Share exchanges: just and reasonable adjustments

Large Corporate

Management of taxes

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New legislation rewrites share exchange anti-avoidance rules, introducing just and reasonable adjustments while keeping the 'main purpose' central.

Key Points

What is the issue?
Court decisions in *Delinian* and *Wilkinson* limited HMRC's ability to deny share exchange relief where tax planning affected only part of a wider commercial transaction. In response, new legislation at TCGA 1992 s 137 allows 'just and reasonable' adjustments where arrangements relating to an exchange have a main tax avoidance purpose.

What does it mean to me?
HMRC can now counteract only the tax-advantaged element of an exchange, potentially preserving relief for unaffected parts or innocent shareholders – but the test of 'main purpose' remains central and contentious.

What can I take away?
The battleground will shift from whether an exchange forms part of a wider scheme to how 'main purpose' and 'just and reasonable' adjustments are applied in practice.

Once in a while (but not often), taxpayers win cases in the courts where there is an alleged tax avoidance element. This happened in *Delinian Ltd (formerly Euromoney Institutional Investor plc) v HMRC* [2023] EWCA Civ 1281 and *Wilkinson and others v HMRC* [2023] UKFTT 695 (TC). Both cases related to share exchanges for capital gains purposes – corporation tax on chargeable gains in *Delinian*, where the taxpayer was a company; and capital gains tax in *Wilkinson*, where the taxpayers were individuals.

The question in both cases was whether the taxpayers could claim share reorganisation relief under Taxation of Chargeable Gains Act (TCGA) 1992 s 135, or whether relief should be denied because a main purpose of the exchange was for tax avoidance under TCGA 1992 s 137(1).

The taxpayers won both cases – in *Delinian*, quite emphatically, as HMRC lost at every stage up to the Court of Appeal – and the matter did not proceed to the Supreme Court.

HMRC clearly did not welcome these decisions. So much so, that it has introduced changes to the reorganisation provisions, now contained in the current Finance Bill, to counter the effect of those cases. The word 'spoilsports' comes to mind. This analysis proceeds on the basis that the draft legislation will be enacted in its current form.

I am closer to the *Delinian* decision than to *Wilkinson*. I thought the courts were right in their conclusions, and I derived considerable comfort from being able to point to a decision (particularly for foreign clients) demonstrating that not all cases involving tax avoidance go against the taxpayer. And what a decision – victories in the First-tier Tribunal, the Upper Tribunal and the Court of Appeal!

Unlike the taxpayer, HMRC can propose changes to the law when it loses a case. If the government considers it appropriate to do so, it simply legislates.

The cases

The case of *Delinian*

In *Delinian*, a corporate seller, EPCL, sold its stake in another company. The original consideration was to consist mainly of shares, with the balance in cash. However, at the behest of a tax director who was brought into the negotiations at a late stage, the (taxable) cash component was replaced with preference shares so that the entire consideration took the form of shares. The transaction would then qualify for rollover relief under TCGA 1992 s 135. Further, because of the terms of the preference shares, their future redemption would also be tax free by virtue of the substantial shareholdings exemption. It was argued that even if there was a tax avoidance purpose in replacing cash with preference shares, it was not a main purpose of the overall arrangements under s 137(1). Relief, therefore, should be available for the entire exchange.

HMRC disagreed. It argued that the whole exchange formed part of a scheme with a main tax avoidance purpose. Relief should be denied in full, not merely in respect of the portion of the exchange involving the preference shares. There was, it argued, no scope for dissecting the exchange into a ‘good’ part and a ‘bad’ part.

The case of *Wilkinson*

Wilkinson involved several members of a family selling shares in a successful business for a consideration consisting of shares and loan notes. The appellants consisted of the mother and father, and their three daughters. The parents received a mixture of loan notes and cash for their shares, whereas the daughters received shares and loan notes. As part of the family’s capital gains tax planning, the daughters had been gifted shares by their parents before the sale and sold those shares to the third-party purchaser as part of the overall transaction. Their loan notes were structured to be redeemed a year and a day after the sale so as to qualify for entrepreneurs’ relief. The daughters also sold their consideration shares at that time to an affiliated company. There were other selling shareholders, but they were not involved in the appeal.

The critical question was whether, under s 137(1), the exchange of shares and loan notes by the appellants formed part of a scheme or arrangements with a main purpose of tax avoidance.

This necessarily required identifying the relevant scheme or arrangements. The First-tier Tribunal found that this was the overall commercial deal to sell the company to the third party: the exchanges formed part of that broader transaction. The family's capital gains tax planning was not a main purpose of that overall deal. In addition:

- The substantial bloc of other minority shareholders had no involvement in the capital gains tax planning.
- Even for the appellants, the value of the capital gains tax planning represented only a very small part of the total financial gain (about 4%).
- The purchaser could have withdrawn if dissatisfied with the capital gains tax planning – it was not a condition of the deal.
- It was clear that the appellants would have proceeded with the sale even without the capital gains tax planning.

The structural difficulty in s 137(1)

There is an inherent difficulty with s 137(1) and with HMRC's arguments. Section 137(1) permits relief only if the exchange 'does 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'. There is a separate limb dealing with bona fide commercial reasons, but that is not relevant here.

The total exchange must not form part of the scheme or arrangements. In plain English, the words 'form part of' suggest that the scheme or arrangements must be larger than the exchange itself.

But if the scheme relates only to part of the exchange (and a small part at that), as it did in both *Delinian* and *Wilkinson*, how can the exchange form part of that? It is rather like trying to fit an elephant into a Mini – and the original 1959 model at that! Admittedly, the elephant would not fit into the current model either.

In *Wilkinson*, the 'scheme' was the wider commercial transaction, not merely the exchange, and that broader transaction clearly did not have tax avoidance as a main purpose. I am not convinced you always need to identify a larger 'scheme or arrangements' where there is no main tax avoidance purpose. However, it remains necessary to test whether the exchange can properly be said to form part of the scheme which is said to have a tax avoidance purpose. If the alleged scheme is smaller than the exchange, there is no proper fit. Nor is there scope for distinguishing a 'good' part from a 'bad' part of the exchange if the latter is sufficiently significant to make tax avoidance a main purpose of the whole exchange.

The Budget proposal

A significant difficulty for HMRC under the existing wording of s 137(1) was precisely this conceptual issue. The new legislation seeks to address it. The legislation contains other features too, but my focus is on the substantive issue concerning the relationship between the exchange and the relevant arrangements.

Section 137(1) has undergone a dramatic makeover. Gone is the reference to bona fide commercial reasons (they did not add much anyway). Gone is the problematic wording about what 'forms part of' what. The new s 137(1) only applies to 'arrangements relating to an exchange'. Corresponding changes have been made to reconstruction relief in s 136, but I am concerned only with exchanges here. The revised s 137(1) and new s 137(1A) state:

1. This section applies in respect of arrangements relating to an exchange as regards which s 135 applies if the main purpose, or one of the main purposes, of the arrangements is to reduce or avoid liability to capital gains tax or corporation tax.

1A Any such reduction or avoidance that would (in the absence of this section) arise from such arrangements is to be counteracted by the making of such adjustments as are just and reasonable (in light of the reduction or avoidance).

Had this wording applied in *Delinian*, rollover relief would presumably have been denied only in respect of the part of the exchange involving preference shares. In *Wilkinson*, appropriate adjustments would have been made in relation to the five Wilkinson family members, while the other sellers would have been unaffected.

Two further changes are worth mentioning. The 5% safe harbour in s 137(2) has been repealed. The apparent thinking is that minority shareholders will in any event be protected unless their exchange forms part of the tax avoidance arrangements – in which case there is no good reason to spare them.

The new provisions apply to the issue of consideration shares or debentures by a purchasing company on or after 26 November 2025, subject to certain transitional protections for clearance applications made before that date. HMRC has published interim guidance in an appendix to the Capital Gains Manual at CG-APP19.

Perhaps the most important new concept is the introduction of 'just and reasonable' adjustments for arrangements with a main purpose of tax avoidance. This phrase has been the subject of much judicial scrutiny in the context of loan relationships for unallowable purposes (Corporation Tax Act 2009 ss 441 and 442). Broadly, those provisions deny tax relief for funding costs to the extent that a corporate debtor has a loan which has 'unallowable purposes'. Section 441(3) provides that:

'The company may not bring into account for that period for the purposes of this Part so much of any debit in respect of that relationship as on a just and reasonable apportionment is attributable to the unallowable purpose.'

Section 442 defines ‘unallowable purpose’. Unlike the former s 137(1), which treated bona fide commercial purposes separately from tax avoidance, s 441 effectively conflates the two concepts. An unallowable purpose cannot be among the business and commercial purposes of the company. Section 442(4) states that a tax avoidance purpose can qualify as a business or commercial purpose only if it is not a main purpose of the company in entering into or being party to the loan relationship.

If the deduction for funding costs relates to a business or commercial purpose (which may include a tax avoidance purpose, provided it is not a main purpose), then it is allowable. This is quite a sophisticated way of allowing apportionment. A cruder alternative would simply have been to outlaw all tax avoidance purposes, whether a main purpose or not.

Despite the apportionment mechanism, the courts have not been enthusiastic about permitting apportionment where the facts show several purposes, including a main tax avoidance purpose. In recent legal decisions – particularly those of the Court of Appeal in *BlackRock HoldCo 5 LLC v HMRC* [2024] STC 740 and *Kwik-Fit Group Ltd v HMRC* [2024] STC 897 – apportionment was rejected because the deductions were held to be wholly attributable to the tax avoidance purpose. As Falk LJ observed in *Kwik-Fit*: ‘In summary, it is an objective exercise which requires apportionment by reference to the relevant purposes. The exercise is a fact-specific one.’

Notably, there is no express apportionment wording in the new s 137(1A). In the context of unallowable purpose situations, apportionment is appropriate because the focus is on a single corporate taxpayer, its reasons for entering into (or remaining party to) a loan relationship, and the amount which it has claimed by way of deduction. That amount may be reduced in appropriate cases, if there are several purposes. This is a purely quantitative exercise – especially as, to date, the higher courts have rejected apportionment in favour of an ‘all or nothing’ approach. The deduction is held to be wholly attributable to a tax avoidance main purpose, and therefore denied: all for the Exchequer, nothing for the taxpayer.

There is no apportionment wording in the new s 137(1A). In s 137 cases, there may be one or more taxpayers entering into the exchange, and each may have different purposes. The common tax objective is the deferral of capital gains tax liability under s 135. HMRC's interim guidance indicates that this deferral alone will not trigger s 137 – something more in the way of tax avoidance is required for it to be engaged.

Accordingly, it is easy to see that in the case of multiple sellers, it is perfectly straightforward for relief to be given to those who seek no additional tax benefit beyond rollover. No adjustments under s 137(1A) are required for such 'innocent' sellers.

The 'just and reasonable' treatment applies only to the tax-avoiding seller. Suppose, as in *Delinian*, the seller receives a mixture of ordinary shares and preference shares, the latter designed with a further tax objective beyond rollover. Under s 137(1A), it is now beyond doubt that rollover relief is available for the ordinary share-for-ordinary share exchange, even if denied for the ordinary share-for-preference share exchange. This is just and reasonable. The adjustment would operate to deny relief only in respect of the latter.

Of course, the battleground will remain the identification of a 'main purpose'. It will also remain contentious in cases where a taxpayer would not have entered into any part of a *Delinian*-type exchange – ordinary and preference shares alike – without the expectation of the enhanced tax benefit.

The ‘just and reasonable’ feature in the unallowable purposes provisions is quantitative, whereas under the new s 137(1A) it is qualitative. In the former, you look at the amounts only in determining what is just and reasonable. In the latter, you look at the nature of what was done to determine which parts, if any, should be denied relief – and, in cases of multiple sellers, the result may differ for each.

It is inevitable that the ‘just and reasonable’ wording in s 137(1A) will be tested in the courts. One hopes that the judiciary will in due course recognise that the phrase serves a different function here from that in the loan relationships regime.

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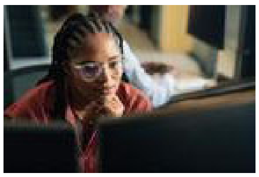

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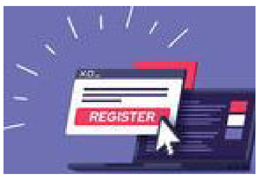

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