

Advanced Corporate Tax Planning

Recent case-law

by

Philip Simpson

**Advocate ~ Barrister
Chartered Tax Adviser**

I. Introduction

It has been a fruitful year for cases relating to corporation tax,¹ and some of the decisions of tribunals from Special Commissioners up to European Court of Justice provide useful guidance as to tax planning. Although sometimes the Revenue responds to decisions by closing loopholes,² some cases provide more general points that may be used by advisers in future. These are the types of cases principally discussed below.

II. Associated companies

The first case to consider is *Commissioners for Her Majesty's Revenue and Customs v. Salaried Persons Postal Loans Limited* [2006] EWHC 763 (Ch). It concerns associated companies and the small companies' rate limits. In the relevant years,³ the rate of corporation tax⁴ a company paid depended on whether its profits were below £300,000, above £300,000 but less than £1.5 million, or above £1.5 million.⁵ These limits were reduced if the company were associated with any other companies. Two companies were associated if, in short, one controlled the other, or both were controlled by the same person or persons.⁶ The monetary limits were simply divided by the number of associated companies, including the company for whom the limit was being set. However, an associated company 'which has not carried on any trade or business at any time' in the

¹ Including capital gains tax.

² A recent example is *Davies v. Hicks* [2005] EWHC 847 (Ch.). The loophole was that shares disposed of were matched with shares acquired within the following 30 days, even where the person disposing of them was non-resident at the time of the subsequent acquisition.

³ Financial years 1998 to 2001. See section 13 ICTA 88.

⁴ In the relevant years, the main rate of corporation tax was 30% (see for example Finance Act 1999, section 27; and Finance Act 2000, section 35); the small companies' rate was 19%; and for financial years 2000 and 2001 the starting rate of corporation tax was 10% (Finance Act 1999, section 29; and Finance Act 2000, section 35).

⁵ The starting rate of corporation tax, now abolished (Finance Act 2006, section 26), was introduced by Finance Act 1998 with effect from financial year 2000 onwards. It is not relevant for the purposes of the present paper.

⁶ Section 13(4) ICTA 88, *in fine*. Note the expansion of the controlling third party: he need just be a 'person', so control by an individual, or a partnership, or a trust would count.

accounting period in question, or in the part of it during which the association endured, was to be disregarded.⁷ Thus, if a company had three trading associates, the limits were divided by four; but if one of those associated was not trading, the denominator would be only three. The latter scenario made it more likely that the company would suffer a lower rate of corporation tax.

In *Salaried Persons Postal Loans Limited*, four companies were 'associated' for the purposes of section 13 of the Income and Corporation Taxes Act 1988. However, one of them, a company called Malcolm Muir Limited ('MML'), did not do very much. Having operated a money-lending business, it ceased trading in 1995. Thereafter, it owned a single asset, being an office building that it rented out through an agent. Rent reviews were carried out automatically, according to a formula in the lease. MML did not have a bank account: rent cheques were paid direct to one of the other three companies, who acted as banker for all four. An inter-company balance existed, but no interest was received or paid. Apart from that, MML had two directors, but no employees; did not pay any directors' fees; did not make any distributions; and did not purchase or own any other assets. But it was inferred that MML had also insured the building as the lease required it to do and collected insurance premiums from the tenant, MML's annual accounts showed that it was not dormant, and MML's objects as per its memorandum of association included letting property. The Revenue thought that MML should be taken into account in determining the applicable limits for corporation tax; the group argued no, on the basis that MML had 'not carried on any trade or business'. After the Special Commissioners agreed with MML that it should not be taken into account, the Revenue appealed to the High Court.

⁷ Section 13(4) ICTA 88.

The first point made by Lawrence Collins, J., was that although the things a company did would not necessarily constitute a 'trade or business' for the purposes of the rules, there was a rebuttable presumption that they did: *American Leaf Blending Co SDN BHD v. Director-General of Inland Revenue* [1979] A.C. 676. This seems fair enough – the average company is no more than a vehicle for carrying on a commercial enterprise. But where, for example, a company is merely a vehicle for owning its principal's holiday home, which is not rented out, and is indeed not even used by anybody else, this presumption may be overcome: *John M Harris (Design Partnership) Limited v. Lee* [1997] S.T.C. (S.C.D.) 240. The same is true where a company has ceased its trading activity and simply holds money in a bank account, even while it waits for payments for services it rendered while carrying on its trade: *Jowett v. O'Neill* [1998] S.T.C. 482. Though not dormant, the company is not carrying on any 'trade or business'. But the least amount of trade will prevent a company from being disregarded. So, where a company's memorandum includes the object of carrying on investment business, the company will be trading if it holds shares in another company, owns a building that is rented out and lends money at interest: *Land Management Limited v. Fox* [2003] S.T.C. (S.C.D.) 152.

It was agreed that MML was not carrying on a trade.

The decision as to whether MML had been carrying on business was one of fact. Accordingly, the question for the High Court was not whether the Special Commissioner was right, but whether the Special Commissioner's decision was reasonable: *Edwards v. Bairstow* [1956] A.C. 14. Lawrence Collins, J., held that it was. One of the points the judge took into account was that there was no avoidance scheme in operation in the case:

the company had simply ceased trading (money-lending), and decided to rent out its old premises instead of selling them.

Standing back from the detail of the case, the arguments presented to Lawrence Collins, J., clearly demonstrate the difficulties in the approach to statutory interpretation that is presently *à la mode*, namely purposive construction: what did Parliament intend? Whereas the Revenue argued that section 13 was a targeted anti-avoidance provision,⁸ the taxpayer argued that it was a relieving provision.⁹ Both of these propositions were clearly tenable; both derived from the wording of the provision; yet they contradict each other. Part of the difficulty may be that before one can ascertain what Parliament's intention was in enacting a particular provision, one must have a basic idea as to that provision's meaning. So in a sense, one must decide what the provision means in order to decide what the provision means.

In any event, the planning point in this case is that groups whose total profits are less than £1.5 million must take care with any dormant¹⁰ companies or companies whose activities are restricted. First, dormant companies should be left dormant: this way, they are not taken into account. But second, although there is a lacuna between a dormant company in company law terms and a company that carries on a trade or business, its scope is not clear. Having a separate company that is virtually inactive and whose profits are small could push the remaining companies in the group into a higher tax rate. Thus, as far as

⁸ Paragraph 40 of the judgment.

⁹ Paragraphs 50 and 51 of the judgment.

¹⁰ For a company to be 'dormant' for the purposes of company law, it must undertake no transaction that will result in a significant accounting transaction, other than the receipt of subscription money for issuing shares: Companies Act 1985, section 249AA. Such a company is clearly non-trading for the purposes of section 13, ICTA 88.

tax is concerned, it may be better to keep investments that produce low amounts of income in one of the principal trading companies in the group.

III. Capital gains tax

A number of cases have considered capital gains tax, whether on individuals or as it applies to companies.

A. Capital v. income

The first three can be grouped under the heading of 'capital v. income'. Two occurred in the context of company acquisitions; the third was an avoidance scheme involving loan notes with irregular payment profiles.

In *Triage Services Limited v. Commissioners for Her Majesty's Revenue and Customs* [2006] S.T.C. (S.C.D.)85, Triage Services Limited ('Triage') was the vehicle for an MBO of part of the business of an ICL company, ICL Sorbus UK Limited ('Sorbus'). The business was computer repairs. The MBO was effected by means of a number of contracts. Under one of those contracts, the sale and purchase agreement, Triage acquired certain assets, leases and employees from Sorbus, and paid Sorbus £8 million. The £8 million was said to be paid by way of consideration for 'the business', and was not further allocated to the different elements of the acquisition. Triage was also to assume Sorbus' liabilities relating to the business being sold. Under another of those contracts, the repair services agreement, Sorbus agreed to offer Triage service work that would be worth gross fees of £63 million over seven years. The evidence showed that the £8 million paid under the first contract had been calculated by reference to the revenue promised under the second contract. Triage argued that it was accordingly a revenue and not a capital payment, and could therefore be deducted in full in the year of the MBO.

The Special Commissioners regarded the question for them as being ‘whether these features distanced the payment from the more common capital payments paid for goodwill on taking over the totality of a trade as a going concern’.¹¹ In other words, one would expect the £8 million to be a capital payment; this was the starting point of the Special Commissioners; and Triage therefore had to show something to displace what would normally be the result of such transactions.

In its accounts Triage added acquisition costs of £220,000 to the £8 million, and deducted the part of the payment (£349,000) that related to fixed assets. This left £7,871,000, which was amortised on a straight line basis over seven years.¹²

The main point made in evidence was that the only correct accounting treatment was to capitalise the payment so far as it related to goodwill and amortise it over an appropriate period.¹³

The argument Triage made was that although the payment had been a lump sum, it was a payment to secure the repair services agreement. This was an ordinary commercial contract that would generate trading income, and the sum paid to secure it was therefore revenue in nature. Crucially, it was said, Triage did not take over any customer contracts and was precluded from using Sorbus’ name to trade under. Accordingly, the payment was not for goodwill, although *faute de mieux* it had been treated as such in Triage’s accounts. Accordingly, it was sufficiently distant from the type of payment the Special Commissioners had described.

¹¹ At 87. It should be noted that this case related to facts prior to the change in the rules relating to the tax treatment of intangible fixed assets: see Finance Act 2002, section 84 and Schedules 29 and 30. This made it crucial to obtain revenue treatment, not just for cash-flow purposes: otherwise, no deduction would be allowed at all so far as the payment related to acquired goodwill. But the fact that the circumstances pre-date the change in legislation does not affect the significance of the decision on the point whether a payment is capital or revenue in nature.

¹² At 94.

¹³ At 94.

The Revenue argued that the fixed assets were in truth worth more than the written down value of £349,000; that Triage's approach failed to give any value to the transferring employees; and that what Triage had done was acquire a new business, rather than make a payment to increase future revenue of an already existing business. The price had simply been determined by reference to future earnings that were to include a certain, guaranteed income stream.¹⁴

The Special Commissioners first pointed out that Sorbus had disposed of assets, or perhaps a part of its business; but Triage had acquired what was for it a complete business, notwithstanding that it wished to extend it in various ways. The reason that customer contracts and the trading name had not been taken over was that they were tied to the part of Sorbus' business that was not sold. So Triage acquired a repair services business as a going concern.¹⁵ The Special Commissioners pointed out that the £8 million was paid under the SPA and not under the repair services agreement, although they did not think that crucial.¹⁶ The deciding points for them were (i) that Triage would not have been able to carry out the work offered to it under the repair services agreement if it had not also acquired the assets of the business, (ii) that there was considerable value in the tangible assets, premises and employees that Triage took over from Sorbus, and (iii) even taking the repair services agreement on its own, the expenditure referable to it had been made 'once and for all ... with a view to bringing into existence an asset or an advantage for the enduring benefit of the trade'.¹⁷

What practical points may be taken from this?

¹⁴ At 95.

¹⁵ As indeed the parties had described it in the SPA for value added tax purposes.

¹⁶ At 97.

¹⁷ The Special Commissioners quoting the dictum of Lord Cave, L.C., in *British Insulated and Helsby Cables Limited v. Atherton* [1926] A.C. 205, 10 T.C. 155.

Although not crucial so far as the Special Commissioners were concerned, it seems clear that in slightly different contexts consideration is more likely to receive revenue treatment if allocated in the contractual documents between fixed assets and revenue-generating contracts entered into at the time. This would be particularly so if the contract entered into can be regarded as the extension of an existing business, rather than as the acquisition of a new business.

Second, the accounting treatment Triage had used was rather a give-away. Indeed, not only had it capitalised the whole of the payment in its accounts and deducted it over seven years, but the expert evidence (it is not clear who instructed the accountant's report, but it was probably Triage) was that this was the only correct accounting treatment. Indeed, the Special Commissioners were rather surprised that this should also be the tax treatment contended for by Triage: if the payment truly was revenue in nature, then it ought simply all to have been deducted in the year in which Triage became liable to pay it.¹⁸ That Triage decided to spread the payment over seven years was held against it. So the practical point here is that one must be consistent and, if necessary, go further than one might like in order to achieve as good a position as possible for persuading the court that one's approach is correct. Triage may have thought that if they claimed only one-seventh of the amount each year this would have been regarded as less objectionable, and therefore as more likely to be allowed, whether by the Revenue or by the Special Commissioners. But if they wanted revenue treatment they should have given revenue treatment, and deducted the whole expense in the year of acquisition.

The Special Commissioners also pointed out that no case was cited in which expenditure had been correctly treated as capital for accountancy purposes but was a revenue expense

¹⁸ At 98.

for tax purposes.¹⁹ So it is crucial to be able to regard an expense as revenue for accounting purposes if one is to be able to persuade the court that it is revenue for tax purposes.

Finally, this case remains important notwithstanding the new rules on intangible fixed assets. The reason is that those rules apply after it is determined that an intangible asset is a fixed one.²⁰ In other words, if an intangible asset is revenue in nature, then one need not go anywhere near Schedules 29 and 30 to the Finance Act 2002.

The second case is *British Telecommunications plc v. Commissioners for Her Majesty's Revenue and Customs* [2006] S.T.C. (S.C.D.) 347, and this went in favour of the taxpayer rather than the Revenue. The Special Commissioner (Dr J. Avery Jones) held that the receipt in question was revenue, and not capital.

The facts were that British Telecommunications plc ('BT') had entered into a conditional merger agreement with MCI Communications Corporation ('MCI'). The agreement allowed each party, in certain circumstances, to renege from the deal, on payment of a fee. The particular circumstance of someone else, namely Worldcom, making MCI a better offer transpired, and so MCI terminated the merger with BT. Under a termination agreement Worldcom paid BT the fee, being \$450 million plus expenses. The Revenue sought to charge the \$450 million to tax as a capital gain, rather than as revenue. It argued that it was a capital sum derived from assets within section 22 of the Taxation of Chargeable Gains Act 1992 ('the 1992 Act').

¹⁹ At 98.

²⁰ See paragraphs 3 and 4 of Schedule 29 to the Finance Act 2002. Intangible fixed assets are (i) assets acquired or created for use on a continuing basis in the course of the company's activities and (ii) goodwill. It is not clear how one might regard the repair services agreement as an asset that would be 'used' on a continuing basis.

The Special Commissioner regarded the difference between the parties as being whether the payment had been made under the merger agreement, in implementation of its terms, or for BT's giving up its rights under that agreement, in which case there would be a surrender or forfeiture of assets and the sum would fall within section 22(1)c) of the 1992 Act, and went on to hold that neither of them was right.

First, the payment had been made by Worldcom pursuant to a separate, tripartite agreement. It could not be said to have been paid under the merger agreement at all.

Second, by the time of the payment BT's rights under the merger agreement were of little value: the merger agreement permitted MCI to recommend the Worldcom offer to its stockholders, without payment of any penalty to BT.

So the real reason for the payment was that Worldcom wanted to obtain BT's and MCI's agreement to the release of BT from its obligations under the merger agreement not to vote its existing, 20% shareholding in MCI otherwise than in favour of BT's merger with MCI, and to persuade BT instead to support Worldcom's bid. Of course, if successful, Worldcom would in addition have to pay BT for its shares, but that would be a separate capital receipt. So the payment by Worldcom did not derive from any asset, and was accordingly not capital.

One point to mention. An issue in the case arose as to whether the payment was made under the agreement between MCI and BT. It is clear that if it had been, capital treatment would have been more likely. The mistake the parties made in this regard was for the payment to flow directly from Worldcom to BT under a separate agreement. Although the taxpayer succeeded in any event, its case would have been bolstered by this approach.

The third and final case under this head is *Cadbury Schweppes plc v. Williams (HM Inspector of Taxes)* [2006] EWCA Civ 657, 24th May 2006, on appeal from [2006] S.T.C. 210, a decision of Etherton, J. This case concerned the accrued income scheme and its application in the context of an avowed tax avoidance scheme, marketed as such by Kleinwort Benson. Under the scheme, a Cadbury group company issued loan notes to the group company that wanted to realise a capital gain. Interest on the loan notes was at a fixed rate, and was simple interest. But interest was to be paid on certain days in specified amounts, and the amounts were not in fact equal to the interest that had accrued up to the relevant payment date, and indeed were not related by the loan note instrument to any particular period at all. Whenever the loan notes were redeemed, a final interest payment would be made so that the total interest over the life of the note was the specified, simple rate. The loan notes were sold early, before redemption. HMRC considered that they were variable rate securities for the purposes of the accrued income scheme, and fixed a just and reasonable amount that was to be included in the seller's income under Schedule D Case VI for the year in question.

HMRC's argument was, in short, that whether the interest rate was fixed or variable depended not on what the loan notes said but on whether the amount of interest paid on any payment date was, by reference to the period since the preceding payment date (or the issue date), the same on each of the payment dates. The consequence of the variable payment profile used was that the interest rate was variable, and the fact that the loan notes stated the interest rate to be fixed was irrelevant.

Cadbury's argument was that the legislation would be unworkable if HMRC were correct. In particular, it would mean that a loan note issued on 31st December with

simple interest payable at a fixed rate but in equal instalments on the last business day of each month would be a variable rate security, because there would be a different number of days between the last business days of successive months. Thus, dividing the payment made by the time elapsed since the last payment would produce a number of different results, and therefore different interest rates, so that the interest rate would be variable.

For the future, the point to take is that unless the statute says otherwise, interest expressed in a loan note to be at a fixed rate will be treated as such (i) notwithstanding that there is an irregular payment profile, but (ii) provided that the interest paid is not related to any specific period within the life of the loan note.

B. Tax avoidance as main purpose

The next case to discuss concerns the rules on exchanges of shares for loan stock, and in particular the question as to whether one of the main purposes of the particular transaction is tax avoidance.

Snell v. Commissioners for Her Majesty's Revenue and Customs [2006] S.T.C. (S.C.D.) 296 concerned the exchange of shares in a company, Sovereign Rubber Limited ('Sovereign Rubber'), for loan stock. Mr Snell was the principal shareholder in Sovereign Rubber. He wanted to sell up and spend more time on other pursuits. In consideration for the sale of his shares, he received loan notes, and claimed deferral relief under section 135 of the 1992 Act. In the course of the same tax year, he went non-UK resident, and then redeemed his loan stock in the following tax year. Of course, at the date of redemption, he was not within the charge to UK capital gains tax, so if he had successfully deferred the crystallisation of gain on the disposal of the shares he would

escape capital gains tax entirely. The question was accordingly whether the deferral relief available under section 135 of the 1992 Act could be claimed.

It was common ground that the exchange had to have been carried out for *bona fide* commercial reasons, and that it must not have been part of a scheme or arrangement one of the main purposes of which was avoidance of liability to capital gains tax.²¹

The question of *bona fide* commercial reasons depended on the approach to be taken. The Special Commissioners held that this issue concerned the reason for undertaking the transaction, and not the reason for choosing the particular means of executing the transaction. In other words, was the end achieved by the transactions a *bona fide* commercial end? On that basis the overall transaction was carried out for *bona fide* commercial reasons.

This is clearly the right approach. The overall purpose of realising one's investment in a company is normally *bona fide*, and was so on the facts of this case. The issue became whether the transactions by which this end were achieved were acceptable as a means of reducing the tax burden resulting.

One of the main purposes of the particular means of executing the overall transaction had been tax avoidance. The key finding of the Special Commissioners was that prior to the sale process starting, Mr Snell had already decided to go non-resident afterwards, at the end of the tax year: he had even gone to the extent of discussing with the Jersey authorities a possible application for residence there.²² It was accordingly clear when the sale of Mr Snell's shares was being planned that if he could sell them prior to going non-

²¹ Section 137 of the 1992 Act. In a case involving a company, the tax whose avoidance must not be striven for is corporation tax.

²² See paragraph 9(15) and (16). Unfortunately for Mr Snell, even after selling £8 million of shares he would not have enough capital to obtain a residence permit: see paragraph 9(16).

resident but defer the gain until the tax year after he had gone non-resident,²³ he would avoid UK capital gains tax altogether. On the facts, Mr Snell had had a sufficiently definite intention to go non-resident in the tax year following the disposal, and accordingly to be non-resident when the capital gain realised on the disposal became chargeable, as to make his purpose in obtaining loan notes in return for the shares one of tax avoidance.²⁴

The lesson to be taken is the same as was to be taken from *R. v. Inland Revenue Commissioners, ex parte Fulford-Dobson*.²⁵ One must go non-resident before the disposal and, in the present state of the law, postpone the disposal until the tax year after one become non-resident. But it must be said that I think there is a basis in European law for challenging the rule that one is resident for a whole tax year, at least in so far as this issue arises in connection with intra-EU migration, and accordingly for challenging the nature of split-year treatment in those circumstances as concessionary only. But that is for another day.

A further point in relation to this case relates to evidence. Mr Snell's problem ultimately was that the Special Commissioners did not believe his evidence that his intention to go non-resident did not become sufficiently definite until after the disposal. The Special Commissioners pointed out in particular that his 'evidence about his late change of intentions would have been more credible if backed up by evidence from his family but there was no such evidence.' So where one is relying on evidence as to intention, one must always consider whether sources other than the taxpayer (and, of course, the

²³ Split year treatment on a concessionary basis under ESC D2 would not have been available: see the well-known case of *R. v. Inland Revenue Commissioners, ex parte Fulford-Dobson* [1987] S.T.C. 344.

²⁴ See in particular paragraph 13 of the Special Commissioners' decision.

²⁵ Cited above, note 23.

relevant documents) may be available to support the taxpayer's word. And if oral evidence can be obtained from independent third parties, so much the better.

C. Groups

The next category to consider is capital gains tax in the context of corporate groups. Two cases were decided in the past 12 months.

By way of introduction, it may be recalled that a transfer of capital assets between two companies in the same group is deemed to be made at a no gain / no loss consideration.²⁶

This enables a group to obtain, in effect, group relief for capital losses. If a group company is about to make a capital gain by selling an asset to a person outside the group, it can first transfer the asset to a group company that has capital losses to relieve. The transfer is at no gain / no loss. So the gain remains unrealised until the transfer by the second company to the third party. The second company makes the gain, but can deduct its capital losses in order to determine the taxable gain.

This possibility led to three tax avoidance structures. First, a group with unrealised capital gains would buy a company that had unrelieved capital losses. After the acquisition, the assets pregnant with the gains would be transferred to the acquired company. That company would realise the capital gain, set off its pre-entry capital loss, and achieve a profit without having to pay any tax. This was combated by the provisions in Schedule 7A of the 1992 Act. Second, the reverse structure was used. So a company with unrelieved capital losses would buy a company with unrealised gains. Following the acquisition, the assets in question would be transferred to the acquiring company, and then sold outside the group. Again, a profit was realised without a corresponding tax burden. This was combated by Schedule 7AA of the 1992 Act. Further provisions were

²⁶ The 1992 Act, section 171.

made to prevent the so-called 'envelope trick', by applying a de-grouping charge when companies left a group following an intra-group transfer.²⁷

The first case decided in the past year concerns pre-entry losses. *Five Oaks Properties Limited and others v. Commissioners for Her Majesty's Revenue and Customs* [2006] UKSPC 00563 concerned a number of groups of companies and whether pre-entry losses could be set off against gains accruing after the disposal of one of the groups by another. A company called Aridgrove Limited ('Aridgrove') acquired assets in 1994. At that time, Aridgrove was a member of the Conrad Ritblat group of companies. In 1997, the Ritblat group acquired a further group of companies, namely the Speciality Shops group. The new group was called the Milner group. The Milner group acquired the Five Oaks group of companies in 1998. In 2002 the Delancey Estates group acquired the Milner group. Finally, in 2001 the Tribeca group acquired the Delancey group. Thereafter, Aridgrove sold the assets it had acquired in 1994, realising a few millions of capital gains. Some of the companies that had become part of the various groups had capital losses. The question arose as to whether those losses were pre-entry losses in relation to gains on Aridgrove's assets, and therefore unavailable to set off against those gains. The point was that the legislation appeared to make those losses available for all the companies that became part of the Tribeca group on the same day, regardless of whether they had become part of the acquired group at the same time or at different times.²⁸

The difficulty was that where one group acquires another, together they are treated as a single group.²⁹ The argument ran that if a loss was incurred by a company after the

²⁷ Sections 179 ff. of the 1992 Act.

²⁸ See in particular paragraphs 1(6) and 7(3) of Schedule 7A to the 1992 Act.

²⁹ Section 170(10) of the 1992 Act.

company became part of the acquired group, then it was not a pre-entry loss in relation to the acquiring group either, because together the two groups were in fact the same group. But this was rejected. So losses incurred by companies that the Ritblat group acquired to form the Milner group (i.e. Speciality Shops companies) or that the Milner group acquired as part of the Five Oaks group were not available to set off against the gains on Aridgrove's assets.

The planning point to be taken from this is simply that one must be very careful when advising on corporate acquisitions. If use of capital losses is financially relevant to the deal, full details must be obtained about the history of the corporate structure and the dates on which losses and gains have been realised. This must be followed by an extremely detailed reading of the legislation in order to ascertain exactly what losses are pre-entry losses in relation to which of the companies involved. And the legislation is far from easy, as is demonstrated by the Special Commissioner's description of the arguments in Five Oaks and of his own tribulations in working out what the legislation was intended to mean.³⁰

The second case, *Johnston Publishing (North) Limited v. Commissioners for Her Majesty's Customs & Excise* [2006] UKSPC 000564, concerns the de-grouping charge. The issue arose in this way. The United Media Group of companies included companies called United Provincial Newspapers Holdings Limited ('UPNH') and United Provincial Newspapers Limited ('UPN'). But they were in different 'legs' of the group: in other words, neither was the parent company of the other, whether directly or indirectly, though both were ultimately controlled by the same third company, namely United News & Media plc. They were sister companies. Taken on their own, they were not part of the

³⁰ For the arguments, see paragraphs 4 and 5 of the decision; for the result, see paragraph 10.

same group, and were therefore not 'associated' for the purposes of the provisions on intra-group transfers.³¹ In that state of affairs, UPN sold some operating subsidiaries to UPNH, for £310 million. This was treated as a transfer at no gain / no loss.³² UPNH then acquired the entire issued share capital of UPN, again intra-group. A few months later, the United Media Group sold UPNH to a third party, at which time UPNH and UPN ceased to be members of the United Media Group.

Because UPNH owned UPN at the time of de-grouping, those two companies were 'associated' at that time. Accordingly, it seemed that no de-grouping charge would arise: section 179(2) of the 1992 Act:

'Where two or more associated companies cease to be members of the group at the same time, [the provision imposing a degrouping charge] shall not have effect as respects an acquisition by one from another of those associated companies.'

However, the Revenue argued that there was a further condition, namely that the companies must have been associated also at the time of the no gain / no loss intra group transaction. It assessed the de-grouping charge as falling to be determined by reference to a capital gain of £280 million. Tax plus interest was estimated as being approximately £100 million by the time of the hearing before the Special Commissioner.

It was already clear that the provision was badly drafted. It had previously been interpreted as implying not only that the associated companies must leave the present group at the same time, but must thereafter remain associated.³³ The Special Commissioner looked to what he saw as the function of the charge to tax. This was to align fiscal gains to economic gains. If an asset entered a group, there should be no charge to capital gains tax unless and until it left that group. It was not until leaving that

³¹ See section 179(10) of the 1992 Act.

³² Pursuant to section 171 of the 1992 Act.

³³ *Dunlop International AG v. Pardoe* [1992] S.T.C. 459 (H.C.J.); [1999] S.T.C. 909 (C.A.).

group that the economic unit consisting of the group would get the economic benefit of the increase in capital value.³⁴ If an intra-group transfer had taken place, the group got the economic benefit of the increase in capital value of the asset transferred if it sold the transferee company. It was in those circumstances that the de-grouping charge bit.³⁵ But if transferor company and transferee company themselves formed a group, the asset remained in that (sub-)group. However, this accorded with the purpose of the legislation only if they had formed a group at the time of the transfer too. If they did not, then there had already been a transfer between groups, albeit both groups were sub-groups of one, larger group.

This was the first time this point had come before a tribunal for decision, notwithstanding the 38 year history of the provisions.³⁶ The Special Commissioner accepted a submission that tax legislation had been rather more loosely drafted in 1968 than it now was, the reason being that the Parliamentary draftsman was nowadays more alive to the need to prevent tax avoidance.³⁷

So far as planning is concerned, the point to take from this case is that where transfers are being made intra-group, for example to utilise capital losses, if possible they should be made so that both transferor and transferee company form part of a group if looked at on their own. This means that should the companies be sold off in the future, no de-grouping charge will arise.

Second, the case reminds us that tax indemnities given in the context of corporate transactions involving the purchase of companies from another group must refer to de-

³⁴ See per Hoffmann, J., in *Westcott v. Woolcombers Limited* [1986] S.T.C. 182.

³⁵ See section 179(1) of the 1992 Act.

³⁶ See paragraphs 82 and 22 of the Special Commissioner's decision. It had been introduced by Finance Act 1968.

³⁷ See paragraph 92 of his decision.

grouping charges on assets sold intra-group to any of the companies being sold within the six years prior the transaction.³⁸

D. Roll-over relief

The next case to mention is *Balloon Promotions Limited and others v. Commissioners of Her Majesty's Revenue and Customs* [2006] S.T.C. (S.C.D.) 167. Apart from the human interest supplied by the fact that counsel for Balloon Promotions Limited ('Balloon') was Viscount Dilhorne, formerly a law lord, the case is important, in particular to the question of when goodwill exists, and accordingly whether there is any qualifying asset for the purposes of roll-over relief. The taxpayers were Pizza Express franchisees. They agreed with Pizza Express that the latter should take over the businesses. To that end the franchises were to terminate. Most of the money paid by Pizza Express was described in the contract as being in respect of goodwill, with the remainder being allocated to plant and equipment, premises, termination of the franchise agreement, and restrictive covenants. The franchisees claimed roll-over relief when they re-invested the money received for goodwill. The Revenue denied that any relevant goodwill had existed, and accordingly refused the claim. Before the Special Commissioner there was no real dispute as to the law: as foreshadowed by the Revenue's reasons for refusing the claim for relief, the issue was a factual one as to whether the payments by Pizza Express had truly been made for 'goodwill', as that term was used for the purposes of roll-over relief in the 1992 Act.

The Special Commissioner (Michael Tildesley) held that the accounting definition of goodwill in SSAP 22 was deficient for the purposes of the roll-over relief provisions. In

³⁸ See the reference in paragraph 83 of the Special Commissioner's decision.

particular, it allowed other intangible assets to be regarded as goodwill.³⁹ Goodwill was to be looked at as a whole, and included whatever added value to a business by reason of situation, name and reputation, connection, introduction to old customers and absence from competition.⁴⁰ It was not helpful to categorise goodwill zoologically, by reference to various types of animal.⁴¹

The Special Commissioner then held that the labels the parties attached in their agreement to what was being sold were not conclusive: accordingly, if the labels were wrong it was perfectly competent for the Revenue to correct them.⁴² There was no rule of law that in the case of a franchise arrangement the only goodwill capable of existing independently of the franchisee's running of the business was owned by the franchisor, in virtue of his ownership of the trademarks and so on that were part of the business.⁴³ So the question was a mixed one of fact and law, fundamentally as to whose goodwill was it. It is clear that the answer depended on close consideration of a wide range of circumstances, but the fundamental element seems to have been the extent to which the franchisees could control their operation. Thus, the fact that Pizza Express laid down no hard rules for layout, uniforms, ingredients, or wines, and did no advertising suggested that any goodwill was built up by the franchisees' own efforts: it was those efforts that led customers to return. This conclusion was supported by the fact that Pizza Express was not a well-known brand at the time (eighties and early nineties), and so, for example, could not charge an initial lump sum fee to new franchisees, by contrast with other better-

³⁹ Paragraph 152 of his decision.

⁴⁰ Paragraph 163 of the decision.

⁴¹ Paragraph 169 of the decision. The animals in question are, of course, dogs (attached to person), cats (attached to place), and rats (attached to wherever convenient).

⁴² Paragraphs 171 to 177 of the decision.

⁴³ See in particular paragraph 197 of the decision.

known brands. So far as goodwill attached to the brand name and trademarks, these were already owned by Pizza Express, and it would make no sense if that company were paying for something it already owned, particularly in circumstances where the franchise agreements permitted it to open restaurants in the vicinity of the franchisees' restaurants.⁴⁴

One important point that comes out of this case is the need for detail in evidence. In particular, the actual way the businesses were run was more or less contrary to what it said in the franchise agreements. On their terms, Pizza Express exercised close control over the franchise operations; but in reality, very little control was exercised, at least in comparison to other, 'harder' franchise arrangements, such as McDonalds or Pizza Hut. The evidence as to how the operation was actually run was available only because of detailed questioning carried out by those preparing the evidence for the case. It is essential that whoever is actually going to be presenting the case to the tribunal, whether General or Special Commissioners, or VAT Tribunal or Court of Session, is involved early on in the investigative process. Taking one step further back, it is also better if agreements properly correspond to facts. Balloon Promotions would have more easily won its case if the franchise agreements had corresponded to the way the restaurants were actually run, and the fact that they did not put in jeopardy the availability of roll-over relief.

E. Valuation

On a valuation point, the case of *Shinebond Limited v. Carrol* [2006] S.T.C. (S.C.D.) 147 describes in short circumstances in which a company should be valued on an assets basis rather than a gross yield basis. Unusually, the taxpayer was arguing for a higher

⁴⁴ Paragraphs 259 ff. of the decision.

valuation, and therefore the gross yield basis; the reason for this was that the value in question was the value as of March 1982 for re-basing purposes. The company's main asset was commercial property in London it held on a leasehold basis. Its business was letting out the property. The leases were full repairing and insuring leases. In summary, it was held that the net assets basis was appropriate, because the company was an investment company whose sole business was owning and leasing the commercial property. The assets to be valued were 100% of the shares in the company, and their owner would have unfettered control over the company, including being able to decide to realise and distributed the company's assets. In those circumstances, the Special Commissioner held that a hypothetical purchaser on the open market⁴⁵ would simply add up the company's assets and deduct its liabilities. The Special Commissioner made the point that the property itself would be valued on a yield basis, and so to apply a yield basis to the shares would be a form of double-counting. Moreover, one could not apply a yield basis to bank interest, as this would fluctuate depending on balances; nor could one take into account capitalised dividends in the case of a controlling shareholding.

On the facts the net assets basis led to a lower valuation. However, the Special Commissioner rejected the Revenue's argument that a prospective purchaser would also take into account the latent corporation tax liability that would accrue on disposal of the building. This was because the date of valuation was 31st March 1982, and the property itself would be rebased to that date.

IV. Industrial buildings allowances

The next area of interest is industrial buildings allowances, and the old problem of storage.

⁴⁵ See section 152 of the 1992 Act.

In *Commissioner's for Her Majesty's Revenue and Customs v. Maco Door and Hardware (UK) Limited* [2006] EWHC 1832 (Ch), the taxpayer was a UK subsidiary of an Austrian parent. The Austrian parent manufactured parts, principally ironmongery, for PVC windows and doors. The taxpayer imported the products into the UK, and stored them at a warehouse for the purpose of distributing them to customers. Because the way the parent company's manufacturing business had to operate, the taxpayer had to order large deliveries with a lead time of about six weeks. The parent did not store any products manufactured for the UK market (which required different products from the market on continental Europe): any surplus was simply sent to the taxpayer. The taxpayer's customers were primarily wholesalers, the rest being window and door manufacturers. It was agreed that the taxpayer used the building for the purposes of its trade and that the products stored were to be used in the manufacture of other goods and materials.⁴⁶ The issue for decision was whether Maco's use of the building was 'for the purposes of a trade which consists in the storage' of what were admitted to be qualifying goods. The Revenue argued that Maco's business was importation and sale. The taxpayer argued that although that was true, storage was part of its trade, and accordingly the rules applied to it.⁴⁷

Of course, the principal authority looked to by Patten, J., was the recent decision of Lightman, J., in *Bestway (Holdings) Limited v. Luff* (1998) 70 T.C. 512. In this case, a 'part of a trade' was not any part of a single activity directed towards making a profit, but one of two more activities each of which were, in themselves, trades. For example, a car dealership might also operate a car repair garage. Each was a separate profit-making

⁴⁶ Capital Allowances Act 1990, section 18; now Capital Allowances Act 2001, table A in section 274.

⁴⁷ Capital Allowances Act 1990, section 18(2); now Capital Allowances Act 2001, section 276.

activity, and each a 'part' of the owner's trade. But the storage of cars in the showroom for the purpose of displaying them pending sale was not a 'part' of a trade.

By contrast, Patten, J., held that the decision in *Crusabridge Investments Limited v. Casings International Limited* (1979) 54 T.C. 246 had been wrong. In that case, the issue was whether storage of tyres as part of a trade of remoulding them, or selling them for remould, constituted use 'as an industrial building or structure' for the purposes of the Capital Allowances Act 1968.⁴⁸ Specifically, the judge in that case had been wrong to hold that the trade carried on need merely involve, as opposed to consist in, storage.⁴⁹

Patten, J., took the decision in *Bestway (Holdings)* to mean that a 'part' of a trade had to be a 'significant, separate and identifiable part of the trade carried on'.⁵⁰ The storage in the present case was not a separate part of a composite business, not being a commercial activity in its own right.⁵¹ It was carried out merely to support the company's wholesale operation, and was not a trading or commercial activity in itself.⁵²

In terms of planning, Patten, J., stated that 'a warehousing subsidiary whose only business was the storage of qualifying goods in connection with the trade of an associated company could, I think, qualify'.⁵³ This opens up an obvious opportunity, simply to incorporate a subsidiary and put all the storage function into it. Of course, the other conditions of the provision must be satisfied, namely that the goods must be going to be used in manufacturing, or are going to be submitted to a process. But where a company's

⁴⁸ Although the issue arose between a landlord and tenant, the lease restricting the use of the premises to use as such a building.

⁴⁹ See paragraphs 21 to 23 of the judgment.

⁵⁰ Paragraph 28 of the judgment.

⁵¹ Paragraph 30 of the judgment.

⁵² Paragraph 41 of the judgment.

⁵³ At paragraph 18 of the judgment.

business is wholeselling parts to manufacturers, incorporation of a storage subsidiary may bring significant tax advantages.

V. Controlled foreign companies

Finally on the past year's cases, the European Court of Justice has decided *Cadbury Schweppes plc v Commissioners of Inland Revenue*,⁵⁴ a case referred to it by the Special Commissioners.⁵⁵ The case concerned the controlled foreign companies legislation. This was designed to prevent UK companies avoiding UK corporation tax by putting profits into foreign subsidiaries that were subject to a lower rate of tax.⁵⁶ Broadly speaking, where a company resident abroad was controlled by persons resident in the UK and was subject to a lower level of taxation, its profits are allocated to the tax base of any UK company that had an interest in it, *pro rata* to the UK company's shareholding.⁵⁷ This was subject to certain exceptions, including one related to motive, as regards the transactions effected by the CFC and the very existence of the CFC.⁵⁸ If the reduction in UK tax achieved by transactions reflected in the profits that would be allocated to the resident company was minimal, or such reduction was not the main purpose of those transactions, or a reduction was not at least one of the main purposes of the existence of the CFC, then the Inland Revenue again could not direct that the legislation should apply.⁵⁹

Cadbury Schweppes plc established two (indirect) subsidiaries in Ireland, namely Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury

⁵⁴ Case C-196/04; judgment of the Grand Chamber of the ECJ, dated September 12, 2006.

⁵⁵ The decision of the Special Commissioners referring the case to the ECJ is reported at [2004] STC (SCD) 342.

⁵⁶ For further details, see Simon's *Direct Tax Service*, vol. 5, at paragraph D4.1201.

⁵⁷ In 1996, it was necessary for the Revenue to make a direction to this effect.

⁵⁸ Section 748(3) ICTA. A further exception was introduced by FA 1998, permitting the Inland Revenue to give block exemptions for companies resident in specified foreign jurisdictions.

⁵⁹ Detailed provisions in relation to the exceptions were contained in Schedule 25 to ICTA 1988.

International (CSTI), the latter as a subsidiary of the former. The purpose of these companies was to provide treasury services to the group generally, including subsidiaries and operations outside the UK. The subsidiaries were established in the International Financial Services Centre (IFSC) in Dublin and the rate of tax to which they were subject was only 10%. The CFC legislation was applied to the subsidiaries by the Inland Revenue so that their profits were included in the tax base of the first group company higher up the corporate structure that was resident in the UK, namely Cadbury Schweppes Overseas Limited (CSOL).⁶⁰ CSOL's corporation tax bill was increased by over £8 million.

The Special Commissioners asked, in short, whether the application of the CFC legislation in context was compatible with European law. The ECJ said that this depended.

First, the fact that the sole reason for incorporating in Ireland was to benefit from the lower level of taxation in the IFSC did not mean that Cadbury was guilty of abusing its freedom of establishment, and therefore not entitled to rely on that freedom.⁶¹

It was common ground that there was a difference in treatment between, on the one hand, resident companies whose subsidiaries enjoyed a lower level of taxation and, on the other, resident companies whose subsidiaries did not (whether because they were also UK resident, or were resident in a country with a sufficiently high rate of corporation tax). But the UK and various other Member States argued that there was no disadvantage, given that the parent company was required to pay no more tax than the group would

⁶⁰ *Cadbury*, n. 2, para. 1.

⁶¹ *Cadbury*, n. 1, para. 38.

have suffered if the subsidiaries had been incorporated in the UK.⁶² The ECJ held that a disadvantage was constituted by the fact that the parent company was taxed on someone else's profits, and that this hindered companies from exercising their freedom of establishment.⁶³

The ECJ turned to justification. Nothing short of overriding reasons of public interest would do and the principle of proportionality also required satisfaction.⁶⁴

The reduction of national tax revenue was not sufficient: what was required was prevention of either tax evasion or of what the ECJ regards as tax avoidance, in other words 'wholly artificial arrangements aimed at circumventing' the tax legislation in question, it may be justified. The ECJ pointed out that the objective pursued by the provisions on freedom of establishment was to assist economic and social interpenetration. Accordingly, the concept of 'establishment' involved the actual pursuit of economic activity through a fixed establishment for an indefinite period: presupposed were actual establishment of the company and genuine economic activity.

The ECJ held that the CFC legislation was capable of thwarting such wholly artificial arrangements:⁶⁵ the difficult part was deciding whether it went beyond what was necessary to achieve that end. The difficulty arises because the approach of the ECJ's case-law does not necessarily correspond to that of the CFC legislation. The ECJ requires the presence of two elements before the CFC legislation can be applied. First, there must be an intention to obtain a tax advantage. The second is that the incorporation of the CFC must not reflect economic reality.

⁶² *Cadbury*, n. 1, paras 43 to 45; this reflects one of the uncertainties identified by the Special Commissioners: *Cadbury*, n. 2, para. 10.

⁶³ *Cadbury*, n. 1, para. 46.

⁶⁴ *Cadbury*, n. 1, para. 47.

⁶⁵ *Cadbury*, n. 1, para. 59.

One point is certain: 'exempt activities' as explained in Schedule 15 to ICTA 1988 are much narrower than 'genuine economic activities' as that term is used by the ECJ. Thus, investment activities, or buying goods from the UK to sell to persons present in the Member State of incorporation, would both be regarded by the ECJ as genuine activities, while clearly not 'exempt' under the CFC legislation. The ECJ accepted that the facts that none of the exceptions in the CFC legislation applied and that the incorporation of the CFC and the transactions that reduced tax were prompted by a desire to achieve a tax reduction would not necessarily mean that the arrangements were wholly artificial. So there is a strong indication from the ECJ that the CFC legislation is not compatible with European law, whether or not its application in the case of Cadbury is lawful.

So in terms of planning, one can avoid the CFC legislation in relation to companies incorporated within the European Union⁶⁶ by ensuring that such companies undertake at least some genuine economic activity there. The minimum that one must do to be carrying on such activity is unclear, but if the foreign company has at least an office and a couple of employees managing whatever activity is carried on by the company, this is likely to succeed.

VI. Favourite quotes

Before concluding, three favourite quotes from this year's cases, each of which illustrates that even the best tax lawyers do not find it easy:

'Therefore in my view Mr Gammie's and Mr Ewart's interpretation is to be preferred. Unfortunately if one spends less than three days thinking about it and does not put oneself in the position of the draftsman, Mr Aaronson's contention seems entirely reasonable, that it looks as if the draftsman has said the opposite...' (per Dr John Avery

⁶⁶ Now having 25 Member States, soon to be joined by Bulgaria and Rumania.

Jones, in *Five Oaks Properties Limited and others v. Commissioners for Her Majesty's Revenue and Customs* [2006] UKSPC 00563).

‘I have given judgment at some length because there is widespread professional interest in this case, but I do not think that there is anything particularly novel or alarming in my decision. I believe that it is a simple application of well-established principles.’ (per Park, J., in *Jones v. Garnett* [2005] S.T.C. 1667, at 1711.)

‘When I first read the papers in this case it seemed to me that a promissory note with an uneven interest payment profile was not a fixed rate security. That was the view of the Special Commissioners and the judge and is the view of The Chancellor. At the end of the argument I was largely persuaded by Mr Ghosh that the notes issued in this case were by their terms securities which carried interest at a fixed rate throughout the period from issue to redemption and so fell within section 717 (2) (a) and that my first impression was wrong because it did not distinguish between the rate of interest and the time or times at which it became payable. That is the view of Sir Peter Gibson which he puts compellingly (together with other reasons) in his judgment. I now have to make up my mind and decide whether I agree with The Chancellor or Sir Peter Gibson, an unenviable task given their great experience in this area of the law with which I am largely unfamiliar’ (per Tuckey, L.J., in *Cadbury Schweppes v. Williams*).

VII. Conclusion

In conclusion, case-law is important in enabling informed decisions to be made as to how the courts will decide future cases. In turn, this enables informed advice to be given to clients as to how they should structure transactions to be more likely to obtain the desired tax treatment. Hopefully, the above will assist in the task of giving such advice.