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Reversal of fortune

A stamp duty blunderbuss has been fired at partition demergers. Is this fair, asks **SEAN RANDALL**.

Reversal of Fortune is a drama that presents 'a complex puzzle of ambiguous evidence and conflicting theories', according to an internet review. That narrative is apt to describe the driver for a change made in 2016 to the stamp duty relief that applies to share-for-share exchanges, FA 1986, s 77 (acquisition of target company's share capital).

The change requires an extra condition to be met before the relief is available. It was presented as both a response to tax avoidance and consistent with the policy of the relief. The particular threat to tax revenue was not identified, however. That omission and the timing of the change are curious. Determining whether the impact of the change on corporate reconstructions was intentional is subjective. One can reasonably draw inferences that some types have been unfairly hit. What is clear to the author, though, is that this is a change of policy. Professionals who advise on corporate reconstructions should understand what has changed and be concerned about the consequences.

Background

Section 77 provides relief from stamp duty on an instrument transferring the entire issued share capital of one company (the target company) to another (the acquiring company) for the issue of shares in the acquiring company. One condition for the relief is that the ownership of the acquiring company after the transfer is the same as the ownership of the target company immediately before the transfer.

The 2016 change

The Finance Act 2016 inserted a new condition into FA 1986, s 77(3), subsection (3)(i), and a new section into FA 1986, namely s 77A (disqualifying arrangements). Since 29 June 2016, the relief has been restricted unless there are no disqualifying arrangements at the time the transfer instrument is executed. Arrangements are disqualifying if it is reasonable to assume that the purpose, or one of their purposes, is to secure that a particular person, or particular persons together, obtains control of the acquiring company. Incidentally, it looks as if formulating motive tests by reference to an objective standard is a trend that is set to continue.

KEY POINTS

- Section 77A of FA 1986, is a new anti-avoidance provision limiting stamp duty relief in s 77.
- Arguably the legislation already contained an adequate anti-avoidance rule.
- Reversal of many years of HMRC practice.
- The effect on demergers involving splitting a business into separate ownership.
- Let HMRC know about problems caused by s 77A.

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The change was introduced as an amendment to the Finance (No 2) Bill 2016 at committee stage with no prior consultation. Bearing in mind that the relief had been operating for 30 years without this condition, it is unclear what prompted the change to be made, especially so rapidly.

The tax information and impact note on the change, *Stamp duty: change of control using share for share exchanges* (tinyurl.com/y8ja3fpn), describes the objective:

> 'Government policy is that stamp duty is paid on takeovers of UK companies (including the acquisition of private companies). This measure makes the tax system fairer and provides certainty by preventing an unfair tax advantage where share for share relief is claimed on takeovers. HMRC have identified transactions which lead [sic] to this unfair outcome and are taking action.'

It went on to describe the background to the measure:

> 'The purpose of the share for share relief is to ensure that there is no stamp duty charge where there is no real change of ownership. That is, the same people hold the same proportion of shares in the companies before and after the reconstruction. The relief allows genuine reconstructions of companies to take place in a tax neutral way.
>
> 'The relief should not apply to company takeovers where there is a change of control. Takeovers are not reconstructions. Takeovers are usually undertaken by

a transfer scheme of arrangement or contractual offer. In both cases, stamp duty is payable. Companies Act regulations (SI 2015/472) prohibit companies from using capital reduction schemes of arrangement to circumvent payment of stamp duty on takeovers. Purchasers should pay stamp duty on a takeover however that takeover is implemented.'

It is reasonable to infer from this that s 77 relief had been used in 2016 as part of tax avoidance arrangements involving the insertion of a foreign company above a UK company to prevent stamp duty arising on a takeover of the UK target by a sale of the foreign entity owning the UK company.

New policy?

Several points are worth noting. First, s 77 already had an anti-avoidance rule, subsection (3)(c). The share-for-share transaction must be effected for genuine business reasons and must not form part of a scheme or arrangement of which the main purpose, or a main purpose, is tax avoidance. Putting a UK company into a foreign company envelope to prevent stamp duty arising on a sale of the foreign company is surely exactly the type of scheme or arrangement that subsection (3)(c) targets.

Moreover, since the process for making a claim involves adjudication, HMRC would be made aware of the purpose of the share-for-share transaction. Further, if it subsequently discovered that it was not it could reasonably withdraw the relief and impose penalties. So, arguably, the 2016 change was not necessary.

Second, as stated above, the tax impact and information note states:

'The purpose of the share for share relief is to ensure that there is no stamp duty charge where there is no real change of ownership. That is, the same people hold the same proportion of shares in the companies before and after the reconstruction. The relief allows genuine reconstructions of companies to take place in a tax neutral way.'

For many years, possibly for most of the 30 years between the 1986 and 2016 Acts, people successfully made claims where there was a plan for a particular person to obtain control of the acquiring company, correctly drawing HMRC's attention to the existence of the plan in the claim letter. The claimant's argument, and HMRC's decision to grant relief, was based on the condition for the ownership of the target company to be unchanged to be tested *immediately* after the share-for-share transaction. In other words, the mirror-image condition in s 77 was treated as a snapshot test. That custom is understandable. Otherwise the term 'after' would refer to an indeterminate period.

What other bright-line test was there to use? Arguably, in 1986 the parliamentary draftsman should have borrowed the 'disqualifying arrangements' test used in stamp duty group relief legislation 19 years earlier. Therefore, the 2016 change both corrects tax legislation and reverses 30 years of Revenue practice. Some might say that it causes a reversal of fortune.

Third, the new condition has a negative impact on types of corporate reconstruction that, until 2016 were reasonably regarded as benign transactions. Pete Miller discussed these in 'Stamp it out' (*Taxation*, 25 May 2017, page 8).

No one can sensibly say that the government is not entitled to review tax legislation nor that HMRC is not entitled to review its practice to ensure that the correct tax is paid on chargeable transactions. But if s 77 relief was being claimed as part of tax avoidance arrangements, HMRC could simply have announced that the words 'after the acquisition has been made' in subsections (3)(e) to (h) would be interpreted purposively and applied to the facts viewed realistically, as all tax legislation should.

Consequently, if, at the relevant time, there was a plan for a takeover of the acquiring company, the relief would be denied. Regrettably, that did not happen. Instead the government chose to make legislative amendments and, as is often the case with anti-avoidance legislation enacted at short notice with no consultation, there are unintended consequences.

"The 2016 change both corrects tax legislation and reverses 30 years of Revenue practice."

Unintended consequences

Six points show the effect of the 2016 change on partition demergers – a type of reconstruction involving splitting a company's business into separate ownership.

- Inserting a new holding company in preparation of a third party disposal can be done 'strategically', namely before sale arrangements are agreed. In that case s 77 relief can be claimed as before. But inserting a new holding company in conjunction with a partition demerger cannot. The arrangement for a particular person to obtain control of the acquiring company is often inexorable on a demerger. That is the point of the demerger.
- The change generally causes reduction of share capital demergers to be chargeable to stamp duty. But it does not cause a liquidation demerger to be so chargeable. It is illogical for the incidence of stamp duty to be driven by a legitimate choice of legal process when both achieve the same economic result.

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- When the ownership of the target company is unequal, the 2016 change does not have a disruptive effect – the demerger can generally be designed so that there is no change of control of the acquiring company. The same cannot be said when the ownership of the company is held 50:50. This encourages shareholders to move equity in the target company in an artificial manner before the demerger to avoid a change of control of the acquiring company and enable the stamp duty relief to be claimed. Anti-avoidance legislation should not drive artificial changes to the design of arrangements that have a genuine business motive. See ***Stamp Duty Diagram***.

> ***"Anti-avoidance legislation should be narrowly drafted so as to be proportionate."***

- Should stamp duty arise on a share-for-share transaction due to the 2016 change, the vendor may decide to use a non-UK company as the acquiring company to prevent multiple charges to stamp duty: one charge on the insertion of the acquiring company and another on the demerger (or takeover). It would be ironic for legislative changes targeted at stopping non-UK companies acting as envelopes to encourage that activity.
- There is no change-of-control restriction for stamp duty reconstruction relief under FA 1986, s 75 (acquisitions: reliefs). If the government was merely giving effect to the long-established principle that the stamp duty reconstruction reliefs are restricted to circumstances in which there is no change of economic ownership, s 75 relief should also be amended.
- There is a contextual distinction between takeovers on the one hand and partition demergers on the other. The policy imperative of the 2016 change was to tackle the relief being used with a takeover. Failing to describe the change of policy on reconstructions in the tax impact and information note is misleading.

Conclusion

Anti-avoidance legislation should be narrowly drafted so as to be proportionate. The 2016 change appears to be inconsequential at first blush. Closer examination reveals that it can be destructive to commercially driven corporate reconstructions.

HMRC has invited representations to be made on the effect of the change. Readers with an interest in this area should respond. The current situation leads to disruption to business, artificial arrangements relating to the shares of the target company before share-for-share exchange or a return to liquidation demergers.

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STAMP DUTY DIAGRAM