The bright red line

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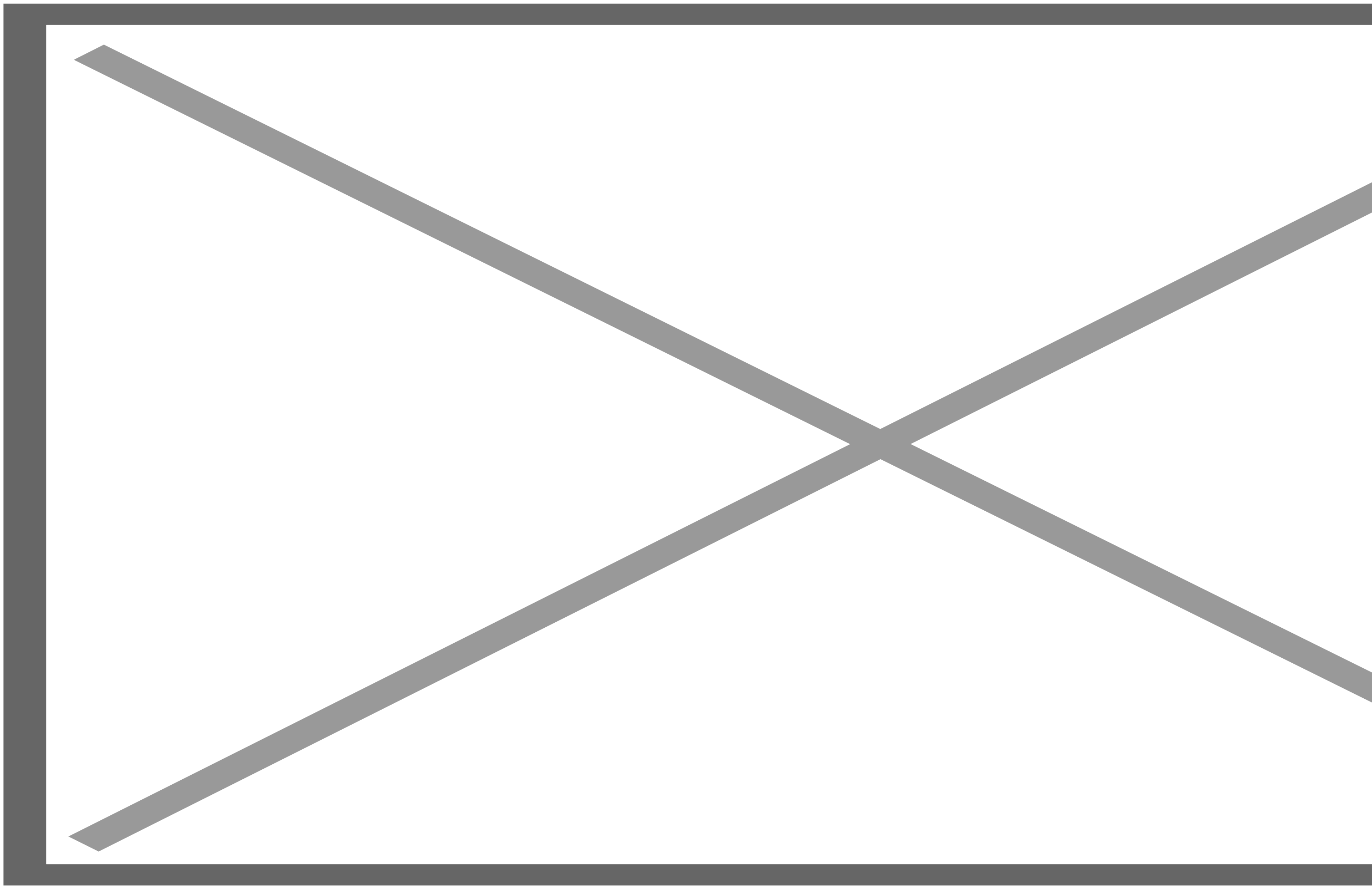

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Keith Gordon looks at a case which identified an absurdity in the holdover relief rules

Key Points

What is the issue?

There are a number of conditions and exclusions that limit the availability of the holdover relief rules in TCGA 1992, particularly if it is going to involve the transfer to a person who would not be subject to capital gains tax on a subsequent disposal.

What does it mean to me?

At the heart of this case is the exclusion in TCGA s 167. Section 167 disapplies section 165 if the transferee is a company controlled by a non-resident who is connected with the person making the disposal. (Section 167 effectively operates in tandem with s 166 which disapplies s 165 in cases where the transferee is non-resident.)

What can I take away?

Consider any of your clients who might have considered a holdover relief claim but were put off by the literal interpretation of section 167. Similarly, the case should give you hope if you have another situation where the literal consequence of a statutory provision gives rise to a totally impractical and absurd result.

Tax advisers will be aware of the usefulness of the holdover relief rules (in the Taxation of Chargeable Gains Act 1992 (TCGA) ss 165 and 260). The former apply to gifts of qualifying 'business assets' and the latter to transactions which give rise to an inheritance tax charge (including one taxed at 0%). When the relief is available, the person making the disposal can defer any capital gains tax arising on the disposal by effectively transferring the potential liability to the recipient of the gift (for such later time as the recipient might dispose of the asset), by reducing the recipient's own base cost by reference to the gain held over.

Unsurprisingly, there are a number of conditions and exclusions that limit the availability of the relief, particularly if it is going to involve the transfer to a person who would not be subject to capital gains tax on a subsequent disposal. One of these exclusions was the subject matter of a recent appeal to the Upper Tribunal in the case of *Reeves v HMRC* [2018] UKUT 293 (TCC).

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Facts of the case

On 1 April 2010, Mr Reeves disposed of his interest in a limited liability partnership to a UK-resident company of which Mr Reeves was the sole shareholder. Ignoring the question of holdover relief, that disposal would be subject to capital gains tax.

Mr Reeves was in fact not resident in the UK which might ordinarily have exempted him from capital gains tax (TCGA s 2). However, the transaction fell within s 10 which extends the scope of capital gains tax to non-residents to the extent that they dispose of the assets used in a trade which is carried on through a branch or agency in the UK.

As the disposal was therefore within the scope of the capital gains tax rules, Mr Reeves duly made a holdover relief claim under s 165 (which was jointly entered into by the UK company to which his interest in the LLP was transferred).

However, HMRC argued that s 167 precluded the holdover relief claim. Section 167 contains two conditions so far as the transferee is concerned: first that it is controlled by a non-resident; secondly, that that controlling person be connected with the person making the disposal. Mr Reeves was undoubtedly the person who controlled the transferee company. He was, of course, not connected with the person making the disposal (because he was in fact the actual person making the disposal).

HMRC accepted that, on the literal wording of s 167 (read on its own), Mr Reeves was not caught by the section. However, they pointed to the wider definitions of connection and control. In particular, Mr Reeves's wife is undoubtedly a person connected with Mr Reeves (TCGA s 286(2)). Section 288 then imported the definition of control then in the Income and Corporation Taxes Act 1988 ss 416 and 417. Under those provisions, Mr and Mrs Reeves are treated as associates of each other. Accordingly, from Mrs Reeves's perspective, her husband is one of her associates (section 417(3)). Furthermore, any rights held by Mr Reeves are also attributed to Mrs Reeves (section 416(6)). Therefore, through Mr Reeves's sole shareholding, Mrs Reeves is deemed to control the UK company. As Mrs Reeves is undoubtedly a person connected with Mr Reeves and deemed to control the UK company, the situation is caught squarely by section 167 if, as was indeed the case, Mrs Reeves was similarly non-resident.

HMRC therefore concluded that holdover relief was not available to Mr Reeves. Mr Reeves appealed against their decision to the First-tier Tribunal which agreed with HMRC. Mr Reeves therefore appealed against the decision to the Upper Tribunal.

The competing arguments

Neither side was happy with the present wording of s 167. HMRC contended that section 167 was incorrectly drafted inasmuch as the condition that the person controlling the company be connected with the person making the disposal should be treated as also encompassing the situation where the person making the disposal actually controlled the company. Mr Reeves would, on that interpretation, have fallen foul of the condition on the basis of his own situation, without reference to his wife. Accordingly, if that represented the proper reading of section 167, there could be little complaint that he was also caught by virtue of his wife's deemed control of the company.

Mr Reeves, however, had two alternative strategies at 'rectifying' s 167. The first was to rely on the words in TCGA, s 288 which applies the ICTA definition of control 'unless the context otherwise requires'. Given, as Mr Reeves's argument proceeded, the importation of the ICTA definition gave an absurd result, it was clear that the context did otherwise require.

The alternative was to insert a requirement that the person controlling the company (or deemed to control the company) must do so by holding shares in the company. This argument would have succeeded in Mr Reeves's case because Mrs Reeves owned no shares in the company; it would not have succeeded had Mrs Reeves owned even a single share. This approach reflected an additional provision within s 167(3).

The Tribunal's decision

The case came before the then President of the Tax and Chancery Chamber of the Upper Tribunal (Mrs Justice Rose) sitting with the President of the Tax Chamber of the First-tier Tribunal (Judge Greg Sinfield).

Having considered the various competing approaches to s 167, the Tribunal eventually allowed Mr Reeves's appeal.

HMRC's preferred interpretation was rejected on the basis of the history of the provision (and its relationship with s 166). Since s 166 was designed to prevent beneficial ownership being transferred (i.e. to a different person), the Upper Tribunal had no reason to suppose that s 167 was meant to include situations where the transferor was also the indirect transferee. This view was reinforced by the relative simplicity of the wording in s 167 and it was hard to imagine that the lack of any express inclusion of the person making the disposal was some kind of oversight.

The Tribunal ultimately favoured the first of Mr Reeves's two contentions (whilst not expressly disagreeing with the second). Ultimately, it treated the control rules in ICTA as if they were subject to an additional requirement that the connected person owns some or all of the shares of the transferee company (this in fact being the same approach as is adopted in s 167(3) and which underlay the second approach put forward by Mr Reeves).

Commentary

Having been heavily involved in the Tax Law Rewrite Project, I remain disappointed that the project was not able to extend to the capital gains tax rules. Even though many of the benefits of the rewrite have been lost by the effect of ill-thought-through legislation in subsequent Finance Acts, it did enable some light to be shone on some of the more arcane parts of the tax code and, surely, some clarity is better than complete obscurity. In my more cynical moments, I do wonder whether the rewrite was stopped because there were people in HMRC who were afraid what skeletons would be unearthed were TCGA subjected to the rigours of the rewrite process – often described as an archaeological excavation through the various Finance Acts which have each added their own geological layer to the statute.

There again, s 167 might well have been rewritten in a very similar form to its current incarnation. It is simple to understand: it is just that, on a literal application, it can give rise to such an absurd result. As the Upper Tribunal noted, such an absurd reading of the legislation would mean that a taxpayer transferring a business to a wholly-owned company would be unable to claim holdover relief if, say, the taxpayer had an adult daughter teaching in Australia during a gap year. Even on the Tribunal's interpretation, such a result would follow if the daughter happened to own one or more shares in the transferee.

It should be remembered, however, that the Tribunal was able to overcome the literal wording only because Mr Reeves owned all of the shares and, therefore, no family member owned any. The Tribunal did feel uncomfortable that even a single share held by Mrs Reeves (or, in my hypothetical example, the daughter) would be sufficient to preclude holdover relief from being available. However, the Tribunal noted that tax law often favours the certainty of 'a bright red line' over the rather vaguer question as to whether or not a minority share interest has any impact in reality.

The Tribunal also considered that, had it not been able to interpret s 167 in the way it did, it would have considered that the legislation would have breached Mr Reeves's human rights by discriminating against him by virtue of the residence status of his family. Again, the Tribunal noted that the situation was unfair 'where his wife and children have no interest in the asset'. This suggests that, as with their interpretation of s 167, their decision on the human rights point was dependent on Mr Reeves being the sole shareholder. However, unlike legislation, human rights law is inherently less precise and it is possible that a sensible and fairer result would be available in other cases as well.

In either case, it should be realised that the Tribunal was effectively trying to fill in gaps in the statute and it is by no means guaranteed that another panel of judges would reach the same outcome, even if one cannot criticise the attempts of the Tribunal to achieve a just result. Given the considerable sum that is at stake and the inherent uncertainty, I would not be surprised to see this case proceed to the Court of Appeal. In the meantime, it is good news for Mr Reeves.

What to do next

Consider any of your clients who might have considered a holdover relief claim but were put off by the literal interpretation of s 167. Similarly, the case should give you hope if you have another situation where the literal consequence of a statutory provision gives rise to a totally impractical and absurd result (particularly where it applies to wider family relationships and/or involves a deeming provision). However, it should be remembered that the Courts will not always intervene – this case being quite an extreme example: see, for example, the case of *Robert Ames*, which I referred to in my article '*You only claim twice*' published in the October 2015 issue of *Tax Adviser* and which was recently upheld by the Upper Tribunal (albeit with a slight twist). It should also be remembered that the Upper Tribunal's decision is unlikely to be the last word on the subject.