SLAUGHTER AND MAY

# Conegate: interpretations of the value shifting rule

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There are various questions that anyone involved in group restructurings, whether as an external adviser or in-house, has to grapple with from time to time for which there may be received wisdom passed down from generation to generation but often no firm answers. These include questions such as how the reorganisation provisions in TCGA 1992 s126 et seq. interact with the value shifting rule in TCGA 1992 s29; and how you ascertain what consideration a person would have demanded from himself had he been dealing with himself at arm's length.

The absurdity inherent in that last question at least partly underpins the widely held belief that the value shifting rule in s 29 requires value to move from shares held by one shareholder to shares held by another shareholder; and that the rule is not in play where, for example, a company has a single shareholder and value passes from one class of shares held by that single shareholder to another class also held by him.

The case of *Conegate Ltd* [2018] UKFTT 82 (TC) provided a great opportunity for the FTT to answer some of these questions. However, not only did it fail to answer them, it is not obvious that the FTT realised that the facts it was asked to consider raised those questions.

## Background

Conegate Ltd ("Conegate") is the principal investment vehicle of D Sullivan, a businessman and the part-owner of West Ham United. Indeed, the issue at the heart of the case is whether the manner in which Mr Sullivan acquired and financed his interest in West Ham gave rise to an allowable loss for chargeable gains purposes of £2m.

The case also raised questions around the waiver of privilege which were the subject of an article by Jason Collins and Stuart Walsh in a previous issue of *Tax Journal* (27 April 2018). This article is concerned only with the substantive chargeable gains issue.

Back in 2009, the Rothschild Group solicited potential buyers for West Ham Holdings Limited (WHH), the parent entity of the football club, on behalf of CB Holding ehf (CBH), an Icelandic company which was suffering financial difficulties. Mr Sullivan, a childhood West Ham fan and erstwhile Birmingham City owner, threw his hat into the ring with a successful bid for 50% of WHH. In early 2010, Mr Sullivan indirectly acquired 1,000 ordinary £1 shares in WHH from CBH. 250 were purchased by Conegate and 750 by Roldvale (essentially Mr Sullivan's pension fund) at £20,000 per share. CBH retained 1,000 ordinary shares and also some worthless deferred shares shortly to be repurchased for £1. Roldvale then sold 500 shares to D Gold, Mr Sullivan's business partner. Mr Sullivan also had a call option over CBH's remaining shares initially for £20,000 per share, then stepping up to £25,000 per share.

West Ham needed more funds which Mr Sullivan and Mr Gold were happy to provide. Plan A was for Mr Sullivan to assign the call option to WHH, which would use it to buyback 200 of CBH's remaining shares for £4m. WHH would then issue 200 new shares, 100 to Mr Sullivan and 100 to Mr Gold, for £4m each. The net result would be that Mr Sullivan and Mr Gold would have each acquired an additional 10% of WHH from CBH and together have injected an additional £4m into WHH. However, there was a concern that subscribing for shares at £40,000 a share would raise the question of whether the call option had value such that a capital gain could be deemed to arise on its assignment to WHH.

Plan B was to achieve the same net result by having WHH repurchase 200 of CBH's shares for £4m, funded out of an issue of 200 new shares to Mr Sullivan and Mr Gold for £8m. But that hit the company law obstacle that WHH did not have the distributable reserves necessary to buy the shares back at a premium.

Hence, Plan C. The call option was exercised over 200 shares. Conegate purchased 100 shares for £2m, as did Roldvale, taking them to 350 shares each and leaving CBH with 800. Mr Gold subscribed for 200 new shares for £4m, giving him 700 as well. Then 100 ordinary shares held by Conegate, and 100 held by one of Mr Gold's companies, were converted to worthless deferred shares and repurchased for £1. The net result was the same as Plans A and B, in that CBH end up with 200 fewer ordinary shares, Mr Sullivan and Mr Gold with an extra 100 each, and WHH with an extra £4m in cash. However, Conegate claimed that the repurchase of its deferred shares for £1 gave rise to an allowable capital loss of £2m.

### HMRC's position

HMRC, not unsurprisingly, disagreed.
Formally, it refused the claim on the basis of TCGA 1992 s17, the market value rule. However, in correspondence it also asserted that no loss arose as a result of the value shifting in s 29; and, for good measure, that if a loss did arise, it would not be allowable as a result of the targeted anti-avoidance rule in TCGA 1992 s16A.

What I find rather surprising is that the FTT's judgment does not use the word 'reorganisation' even in passing.

### Section 29

The FTT began its judgment with TCGA 1992 s29(2), which provides that:

> *"If a person having control of a company exercises his control so that value passes out of shares in the company owned by him or a person with whom he is connected, or out of rights over the company exercisable by him or by a person with whom he is connected, and passes into other shares in or rights over the company, that shall be a disposal of the shares or rights out of which the value passes by the person by whom they were owned or exercisable."*

HMRC asserted, and the FTT agreed, that as a result of s29(2), Conegate should be treated as having disposed of 100 ordinary shares in WHH for £2m, being their market value; and that as it had paid £2m for those shares, no loss arose.

The FTT rightly dismissed Conegate's argument that although it was settled by the House of Lords decision in *Floor v Davies* [1980] AC 695 that "person having control of a company" included 'persons having control', those persons had to be connected with each other. Conegate also tried an argument to the effect that WHH was so underwater that no value could have passed out of its shares in WHH, which the FTT also rightly dismissed given the lack of evidence on the point, although its comments here are interesting.

Paragraph 64 of the judgment notes that:

> *"We consider that the overall value of WHH must have remained the same throughout the events in question as the transactions of 24 May 2010 occurred in quick succession. We have found that, as a result of those 24 May 2010 transactions, the overall number of ordinary shares in WHH was reduced."*

Being charitable to the FTT, if one limits the 'events in question' to being the conversion of 200 ordinary shares to deferred shares and their repurchase for nominal consideration, that is true. That would not have affected the value of WHH and would have reduced the number of ordinary shares in issue. But if one considers all of the events which took place on 24 May 2010, then both of those statements are wrong. WHH began and ended the day with 2000 ordinary shares in issue. The 200 ordinary shares converted to deferred shares and repurchased were balanced out by the additional 200 ordinary shares issued to Mr Gold. Further, WHH was worth £4m more at the end of the day than the beginning, as a result of receiving the subscription proceeds for those shares. That was the whole point of the exercise.

That is a relevant fact that appears to get overlooked when the FTT moves on to consider s 29(1), which provides that where a transaction is to be treated as a disposal under s29(2):

> *"so far as, on the assumption that the parties to the transaction were at arm's length, the party making the disposal could have obtained consideration, or additional consideration, for the disposal, shall be treated as not being at arm's length and the consideration so obtainable, or the additional consideration so obtainable added to the consideration actually passing, shall be treated as the market value of what is acquired"*.

It is a relevant fact because the FTT starts from the premise that Conegate disposed of 100 ordinary shares for consideration of 100 deferred shares worth £1. No mention is made of the fact that Conegate owned a further 250 ordinary shares in WHH which, as a result of the conversion, increased in value from £20,000 per share to £22,000 per share, a total of £500,000. One might reasonably conclude, therefore, that Conegate would only have required consideration of £1.5m to agree to the transaction (effecting, together with the other shareholders, the conversion) acting at arm's length.

Indeed, the FTT's reasoning on s29(1) is somewhat confused, as it seems to agree with HMRC's counsel's assertion that the effect of s29(1) is to deem the consideration for the disposal in question to be the market value of what is disposed of; whereas it is clear that what the section is actually doing is essentially the opposite. It operates by deeming: (i) the actual transaction to be on non-arm's length terms; and (ii) the consideration which could have been obtained at arm's length to be the market value of the asset in question. HMRC and the FTT's position here is illogical because the consideration for the transaction is irrelevant once it is deemed to be on non-arm's length terms, since at that point s17 steps in to substitute market value for the consideration. That is the very reason why s29(1) goes on to set market value in this particular case.

Of course, in many situations the actual market value of the asset in question, and the consideration which could have been obtained at arm's length, will be one and the same. However, in the circumstances at hand, and certainly in the single shareholder example, that may not be the case.

Viewed thus, Conegate potentially makes a £500,000 loss. This does not look quite so outrageous if one steps back and considers what Conegate has done. It paid £2m, increased the value of its remaining shareholding in WHH by £500,000 and is not claiming any increased basis in that shareholding. It is left with ordinary shares worth £5.5m but basis of only £5m; i.e. that loss would be matched by a paper gain.

However, in my opinion the correct application of the law to the facts should result in Conegate not realising any loss and having basis of £5.5m in its shares. Applied correctly, the law in fact tracks the substance and the economics appropriately.

To my mind, a "conversion" of 100 ordinary shares out of a total holding of 350 ordinary shares into deferred shares screams 'reorganisation'. I understand why the taxpayer would not have raised this (it eradicates the loss they want to claim) and I understand why HMRC would not have raised it (it just wants to knock out the loss) but I am surprised it was not mentioned by the FTT.

The conversion of ordinary shares into deferred shares should be a reorganisation within the meaning of TCGA 1992 s126. Further, all of the ordinary shares held by Conegate are concerned in that reorganisation. Whilst only a portion are actually converted into deferred shares, the remainder increase in value and represent, to an extent, those converted. Prima facie then, no disposal treatment should therefore apply under TCGA 1992 s127.

This is where the interaction between s29 and s127 comes into play - and, indeed, the share identification rules in TCGA 1992 s107. In my view, whilst s 107 could stop the 100 ordinary shares acquired from Conegate from being added to a s 104 holding with Conegate's existing ordinary shares under the ten day disposal rule, I do not believe it prevents the single asset fiction in s127 from applying to them. Further, logic would suggest that s29 has to be applied to that single asset. That single asset is ordinary shares in WHH, for which Conegate has paid an aggregate £7m and out of which value of £1.5m passes. TCGA 1992 s128(3) can be triggered by deemed consideration; and, as such, there should be a deemed part disposal of Conegate's ordinary shares for £1.5m as a result of applying ss29 and 128. £1.5m is the consideration that I believe Conegate would expect to receive in an arm's length transaction, which resulted in a £1.5m reduction in the value of its holding. This therefore should be taken to be the market value of what Conegate had disposed of.

We then need to find out how much of Conegate's basis of £7m is attributable to that part disposal. Section 128(4) applies the market value apportionment of basis rule in s129. Section 29(2) tells us that the market value of what is disposed of is the consideration that could have been obtained; i.e. £1.5m. The market value of what remains is £5.5m. Consequently, basis of £1.5m should be attributable to the part disposal, resulting in neither a gain nor a loss arising, and leaving Conegate with £5.5m of basis in those shares for the future.

### TCGA 1992 s 17

With regards to TCGA 1992 s17, the FTT held that the conversion of ordinary shares into deferred shares was a disposal, that it was otherwise than by way of arm's length bargain and, as such, could be deemed to be for the market value of the shares disposed of (being the ordinary shares worth £2m). It should be apparent at this point, I think, that the FTT erred in viewing the conversion as a disposal and not a reorganisation. As such, s17 should not have been in point, other than as a result of s29, and using the deemed market value provided by s29 rather than the actual market value of the shares.

### TCGA 1992 s 16A

The FTT's reasoning on TCGA 1992 s16A is contained in a single paragraph. Whilst its conclusion may well be right, that paragraph simply does not contain sufficient reasoning to support it. The key passage is as follows:

> *"It is clear from our findings of fact that there was more than one way to provide funding to the football club and that one of the reasons that Mr Sullivan chose to provide funds to the football club in the specific way that transpired was so that the appellant could claim a capital loss. Therefore we consider securing a tax advantage to have been "one of the main purposes" of the arrangements."*

Unpicking this a little, there are three key stages to applying a main purpose test like TCGA 1992 s16A.

The first is to establish whether there is a 'tax advantage' at all by comparing the transaction that the taxpayer actually made with an appropriate comparator that achieves the same commercial aims. Unless the tax consequences of the appropriate comparator transaction are worse than the consequences of the actual transaction, there can be no tax advantage. But let us assume that is all implicit in the first half of the first sentence quoted above and the FTT is, in effect, saying that Plan A is an appropriate comparator transaction because it is what Mr Sullivan would have done, had he not been thinking about tax, and Plan C potentially produces a tax advantage over Plan A.

The second is to establish what the purposes of the arrangement were in this case. Whilst purpose and motive are not the same thing, let us assume that despite its references to 'reasons', the second half of that first sentence is concluding that a purpose of the transaction was to obtain a tax advantage. The third step is to assess and rank those purposes to determine which, if any, are main purposes and which might be considered mere 'icing on the cake'. As the various decisions in *Lloyds TSB Equipment Leasing (No. 1) Ltd* have shown, ranking purposes and determining which ones are 'main' is a detailed exercise (technically, in that case, 'objects' rather than 'purposes', but the principle is the same). Given the evidence here that:

> *"Mr Sullivan told us that he regarded [the capital loss] as a bonus; he told us: I was pleased, but thought it wouldn't be allowed. I'm still here, and I'm still not getting it allowed".*

One might have expected the FTT to take rather more trouble to explain why it did not accept that assertion.

## Conclusion

All in all, the *Conegate* decision is an unusual one. I cannot remember the time I last disagreed more with a judgment and thought it contained key errors on some fundamental points of tax law. I also think it important to call these out, as there could be a read across to many more innocent scenarios. And yet, at the same time, I do not think the taxpayer should have any real complaint about the outcome, nor should hope for any better result on any appeal!

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