A ‘secret’ appeal

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Mark McLaughlin looks at a ‘hidden’ appeal route for taxpayers, which is not commonly known

Key Points

What is the issue?

HMRC’s approach to company reconstructions seems to have changed significantly in recent times, as has its response to some applications for statutory clearance on the tax effect of transactions such as share-for-share exchanges.

What does it mean for me?

The applicant can require HMRC to refer to the tax tribunal its refusal to give clearance under TCGA 1992 s 138 on a share-for-share exchange or a company reconstruction involving the issue of shares.

What can I take away?

A referral of HMRC's clearance refusal should be considered as soon as it seems probable that HMRC will not be persuaded to give clearance. You may need to ask HMRC to formally refuse clearance, so that you can start the ball rolling.

The tax landscape is constantly changing, whether due to legislative changes, new case law or HMRC practice. One aspect of HMRC's approach that has seemingly changed significantly in recent times is in connection with company reconstructions, and its response to some applications for statutory clearance on the tax effect of transactions such as share-for-share exchanges.

Capital gains tax clearances

For example, on a share-for-share exchange, the vendor shareholders will generally wish to avail themselves of the capital gains treatment in the Taxation of Chargeable Gains Act (TCGA) 1992 s 135 to prevent a 'dry' tax charge (i.e. a tax liability resulting from a sale of shares that generates no cash proceeds).

The effect of the share exchange provisions in TCGA 1992 s 135 for the vendor shareholders is broadly that the 'Newco' shares stand in the shoes of the 'Oldco' shares, so that no immediate capital gain arises on the share disposal. However, this tax treatment does not apply unless the exchange is for bona fide commercial reasons and does not form part of a scheme or arrangement of which the main purpose, or one of the main purposes, is the avoidance of a capital gains tax or corporation tax liability (TCGA 1992 s 137).

A statutory clearance procedure is available to taxpayers in advance of a share exchange (or reconstruction) to confirm whether HMRC is satisfied that the exchange will be carried out for bona fide commercial reasons, and will not form part of a scheme or arrangement as mentioned above (TCGA 1992 s 138(1)).

A further advance clearance application is often submitted to HMRC (under the Income Tax Act (ITA) 2007 s 701) for confirmation that:

- the ‘transactions in securities’
- anti-avoidance provisions are not considered to apply; and
- no notice ought to be given by HMRC to counteract an income tax advantage arising.

This article concerns the capital gains clearance application mentioned above. However, it should be noted that whilst HMRC might give clearance in respect of the transactions in securities provisions (for income tax purposes), this does not necessarily help for the purposes of a clearance application on a share-for-share exchange, which relates to capital gains tax or corporation tax on chargeable gains.

What’s the problem?

There is anecdotal evidence that in mid-2019 some tax practitioners began noticing HMRC was no longer granting clearance under TCGA 1992 s 138 for transactions where it would previously have normally given clearance based on similar transactions.

It is understood that HMRC resisted clearance applications where the transactions were being undertaken in a particular manner (e.g. involving the insertion of a holding company) for reasons that included personal benefit to individual shareholders, with HMRC questioning whether there was any connection with commercial reasons relating to the business carried on by the company.

This approach by HMRC was pursued despite established case law in Clark v Commissioners of Inland Revenue (1976-1980) 52 TC 482. In Clark (a case on the transactions in securities anti-avoidance provisions), the taxpayer was a farmer who held shares in a family investment company (E Ltd), and in a second company (H Ltd), whose only significant asset was a 20% holding in a public company (C Ltd) of which his father was managing director and in which E Ltd held shares. The taxpayer wanted to raise cash to purchase an adjoining farm.

His father wished to keep ownership of C Ltd within the family. The taxpayer sold his shares in H Ltd to E Ltd.

The Revenue (as it then was) issued notices under what is now ITA 2007 s 695. The taxpayer appealed, contending that the shares had been fairly valued and the transactions had been carried out for commercial reasons. The High Court allowed his appeal.

Furthermore, in Commissioners of Inland Revenue v Brebner [1976] UKHL 43 TC 705, the House of Lords held (once again in the context of the transactions in securities legislation) that obtaining a tax advantage is not a 'main purpose' if it is incidental to a larger commercial purpose. The decision in Brebner recognises the taxpayer's right to undertake commercially driven restructuring in a tax efficient manner without any question of unmeritorious tax avoidance thereby arising. In that case, Lord Upjohn said:

'…when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved.'

However, it appears that even where HMRC accepts there is a commercial element to a transaction, it does not necessarily follow that (notwithstanding Brebner) HMRC will accept the transaction is being effected for bona fide commercial reasons and so may not give clearance under TCGA 1992 s 138 (see 'Too late!' below). This is despite HMRC sometimes giving clearance for the same transaction under the transactions in securities provisions, which are concerned with whether transactions are undertaken with a main purpose of obtaining an income tax advantage, as opposed to whether there is a commercial purpose.

What can be done?

All is not necessarily lost if HMRC refuses to give capital gains clearance under TCGA 1992 s 138. The applicant can require HMRC to refer to the tax tribunal its refusal to give clearance under s 138 on a share-for-share exchange or reconstructi on involving the issue of shares (or can refer a clearance application to the tribunal if HMRC fails to give its decision within 30 days of the application or the supply of further particulars).

The referral procedure to the tribunal is as follows (TCGA 1992 s 138(4)):

‘If the Board notify the applicant that they are not satisfied as mentioned in subsection (1) above or do not notify their decision to the applicant within the time required by subsection (3) above, the applicant may within 30 days of the notification or of that time require the Board to transmit the application, together with any notice given and further particulars furnished under subsection (2) above, to the tribunal; and in that event any notification by the tribunal shall have effect for the purposes of subsection (1) above as if it were a notification by the the Board.’

It should be noted that the tribunal considers referrals ‘on paper’, as opposed to the ‘face to face’ hearings that are a common feature of appeal hearings before the tax tribunal.

A referral can therefore be relatively inexpensive. The applicant can ask HMRC to forward the correspondence to the tribunal, and the turnaround is relatively quick in general.

The tribunal referral procedure also applies to refusals by HMRC to give clearance on the transfer of a business (under TCGA 1992 s 139), as it does to refusals to give clearance under s 138 (see s 139(5)).

A referral of HMRC’s clearance refusal should be considered as soon as it seems probable that HMRC will not be persuaded to give clearance. You may need to ask HMRC to formally refuse clearance, so that you can start the ball rolling.

Too late!

I have successfully used the referral procedure on behalf of a client in a company reconstructi on involving the insertion of a holding company prior to a capital reducti on, in circumstances where the purchaser wished to acquire only one of a company’s trades and assets in a ‘clean’ new company.

Unfortunately, in the time taken to (unsuccessfully) argue with HMRC that clearance should be given, and ultimately for the referral to be made and the decision given, the client’s proposed sale of the existing company’s main trade fell through, as the prospective purchaser lost interest in acquiring it.

End of the line?

Of course, HMRC’s refusal to give clearance in the first instance does not necessarily mean the matter should be referred to the tribunal, or that the proposed transaction cannot take place.

If the statutory requirements for capital gains tax relief are met, consideration could be given to carrying out and reporting the transaction and providing additional supporti ng information in case HMRC chooses to make any enquiries.