TAX AVOIDANCE PURPOSE WINNER TAKES ALL (AGAIN)

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I. The Early Tax Bird

Tax specialists learn (or should learn) very early in their careers the importance of persuading others to involve them early on prospective deals. In professional firms, the adviser usually has two clients-the external client and the internal client-for example, in the law firms, tax lawyers work with corporate and finance colleagues. It is important to get "buy-in" from both internal and external clients. You would think that getting that from your own colleagues would be easy enough, but it is not. There could be any number of reasons for this, including simple ignorance of the weight to be given to tax advice, keeping costs down by not involving your own specialists on "your" client files, and assuming that another firm is doing the tax or that it is being done inhouse by the external client. And unless the client relationship emanates from the tax practice, there is the task of getting the external client on board too-which often involves the help of your internal colleagues to do the job of persuasion.

Tax managers working in internal departments of corporates have similar issues with their colleagues working in other areas like treasury, finance, and corporate execution.

Barristers tend to be relatively insulated from these issues. Once in a while, a barrister may get involved in informal mediation between different parts of an institution, sometimes without knowing it! It is also quite common for a barrister never to know what happened to the advice given in conference or by written opinion.

When I was a City tax practitioner, I recall a large group call on a transaction where one banker, presumably unaware that tax specialists were on the call, referred to us as "pond life". Whatever one may think of pond life, the banker was clearly unimpressed with it. I think (and hope) that his is an extreme view, but there is no doubt that we are not always valued as much as we would like to be, and being brought in early can go some way to softening the relationship.

In other situations, there is undoubtedly a judgment call to be made as to whether it is prudent to bring in a tax adviser at a particular point in time or not. In the heady days of tax-based structured finance, when loan relationships were capital assets for corporates, a number of banks set up investment, not trading, subsidiaries to invest in debt instruments on the basis that they were capital assets for those companies. The investment "product" was developed by structured finance teams within the banks, and then put to the investment company board for consideration and approval. The whole process, although done inhouse within the banking group, was quite rigorous and the investor's board took separate legal and tax advice on whether the investment was a "good thing". I remember attending board meetings regularly as an external adviser to the board and being asked for my independent view. In that situation, it made sense for someone like me to be on the record as having advised at the board meeting. But for a tax adviser to attend board meetings in many other situations is perhaps not a good thing, particularly where the impression can be created of placing too much importance on the tax aspects of the subject-matter. HMRC are very alert to this when reviewing documentation in the course of an enquiry, and sometimes get carried away. I have a current enquiry for a multinational client where one of the many points taken by HMRC to demonstrate the tax motivation for a cross-border deal done years ago is the fact that a tax manager from one of the Big 4 attended certain meetings, as part of a large cast. Just like the pond life commentator, HMRC are taking things a bit too far with that sort of reaction to the presence of a tax person.

II. The Late Bird

You would think that, if it is a good thing to bring in tax specialists early, it must be a bad thing to bring them in late. But that is not always the case, as was demonstrated by the First-tier Tax Tribunal in its decision in *Euromoney Institutional Investor PLC v HMRC [2021] UK FTT 61(TC)*. I will come on to what the case was about shortly. But the point I want to make first is that the facts involved an internal tax specialist, the tax director of a corporate group, being brought into a corporate share sale at a very late stage on the seller's side; he then suggested a tweak to the consideration in order to get a tax benefit, and his advice was accepted to by his corporate colleagues as well as the purchaser! Even more impressively, the FTT upheld the availability of the added benefit sought.

III. The Euromoney Facts

So, what happened in the case? The facts can be summarised as follows:

- The taxpayer company, EPLC, was 63% owned by another company, DGMT. The tax director, Mr Flint, was DGMT's tax director, but also provided tax support to group subsidiaries including EPLC;
- EPLC had equity stakes in two joint venture companies, CDL and CNL, of 50% and 49% respectively;
- The other principal shareholder in both companies was DL, a company owned indirectly by DHPLC and directly by DTL-the decision does not expressly say so in terms of DTL's involvement, but this seems to make sense;
- A well-known private equity group, CG, wanted to

buy DHPLC and its underlying investments, including the stakes in CDL and CNL. Negotiations began in September 2014;

- CG also wanted to buy out EPLC's stakes in CDL and CNL;
- EPLC, on the other hand, wanted to acquire a large stake in its fellow joint-venturer, DL; it saw great potential in DL and wanted to be in a position to acquire it in a few years' time. I suppose acquiring DL (or DTL) was a feasible goal as, if CG successfully bought DL, it would have a private equity owner whose aim would be to increase the value of DL with a view to an exit in a few years. A trade buyer would not have the same goal of divestment, so there clearly seemed to be a realistic opportunity for EPLC in the future.

In order to bring together the aims of both seller and buyer, the deal struck was that CG would buy EPLC's stakes for a mixture of equity and cash. The final deal consisted of EPLC selling its holdings in CDL and CNL for US$85m, to be satisfied by a 15.5% equity stake in DTL (reflecting DL's value) and a cash consideration of US$26m. Commercial negotiations were concluded on that basis in October 2014 without any involvement from Mr Flint, or any other tax person.

Mr Flint was then told about the deal and had an idea. What if, instead of the cash element of the consideration, EPLC got preference shares which effectively behaved as deferred cash and were redeemable after an agreed period of months, not years? The idea was neat enough-to get full rollover relief for the sale by turning it into a 100% share exchange, and then to be eligible for the substantial shareholdings exemption ("SSE") when the preference shares were redeemed. The earliest redemption date was fixed so that the shares clearly satisfied the minimum period of holding condition in the SSE conditions. The net result was that payment of the cash element would be deferred but received tax-free on redemption.

Now, there are certain bits in the factual description in the Decision which are a bit unclear. While Mr Flint appears to have suggested that his "pref trick" (who remembers what that really was?) could be implemented for the full $26m of cash, it looks as if it was actually only implemented for $21m, and the balance remained as cash consideration attributable to the sale of the CNL holding. In other words, I think the transaction which was the subject of the appeal to the FTT was the exchange of EPLC's shares in CDL for ordinary and preference shares in DTL. CNL did not feature in this part.

As I alluded to earlier, Mr Flint's recommendation, subject to the variation from $26m to $21m for the preference shares, was adopted by his commercial colleagues-including in particular, Mr Fordham, who was EPLC's Group Managing Director, and who gave evidence along with Mr Flint. The variation was also accepted by CG with no objection-everyone assumed this was an optional extra which had no downside for anyone.

The amended deal was agreed on 5th November 2014. On the same day, Mr Flint applied to HMRC for rollover clearance under Section 135 of the Taxation of Chargeable Gains Act 1992 ("TCGA"). It is a little puzzling that HMRC raised questions on the clearance application on 9th December 2014 because this was outside the 30-day statutory period prescribed in Section 138(2). Perhaps they had asked other questions earlier, so that the period ran afresh from the previous request. Anyway, no-one seems to have objected to what, at first blush, looks like a late response. But the substantive response was dated 19th December and consisted of a refusal to grant clearance. As it turned out, the parties had implemented the exchange on the previous day, i.e., before the outcome of the clearance application was known.

HMRC refused to grant clearance on the basis that they considered that the exchange did formed part of a scheme or arrangements within Section 137(1) TCGA.

To fall outside Section 137(1), the exchange must be effected for bona fide commercial reasons and must not form part of a scheme or arrangements “of which the main purpose, or one of the main purposes, is avoidance of liability to capital gains tax or corporation tax”.

I should say now, so that it requires no further consideration, that there was no dispute regarding the “bona fide commercial” limb of the wording, which HMRC accepted. The battle waged was over the second limb regarding tax avoidance. For brevity, I am going to refer to “the main purpose, or one of the main purposes” as “the predominant purpose”.

There is no impermissible tax purpose to be found in the benefit of rollover treatment itself within Section 135. What appears to be objectionable is for that treatment to be coupled with another tax benefit, and for the obtaining of that second benefit to be a predominant purpose.

The preference shares in DTL (the Decision mistakenly refers to DL) were redeemed for cash on 17th January 2016. EPLC claimed the benefit of the SSE on that disposal. It also claimed rollover treatment for the 2014 share exchange in full despite HMRC’s earlier refusal to grant clearance. The net result was that no tax was payable on either the share exchange or the redemption of the preference shares.

HMRC, on the other hand, took the view that Section 135 did not apply to the share exchange so that, in 2014, EPLC had disposed of its shareholding in CDL and the gain on that disposal was taxable.

The evidence before the FTT, in particular the evidence of both Mr Fordham and Mr Flint, was commendably clear. From Mr Fordham’s viewpoint, the commercial deal was as notified to Mr Flint. The preference share variation was only worth considering if it was straightforward, did not alter the commercial deal, and had no downside. Mr Flint did not think the variation would jeopardise rollover relief for the share exchange consisting of the CDL shares being exchanged for 15.5% of DTL's ordinary shares as had been negotiated before his involvement. His introduction of the preference shares would only have upside. It was no more than "nice to have".

If there had been a risk of rollover relief on the ordinary shares for ordinary shares part of the exchange being denied, Mr Fordham said he would have rejected the preference share variation.

So, the commercial cake had effectively been baked before Mr Flint's involvement: everyone regarded the preference shares as nothing more than icing on the top, with no alteration to the taste of the cake, and the icing only making it look a little prettier. In fact, so unimportant was the availability of the tax benefit that the parties completed the deal a day before HMRC refused clearance.

IV. FTT Findings

The FTT made some strong findings of fact, which may benefit EPLC on appeal:

- The potential tax saving from the preference shares variation was nothing more than a bonus to EPLC;
- Tax was not the main driver of the transaction, which would have gone ahead anyway;
- Had the preference shares been rejected by CG, EPLC would have proceeded with the cash deal anyway (this seems like just another way of expressing the previous finding, but no matter);
- EPLC devoted little time to tax aspects: Mr Flint himself spent no more than 1-2 days in total on the tax planning;

- The clearance application did not hold up the commercial timetable;
- EPLC believed there was no tax downside, which is why the transaction was completed before HMRC's decision. The risk of clearance being refused was regarded as acceptable.

I could not help being amused by the finding about how little time Mr Flint spent on the transaction. It reminds me of the old adage that a tax adviser's worth should be measured by the value added, not by the number of hours spent. You cannot value the "Eureka" moment in the bath by applying an hourly rate.

V. Arguments

EPLC's main argument was simple: the arrangements implemented were entirely commercial. They were driven by commercial, not tax, purposes; those purposes were merely implemented in a tax-efficient way. They did not fall foul of Section 137(1).

Alternatively, the tax avoidance purpose inherent in the preference share variation, was not a main purpose of the arrangements, which must mean the overall arrangements for the exchange including the consideration consisting of ordinary shares in DTL.

HMRC contended that the arrangements were the arrangements for the issue of the preference shares i.e., those arrangements which came into being as a result of Mr Flint's late involvement. The whole of the exchange formed part of that arrangement, the predominant purpose of which, was tax avoidance.

The middle ground which EPLC had assumed would apply if clearance was denied, did not apply according to HMRC. That middle ground entailed saying that the arrangements were indeed those relating to the preference shares, but if they had a predominant tax avoidance purpose, then that should only affect the ordinary shares for preference shares part of the exchange, not all of it.

Two points agreed as common ground between the parties are interesting:

- Section 137(1) was an all-or-nothing provision. If it applied, none of the shares exchanged could qualify for rollover relief, including the ordinary shares;
- The whole exchange formed part of the "arrangements". However, the parties did not agree what the arrangements were.

VI. All-or-Nothing in Section 137(1)

The first point agreed is interesting because it seems to contradict the approach of EPLC to the deal negotiations. The preference shares were only built in on the basis that if Section 137(1) applied, the ordinary shares part of the exchange would survive. It could hardly do so on an "all-or-nothing" approach, as I explain below.

It is not entirely clear what the basis for the "all-or-nothing" approach is since there was no argument about it.

The approach may be based on the Upper Tribunal's decision in *Coll v HMRC [2010] UKUT 114*. This case was mentioned in the Decision, along with the High Court's decision in *Snell v HMRC [2007] STC 1279*. Both cases involved exchanges of shares for loan stock, with the loan stock redeemed by the exchanging shareholders at a point in time when they had become non-resident so as to be outside the UK tax net. The planning for non-residence was found to be a predominant purpose at the time of the exchange. There are no other cases on Section 137(1) decided in higher courts than the High Court. The relevant passage in *Coll* is as follows:

> *"The starting point is that if there is a reorganisation of a company's share capital within s 126 then by s 127 the original*

> *shares and the new holding are treated as a single asset. Either there is a reorganisation of the share capital of a company or there is not; if there is, the same treatment must apply to all the shares. Section 135(3) applies the same approach to a share exchange by treating both companies involved as a single company and the exchange as a reorganisation of the share capital of that deemed single company. Again, this treatment must apply to all the shares if it applies to any of them…. Section 137 says that s 135 shall not apply to any issue in the exchange unless the conditions there set out are satisfied, except that an unconnected shareholder holding 5% or less will in any event qualify under s 135. This also points to all the shareholders being treated in the same way."*

There is a little bit of circularity in this reasoning. For a share exchange to get the 126/127/135 single asset treatment, it needs to be a share exchange satisfying Section 137(1). If it does not do so, then the single asset treatment cannot apply. So, when you are considering the application of Section 137(1) to an exchange, you cannot start with the proposition that it already represents a single asset. That seems to me to beg the question. And if you do not presume singularity, then you look at the actual exchange to see if it is all fine within Section 137(1) or if any of it is not. If the latter, that means you need to identify the arrangements and to see whether the predominant tax purpose colours the whole exchange or just part of it.

I note the UT placed emphasis on the word "any" in Section 137(1) as somehow validating the proposition that the 137(1)-treatment applied to the whole exchange. But this is unconvincing: after all, the word "any" could mean a smaller part of the exchange than the whole. Had it said "all issues" in the exchange or "each and every issue", I can see the force of the *Coll* reasoning.

Unlike *Euromoney*, there was more than one selling shareholder in *Coll*: Mr and Mrs Coll were the two sellers. It is worth noting that the judges' comments in *Coll* reproduced above were made in response to a new argument taken on behalf of the taxpayers that Mr Coll's perceived tax avoidance purpose should not affect Mrs Coll's treatment on the exchange if she did not have the same purpose. This was rejected on the basis that all shareholders should have the same treatment under the "all-or-nothing" approach. To my mind, it does not necessarily follow that the same approach should apply where there is one selling shareholder, but the exchange consists of two different forms of paper consideration, one of which is inserted for tax avoidance purposes. Neither *Snell* nor *Coll* addresses this at all. The *Coll* approach, applying as it did to different shareholders, was more in the nature of "all for one, one for all" rather than "all-or-nothing" in relation to the exchange. The tax avoidance purpose in the *Coll* scenario applied to both shareholders. In *Euromoney*, this was academic since there was only one shareholder: indeed, in *Snell*, there was also in practice a single shareholder-Mr Snell, who owned 91% of the company. The case concerned only his tax position. So, there was no need for the "all for one, one for all" approach, and no need to spell out that the whole of the exchange was affected: Mr Snell exchanged all his shares for loan notes with a view to redeeming them when he had become non-resident. The predominant tax purpose extended to the whole exchange.

EPLC appears to have concluded that the partial approach to Section 137(1) was legitimate. If EPLC had known that the preference share variation could have affected the tax treatment of the whole exchange in a negative way, then it would not have proceeded. This is leaving aside any question of defining what the "arrangements" were. I deal with this next.

VII. Identifying the Arrangements

The passage from *Coll* set out above was in fact adopted by the FTT in *Euromoney* as authority for the proposition that the whole of the exchange, consisting of a single asset, had to form part of the arrangements within Section 137(1). This is not quite what the Upper Tribunal said in *Coll*, but there are probably other ways of arriving at the same conclusion.

The relevant statutory wording requires that the "exchange", which the FTT and the parties took to mean the whole exchange, "does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is [tax avoidance]". Now, if the arrangements are those relating only to the preference shares, it is hard to see how a bigger arrangement, consisting of the overall exchange, can form part of this smaller arrangement. Arguably it cannot as a matter of plain English. The only way in which one might get there is to say that the SSE availability in the future on redemption of the preference shares depends on the status of the ordinary shares, so there is some cross-contamination between the two parts of the exchange such that the ordinary shares part also acquires a tax avoidance purpose. This again can only have happened once the parties decided to go with the preference shares. Until then, there was clearly no tax avoidance purpose.

But that is not what HMRC argued. They said, more simply, that the arrangements were only those involving the replacement of the cash consideration with the preference shares and holding them until the SSE became available on redemption. I struggle with how the wider exchange can form part of this smaller arrangement without some cross-contamination.

So, if you take HMRC's view of the arrangements, they are the preference shares variation of the exchange only. Since that variation is purely tax driven, the arrangements have a predominant tax purpose. On the all-or nothing approach to Section 137(1), it follows that the whole of the exchange did not qualify for rollover treatment.

EPLC, on the other hand, argued that the arrangements cannot be less than the whole exchange as a matter of plain construction of the statutory language. If the whole exchange forms part of the arrangements, then there cannot be a predominant tax purpose. So, on this view of things, the all-or-nothing approach meant that the whole exchange should get the benefit of rollover relief.

The FTT preferred EPLC's view of the arrangements and concluded that, while there was a predominant tax purpose for the preference shares, when one looked at the arrangements as a whole, the predominance did not extend to the ordinary shares part of the exchange, which was a much bigger part. Accordingly, EPLC would be entitled to rollover relief on the exchange and the subsequent redemption of the preference shares qualified for the SSE.

The way in which the appeal was argued raised the stakes considerably higher than the way in which Mr Flint had, with some justification, thought about his own idea. The safest way of concluding there was no downside would have been to say that the exchange itself could be split between a good bit and a bad bit and, if the arrangements, whatever they were, had a predominant tax purpose, then that would taint only the bad bit. But accepting the all-or-nothing approach meant that the splitting treatment was unavailable and the battle had to be won by EPLC on defining the arrangements. As it turned out, EPLC was victorious.

Neither party argued as a fallback that the denial of rollover relief should be restricted only to the exchange for preference shares.

As I said earlier, the case has gone on appeal, and I would expect it to be heard in the summer. Since the UT judge(s) will have the same seniority as the judges in *Snell* and *Coll*, I hope the new judges will take the opportunity to clarify a number of points, both on the "all-or-nothing" approach and on the scope of arrangements. Of course, they may not get a chance to do so on the first topic if it is again agreed as common ground by the parties.

While EPLC succeeded in the FTT, I think another successful outcome is far from clear; but, as a matter of plain common sense, it would be harsh for EPLC to be denied relief for the ordinary shares part of the exchange. Getting to that conclusion, on the basis of the current authorities, is not easy.

VIII. BlackRock

The *Euromoney* case has been lumped together by a number of commentators with an earlier decision of the FTT: *BlackRock HoldCo 5 LLC v HMRC [2020] UKFTT 443 (TC)*. The relevant part of that case relates to tax avoidance purposes again, but this time in relation to the "unallowable purposes" provision for loan relationships in Section 441 of the Corporation Taxes Act 2009. In a nutshell, companies are denied loan relationship deductions which, on a just and reasonable basis, are attributable to an "unallowable purpose" which is not within the business or commercial purposes of the company. A tax avoidance purpose is capable of being a business or commercial purpose, but only if it is not a main purpose, or one of the main purposes, for the company either being a party to the relevant loan relationship or entering into a related transaction e.g., terminating the loan.

The facts of *BlackRock* are complex, and the main thrust of the appeal related to transfer pricing: I suppose I should use the word "main" guardedly given the current topic, but I do so on the basis that the transfer pricing issue took up paragraphs 56-106 of the decision, and the unallowable purpose issue took up only paragraphs 107-122. Whether the unallowable purpose issue had to be adjudicated on at all also depended on the outcome of the transfer pricing issue.

The question at issue was whether a BlackRock special purpose investment company, LLC5, was entitled to tax deductions in relation to loan relationships entered into as part of a larger series of transactions within the group to facilitate a substantial corporate acquisition.

The judge found that LLC5 had both commercial and tax avoidance purposes for entering into and being a debtor party to the loan relationships, and that both those purposes were main purposes. This led him to state that a just and reasonable apportionment was required by Section 441 between the two main purposes. He concluded that, since the tax avoidance purpose did not generate any larger relief than that generated by the commercial purpose on its own, a just and reasonable approach meant that the deduction claimed did not have to be reduced because of the tax avoidance purpose. Quite simply, that purpose did not enhance the amount of the deduction. He had found earlier that LLC5 would have entered into the transaction whether or not the tax relief was available, a little like EPLC. In adopting this approach, he followed the approach of another FTT judge in the decision of *Oxford Instruments UK 2013 Ltd v HMRC [2019] UK FTT 254 (TC).*[1]

BlackRock and *Euromoney* are notable for the fact that the taxpayer was successful in a notoriously difficult area of law involving the sensitive topic of tax avoidance purposes. Both cases will be heard on appeal later this year, so it remains to be seen whether that success survives. Although the relevant statutory provisions in each case are different, there is some commonality in having to identify the approach to be adopted where both commercial and tax avoidance purposes are to be found in the facts. Section 441 requires one to look at a just and reasonable apportionment between the two: there is no such provision in Section 137(1). What is interesting about the just and apportionment approach is that, to this day, there is not a single case where this apportionment was made arithmetically, so as to give the taxpayer a partial tax deduction. Even on a just and reasonable apportionment, as demonstrated by *BlackRock* itself, we remain in "all-or-nothing" territory. In *BlackRock*, the taxpayer got all and HMRC nothing, whereas in *Oxford Instruments*, the position was reversed. To me, this is too much of a lottery even for litigation. We need the higher courts to determine a rational approach to statutory justice and reasonableness.

But if Section 137(1) had a just and reasonable feature, and one asked what would have happened without the preference shares, the answer is that rollover relief would only have applied to the ordinary shares-for-ordinary shares exchange, with the cash consideration giving rise to a tax charge on any gain.

If you build in the preference share feature, then, apparently unlike Section 441, the tax benefit is increased because rollover relief applies to the full exchange. On that basis, it seems just and reasonable to deny relief only for the increase in the rollover brought about by the preference shares.

As it happens, in *Euromoney*, the all-or-nothing pendulum swung towards the taxpayer, so the question of downside risk has so far proved academic. But pendulums can swing the other way.

Finally, given how I started, I thought I should consider what might have happened had Mr Flint been brought in much earlier in the discussions i.e., at the structuring stage. You may say that I am bound to say this, but I believe that EPLC could have been on even stronger ground if the preference share variation had developed as part of the commercial discussions. Of course, evidence is key. As I understand it, CG, the purchaser, originally made a cash only offer, which was then modified by EPLC looking for an equity stake in DTL. Had the preference shares been included in that counter-offer, the commerciality would have looked that much stronger-and the main purpose of securing the SSE might even have been relegated to a tax consequence, not a purpose. This might even have prompted

HMRC to grant clearance. But I accept this is speculation: I just do not want to end with the impression that *Euromoney* is authority for the proposition that it does not matter how late you leave it to bring in tax specialists. Pond life matters!

Endnotes

1. For a detailed discussion of this case, please see my article "Judicial Unallowable Purposes", published in January 2020 in GITC Review, Vol. XVI, No. 2.