HMRC Guidance

Avoidance through the creation and use of capital losses

21 March 2007

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This guidance is intended to be read in conjunction with the statement on capital losses first published on 6 December 2006. This guidance was published in draft form on 6 December 2006 but following discussions with representative bodies and other interested parties it has been revised and extended.

Statutory references in this note are to the Taxation of Chargeable Gains Act 1992, unless otherwise indicated.

Introduction

1. Draft anti-avoidance legislation was published at Pre-Budget Report 2006 targeting arrangements intended to avoid UK tax through the creation and use of contrived capital losses. Final legislation will be included in Finance Bill 2007.
2. The legislation will apply to capital losses which arise on disposals on or after 6 December 2006 and give rise to a tax advantage. Where the legislation applies to a capital loss, the loss will not be an "allowable loss" and may not, therefore, be set off against chargeable gains, nor against income, to reduce liability to capital gains tax, income tax or corporation tax. It will replace the legislation which applies currently to capital losses of companies subject to corporation tax, but does not alter its effect. The guidance published on 27 July 2006 relating to the anti-avoidance rule for companies will remain valid (with the proviso that references to section 8 in that guidance should be read in future as references to section 16A). This paper provides guidance on how the legislation will apply in relation to capital gains tax and income tax.
3. Besides continuing to apply to companies liable to corporation tax in respect of chargeable gains, the legislation will now apply also to any person liable to tax on capital gains, including individuals, trustees, and the personal representatives of deceased persons. But, because it is targeted at arrangements that are intended to avoid UK tax, most persons will not be affected, nor will it apply to the majority of transactions undertaken by such persons. In particular it is unlikely that individuals with a normal portfolio of investments who make disposals in the ordinary course of managing their portfolio would be affected by these new rules because there is currently little evidence to suggest that such individuals undertake the type of arrangements that are targeted by this legislation.
4. The legislation is intended to have effect where a person enters deliberately and knowingly into arrangements to avoid tax.
5. The effect of the legislation will be to restrict the use of capital losses resulting from the arrangements where tax avoidance is the main purpose or one of the main purposes of the arrangements.

“Arrangements” and “tax advantage”

6. This section provides information about the terms “arrangements” and “tax advantage” used in the legislation.

“Arrangements”

7. The term “arrangements” is widely drawn to include any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable.

8. Whether a transaction forms part of a series of transactions, or a scheme, or an arrangement is in general a question of fact, but this conclusion will follow in any case where one transaction would not have taken place without another transaction, or would have taken place on different terms without that other transaction. However, it is not necessary that transactions must depend on each other in this way in order that they form part of a scheme or arrangements.

“Tax advantage”

9. It is a condition for the legislation to apply that the main purpose, or one of the main purposes, of any arrangement(s) is to gain a “tax advantage”. This expression is defined in the legislation, and has four legs covering relief from tax, repayment of tax, reduction or avoidance of a charge to tax, and avoidance of an assessment to tax.

10. If a tax advantage arises out of a transaction that is part of the arrangements, the legislation asks whether the main purpose or one of the main purposes of the arrangements (referred to as “a main purpose” in this guidance) is to achieve a tax advantage. The purpose of the arrangements is determined by the purpose of the participants in entering into the arrangements. If any participant has a main purpose of achieving a tax advantage, that will constitute a main purpose of the arrangements.

11. There is no one factor that determines whether the obtaining of a tax advantage is a main purpose of an arrangement. All the circumstances in which the arrangements were entered into need to be taken into consideration. The circumstances might include:

    - the overall commercial objective: this should be considered not only from the perspective of individual participants in the arrangements, but also from any wider perspective, such as that of the settlor or beneficiaries of a settlement whose trustees were participants: for these purposes a commercial objective does **not** include tax motivated reasons;

    - whether this objective is one which the parties involved might ordinarily be expected to have, and which is genuinely being sought;

    - whether the objective is being fulfilled in a straightforward way or whether the introduction of any additional, complex or costly steps would have taken place were it not for the tax advantage that could be obtained.

12. The straightforward use of a statutory relief does not of itself bring arrangements within the TAAR. Equally, the existence of a tax advantage, such as obtaining a deduction

for tax purposes, is not enough in itself to show that the arrangements have a main purpose of obtaining a tax advantage.

13. For instance, where there is evidence that a person considered two ways to achieve a commercial objective and chose on commercial grounds to pursue one of them, the fact that there was a beneficial difference in tax treatment for the chosen route would not meet the main purpose test. Where the potential tax treatment was a factor in choosing between alternative arrangements, then it would still be necessary that securing a tax advantage was a main purpose to the arrangements. There may be situations where the tax advantage secured through undertaking one arrangement rather than another is so significant that this indicates that achieving a tax advantage was a main purpose. This is unlikely to be the case where the arrangements chosen do not involve additional, complex or costly steps included solely to secure or enhance a tax advantage. Where a person has entered into a marketed tax avoidance scheme, this will be taken as an indicator that securing a tax advantage was a main purpose of the arrangements.

14. Hence it will be relevant to draw a comparison in order to consider whether, in the absence of the tax considerations:

- the transaction giving rise to the advantage would have taken place at all;
- if so, whether the tax advantage would have been of the same amount; and
- whether the transaction would have been made under the same terms and conditions.

15. Nothing in the new legislation prevents relief for losses under section 24 where a genuine loss has been incurred on an asset which has been lost or extinguished, etc., or where an asset has genuinely become of negligible value. Nor will the new legislation ordinarily prevent a genuine loss on a real disposal of an asset from being set off against a person's own gains, including the case where, before the real disposal that gives rise to the genuine loss, the person acquires the relevant asset from a spouse or civil partner at no gain/no loss under section 58.

Restriction on allowable losses

16. There is evidence to show that a variety of schemes to generate capital losses which the existing legislation was never intended to produce are being marketed and implemented. Typically the schemes involve the generation of a capital loss for tax purposes where there is no genuine commercial loss and/or no genuine commercial disposal, often through schemes with no commercial rationale.

17. The intent of this targeted anti-avoidance rule ("TAAR") is to apply the principle set out in the HMRC statement of 6 December 2006, that relief for capital losses should be available only where a person has suffered a genuine commercial loss and made a real commercial disposal. This principle is neither new nor startling. Indeed, judicial support for such an approach can be found as far back as 1978:

> "The capital gains tax is of comparatively recent origin. The legislation imposing it, mainly the Finance Act 1965, is necessarily complicated, and the detailed provisions, as they affect this or any other case, must of course be looked at with

care. But a guiding principle must underlie any interpretation of the Act, namely, that its purpose is to tax capital gains and to make allowance for capital losses, each of which ought to be arrived at upon normal business principles. No doubt anomalies may occur, but in straightforward situations, such as this, the courts should hesitate before accepting results which are paradoxical and contrary to business sense. To paraphrase a famous cliché, the capital gains tax is a tax upon gains: it is not a tax upon arithmetical differences."[1]

18. This legislation will not apply where there is a genuine commercial transaction that gives rise to a real commercial loss as a result of a real commercial disposal. In these circumstances there will be no arrangements with a main purpose of securing a tax advantage. Conversely, where there is either no genuine commercial disposal, or no real commercial loss, or no real commercial disposal or any combination of the foregoing, then there are likely to be arrangements in place with a main purpose of securing a tax advantage so the legislation will apply.

19. Nor will the legislation apply where the Act provides that an event is treated as a disposal, such as in the case of a negligible value claim, or where a capital sum is derived from an asset - provided that such an occasion of charge does not form part of arrangements which have been entered into with a main purpose of securing a tax advantage.

20. The effect of the new legislation is that any capital loss arising on a disposal on or after 6 December 2006 will not qualify as an allowable loss when it arises in connection with arrangements having a main purpose of obtaining a tax advantage.

21. In order to prevent abuse where losses are created either for immediate use or for use in future years, the legislation applies even if, at the time the loss arises, there are no chargeable gains from which the loss could otherwise have been deducted.

22. It also prevents abuse where the tax advantage would ultimately have arisen to a person other than the person to whom the loss arises, for example where the trustees of a settlement enter into arrangements to create a loss that would ultimately confer a tax advantage on the settlor because the trustees' gains are, in effect, charged on the settlor.

23. Whilst we will not give advice under Code of Practice 10 in respect of transactions which, in our view, may have been undertaken with the purpose of avoiding tax, HMRC will provide advice about the interpretation of the wording of the legislation where there is genuine uncertainty, in accordance with the principles set out in Code of Practice 10.

Examples

24. Examples of how the legislation will apply in particular circumstances are set out below.

[1] Lord Wilberforce in Aberdeen Construction Group Ltd v CIR, 52 TC 281.

Example 1 – loss on second-hand life insurance policy

25. An individual, C, acquires a life insurance policy “second-hand” for £1 million. The policy had been issued a few days earlier to a third party for a single premium of (say) £990,000. The policy falls within the income tax regime for ‘chargeable event gains’.

26. C surrenders 95% of the policy back to the insurance company, receiving (say) £955,000 for the surrender. A few days later C surrenders the remaining 5% of the policy, receiving (say) £55,000 in final settlement.

27. C’s intention is to generate a capital loss broadly equal to the cost to him of acquiring the policy, even though he has made no economic loss. There are two legs to the disposal: it is claimed that the interaction of the income tax rules for chargeable event gains in Chapter 9 of Part 4 of the Income Tax (Trading and Other Income) Act 2005 and the capital gains part-disposal rules mean that the first part-disposal results in neither a chargeable gain nor an allowable loss, while the second results in a loss equivalent to virtually the whole of the £1million paid by C for the policy, with only a very small chargeable event gain on which C is chargeable to income tax.

28. But any such loss will be generated as a result of arrangements whose main purpose (or one of the main purposes) is to gain a tax advantage. The loss will be caught by the TAAR and will not be allowable.

Example 2 – capital loss set against income

29. An individual, F subscribes £20 for 20 ordinary shares in a company, G Ltd., which meet the requirements for any loss on disposal of the shares to be relievable against F’s income (section 574 ICTA 1988, or, from 6 April 2007, section 131 Income Tax Act 2007).

29. To generate a significant loss F arranges to sell the shares for their current value to a third party, P. F also grants P an option to sell the shares back for their market value at the time the option is exercised.

30. P injects (say) £1 million into G Ltd. by subscribing for another share at a premium of £999,999. P then exercises the option (within 30 days of F’s original sale) and sells the 20 shares back to F for their current value of (say) £1 million.

31. The CGT ‘bed and breakfasting’ identification rules in section 106A(5) match the shares disposed of (by F) with the later reacquisition, and a loss of £999,980 arises to F. F claims to set this loss off against income. But the loss has been generated by arrangements which F clearly entered into with the aim of gaining a tax advantage. The new legislation will therefore apply and the capital loss will not be an allowable loss, and cannot be set off against F’s income (or against F’s capital gains).

Example 3 – artificial loss from matched options, etc.

32. A body of trustees, W, takes out two options or futures, designed so that one will yield a loss and the other a corresponding (or similar) gain, depending on how the value of the underlying assets has changed. The contracts are completed so that a loss and a matching (or similar) gain arise.

33. A tax advantage could be obtained by setting the loss on one of the contracts against chargeable gains on some other disposal (in the same year that the loss arises or another year) while the gain on the other contract is perhaps

- not taxed at all, or
- taxed at a lower rate than the 'saving' achieved by setting the loss against the other chargeable gains, or
- not taxed until a later year.

34. The matching contracts are arrangements which W has entered into with the aim of gaining a tax advantage. The arrangements ensure that W will obtain a capital loss intended to reduce his tax liability while suffering no overall economic loss. The loss arising will therefore be caught by the TAAR and will not be allowable.

Example 4 – sale of shares to realise capital loss

35. Mr H, sells shares in a company, S plc, in order to crystallise a loss which can be set against his chargeable gains arising in the year. Unbeknown to Mr H, his wife Mrs H buys shares of the same class in S plc a few days later, at the same price as Mr H sold the original holding.

36. In this case, Mrs H’s decision to acquire shares in S plc is unconnected with Mr H’s disposal of similar shares. Mr H has simply taken advantage of the statutory relief for capital losses in section 2(2). Mr H has incurred a real economic loss on a genuine disposal to a third party, and Mrs H has made a genuine purchase on arm’s-length terms. No arrangements have been made with a main purpose of obtaining a tax advantage, so this does not fall foul of the TAAR.

Example 5 – sale of shares to realise capital loss

37. As in example 4, Mr H sells shares in a company, in order to crystallise a loss which can then be set against his chargeable gains arising in the year. Mr H makes arrangements for his wife Mrs H to purchase the same number and class of shares. Mrs H then transfers the shares back to Mr H on the following day. By virtue of section 58 TCGA this is a no-gain, no-loss transaction.

38. In this case, arrangements have been made, and the purpose of the arrangements is to secure a tax advantage. Following the transactions there has been no change in the real economic ownership of the assets, as an identical shareholding is still owned by Mr H, and the only change is that a tax loss has been obtained. As arrangements have been entered into with a main purpose of securing a tax advantage, the TAAR applies and the capital losses claimed by Mr H will be disallowed.

Example 6 – sale of shares to realise a capital loss

39. An individual, R, who has realised a chargeable gain in a particular tax year, sells shares in a company, X plc., which are standing at a loss, to an unconnected third party. R wishes to offset the resulting capital loss against the other chargeable gain. 31 days later R buys back the same number of shares in X plc., again from an unconnected third party.

40. R has incurred a real economic loss on a genuine disposal to a third party. As the shares were bought back after the 30 day time limit in section 106A(5) TCGA the transaction is not within those “bed and breakfasting” rules. Provided that R has not entered into some form of arrangements, for instance, to ensure that he is not exposed to a genuine commercial risk in respect of the shares during the period they were not in his ownership, this suggests that he has not entered into arrangements with a main purpose of securing a tax advantage. The transactions therefore fall outside the scope of the TAAR.

Example 7 – sale of shares to realise a capital loss

41. R (from example 6) sells the same shares in X plc. to an unconnected third party, again in order to realise a capital loss which can be set against a chargeable gain. However, the contract specifies that R has the right to require the same third party to sell the shares back for their market value within 35 days, provided that the market value has not risen or fallen by more than 5%. R duly buys the shares back after 31 days.

42. The additional step suggests that R has entered into arrangements which have a main purpose of securing a tax advantage. Following these transactions R still has the same shareholding in X Ltd., but he has used the capital losses to secure a tax advantage by reducing his chargeable gains, and other than the realisation of the loss there has been no real economic change. As there have been arrangements with a main purpose of securing a tax advantage, the transactions fall within the scope of the TAAR and R’s losses will be disallowed.

Example 8 – sale of asset by trustees

43. A body of trustees sell a capital asset and realise a chargeable gain. In the same year, they also sell an asset which is standing at a loss in order to crystallise that loss. The loss can be set against the gain, and so no CGT is payable in that year.

44. Each of these transactions is a genuine commercial transaction, and the relief the trustees receive for their loss is explicitly provided for by section 2(2) TCGA. There has been a real change in the economic ownership of both assets. The trustees have not entered into arrangements which have a main purpose of securing a tax advantage and the TAAR does not therefore apply.

Example 9 – sale of asset by trustees

45. The same body of trustees have carried out the transactions as in example 8 above. They realise a chargeable gain and a capital loss. The trustees then appoint cash to a beneficiary of the settlement, Z, in order to allow him to buy back the asset on which the loss has been realised, and the beneficiary does so.

46. The additional step, and the fact that Z is a beneficiary of the settlement, suggests that the trustees have entered into arrangements which have a main purpose of securing a tax advantage. Where trustees have entered into arrangements with a main purpose of realising such an advantage the TAAR will apply and the losses will be disallowed.

Example 10 – investment in EIS shares

47. An individual, J, invests in shares under the Enterprise Investment Scheme (EIS), with a view to securing income tax relief. In order to fund the purchase of the shares J sells a capital asset which is standing at a loss to a third party.

48. J has made a real commercial disposal and incurred a genuine economic loss. The fact that the disposal has been made with a view to making use of a particular tax relief does not mean that the arrangements have been entered into with a main purpose of securing a tax advantage. Hence the TAAR does not apply.

Example 11 – deferred gain covered by capital loss on EIS shares

49. Y has realised a chargeable gain but this is deferred because he invests a sufficient amount in shares issued under the Enterprise Investment Scheme (EIS). Unfortunately the company does not succeed and the shares later become worthless. Y makes a negligible value claim under section 24(2) and the resulting loss is set against the original gain that is brought back into charge under the EIS rules, or possibly against Y's income under section 574 ICTA.

50. Y's loss is allowable (where a competent notice is given) because it is a genuine commercial loss. The negligible value claim only creates a disposal for capital gains purposes. It makes no difference that a gain on the EIS shares may have been exempt. The new legislation does not have any effect on the normal operation of the relief.

Example 12 – capital loss following disposal of company assets

51. M and K are married and between them own all the shares in a property investment company, B Ltd. The shares are standing at a loss but B Ltd owns a valuable property. M and K jointly buy the property from B Ltd. for cash at its open market value and the company distributes its remaining assets, the cash, during its winding up. M and K each realise a capital loss on the disposal of their shares in B Ltd.

52. The new legislation will not apply because B Ltd. has simply converted value represented by property into the same value represented by cash. No arrangements have been made with a main purpose of realising a tax advantage, and so the TAAR does not apply.

Example 13 – trustees make a deliberate transfer of value

53. A body of trustees who fall within the terms of Schedule 4B have outstanding borrowing which has not been used for trust purposes (Schedule 4B is a measure introduced to discourage trustees avoiding capital gains tax by incurring debt and advancing funds from the settlement). The trustees intentionally make a transfer of value which triggers off a charge under Schedule 4B, and as they expect this transaction results in a capital loss. The trustees have realised chargeable gains in the same year, and claim to set the loss against those gains.

54. It is necessary to look at the arrangements which have been entered into by the trustees to determine whether these have been entered into with a main purpose of securing a tax advantage. It is significant that Schedule 4B is itself anti-avoidance

legislation, intended to counter avoidance of tax on gains by contrived arrangements between settlements and it is clear in this case that the main purpose of the arrangements is to secure a tax advantage. Hence the TAAR applies and the loss is not allowable.

Example 14 – trustees distributing assets to beneficiaries

55. The trustees of a settlement wish to distribute an asset to a beneficiary of the settlement. They are aware that this will give rise to a chargeable gain. They are also aware that they own a second capital asset which is standing at a capital loss. They therefore transfer that second asset to the beneficiary in the same year. The loss the trustees incur on the transfer of the second asset is set against the gain arising on the transfer of the first asset.

56. Although it is the case that the trustees have arranged to dispose of the two assets in the same tax year, there is no suggestion that the main purpose of the arrangements was to secure a tax advantage. The two disposals have been made with a view to taking advantage of the statutory relief in section 2(2) in a straightforward way. In such a case the TAAR will not apply and the losses will be available to set against the chargeable gains.

Consultation

57. The legislation to which this guidance refers can be found at www.hmrc.gov.uk. Queries or comments relating to this guidance should be sent to:

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