's position is that Mr X seeks to turn a tax deferral into permanent tax advantage, and in particular that Mr X seeks to avoid a charge to income tax on the sale relating to his future LLP profits.

7. ***Tax results argued for by the taxpayer***

7.1. Mr X argues that he has the benefit of a permanent tax advantage as his capital account sales proceeds are not chargeable to income tax.
7.2. Mr X argues that he has entered into two transactions that need to be looked at separately:
a) the first is a sale of Mr X's capital account in tax year 2013/2014, the proceeds of sale Mr X argues fall outside of the relevant "sale of future profits" and LLP interest disposal income taxing provisions in sections 796 to 799; and
b) the second is a sale of Mr X's retained interest in the LLP in tax year 2014/2015, Mr X accepts the nominal sum proceeds of sale are taxable.
7.3. Mr X argues that he remains, by virtue of his continued legal entitlement to a share of LLP profits, subject to income tax on his LLP profit share until the sale of his retained LLP interest.

8. ***Disputed facts – composite transaction***

8.1. HMRC maintains that the sales of the capital account and retained LLP interest over two separate tax years are part of a single arrangement "conceived and planned as a whole".
8.2. Mr X maintains it was not inevitable at the time of the capital account sale that there would be a sale of his retained LLP interest.

8.3. In coming to our conclusion in this opinion we have not found it necessary to affirm either HMRC's or Mr X's position.

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

9.1. At the time of the LLP investment, legislation aimed at promoting the British film industry gave a taxpayer the opportunity to, in effect, set the LLP member's day one investment in a film partnership against current year taxable income from other sources. The "tax break" is in the form of a deferral, the taxpayer is subject to income tax on future profits (rental payments) derived from the LLP.

9.2. Anti-avoidance legislation in sections 796 to 803 (*Individuals claiming relief for film-related trading losses*) was introduced to stop taxpayers seeking to turn the tax deferral into a permanent saving by expressly bringing into charge to income tax the disposal of rights to future profits.

9.3. This anti-avoidance legislation provides that "non-taxable" consideration received by a partner (including an LLP member) in connection with the disposal of a right to profits is chargeable to income tax. Consideration is "non-taxable" if it is not chargeable to income tax (section 798(2)).

9.4. The principles and policy of the legislation is clear, the relevant tax break for investing in British films is in the form of a tax deferral and not in the form of a permanent tax advantage. The anti-avoidance legislation makes it clear there is no exception to this deferral position where a partner cashes in early. Instead the anti-avoidance legislation in those circumstances seeks to bring forward the tax charge to reflect the taxpayer's economic position.

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

10.1. The secured capital contribution loan, film sale and leaseback and bank guarantee of lease rentals with secured cash flows was not an unusual structure in early 2007.

10.2. The Promoter proposed in 2013 a refinancing of LLP members' capital contribution loans. Two (non-tax) commercial arguments were given:

a) LLP members were exposed to a failure of the bank guaranteeing the lease rentals; and
b) LLP members needed bank permission to dispose of their LLP interests.

10.3. The Promoter proposed alternative courses of action to fund the repayment of member capital contribution loans:

a) the sale of the beneficial interest in the member's LLP capital account (being in essence the member's future LLP Drawings), and the application of those sale proceeds to the repayment of the outstanding capital contribution loan; or
b) borrowing the full proceeds of the outstanding capital contribution loan from a replacement lender (an entity owned and controlled by the Promoter), and the application of those funds to the repayment of the outstanding capital contribution loan.

10.4. The natural course of action for a promoter seeking to assist LLP members to repay borrowings in circumstances in which members would have no further interest in LLP revenues would have been to look for potential purchasers for members' <u>entire</u> LLP interests.

10.5. It is contrived and abnormal, in the absence of section 799, to seek to split out and sell the beneficial interest in a capital account (being in essence future LLP Drawings) and leave a negative value LLP interest.

10.6. We can see no compelling reason, other than to seek a tax advantage, for Mr X's financial exit from the LLP to be structured in this way.

10.7. We are of the view that the steps comprising the tax arrangements 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. On the sale of his capital account and repayment of his capital contribution loan, the resulting commercial position is one in which Mr X:

a) has received monies representing the value of his future LLP Drawings;

b) has used those funds towards repaying his capital contribution loan;

c) has exited the substantive financial arrangements he had with the LLP and with his lender; and

d) retains a negative value LLP interest.

11.2. The overall policy objective of the film legislation is to provide a "tax break" in the form of a tax deferral; a potentially large upfront income tax deduction with subsequent profits being subject to income tax.

11.3. The deferral nature of the "tax break" is reinforced by the sections 796 to 803 anti-avoidance provisions.

11.4. Mr X having taken the benefit of the upfront tax deduction in 2007 seeks to receive an amount representing future LLP profits free from income tax.

11.5. Given the resulting commercial position, in our view the most likely comparable commercial transaction is a sale of the taxpayer's entire undivided LLP interest (including the entitlement to future LLP Drawings) to a purchaser. The purported split between the beneficial interest in Mr X's capital account on the one hand and his legal interest in his capital account and LLP membership interest on the other hand, was artificial and lacking in commercial substance.

11.6. The intended outcome of putting Mr X in a position to make an absolute tax saving is accordingly not consistent with the policy objectives of, or the principles behind, the legislation.

11.7. The Guidance states at paragraph C5.7.6 "*Where the provisions and policy objectives* [of the legislation] *are discernible* [as is the case here] *then these will usually be particularly important matters to take into account in considering whether the arrangements are a reasonable course of action."*

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

12.1. Under the arrangements Mr X receives a market value payment for the sale of his future LLP Drawings. Mr X maintains that receipt is not chargeable to income tax.

12.2. The section 796 anti-avoidance charge applies to a "disposal of a right of the individual to profits". The sale of the capital account clearly has the same economic effect as the disposal of Mr X's right to LLP profits.

12.3. The section 796 charge in addition applies to a "disposal of the individual's interest in the firm". Where an LLP investment is purely a financial investment and future drawings derived from profits are sold so as to leave only a negative value interest it is arguable that the charge under this heading is intended to apply. Although we find the argument attractive, we do not in this opinion rely on the argument.

12.4. There is no suggestion that the underlying policy supports a taxpayer choice between a taxable disposal of future profits and a non-taxable disposal of future profits, and there are no relevant "bear traps" the taxpayer is seeking to skirt. Paragraph C5.6.5 of the Guidance is in point: "*If the companies concerned enter into complex transactions designed for the specific purpose of getting around these legislative rules, then it is not possible to regard those transactions as a reasonable course of action in relation to the relevant tax provisions as they were specifically designed to frustrate the effect of those provisions."*

12.5. There is a clear shortcoming if the section 799 events are to be read narrowly and exclusively so as not to cover the situation in which a taxpayer enters into a market value sale transaction in which a third party acquires the economic entitlement to the taxpayer's future LLP Drawings.

12.6. In our view the income tax position is clear. The way Mr X exits his financial investment, via the capital account sale, is designed to exploit a perceived shortcoming in section 799.

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. Mr X receives the economic value of future profits from the sale of his capital account but argues that economic value falls out of charge to income tax.

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 Mr X has not disagreed.

15. Discussion

15.1. Mr X made a tax enhanced investment in 2007. The tax advantage was an upfront income tax deduction.

15.2. However, the scheme of the legislation is clear. This was a deferral advantage, and not an absolute advantage.

15.3. Sections 796 to 803 provide a further legislative overlay. Where the rights to future profits are disposed of in circumstances in which the disposal proceeds are not otherwise subject to tax, the disposal consideration is treated as income subject to tax.

15.4. In 2013 the Promoter suggested an arrangement under which Mr X could, as part of a refinancing, achieve an economic sale of his future LLP Drawings without that sale being the sale of a "*right to profits*" or the "*disposal, giving up or loss of [Mr X's] interest in [the LLP]*". (quotes from section 799)

15.5. The Promoter saw this being achieved by Mr X selling the beneficial interest in his capital account (being in essence his future LLP Drawings) and leaving Mr X with a negative value LLP interest.

15.6. The Promoter and Mr X in effect argue:

a) the sale of the beneficial interest in the LLP member's capital account (being in essence the member's future LLP Drawings) is not an income tax event as it does not fall within the prescriptive section 799 language;

b) any subsequent disposal of the remaining negative value LLP interest is a taxable event, but with nominal value involved;

c) any LLP profits arising prior to the retained LLP interest disposal are taxable as income; and

d) once an LLP purchaser has been lined up for the LLP member by the Promoter, the LLP member has the highly attractive option of whether or not to pay income tax on future profits.

15.7. It cannot be correct that, against the background of clear legislative intent (including the intent of a relevant anti-avoidance provision), an abnormal and contrived arrangement should fall out of charge to income tax when economically equivalent arrangements would be "appropriately taxed". We use "appropriately taxed" here to mean income tax following the economic substance of the transaction.

15.8. A sale in the form of a "disposal of a right to profits" will have fallen squarely within the charging provisions, and as a matter of economic substance the sale of the capital account has the same effect. Following the capital account sale Mr X retains no economic interest in the LLP's future profits.

15.9. The sale of the capital account is in economic substance a "disposal of a right of the individual to profits" and there is no reason to think it was not intended to be covered by sections 796 to 799.

15.10. In our view the most likely comparable commercial transaction, if the aim of avoiding section 799 was not an issue, is a sale of the entire LLP interest (including future profits).

15.11. The Promoter has sought to implement an arrangement to avoid tax on a commercial outcome targeted by section 799. The Promoter identified a perceived shortcoming in the legislation. That shortcoming is seen to exist because section 799 read narrowly requires the taxable consideration either to come from the disposal of Mr X's LLP interest or from Mr X disposing of a right to profits.

15.12. Taxing in tax year 2013/2014 the capital account sales proceeds Mr X receives is consistent with the principles and policy objectives of the scheme of legislation and in particular sections 796 to 803. Irrespective of his LLP residual interest dealings, the economic transaction under which Mr X receives consideration for his future profits in the LLP is the sale of his capital account interest in tax year 2013/2014.

15.13. In our view neither the entering into nor the carrying out of the steps in this case amount to a reasonable course of action in relation to the sections 796 to 803 income tax charging provisions.

15.14. Each of the circumstances set out in section 207(2) FA 2013 and section 207(4)(a) FA 2013 points 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 British film relief and anti-avoidance legislation in sections 796 to 803 are based;
b) the means of achieving the intended result relies on an abnormal and contrived splitting out, and selling, of the beneficial interest in Mr X's capital account (being in essence future LLP Drawings) and leaving Mr X with a negative value LLP interest;
c) the steps are intended to exploit perceived shortcomings in section 799; and
d) the overall tax outcome is an inclusion of an amount for income tax purposes that is significantly less than, and does not reflect, the economic gain.

16. Comment

16.1. In the event that the LLP interest is retained such that the taxpayer continues to be chargeable to tax on LLP profits despite having been taxed on the earlier capital account sale, we would expect the taxpayer to make a consequential adjustment claim under s210(2) FA 2013 to ensure no double taxation.

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.