GAAR ADVISORY PANEL

Redacted and sub-panel approved version of the Opinion Notice issued on 12 April 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 options additional contributions 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 25 January 2019 relating to taxpayer 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 A, 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 A and Mr B owned and were the directors of the Company; Mr A was a 34% shareholder and Mr B a 66% shareholder (Mr A and Mr B are together referred to as "the Shareholders").

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

2.4. Separate references to the Panel were made in relation to each of the Taxpayers. We are issuing today opinion notices relating to each of the three references.

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

2.6. "IFA Letters" means the letter of 29 January 2014 written by Mr A to an independent financial advisor ("the IFA") and by Mr B to the IFA.

2.7. "Mirror Option" means the option or options with terms mirroring the Options entered into by the Shareholders and entered into by the manager of the Offshore Bond with a third party to hedge the Offshore Bond portfolio's post novation exposure under those options.

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 £250,000 and able to accept additional contributions in cash or in specie.

2.9. "Options" means the "out of the money" options sold on 3 March 2014

a) by Mr A for a premium of £85,000 under which Mr A is liable to pay the counterparty £1.7m in gilts; and
b) by Mr B for a premium of £165,000 under which Mr A is liable to pay the counterparty £3.3m in gilts.

if the GB£/US$ rating reaches or surpasses either of two predetermined barrier levels before the 11 March 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. *Outline of the arrangements*

3.1. *Acquisition by the Shareholders of interest in Offshore Bond (28 February 2014)*

a) The joint acquisition by the Taxpayers of the Offshore Bond for £275,000; the Shareholders (each contributing £1,000) and the Company (contributing £23,000 and assuming a £250,000 liability).
b) Mr A provides a guarantee of £85,000 and Mr B provides a guarantee of £165,000 together covering the liability of £250,000 assumed by the Company.

3.2. *Sale by the Shareholders of the Options (3 March 2014)*

a) Sale by the Shareholders of the Options to a third-party counterparty option purchaser.
b) The Options entitle
    i. Mr A to a premium of £85,000 and carries a 5% chance on expiry of requiring Mr A to make a £1.7m gilt settlement to the option purchaser;
    ii. Mr B to a premium of £165,000 and carries a 5% chance on expiry of requiring Mr B to make a £3.3m gilt settlement to the option purchaser.

3.3. *Additional investments into Offshore Bond (3 March 2014)*

a) The Shareholders agree to make an additional contribution into the Bond of £1,000 (each) and, by way of novation, the Options.
b) The additional contribution carries "cooling off" rights giving Shareholders the right (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. "Cooling off" rights do not apply.

3.4. *Expiry of the Options (11 March 2014)*

a) The Options expire out of the money so there is no obligation to make a payment under the Options, but an entitlement (at that stage) for the Offshore Bond manager to receive the £85,000 and £165,000 premiums.
b) The Shareholders exercise their "cooling off" cancellation rights and the novations of the Options are reversed; Mr A is entitled to receive the £85,000 premium and Mr B the £165,000 premium.
c) The Mirror Option expires, and Mirror Option premiums of £250,000 are paid; the Offshore Bond reduces in value by £250,000.
d) The Company is required to meet its outstanding Offshore Bond purchase obligation of £250,000.
e) The Shareholders' premiums are used to meet the Shareholders' guarantee of the Company's liability (see 3.1 b) above).
f) The Company credits £85,000 to Mr A's loan account with the Company.
g) The Company credits £165,000 to Mr B's loan account with the Company.
h) The Offshore Bond is now effectively worthless, and the Company's assets have been reduced by £273,000 (see 3.1 a) above).

4. *Summary of substantive result of the arrangements*

4.1. Mr A receives £85,000 in the form of a credit to his loan account with the Company. Mr B receives £165,000 in the form of a credit to his loan account with the Company.
4.2. The Company's assets reduce in value by £273,000, representing the aggregate of

a) scheme costs of £23,000;
b) £85,000 reflecting the credit to Mr A's loan account with the Company; and
c) £165,000 reflecting the credit to Mr B's loan account with the Company.

4.3. Under the arrangements the Shareholders have not taken any material financial risk and the Company has not been in a position to make a profit.

5. *The tax advantage*

5.1. HMRC's position is that the Shareholders are provided with tax free access to £85,000 in the case of Mr A and £165,000 in the case of Mr B with the aggregate £250,000 being effectively funded by the Company.

6. *Tax results argued for by the taxpayer*

6.1. The Taxpayers argue the Shareholders acquired a gilt option from a third party and hedged the downside risk through the Offshore Bond.

6.2. The Taxpayers argue the £85,000 and £165,000 premiums are exempt from both income tax and capital gains tax under legislative provisions dealing with financial options and gilts.

7. *The likely comparable transaction*

7.1. The purpose of the arrangements is the extraction of value by the Shareholders from the Company.

7.2. The extraction is achieved by exploiting:

a) the Shareholders' no cost ability (thanks to the cooling off right on the additional contribution to the Offshore Bond) to reverse the novations of the Options and so become entitled to premiums of £85,000 and £165,000;

b) the manager of the Offshore Bond's agreement to accept, without reward, the novations of the Options as additional contributions 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).

7.3. 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

a) £85,000 paid by the Company to Mr A with that amount being credited to Mr A's loan account with the Company; and

b) £165,000 paid by the Company to Mr B with that amount being credited to Mr B's loan account with the Company.

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

8.1. 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).

8.2. 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).

8.3. Section 1000 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 the shares in the company" condition is satisfied. The £250,000 benefit that flows from the Company to the Shareholders is split between Mr A and Mr B in their shareholding ratio of 34:66. By way of further confirmation, the IFA Letters open with the words *"I am a shareholder of [the Company]…".*

8.4. The Company is a "close company" and each of Mr A and Mr B 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.

8.5. 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 amount of 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)).

8.6. 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).

8.7. The Taxpayers in representations have made it clear that the benefit arising to the Shareholders is not remuneration (or disguised remuneration) and consistently with that position the Company has not claimed a deduction. HMRC has not argued otherwise.

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

a) for financial options 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.

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

9.1. 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.

9.2. 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 £23,000 and otherwise makes a loss of about £273,000;
b) Mr A is in the position that at worst he loses £2,000 (if his option requires a gilt settlement to be made) and otherwise makes £84,000;
c) Mr B is in the position that at worst he loses £2,000 (if his option requires a gilt settlement to be made) and otherwise makes £164,000;
d) the manager of the Offshore Bond accepts the novations of the Options notwithstanding the expectation that (when coupled with the Mirror Option) the result of those contracts will be the £250,000 reduction in the value of the Offshore Bond portfolio; and

e) the Options counterparty summarised for the Shareholders the effect of the option transaction and novation as follows: *"since the option contract will be novated away from you at the point of execution you will neither benefit from the premium due nor suffer the loss (if it arises); this transaction has no cost to you, no risk to you, nor any benefit to you."* The counterparty was clearly not taking account of the benefit that would arise from the exercise of the Shareholders' cooling off right.

9.3. Our view on the lack of commerciality is consistent with the IFA Letters in which Mr A and Mr B say: *"I should re-iterate that I am acquiring my interest in the [Offshore Bond] and entering into the [Options] primarily for fiscal rather than investment purposes".*

9.4. 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.

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

10. *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)?*

10.1. The principles and policy objectives of the legislation referred to in section 8 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.

10.2. 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 Options settlement date.

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

10.4. Looked at in isolation the Options satisfy the conditions necessary for the premiums to be received free from income tax and capital gains tax. The Taxpayers in effect seeks to argue that the Options should be looked at as a standalone starting point. The Taxpayers say in representations the Shareholders "*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]."*

10.5. In our view the Options were never intended to, and could never, exist in isolation in this case. The Options would only ever be entered into by the Shareholders as part of the arrangements package.

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

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

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

12. ***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)?

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

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

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

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

13.1. 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.

13.2. 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.

13.3. 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."*

13.4. 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.

13.5. HMRC agreed not to pursue its DOTAS argument. We do not accept that, without something express, even if HMRC agreed that arrangements were not disclosable under DOTAS that this would represent acceptance that the underlying arrangements did not involve a tax advantage. There are other conditions that have to be met for arrangements to be disclosable under DOTAS.

13.6. We note that advice provided to the Taxpayers by the Scheme Protagonists in February 2014 expressly warned that *"you must be aware that it is a reasonable expectation you will receive an HMRC enquiry if you decide to undertake the tax planning of which the [Offshore Bond] is a transactional element."*

13.7. We are of the view that the Company has not established the existence of favourable established practice in relation to "no tax advantage" or HMRC's acceptance of that practice.

14. Discussion

14.1. 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 Mr A and Mr B.

14.2. 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.

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

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

14.5. 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 buyer of the note would readily be found meant that on a realistic view of the facts the scheme would proceed as planned that is, 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.

14.6. 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.

14.7. The Taxpayers argue the GAAR is intended to apply "*where the parameters of sensible and proportionate tax planning are not impinged upon"*, 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"*.

14.8. 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.

14.9. 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.

14.10. Each of the circumstances set out in section 207(2) 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.

15. Comment

15.1. We have not been provided with the distributable reserves position of the Company in March 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.

16. 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.