

Miller's Tales VI

DAVID ADAMS TC00048

Mr Adams got himself into bother over the form of his election under TCGA 1992, s 138A. Section 138A provides that, where there is an earn-out right in a transaction and the earn-out right consists of a right to receive further shares or securities in the purchaser, the right itself will be treated as a security such that the gain on that element of the consideration will also be rolled over until the earn-out shares or securities have, themselves, been disposed of.

Mr Adams sold his company, MPM Adams Ltd, for a mixture of cash and shares. Included in the consideration was an earn-out contingent on performance targets, to be satisfied by the issue of further shares of the purchaser company. Mr Adams's then accountants had, in April 1999, applied for clearance under TCGA 1992, s 138 that the Board of HMRC was satisfied that the share-for-share exchange element of the transaction was carried out for *bona fide* commercial reasons and not part of a scheme or arrangements for the avoidance of capital gains tax, so that TCGA 1992, s 135 would apply to that component of the transaction. His advisers also asked for confirmation that s 138A would apply to the earn-out right.

HMRC granted clearance under s 138 but only in the normal terms, that the Board of HMRC was satisfied that TCGA 1992, s 137(1) would not deny the rollover on the share-for-share exchange element. This is the only clearance that HMRC is entitled to give and the clearance letter specifically did not refer to any confirmation as to the application of s 138A.

The transaction completed in May 1999 and Mr Adams's 1999/00 tax return was completed, by new advisers, on the basis that the only element of the consideration subject to capital gains tax for that year was the cash element. No enquiry was made into this return.

Some element of the earn-out consideration was received, as in his 2002/03 return Mr Adams showed proceeds of £913,000 in respect of the earn-out shares.

HMRC opened an enquiry into that return, specifically into the capital gains. The Inspector contended that no election

Pete Miller, Powrie Appleby LLP, writes about some more recent tax cases that have taken his interest. The article looks at three cases that introduce some interesting questions of procedure

had been made under s 138A, that the clearance application did not constitute such an election and, furthermore, that an election could not be made because there was a cash alternative in the earn-out right. It should be noted that this last point, that no election would have been valid because of the cash alternative, does not appear to have been pursued in front of the Tribunal and was, therefore, only referred to in passing by the judges.

HMRC raised an assessment under TMA 1970, s 36 on the basis of fraudulent or negligent conduct of Mr Adams, or of somebody acting on his behalf, in order to make good to the Crown the loss of capital gains tax. Section 36(3) allows the person on whom the assessment is made to require effect to be given to any relief or allowance that might have been available for the relevant chargeable period had it been claimed within the normal time limits.

The Tribunal judges identified four questions to be answered.

1. Was a valid election made under s 138A in the tax return, or in the tax return as read together with the clearance application?

2. If not, was there negligent conduct by someone acting on Mr Adams's behalf (HMRC had accepted that Mr Adams himself had not been negligent, presumably on the basis that he had taken professional advice both in terms of the clearance application and his various tax returns)?

3. If there was a loss of tax, was Mr Adams entitled to effectively claim the benefit of s 138A *ex post facto*, on the basis of s 36(3)?

4. If not, was the loss of tax attributable to any negligent conduct?

The main body of the judgment discussed the question of whether there had, in fact, been a valid election under s 138A. HMRC's technical expert stated that Mr Adams had to elect for the s 138A treatment in a notice made to HMRC but

accepted that there was no prescribed form and the election did not have to be made in a return. He referred to various guidance notes on completion of tax returns but accepted that these documents did not have any legal force. Counsel for Mr Adams contended that the tax return and computations, read with the clearance application, constituted a valid election under s 138A.

Both parties relied on the decision in *Gallic Leasing Ltd v Coburn* [1991] STC 699. In that case the dispute had been over whether the company had made a valid claim to group relief. Mr Ellis, HMRC's technical expert, distinguished the case on the basis that in *Gallic Leasing* there had been a reference to group relief and the Inspector had not been under any misapprehension. In contrast, Mr Adams's return made no reference to s 138A: HMRC was not required to infer an election and it was not sufficient for the taxpayer merely to have made a return as if the election had been made. Mr Ellis also distinguished the case on the basis that *Gallic Leasing* was about making a claim, whereas Mr Adams was required to make an election.

Julian Ghosh QC, Counsel for Mr Adams, suggested that there was no difference between a claim and an election. He submitted that the principles derived from *Gallic Leasing* were directly applicable to Mr Adams: if there is no prescribed form for a claim, the taxpayer can choose how to make the claim; documents can amount to a claim even if they do not expressly say so; it is sufficient that HMRC is alerted to the fact that the taxpayer is seeking the treatment resulting from a claim and that the Inspector could not be under any misapprehension; and there is no minimum information requirement if HMRC has not imposed one. He noted that Mr Ellis's predecessor in the case had accepted that reading the clearance application and the returns together made it clear that s 138A

treatment was intended to be claimed and he also said that there was no difference between a claim and an election.

In coming to their decision, the judges suggested that the requirement in s 138A that 'a notice' be given clearly required a document of some sort and not merely an oral claim. However, in the absence of any other prescribed form of election, this was the only requirement. The computations in Mr Adams's tax return clearly showed that the capital gain which Mr Adams considered chargeable was on the basis that the earn-out consideration was not immediately taxable, but was deferred as if s 138A applied and the judges noted that Mr Ellis, one of HMRC's witnesses, had accepted that the only explanation for the exclusion of the deferred consideration was that s 138A applied. Mr Ellis had also accepted that notice of the election did not have to be given in the return and that there was no requirement for a document containing the word 'election' or the equivalent, or a reference to s 138A. The judges concluded that the requirement for a notice of election was only to alert an inspector that reliefs were sought by a taxpayer and that 'any officer with sufficient knowledge of the law who received the return with the computation could not have been under any misapprehension that the appellant [Mr Adams] wished s 138A to apply', even if the Inspector receiving the return had not been aware of the clearance application. So the judges found that a valid election had been made in the return and, indeed, that there was no requirement to read the return in conjunction with the clearance application.

Having found that a valid election had been made, there was no need to answer the other questions but the Tribunal judges considered them in case they were wrong on the main issue.

Most importantly, the judges considered that TMA s 36(3) was in point, so that Mr Adams could have required that effect be given to TCGA s 138A in this case, which would have had the effect of negating the assessment raised by HMRC, so that there was no loss of tax in this case. As noted above, HMRC did not pursue the argument that a claim under s 138A would not be valid because of the cash alternative.

In terms of whether there might have been negligent conduct, the judges found that Mr Adams was 'fully entitled to rely on his professional advisers', so he could not be said to have been negligent.

In considering whether any of the advisers had been negligent, they noted



Pete Miller

that the Inspector who opened the enquiry had observed that 'I can appreciate that you may feel that such an election [under s 138A] was made on time'. And at a meeting in November 2007 HMRC's technical expert had said that he would have to take further specialist advice as to whether an election had indeed been made. The judges took these as evidence that 'any error by the appellant's agents was not unreasonable'.

Finally, the judges did find that, if they were wrong on all previous points, the question of negligence would depend on how the question was asked. If there was negligence in failing to make an election, there would not have been a loss of tax to HMRC. On the other hand, if the question was whether somebody had been negligent in submitting an incorrect return, then the judges agreed that the appropriate causal connection would have been present.

Comments

There are some important procedural lessons to be learned in this case. First, it is imperative that any claims or elections to be made should be clearly shown on the face of the return, not merely by giving effect to them but by stating explicitly what is being claimed. While Mr Adams won the day, he no doubt incurred substantial expenses in defending his position and probably suffered a great deal of worry along the way. All of this could have been prevented by the simple addition of a few extra words to his tax returns.

On the other hand, I suggest that HMRC might ask itself why it considered this to be an appropriate case to pursue.

Once it had decided not to argue that s 138A was not in point, it is difficult to see what HMRC hoped to gain: either the tax return, possibly read in conjunction with the clearance application, constituted a valid election under s 138A; or Mr Adams could have required HMRC to give effect to s 138A by virtue of s 36(3). In either case, there would have been no loss of tax, so why did HMRC take this case?

AJ EBSWORTH TC00152

This is a case about the application of the transactions in securities legislation and whether transactions were undertaken for tax avoidance purposes. The legislation referenced in the case was at ICTA 1988, ss 703 to 709. Insofar as it applies to individuals, that legislation is now at ITA 2007, ss 682 to 713.

Mr Ebsworth held 51% of the shares of Business Systems Applications and Solutions Ltd (BSAS1) and his wife held the other 49%. The network division of the company sold landline telecommunications networks to business users and this division was very profitable. There was an agreement with WorldCom whereby BSAS1 received substantial commissions (around £80,000 per month by 2001) from WorldCom. WorldCom also had a right to take over the customer base and end the commission payments in return for a lump sum termination payment to BSAS1. BSAS1 also had a hardware division, which supplied business telephone handsets. This division was not particularly profitable and was worth very little.

Mr and Mrs Ebsworth separated in 1998, although they continued to run the company together. In 2001 WorldCom terminated the commission agreement and paid a termination payment of £2,164,050. Shortly before this Mr and Mrs Ebsworth had set up a new company (BSAS2) held in the same proportions as BSAS1, but Mrs Ebsworth then transferred her shares to Mr Ebsworth. Since this was a new company it is assumed that the parties agreed that there was no value in these shares.

Shortly after terminating the WorldCom agreement, BSAS1 sold its hardware division to BSAS2 (now wholly owned by Mr Ebsworth). BSAS2 then entered into a new agreement with WorldCom in respect of the network business. In the meantime, BSAS1 was placed into members' voluntary liquidation and capital distributions of around £800,000 were made to each of Mr and Mrs Ebsworth.

HMRC considered that the transfer of the business of BSAS1 to BSAS2, followed by the liquidation of BSAS1 so

that Mr and Mrs Ebsworth received capital sums, rather than dividends or distributions of profits from BSAS1, potentially contravened s 703, so that counteraction should be taken. No counteraction was taken against Mrs Ebsworth, who took no part in the business of BSAS2, had no shares in BSAS2 and was, as a result of the liquidation, giving up all her shares in BSAS1. However, counteraction was taken against Mr Ebsworth, who continued to run the business through BSAS2 rather than through BSAS1.

Many arguments were put for both sides and judge Adrian Shipwright's decision runs to 103 paragraphs over 30 pages. This article will restrict the discussion to what I consider to be the more important arguments.

1. Was there a tax advantage?

2. Did the tax advantage arise in consequence of a transaction in securities?

3. Were the transactions carried out for *bona fide* commercial reasons and not for the avoidance of tax?

Section 703 requires there to be a tax advantage which, of necessity, requires there to be a comparison between the position achieved for Mr Ebsworth – the capital receipt – and a receipt in some other form which would have been chargeable to tax as income. The judge noted that HMRC was 'not clear in precisely formulating their argument nor how the mechanics would work'. Indeed, HMRC apparently changed its view during the hearing, requiring an adjournment of the proceedings. In the end, HMRC apparently contended that the comparator would have been a purchase by BSAS1 of the shares held by Mrs Ebsworth, prior to the receipt of the termination payment from WorldCom. It is not clear from the judgment why the purchase of own shares should have been carried out before this payment, rather than afterwards, but the significance of this transaction is that ICTA 1988 ss 219 *et seq* would have allowed Mrs Ebsworth to apply for clearance that any sum received by her would be treated as capital, overriding the provisions of ICTA 1988, s 209(2)(b) that anything over and above the original amounts subscribed for her shares should be treated as a distribution. HMRC's position appeared to be to assume that such clearance would have been forthcoming, on the basis that Mrs Ebsworth was exiting from the business and would have no further involvement in running the company. If Mr Ebsworth had wanted to extract funds from BSAS1, he would have had to do so by way of an income distribution, hence

the contrast with the capital sum that he actually received.

The judge first commented that a purchase of own shares would require financing and that HMRC had not suggested any way in which such funds might have been available, prior to receipt of the termination payment from WorldCom. Furthermore, one of the conditions of s 219 is that there be a benefit to the trade from the purchase of own shares (these provisions are often used, for example, as a way to get rid of a dissenting shareholder from a company) and that HMRC had not indicated how either the network trade, now arguably ceased, or the hardware trade would have been benefited from a purchase of Mrs Ebsworth's shares. It was not, therefore, clear that capital treatment would have been available to Mrs Ebsworth on such a transaction.

Judge Shipwright said that 'the simplest route and most commercially sensible route in my view would have been to liquidate BSAS1 and for Mr Ebsworth to buy Mrs Ebsworth's share of the hardware business'. Such a transaction would have given both Mr and Mrs Ebsworth capital receipts arising from the liquidation, so that there would have been no tax advantage in comparison to the transactions actually carried out. He concluded that HMRC had not shown that a tax advantage was obtained as a result of the transactions.

The judge went on to consider whether, if he was wrong on the question of whether there had been a tax advantage, that tax advantage arose in consequence of a transaction in securities, or the combination of the liquidation and a transaction in securities.

By way of background, a pure liquidation of a company is not considered to be a transaction in securities for the purposes of the application of this legislation (arising from comments made by the minister at the time the legislation was enacted: '... liquidation is not a transaction in securities any more than is the payment of a dividend on shares' (*Hansard*, 25 May 1960, Col 511)). On that basis, the only transactions in securities were the issue of shares by BSAS2 to Mr and Mrs Ebsworth and Mrs Ebsworth's subsequent transfer of her shares to Mr Ebsworth. HMRC took the view that BSAS1 could not have been liquidated without the previous transfer of its trades to BSAS2. Judge Shipwright took an alternative view that, as noted previously, BSAS1 could have been liquidated and its activities distributed

in specie to Mr and Mrs Ebsworth such that Mrs Ebsworth could then have transferred her part of the business to Mr Ebsworth. As noted, these would have been capital transactions for both Mr and Mrs Ebsworth and, in any case, this would have been a normal liquidation and would have had no nexus with the issue or transfer of shares in BSAS2. As a result, the judge found that any 'alleged tax advantage (assuming there to be one)' was not in consequence of any transaction in securities.

Finally, he considered whether the escape clause, whereby transactions carried out for *bona fide* commercial reasons and not for tax avoidance purposes are not susceptible to counteraction under the transactions in securities legislation, applied. In the decision itself, he concludes fairly briefly that 'considered as a subjective matter of intention the main purpose or one of the main purposes was not the avoidance of tax or the obtaining of tax advantages ... the predominant motive was to bring the business and personal ties [of Mr and Mrs Ebsworth] to an end.' Therefore, even if there was a tax advantage and that tax advantage arose in consequence of a transaction in securities, the escape clause would apply and the transactions in securities legislation could not be used to counteract those tax advantages to Mr Ebsworth.

We need to look, however, at the evidence given in this case in order to understand how Judge Shipwright came to this view. The majority of the evidence for Mr Ebsworth was given by Mr Ebsworth himself. He clearly had a detailed recollection of the circumstances surrounding the transactions and his separation from Mrs Ebsworth, as reproduced in the case report. Judge Shipwright found this evidence compelling. He stated, for example, that 'I found Mr Ebsworth a careful and honest witness who tried to help the tribunal. I accept his evidence in full.' Furthermore, he said 'I am not persuaded by HMRC's suggestions particularly the suggestion that his evidence was "self serving".'

HMRC clearly suggested during the hearing that notes made by Mr Ebsworth's tax advisers were evidence of a tax avoidance motive. Judge Shipwright rejected this contention by saying that the notes 'were what one would expect from a tax adviser engaged to advise on tax'. He went on to say that 'taking tax advice does not of itself make tax avoidance one of the main objects of the transactions concerned'.

Mr Ebsworth, therefore, won his

appeal on the basis that there was no tax advantage, if there had been a tax advantage it was not in consequence of any transactions in securities and, in any case, the transactions were carried out for *bona fide* commercial reasons and not with a view to obtaining a tax advantage.

Comments

The procedural interest in this case is that there are hints throughout the judgment that HMRC's presentation of the case was not particularly helpful. For example, the judge himself commented that HMRC had been unclear as to how to determine whether there had been a tax advantage in this case and that HMRC did not conclude on the transaction against which a comparison needed to be made until part way through the hearing, requiring an adjournment to allow Mr Ebsworth and his advisers to consider this new argument. This suggests that HMRC perhaps rushed into counteraction and then into defending its assessment, without having properly considered the detail of its case.

I also find this case interesting for the Tribunal judge's comments as to the plausibility of the evidence given by the chief witness, the appellant himself. In contrast to a number of other cases, the judge felt the witness to be honest, open and helpful and not self-serving. This is a lesson to all appellants and witnesses in front of a Tribunal: as the Tribunal is the primary fact-finding body for any tax appeal, it is the plausibility and apparent honesty of the witnesses that will be paramount in helping the judges reach decisions of fact, particularly if there is no other evidence of those facts. In this case, Mr Ebsworth's evidence as to the motives behind the transactions was clearly vital in helping him win his case.

The case is also important in reminding all of us, HMRC included, that people are entitled to take tax advice from tax advisers – indeed, that they should always do so in complicated situations – and that taking tax advice does not somehow taint any transactions carried out as being tax-driven.

Finally, I think that this case also adds further judicial support to the decision in the case of *Trevor G Lloyd SpC 672* (see Miller's Tales IV) that there is an important distinction between whether transactions are themselves commercial and whether the reasons for carrying out those transactions are commercial. HMRC's arguments suggest to me that it considered that the transactions were unusual and that a more straightforward approach could or should have been taken to achieve the required aims of the parties,

such that HMRC considered that the unusual transactions were evidence that they were not commercial transactions, or that they were not carried out for *bona fide* commercial reasons.

As the judgment makes clear, once the transactions are found to have been carried out for *bona fide* commercial reasons, the fact that they might be unusual, or that they are not the simplest approach to achieving the target, is not relevant.

PHILIP JOHN WRIGHT TC00177

Mr Wright's case is mainly interesting for the procedural issues. The substantive case related to whether certain sub-contractors working for Mr Wright should have been treated as his employees; there were sums of just under £160,000 each of income tax and National Insurance contributions at stake. In 2005 the original case was heard by the General Commissioners, who found for Mr Wright. The Inland Revenue, as it was then, appealed and the judge decided (see [2007] STC 1684) that the General Commissioners had not answered the right question. The case was therefore remitted to the General Commissioners for consideration of that question.

There were substantial delays in the case, which was transferred from the General Commissioners to the Special Commissioners and was eventually heard by a Special Commissioner on 26 March 2009. Since 1 April 2009 we have had the new unified Tribunal system, with a First-tier Tribunal that covers the functions of both the old General and Special Commissioners, so this element of the procedural discussions is no longer relevant.

By the time the case came to the Special Commissioner, Mr Wright was no longer represented. The Special Commissioners had, however, offered to sit in Colchester, Mr Wright's home town, rather than London. Mr Wright had indicated that he did not, in any case, intend to appear at the hearing, as he felt it was not fair that the case should be heard again. In the event, the case was heard by the Special Commissioners sitting in London.

In early 2008 a Special Commissioner had issued Directions as to how the case should proceed. One of these, Direction 13, provided that 'no further documentary or witness evidence should be admitted unless the parties agreed or the tribunal directs'. There was no such agreement by the parties or direction by the Tribunal. Directions 15 and 16 required core bundles and skeleton arguments to be served 14 days before the hearing.

Nine days before the hearing HMRC sent amended witness statements to the

Tribunal and to Mr Wright, along with a copy of the original Revenue bundle for the General Commissioners hearing. No core bundle or skeleton arguments were served prior to the hearing, regardless of Directions 15 and 16. The Special Commissioner found in favour of HMRC. In the current proceedings, the Tribunal was asked whether that decision should be set aside in the interests of justice.

In terms of the issues that are still relevant, the judge noted, firstly, that the original hearing before the General Commissioners had involved oral witnesses appearing for the appellant, whereas before the Special Commissioner four years later the only witnesses were for HMRC. The judge observed 'it is the type of case where the inequality of arms is particularly unfortunate'.

The judge also noted that the hearing in London was on a date when Mr Wright's adviser was not available. To be fair, neither HMRC nor the Special Commissioner had been aware that Mr Wright was being assisted on a *pro bono* basis by a retired tax adviser. Mr Wright had merely indicated that his 'friend' was not available for the proposed hearing date but had not explained the significance of that friend. Nevertheless, it appears that the Tribunal judge took the absence of representation into account in reaching his decision that the case should be reheard.

Finally, and perhaps of most current relevance, is the fact that HMRC had not complied with the Directions that had been originally given by the Special Commissioner in early 2008. For example, while there had been no agreement between the parties or direction by the tribunal that new evidence should be brought, HMRC had submitted amended witness statements, contrary to Direction 13. And HMRC had not served core bundles or skeleton arguments at least 14 days before the hearing, as required by Directions 15 and 16. The observation of the judge was that, despite Mr Wright having said that he had no intention of appearing at the hearing, 'if the Revenue had complied with the Management Directions and done so in proper time this may well have caused the appellant to think again about not attending'.

Comments

This is another of those unfortunate cases where the appellant did not help himself: indeed, with a little effort Mr Wright might have avoided some of the difficulties that have arisen. For example, he could have explained that his 'friend' was actually a professional adviser, so that

HMRC and the Special Commissioner might have been minded to rearrange the hearing for a date when the adviser could be present. Similarly, despite considering that the necessity for a rehearing of the case was unfair, if Mr Wright had been less adamant about not attending the hearing, the Special Commissioner might have sat in Colchester in the first place, which would have been more convenient for Mr Wright. Since neither of these things happened, it is perhaps not surprising that HMRC 'strongly pressed' the Special Commissioner to hear the case in the absence of Mr Wright.

Conversely, it is unfortunate that HMRC did not comply with the Special Commissioners' Directions as to case management. It served amended witness statements when Direction 13 expressly denied it the right to do so and failed to serve core bundles or skeleton arguments, in contravention of Directions 15 and 16. All of this suggests a cavalier approach to the procedural requirements, a situation which looks even worse in the case of an unrepresented taxpayer. If Mr Wright had been professionally represented, these procedural discrepancies would have been picked up and brought to the Special Commissioner's attention. Once again,

perhaps, we see the inequality of arms at work in this case.

Since HMRC was aware (or at least believed) that Mr Wright was unrepresented, one might have hoped that in the interests of justice it would have accepted an adjournment and given Mr Wright another chance to consider whether to appear to appoint an adviser. Instead, its approach seems to have been swayed by delays in correspondence. It is interesting, therefore, that the Tribunal judge made it clear that HMRC was not, itself, blameless in terms of delays in this case.

CONCLUSIONS

These three cases bring out some interesting issues. In two of them, the taxpayers concerned could have acted very differently and perhaps avoided hearings altogether: Mr Adams (or his advisers) could have been more explicit about the s 138A election, and Mr Wright might have explained his position more clearly to the Special Commissioner.

But HMRC could also have acted differently in bringing each of these cases to a just conclusion. It is difficult to see why Mr Adams's case came to the Tribunal at all, as he had either made a

s 138A election or was entitled to be treated as if he had, by s 36(3). And HMRC could arguably have been more understanding of Mr Wright's predicament and should in any case have complied with the Special Commissioner's Directions. Had it done so, the need for yet another hearing of the case, with associated extra costs from the public purse, might have been avoided.

As far as Mr Ebsworth's case is concerned, the main procedural issue is that HMRC does not seem to have been particularly thorough in preparing its case, as demonstrated by its uncertainty regarding how to determine whether there was a tax advantage at all. Better preparation of the arguments might have led HMRC to a realisation that there was no tax advantage, so that no hearing would have been necessary. Alternatively, if HMRC had been able to put a more robust case, the Tribunal decision might have been different.

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