[2016] UKUT 0081 (TCC)

Appeal numbers: UT/2014/0046 & 0047

Capital gains tax – redemption of qualifying corporate bonds (QCBs) - scheme to avoid the application of s 116 TCGA to a conversion of non-QCBs into QCBs – s 116(1)(b) and s 132 - whether a single transaction of non-QCBs and QCBs into QCBs or two separate transactions – whether the conversion and redemption should be treated as a single composite transaction of the disposal/redemption of non-QCBs – the Ramsay principle

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Appellant**
- and -	
(1) ANTHONY HANCOCK **(2) TRACY LEE HANCOCK**	**Respondents**

TRIBUNAL: MRS JUSTICE ROSE, CHAMBER PRESIDENT
JUDGE HOWARD NOWLAN

Sitting in public at the Rolls Building, London EC4 on 25 November 2015

Michael Gibbon QC and Elizabeth Wilson, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

Michael Sherry, instructed by Haines Watts Farnborough, for the Respondents

DECISION

1. The Appellants ('HMRC') appeal against the decision of the First-tier Tribunal (Judge Berner and Nigel Collard) dated 21 July 2014 ([2014] UKFTT 695 (TC)) allowing the Respondents' appeal against closure notices and amendments made in November 2011 to their self-assessment tax returns for the year to 5 April 2004. The effect of the appeal was that a disposal for cash by the Respondents ('the Hancocks') of two loan notes which had an aggregate nominal value of £9,724,651 did not bring into charge an accrued capital gain. The issue in the appeal is whether the redemption of the loan notes generated a chargeable gain in respect of the capital gain accruing on the total value of the secured discounted loan notes or only on a small proportion of that value.

2. The facts were largely agreed before the First-tier Tribunal. The Hancocks held in total 100 per cent of the share capital in a limited company, Blubeckers Limited. On 24 August 2000 Blubeckers Ltd was sold to Lionheart Holdings Limited ('Lionheart'). At the date of disposal the issued share capital of Blubeckers Limited consisted of 5,219 £1 ordinary shares. Mr Hancock held 2,611 shares and Mrs Hancock held 2,608 shares. The initial consideration payable by Lionheart took the form of loan notes issued by Lionheart to the value of £9,270,000, with provision for payment of further consideration depending on the subsequent performance of the business.

3. The loan notes issued on 24 August 2000 were:

   a. £500,000 A Loan Notes 2007, which were issued to Mr Hancock;

   b. £4,137,664 B Loan Notes 2004, which were issued to Mr Hancock; and

   c. £4,632,336 B Loan Notes 2004, which were issued to Mrs Hancock.

4. This appeal is concerned with the tax consequences arising from subsequent actions taken with the B Loan Notes 2004. The A Loan Notes 2007 are not directly involved in the case. We refer to the B Loan Notes 2004 issued to the Hancocks in August 2000 as the '08/00 Loan Notes'.

5. The 08/00 Loan Notes bore interest at 0.5% per annum below HSBC's base rate and were repayable on 24 August 2004 or at such earlier time (so long as not less than six months after issue) as the note holder might require. Clauses 1.3 and 5.3 of the conditions set out in the 08/00 Loan Notes provided that the note holder could require repayment in US dollars, with the exchange rate to be the spot rate obtained or obtainable by Lionheart twenty days before repayment. It is agreed that the provision for payment in a currency other than sterling and at an exchange rate other than that prevailing at redemption prevented the 08/00 Loan Notes from being qualifying corporate bonds for the purposes of section 117 of the Taxation of Chargeable Gains Act 1992 ('TCGA'). The precise definition of what is a qualifying corporate bond is not relevant to this dispute.

6. Additional purchase consideration became payable and was paid on 22 March 2001, as follows:

a. £477,516 B Loan Notes 2004 were issued to Mr Hancock; and

b. £477,135 B Loan Notes 2004 were issued to Mrs Hancock.

We refer to these additional B Loan Notes 2004 as the 03/01 Loan Notes.

7. On 9 October 2002 deeds of variation removing the rights to redemption in US dollars from all the 03/01 Loan Notes were executed. We refer to these amended notes as the 'Revised 03/01 Loan Notes'. The Revised 03/01 Loan Notes were qualifying corporate bonds (QCBs) whereas the 08/00 Loan Notes were still not qualifying corporate bonds (non-QCBs).

8. On 7 May 2003 the 08/00 Loan Notes and the Revised 03/01 Loan Notes beneficially owned by the Hancocks were exchanged for two Secured Discounted Loan Notes 2004; one with a nominal value of £4,615,180 (in the case of Mr Hancock) and one with a nominal value of £5,109,471 (in the case of Mrs Hancock). The Secured Discounted Loan Notes were QCBs. Significant features of the exchange (or exchanges) effected on 7 May 2003 were that the terms of the exchange or exchanges were set out in a single document and the Secured Discounted Loan Notes issued to each of the Hancocks were issued in their aggregate amounts, without those attributable to the 08/00 Loan Notes and the Revised 03/01 Loan Notes being separately identified.

9. The Secured Discounted Loan Notes provided for redemption on 30 April 2004 or for early redemption on either 30 June 2003 or 31 December 2003 on 30 days' notice. An early redemption notice was given and the Secured Discounted Loan Notes were redeemed on 30 June 2003 for cash, together with the payment of the associated redemption premium.

10. To summarise the chronology therefore:

a. 24 August 2000 – the 08/00 Loan Notes were issued (non-QCBs)

b. 22 March 2001 – the 03/01 Loan Notes were issued (non-QCBs)

c. 9 October 2002 – the 03/01 Loan Notes (non-QCBs) were converted into the Revised 03/01 Loan Notes (QCBs)

d. 7 May 2003 – the 08/00 Loan Notes (non-QCBs) and the Revised 03/01 Loan Notes (QCBs) were converted into Secured Discounted Loan Notes (QCBs)

e. 30 June 2003 – the Secured Discounted Loan Notes (QCBs) were redeemed for cash.

11. The First-tier Tribunal heard evidence from Mr Hancock mainly directed at the question whether it had been the Hancocks' intention when the 08/00 Loan Notes and the Revised 03/01 Loan Notes were exchanged for the Secured Discounted Loan Notes on 7 May 2003 that the Secured Discounted Loan Notes would shortly thereafter be redeemed. This is relevant to the second issue that arises in this appeal, namely whether that step of exchanging the two earlier kinds of loan notes for the Secured Discounted Loan Notes should be ignored pursuant to the *Ramsay* principle. The Tribunal's finding, set out in paragraph [32] of the decision, was that at the date of the restructuring, the Hancocks had a settled

intention to redeem the Secured Discounted Loan Notes and had a settled intention to do so with the tax advantage that the restructuring was intended to bring about. The correspondence demonstrated, the Tribunal found, that redemption of the Secured Discounted Loan Notes was at the forefront of the Hancocks' thinking and that their tax adviser was concerned to achieve that objective. It followed, and could not be seriously disputed, that the dollar redemption provision that attached initially to the 03/01 Loan Notes was removed also to pave the way for the implementation of the present scheme.

The law

12. The provisions of the TCGA at the centre of this case are the provisions which apply when companies undergo some corporate restructuring that involves swapping existing shares or securities for new shares or securities. Such swapping of assets might, but for the provisions described below, generate a chargeable gain. For example, when the Hancocks sold their Blubeckers shares to Lionheart in August 2000, this was a disposal by them of their assets and might have generated a chargeable gain if the consideration they received from Lionheart was more than the cost to them of the shares in Blubeckers when they acquired them.

13. However, the provisions generally referred to as "the reorganisation provisions" operate in relation to such a swap. The relevant provisions for the initial swap of Blubeckers shares for Lionheart loan notes were sections 126, 127 and 135 of the TCGA. The effect of those provisions is that there is deemed to have been no disposal of the Blubeckers shares (which were the 'original shares' for the purposes of this transaction) but rather those original shares and the consideration loan notes (the new holding for this purpose) are treated as the same asset, so that the new holding is deemed to have the same acquisition date and cost as the original shares.

14. So far as material, section 126 and section 127 TCGA provide as follows:

"**126 Application of sections 127 to 131**

(1) For the purposes of this section and sections 127 to 131 "reorganisation" means a reorganisation or reduction of a company's share capital, and in relation to the reorganisation—

(a) "original shares" means shares held before and concerned in the reorganisation,

(b) "new holding" means, in relation to any original shares, the shares in and debentures of the company which as a result of the reorganisation represent the original shares (including such, if any, of the original shares as remain).

(2) The reference in sub-section (1) above to the reorganisation of a company's share capital includes-

(a) any case where persons are, whether for payment or not, allotted shares in or debentures of the company in respect of and in proportion to (or as nearly as may be in proportion to) their holdings of shares in the company or of any class of shares in the company, and

(b) any case where there are more than one class of share and the rights attached to shares of any class are altered."

127 Equation of original shares and new holding

Subject to sections 128 to 130, a reorganisation shall not be treated as involving any disposal of the original shares or any acquisition of the new holding or any part of it, but the original shares (taken as a single asset) and the new holding (taken as a single asset) shall be treated as the same asset acquired as the original shares were acquired."

15. Neither side to this dispute sought to rely on the words '(taken as a single asset)' in section 127 in support of their arguments.

16. Although those provisions refer to a reorganisation where the new holding is of shares, the provisions also apply where there is a conversion of securities. This is achieved by section 132 TCGA:

"**Equation of converted securities and new holding**

132— (1) Sections 127 to 131 shall apply with any necessary adaptations in relation to the conversion of securities as they apply in relation to a reorganisation (that is to say, a reorganisation or reduction of a company's share capital)."

17. Section 132 then goes on to define, in a non-exhaustive way, what is meant by 'conversion of securities' for the purpose of these provisions. Section 132(3) (as amended) provides:

"(3) For the purposes of this section and section 133—

(a) "conversion of securities" includes any of the following, whether effected by a transaction or occurring in consequence of the operation of the terms of any security or of any debenture which is not a security, that is to say—

(i) a conversion of securities of a company into shares in the company, and

(ia) a conversion of a security which is not a qualifying corporate bond into a security of the same company which is such a bond, and (ib) a conversion of a qualifying corporate bond into a security which is a security of the same company but is not such a bond, and

(ii) a conversion at the option of the holder of the securities converted as an alternative to the redemption of those securities for cash, and

(iii) any exchange of securities effected in pursuance of any enactment (including an enactment passed after this Act) which provides for the compulsory acquisition of any shares or securities and the issue of securities or other securities instead."

18. Where an asset is a QCB, a gain accruing on the disposal of that asset is not a chargeable gain. This is the effect of s 115 TCGA. As the First-tier Tribunal noted at paragraph [10] of the decision, if section 115 were combined with the operation of sections 127 – 131 (as applied by section 132) to a conversion of securities without more, a gain that is rolled over into a QCB under section 127 would escape capital gains tax when the QCB was disposed of because of section 115. In order to avoid that, the TCGA provides generally that the frozen gain that had not been realised on the disposal of the original shares or securities would be realised on the later disposal of the QCBs, but that any movement in the value of the QCBs themselves would occasion neither a gain nor a loss for tax purposes on the disposal of the QCBs. In broad terms, therefore, where section 116 applies, its effect is not to roll over a gain into the QCB, as would be the case under the ordinary reorganisations rules, but to freeze the gain that would have accrued on a disposal of the original shares or securities at market value at the time of the transaction, and to deem that gain, as a chargeable gain, to accrue on a subsequent disposal of the QCB.

19. Section 116 TCGA provides so far as relevant:

"**116 Reorganisations, conversions and reconstructions**

(1) This section shall have effect in any case where a transaction occurs of such a description that, apart from the provisions of this section—

(a) sections 127 to 130 would apply by virtue of any provision of Chapter II of this Part; and

(b) either the original shares would consist of or include a qualifying corporate bond and the new holding would not, or the original shares would not and the new holding would consist of or include such a bond;

and in paragraph (b) above "the original shares" and "the new holding" have the same meaning as they have for the purposes of sections 127 to 130.

(2) In this section references to a transaction include references to any conversion of securities (whether or not effected by a transaction) within the meaning of section 132 and "relevant transaction" means a reorganisation, conversion of securities or other transaction such as is mentioned in subsection (1) above, ….

(3) Where the qualifying corporate bond referred to in subsection (1)(b) above would constitute the original shares for the purposes of sections 127 to 130, it is in this section referred to as "the old asset" and the shares or securities which would constitute the new holding for those purposes are referred to as "the new asset".

(4) Where the qualifying corporate bond referred to in subsection (1)(b) above would constitute the new holding for the purposes of sections 127 to 130, it is in this section referred to as "the new asset" and the shares or securities which would constitute the original shares for those purposes are referred to as "the old asset".

(4A) …

(5) So far as the relevant transaction relates to the old asset and the new asset, sections 127 to 130 shall not apply in relation to it.

(6) In accordance with subsection (5) above, the new asset shall not be treated as having been acquired on any date other than the date of the relevant transaction or, subject to subsections (7) and (8) below, for any consideration other than the market value of the old asset as determined immediately before that transaction.

…

(9) In any case where the old asset consists of a qualifying corporate bond, then, so far as it relates to the old asset and the new asset, the relevant transaction shall be treated for the purposes of this Act as a disposal of the old asset and an acquisition of the new asset.

(10) Except in a case falling within subsection (9) above, so far as it relates to the old asset and the new asset, the relevant transaction shall be treated for the purposes of this Act as not involving any disposal of the old asset but—

(a) there shall be calculated the chargeable gain or allowable loss that would have accrued if, at the time of the relevant transaction, the old asset had been disposed of for a consideration equal to its market value immediately before that transaction; and

(b) subject to subsections (12) to (14) below, the whole or a corresponding part of the chargeable gain or allowable loss mentioned in paragraph (a) above shall be deemed to accrue on a subsequent disposal of the whole or part of the new asset (in addition to any gain or loss that actually accrues on that disposal); and

(c) on that subsequent disposal, section 115 shall have effect only in relation to any gain or loss that actually accrues and not in relation to any gain or loss which is deemed to accrue by virtue of paragraph (b) above."

20. The issue in this appeal is therefore how far section 116 applies to the transactions carried out by the Hancocks as described earlier, in particular to the events that

took place on 7 May 2003 when the 08/00 Loan Notes and Revised 03/01 Loan Notes were exchanged for the Secured Discounted Loan Notes. That depends on whether the condition set in section 116(1)(b) is satisfied. That condition, inserting the words that are there by implication, is that:

either {the original shares would consist of or include a QCB and the new holding would not consist of or include a QCB} or [the original shares would not consist of or include a QCB and the new holding would consist of or include a QCB]

We refer to the words within the curly brackets as the first limb of section 116(1)(b) and the words within the square brackets as the second limb of section 116(1)(b).

21. Since it is accepted that the Secured Discounted Loan Notes (the 'new holding' here) were QCBs, it is the second limb of that condition which is in question here. The 08/00 Loan Notes were still chargeable assets at the time of the conversion into Secured Discounted Loan Notes and the Revised 03/01 Loan Notes were already QCBs at that time. If the correct way to apply the second limb of section 116(1)(b) in this case is, as the Hancocks contend, to treat both the 08/00 Loan Notes and the Revised 03/01 Loan Notes as together constituting "the original shares" for the purpose of a single composite conversion into the Secured Discounted Loan Notes, the second limb of section 116(1)(b) would appear not to be satisfied because QCBs would be "included" in that composite holding of "original shares". Accordingly since section 132 would still have engaged the reorganisation rule of section 127 (unless at least that composite analysis itself disapplied section 132), the gain in respect of the potentially chargeable holding of 08/00 Loan Notes would have been rolled into tax exempt QCBs, and on the disposal of those QCBs the gain would have escaped tax under section 115. Section 116(10) could not have brought any frozen gain into charge because the whole of section 116 would have been rendered inapplicable.

22. On the contrary approach, advanced by HMRC, there would have been two conversions. The first, being the conversion on 7 May 2003 of the 08/00 Loan Notes into Secured Discounted Loan Notes, would have engaged the provisions of section 116 because no QCBs would have been included in the holding of "original shares" for the purposes of that conversion, and as a result on the disposal of the QCBs on 30 June 2003, section 116(10) would have triggered the charge in respect of the frozen gain calculated as at 7 May 2003. The second conversion on 7 May 2003, that of the Revised 03/01 Loan Notes into Secured Discounted Loan Notes, would not have engaged the provisions of section 116 but since it was acknowledged that section 116 had applied on the earlier removal of the dollar redemption provision on 9 October 2002, section 116(10) would, on 30 June 2003, have triggered the charge on the frozen gain, calculated on that earlier occasion, on the first non-disregarded disposal of the resultant QCBs, i.e. on the redemption of the Secured Discounted Loan Notes. Accordingly, both parties agreed that on any analysis this element of gain was indeed rendered chargeable on the redemption of the Secured Discounted Loan Notes in June 2003.

23. We were told that the tax at stake here is about £830,000 and that as a result of the overall scheme operated here, about £3.5 million is known to be at stake.

The First-tier Tribunal's decision

24. In their treatment of the crucial issue as to whether section 116(1)(b) should be applied by reference to there being one composite conversion or two conversions, the First-tier Tribunal recognised that if the Hancocks' contention was upheld this would occasion an odd result, and indeed one that Parliament could not possibly have intended. It would have the effect that a real gain deferred in accordance with the reorganisation provisions would vanish, in the sense of ceasing to be chargeable, because the asset ultimately disposed of was a QCB exempt under section 115.

25. The First-tier Tribunal began its analysis with examining the meaning of the terms 'original shares' and 'new holding' in section 126 TCGA, adapted in accordance with section 132(1) as necessary to take account of the fact that we are dealing with a conversion of securities rather than a reorganisation of share capital. The meaning of 'original shares' in section 126 is 'shares held before and concerned in the reorganisation'. Adapting this to the conversion of securities, must mean, the Tribunal held, that the original shares are 'any securities held before and concerned in the conversion of securities'. Likewise the meaning of 'new holding' in section 126 as adapted is 'the securities that represent the original securities as a result of the conversion'.

26. The Tribunal held that it was not possible to conclude from the drafting of section 132 that "each security involved in such an arrangement (to use a neutral term) must be regarded as giving rise to a separate conversion, irrespective of the facts of the case": see paragraph [44]. The Tribunal went on:

> "45. It is evident that a "reorganisation" of share capital within s 126 is capable of encompassing a case where more than one class of shares is concerned in the reorganisation. Section 130 expressly envisages a new holding comprising more than one class of shares or debentures. Section 127 envisages shares that would not otherwise be treated as a single asset being taken to be a single asset. Any adaptation of s 127 to s 131 required by s 132 would have to encompass a similar result in the case of conversions of securities. In the context of the reorganisations rules, there is therefore, in our view, no bar in principle to a conversion of securities being a single conversion encompassing a conversion of more than one class of security into a different security."

27. The Tribunal then considered the wording of section 116 itself. They recognised the 'unfortunate mismatch' between the wording of section 116(1)(b) which

envisages a situation where the original shares or the new holding would ‘consist of or include’ a QCB with the wording in subsections (3) and (4) which refer to where the original shares or the new holding ‘would constitute’ a QCB. However, the Tribunal held as follows:

> “47. In our judgment s 116(3) and (4) should be construed so as to apply both where the original shares or the new holding comprised only the QCB, and where the original shares or the new asset merely included a QCB. Only in this way could effect be given to circumstances that s 116(1) makes clear are intended to be governed by s 116. Given the meaning of “original shares” and “new holding” within s 126, as modified for s 132 purposes, the true construction of s 116(3) and (4) is, in our view, to encompass any QCB that, respectively, forms part of the description “original shares” or “new holding”, whether or not there is another asset included within the same description in respect of the same reorganisation or conversion.”

28. The Tribunal considered that if HMRC’s contention that the conversion of the two securities into a single new security should be treated as two separate conversions was correct, it was difficult to see what the words ‘or include’ in section 116(1)(b) mean. Although they accepted in paragraph [52] that that cannot have been the intention of Parliament to allow the non-QCB element of a conversion of securities to escape taxation, they held that that was the effect of the clear words of section 116(1)(b).

29. The Tribunal then found that on the particular circumstances of the case, there had been one conversion rather than two or more conversions. They found that there had been a single conversion of, on the one hand, the 08/00 Loan Notes and the Revised 03/01 Loan Notes into on the other hand, the Secured Discounted Loan Notes. Since the ‘original shares’ for the purposes of section 116(1)(b) were both the 08/00 Loan Notes and the Revised 03/01 Loan Notes, they included a QCB. The new holding, that is the Secured Discounted Loan Notes consisted of a QCB so neither limb of section 116(1)(b) was met.

30. In analysing the parties’ submissions in this appeal, we deal first with our approach to statutory construction and then outline our interpretation of the various provisions, and in particular the relationship between the reorganisation provisions and section 132 on the one hand and section 116 on the other. We will then set out our approach based on our understanding of the way that the reorganisation provisions work, and the bearing that that approach has on the "one composite conversion/two conversions" issue.

Approach to statutory construction

31. The reorganisation provisions in the TCGA and their application to QCBs have been considered in earlier cases in particular by Briggs J (as he then was) in

Harding v HMRC [2008] EWHC 99 (Ch). The loan notes considered in that case started life as non-QCBs because they included an option to convert them into another currency. That option lapsed by effluxion of time. The question raised was whether a security in which a currency conversion option has lapsed becomes, at the moment of lapse, a QCB. Briggs J explained the importance of the point as follows:

> "50. The reason why this short point of construction is of such importance to the parties is that, upon issue to Mr Harding, the Loan Notes had rolled-over into them a very substantial capital gain which had accrued by reason of the large increase in the value of the shares for which the Loan Notes were exchanged. If HMRC's case on construction is correct, then that rolled-over gain, together with any additional gain between the issue and redemption of the Loan Notes, became chargeable to tax on 1st July 1995. If Mr Harding's case on construction is correct, then the rolled-over gain simply disappeared from tax altogether when his currency conversion option lapsed on 23rd January, with the delightful consequence (for him) that it will never be taxable at all. Since Mr Southern who appeared for Mr Harding could not point to any other circumstances in which Parliament had consciously legislated for a rolled-over gain to disappear altogether from tax, and could suggest no reason why it should have been consciously intended as the consequence of the specific language of section 117(1)(b), it is, or at least became, common ground before me that if this appeal should succeed, Mr Harding would obtain a windfall benefit as the unintended result of a drafting anomaly."

32. Briggs J described the history and purpose of the tax treatment of QCBs. He held in paragraph 23 of his judgment that construing section 132 as it then stood, the mere lapse by non-exercise of a currency conversion option was not a 'transaction'.[1] The judge then focused on the proper construction of section 117 and it is in that context that he referred to earlier authorities concerning how to approach that task. He cited first the judgment of Robert Walker LJ in Billingham v. Cooper [2001] STC 1177:

> "Whatever the difficulties the court has to do its best to make sense of the statute, and that means not only making grammatical sense of the text but also finding a rational scheme in the legislation. That is not to say that

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[1] The amendments introduced to section 132(1) as from November 1996 expanding the word transaction to include a conversion "whether effected by a transaction or occurring in consequence of the operation of the terms of any security or of any debenture which is not a security" were aimed at closing the anomaly which Mr Harding had identified: see paragraph 66 of Briggs J's judgment.

> the court should start off with preconceptions about what it expects to find, or that it should shrink from saying so in the rare case where a tax statute has 'plainly missed fire' (the expression used by Lord Macmillan in *Ayrshire Employers Mutual Insurance Association Ltd v. IRC* 1946 SC (HL) 1 at 9, 27 TC 331 at 347). But as Viscount Simon LC said in *Nokes v. Doncaster Amalgamated Collieries Ltd* [1940] AC 1014 at 1022 (which was not a tax case, but has often been cited in tax cases)–
>
> '… if the choice is between two interpretations, the narrower of which would fail to achieve the manifest purpose of the legislation, we should avoid a construction which would reduce the legislation to futility and should rather accept the bolder construction based on the view that Parliament would legislate only for the purpose of bringing about an effective result.'
>
> These authorities were not cited, but they are well known."

33. Briggs J then referred to the judgment of Neuberger J in *Jenks v Dickinson* [1997] STC 853, another case about anomalies arising from a particular construction of the QCB regime. Having cited from the judgment of the Privy Council in *Mangin v Commissioner of Inland Revenue* [1971] AC 739 at 746 and from the speech of Lord Reid in *Luke v IRC* [1963] AC 557, at 577 and 579 Neuberger J applied those principles to the anomaly with which he was faced as follows:

> "The taxpayer's construction does produce an undoubted anomaly which is contradictory to the evident purpose of the relevant statutory provisions viewed as a whole, viz that capital gains made on qualifying corporate bonds should be exempt from tax, whereas capital gains made on shares should be subject to tax. In these circumstances, principle, common sense and authority show that the court is 'entitled, and indeed bound, to … adopt some other possible meaning' if it exists.
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> "… the signposts in this case point firmly to the conclusion that the one thing the legislature did not intend was that capital gains – particularly those which had already accrued on shares- should be exempt from tax.
>
> …

> "Where a particular construction produces an anomaly which only arises in a rather unusual set of facts, its force as an aid to construction, is, in my judgment, somewhat weakened. If, in construing a statute, the court's object is 'to ascertain the will of the legislature', it is a little easier to accept a construction which gives rise to an undisputed anomaly only in the context of a somewhat unusual set of facts, whose existence simply may not have occurred to the legislature, than where such an anomaly is comparatively self-evident or of more general application …"

34. Briggs J stated his conclusions on the statutory construction issue arising in *Harding* in the following terms:

> "59. In my judgment a cardinal feature of the task of construction in the present case is the anomaly [arising] from Mr Harding's construction which, by permitting a security to change after acquisition from a non-QCB to a QCB before disposal but without any transaction, thereby enables substantial accrued gains to fall altogether out of tax. It is one which is not created by any other provision in section 117 (since all the other potential changes of status are triggered by transactions). The most egregious example of the anomaly is where the non-QCB has, because of its status as such, rolled-over into it a substantial chargeable gain already accrued on the shares for which it was exchanged. In that context it falls fairly and squarely foul of Neuberger J's analysis in <u>Jenks v. Dickinson</u>, and it gives rise to an apparently irresistible temptation for tax avoidance. The holder of shares replete with chargeable gains may, rather than by selling them and paying the tax, exchange them for a security which is only not a QCB because of a currency conversion option, and then by declining to exercise it convert the security into a QCB which is redeemable tax-free. …"

35. He noted that the anomaly of which Mr Harding sought to take advantage was not one which arose only 'on a relatively unusual set of facts'. In paragraphs 62 onwards he accepted Mr Harding's submission that 'literally construed' the statutory provision did appear to have the consequences for which he contended. He further accepted that there was 'nothing linguistically inappropriate' in that literal construction. But he went on (paragraph 63):

> "Nonetheless, the question remains whether there is some legitimate alternative construction … which avoids the glaring anomaly presented by the literal construction, nonetheless implements the general purpose of the QCB regime, and which carries no counter-mischief of its own."

36. He held that there was an alternative construction available which was both an available construction and the construction which ought to be preferred. His reasons for preferring that construction were that it plainly avoided the glaring anomaly and no counter-mischief had been suggested. He also based his decision on the fact that it was impossible to believe that the draftsman who framed the relevant provision, or Parliament when it passed it, consciously intended to introduce a provision with the result contended for. No conceivable purpose can have existed for introducing such a result. He therefore dismissed Mr Harding's appeal. Mr Harding's further appeal was dismissed though the Court of Appeal came to a conclusion on the literal wording of the provisions which did not require 'any special construction to avoid anomalies': [2008] EWCA Civ 1164. They did not however say anything to cast doubt on the principles enunciated by Briggs J at first instance.

Discussion

37. The correct starting point for this analysis is not section 116(1)(b) but rather section 132. The opening words of section 116 direct us to identify what is the transaction to which sections 127-130 would apply in the absence of section 116. There are a number of routes into section 116 but the relevant one here is section 132. The first task therefore is not to decide whether section 116 applies to the transaction but to identify what that transaction is.

38. The Hancocks argue that in referring to a transaction falling within sections 127-130, section 116 is not necessarily using the term 'transaction' to mean the 'conversion of securities' for the purposes of section 132. They point out, and we agree, that section 116 refers to a 'transaction' rather than to a 'disposal' because the effect of sections 127 to 131 is to prevent the event that would otherwise be a disposal from being one. But we do not agree with their assertion that the word 'transaction' in section 116 can encompass more than one conversion of securities where the route to sections 127 – 131 is through section 132. Such a construction of the word 'transaction' in section 116 would be inconsistent with section 116(2). That provides that in section 116 references to a transaction include "references to *any conversion of securities* (whether or not effected by a transaction) within the meaning of section 132' (emphasis added). That subsection further provides that references in section 116 to 'relevant transaction', a term used in section 116(10), mean a conversion of securities or other transaction such as is mentioned in subsection (1).

39. These words are a clear pointer to the fact that the 'transaction' referred to in section 116(1) is the conversion of securities as defined in section 132 and not some broader transaction that can include more than one such conversion. Any other construction creates the question that has generated the difficulty in this case

namely: how is one to decide whether a series of closely connected conversions of securities is to be treated as one transaction for the purposes of section 116 or as more than one transaction and if more, then how many? The absence of any statutory mechanism for answering that question enables the Hancocks to assert that it is a question to which they can choose the answer by drafting either one or more contracts. We do not accept that that can have been Parliament’s intention and it is a not a construction compelled by the wording of the provisions.

40. We therefore hold that the ‘transaction’ referred to in those opening words of section 116(1) (as expanded in section 116(2)) is intended to be the conversion for the purposes of section 132, where the relevant route in to section 116(1)(a) is section 132. Each ‘conversion’ for the purposes of section 132 is a different ‘transaction’ for the purposes of section 116(1).

41. The next question is therefore whether there was one or more conversion of securities in this case. For the answer to that, one must go to section 132. Section 132 covers ‘the conversion of securities’. That term is defined, non-exhaustively, as including a conversion of a security which is a non-QCB into a security which is a QCB (s 132(3)(a)(ia)) and a conversion of a security which is a QCB into a security which is a non-QCB (s 132(3)(a)(ib)).

42. We agree with HMRC that it is significant that the examples given in section 132(3)(a) only encompass what they call unmixed conversions. We consider that section 116(3) and (4) are also pointers to conversions only being unmixed conversions.

43. In our judgment, on the proper constructions of sections 132 and 116, each original single asset or single security should be treated as the subject of a conversion whenever this is provided for by section 132. This accords not only with the natural meaning of the wording in section 132 but with the overall structure of the provisions in sections 126, 132, 135 and 136 for the rollover of gains in the case of reorganisations, conversions, takeovers and schemes of arrangement. The common feature of all these provisions is that they are addressing the situation in which there would be a chargeable disposal of some asset for capital gains purposes, and their purpose is to nullify that disposal but then to attach the latent gain or loss in respect of the "original shares or securities" to the new asset or assets that then represent the original shares or securities.

44. The provisions can only operate sensibly if there is separate treatment of each asset that might otherwise have been the subject of a disposal or part disposal. We fully accept that on any form of reorganisation, conversion etc, the new holding might well be composed of two or more shares or securities. The legislation has always contemplated this and dealt with the two different ways in which the gain or loss should be calculated if there is a later disposal of only one of the two or more new assets that replaced the original asset. But since the various provisions are designed to nullify a disposal of the original asset, they must, in our judgment, be applied separately by reference to that asset, and not by reference to some composite aggregation of two or more assets which might have quite different acquisition dates and costs.

45. The First-tier Tribunal placed some reliance on the wording in section 126(1)(a) that refers to the original shares being "shares concerned in the reorganisation" as if this suggested that different shares should be aggregated together if they were concerned in the reorganisation. We consider that the reference to the original shares being concerned in the reorganisation does not have any such connotation. In describing the characteristics of "the original shares", sub-section (1)(a) is simply making the perhaps obvious points that the original shares must have been held before the reorganisation and they must have been involved in or affected by the reorganisation.

46. HMRC accepted at the hearing before us that while they contended that a conversion could only apply separately to the conversion of one single asset, the expression "reorganisation" could refer to and encompass transactions in several shares. We agree with that in the sense that it would indeed be perfectly apt to describe transactions that allotted, say, various bonus shares to the holders of two or more classes of existing shares as "a reorganisation". But we do not take that to mean that it would then be appropriate to treat the different classes of shares, in right of which bonus issues were made, as being comprised, in some composite sense, as "original shares". Section 126(2) makes this clear by addressing the way in which a bonus issue, for instance, will always be made to persons "in respect of and in proportion to … their holdings of shares in the company or of any class of shares in the company". Although the two transactions might aptly be said to be comprised in one reorganisation, the rollover provision would have to be applied separately in relation to each separate original asset.

47. In the case of conversions addressed by section 132, there is no such difficulty as is posed by the potential contrast between the 'transaction' referred to in section 116 and the 'reorganisation' referred to in section 126. For in section 132, there is no such wider overall term and as we have considered above, the various transactions or steps that can occasion "conversions" have all been described singly, and do not envisage aggregation.

48. The feature that for capital gains purposes one must deal separately with every distinct separate asset is in our view supported by the fact that while there are two separate provisions, sections 129 and 130, that deal with the situation where, following some rollover event, the taxpayer ends up with a new holding which comprises shares or securities of more than one class, there is no equivalent provision for the situation where two different original holdings might be treated as the subject of some composite conversion, reorganisation, takeover or scheme of arrangement. The legislation provides for where the original base cost of a single asset needs to be allocated between the constituent parts of the new holding for the purposes of later disposals and part disposals. One would expect to see some provision setting up a mechanism, for example, for averaging the acquisition date and cost of the two or more kinds of original holdings in a composite 'original shares'. There is no such provision in the legislation.

49. We accept that the difficulty about allocating the base cost of a composite holding of original shares does not arise in the present case because it appears that both parties accepted that the acquisition facts in relation to both the 08/00 Loan Notes and the 03/01 Loan Notes all derived from the same Blubeckers ordinary shares.

Accordingly, the inherited cost of the two holdings of loan notes would be the same. But the problem would have arisen if, for example, the Hancocks only effected the one original swap of Blubeckers shares for Lionheart loan notes, and then later subscribed to some 03/01 Loan Notes for cash at market value. The Hancocks could have advanced the same contention that there had been one composite conversion if the dollar redemption option been removed from the 03/01 Loan Notes subscribed for cash, and there had then been the conversion of both the 08/00 Loan Notes and the Revised 03/01 Loan Notes in the one document, all for Secured Discounted Loan Notes. The question that would then have arisen is whether some of the Secured Discounted Loan Notes (those issued on the conversion of the loan notes subscribed in cash, with no latent gain attaching to them) would have a market value base cost, with little or no gain attached to them, or whether all the new holding of loan notes would have an amalgamated base cost, and thus a slightly diminished latent gain in respect of them on account of the cash subscription that would have to be merged into the calculations. Such a contention would highlight the fact that the legislation makes no provision about how to apply the rollover provisions in such a situation. This indicates strongly to us that Parliament did not contemplate that such a situation could arise.

50. We accordingly conclude that the effect of the conversion of the 08/00 Loan Notes into Secured Discounted Loan Notes fell to be treated as one conversion to which section 116(1) applied so that on the redemption of the successor notes, the frozen gain was realised under section 116(10), and that the redemption of the successor notes following the conversion of the Revised 03/01 Loan Notes into Secured Discounted Loan Notes, triggered the gain calculated at the earlier point of the removal of the dollar redemption provision.

51. The Hancocks' argument against such an analysis rested on two additional planks. The first was the fact that the conversion of the 08/00 Loan Notes and the Revised 03/01 Loan Notes into the Secured Discounted Loan Notes was effected by a single document and not two separate documents. The terms of the conversion agreement concluded in May 2003 were drafted on the basis that there was a single transaction. The Hancocks submit that there is no warrant in the documentation or in the language of section 116 to treat what is clearly a single transaction whereby they exchanged their 08/00 Loan Notes and their 03/01 Loan Notes and received the Secured Discounted Loan Notes in exchange. They argue that it is not possible to regard this as though it were two transactions merely so that section 116 can then be applied to those two transactions separately.

52. There are two flaws in that argument. First we reject the suggestion that the parties can determine how the statutory provisions apply to a transaction by the simple expedient of drafting one or more separate documents. That would be too formalistic an approach. Secondly the question whether there is one or more transaction must be analysed not in order to apply section 116(1)(b) but in order to apply section 132 in order then to apply sections 127 to 130. It is only once one has worked out whether and how section 132 applies to the events that have happened that one can move to applying section 116(1).

53. The Hancocks also rely on a point which formed an important part of the First-tier Tribunal's reasoning. This is the puzzle of the inclusion of the words 'or include' in both limbs of section 116(1)(b). It is worth setting out again what the full text of the subsection would look like if implied words were included:

> *either the original shares would* <u>*consist of or include*</u> *a QCB and the new holding would not consist of or include a QCB or the original shares* <u>*would not consist of or include*</u> *a QCB and the new holding would consist of or include a QCB.*

54. The First-tier Tribunal held in paragraph [48] that if the transaction which resulted in the conversion of two securities, one QCB and the other not, into a single new security should be regarded as two separate conversions, 'it becomes difficult to discern why s 116(1)(b) is couched in terms that recognise the possibility of the "original shares" not being wholly comprised of a QCB or a non-QCB'. Before the First-tier Tribunal, HMRC had contended that the relevance of a mixed holding, within the "original shares" of QCBs and non-QCBs might have been designed to deal with the transitional point that some securities of one class might have fallen on both sides of the transitional provision on the introduction of the QCB rules. The First-tier Tribunal rejected this suggested scope for the notion of a mixed holding in the original shares for the purposes of the relevant second limb of section 116(1)(b) because they pointed out that even on this limited scope, the feature of treating there as being a composite conversion would still occasion an incoherent result, namely that the latent gain in respect of the non-QCB component of the mixed holding would still evaporate. We agree with that analysis.

55. We acknowledge the conundrum that is posed by this provision. We do not need to assert that there is no situation in which the notion of a mixed conversion advocated by the Hancocks could apply without being inimical to the structure of the legislation. It may be that we have failed to identify that situation. All that we say is that on the facts of this case our application of the reorganisation rules leads to the conclusion that there were two separate conversions at the relevant stage of the transactions in this case.

56. Bearing in mind the approach to construing the statutory provisions indicated in the *Harding* judgment, we note that the anomaly on which the Hancocks rely is not one that would only arise on a relatively unusual set of facts. It would have arisen on any occasion when a taxpayer holding securities with a large latent capital gain chooses to convert a small amount of them to QCBs, then convert the supposedly mixed batch to QCBs and then redeem those QCBs. No 'counter mischief' generated by the contrary construction has been identified. Parliament cannot have intended to allow gains to fall out of tax by the simple expedient of the scheme which the Hancocks adopted.

57. The interpretation of section 116 whereby the 'transaction' referred to is the conversion under section 132 and whereby that conversion is a single event relating to a particular class of security is, in our view, clearly an available construction and the one to be preferred.

HMRC's secondary argument.

58. The second argument relied on by HMRC is that the conversion which took place on 5 May 2003 (converting the 08/00 Loan Notes (non-QCBs) and the Revised 03/01 Loan Notes (QCBs) into the Secured Discounted Loan Notes (QCBs)) and the redemption of the Secured Discounted Loan Notes for cash on 30 June 2003 should be treated as a single composite transaction. This would mean that the 08/00 Loan Notes (non-QCBs) are simply treated as having been redeemed for cash so that there is neither a disposal of QCBs within section 115 nor a conversion within section 132.

59. Given our findings on the proper construction of the relevant legislation set out above, this second point does not arise for decision. But we set out our conclusions on it briefly below.

60. In its decision, the First-tier Tribunal described the *Ramsay* principle as considered by the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51. HMRC argue that the step whereby the 08/00 Loan Notes and the Revised 03/01 Loan Notes were converted into the Secured Discounted Loan Notes was a step inserted solely for tax purposes and had no commercial purpose. One should therefore leave it out of account.

61. The First-tier Tribunal made findings of fact and then considered how the *Ramsay* principle applied. In paragraph 67 of the decision the Tribunal stated:

> "67. On the basis of the evidence, we find that, at the time Mr and Mrs Hancock entered into the transaction whereby their [08/00 Loan Notes] and [Revised 03/01 Loan Notes] were converted into the Secured Discounted Loan Notes 2004, they intended to redeem the Secured Discounted Loan Notes 2004 as soon as practicable after the conversion. There was no practical likelihood that such a redemption would not take place, as indeed it did. The earliest redemption date in the Secured Discounted Loan Notes 2004 had been specifically fixed so as to enable such a redemption."

62. However, the Tribunal held that that did not entitle them to disregard the conversion of the 08/00 Loan Notes and the Revised 03/01 Loan Notes into the Secured Discounted Loan Notes in May 2003 for two reasons. The first was that the intention to redeem was in respect of the Secured Discounted Loan Notes once they had been issued and that intention only 'crystallised' in relation to the Secured Discounted Loan Notes. Although the May 2003 conversion was intended to give rise to a tax advantage that did not result in the transaction on 30 June 2003 viewed realistically being in fact the redemption of the 08/00 Loan Notes and Revised 03/01 Loan Notes and not the redemption of the Secured Discounted Loan Notes. The second reason was that the 08/00 Loan Notes could

not be redeemed until 30 September 2003. The earlier redemption could only take place if the conversion occurred.

63. We also take into account the fact that following the conversion of the loan notes, the Secured Discounted Loan Notes remained outstanding for a considerable period following the conversion or conversions, the parties' entitlement then being governed (so far for instance as entitlement to interest or premium was concerned) by the terms of the newly issued notes. Accordingly, and for all these reasons, it was difficult, when viewing the facts realistically, to disregard the conversion of the two loan notes into Secured Discounted Loan Notes and to elide that conversion with the subsequent redemption.

64. In interpreting the statutory provisions, the First-tier Tribunal considered that the overall structure of the reorganisation provisions and the rules in section 116 dealing with conversions involving QCBs established a coherent regime for taxing chargeable gains where QCBs are involved. In other words, putting on one side the anomaly we have discussed in section 116(1)(b), the various provisions worked as intended. In the usual case, if the conversion was from a chargeable security to a QCB, the latent gain would be calculated and frozen by section 116(10) and then rendered chargeable on the disposal or repayment of the QCB; there would be no need for HMRC to seek to elide the conversion with the subsequent redemption. The provisions only failed to achieve that result, on the First-tier Tribunal's analysis, because of a drafting error. The Tribunal held that it was not possible to get round the wording of section 116(1)(b) by purportedly applying the provisions in a purposive manner.

65. We agree with the reasoning of the First-tier Tribunal in relation to the *Ramsay* issue. We are inclined to place more reliance on the difficulty in treating it as realistic to ignore the conversion of the two loan notes into Secured Discounted Loan Notes and the 7 week existence of those notes, with their different redemption provisions.

66. We therefore hold that the First-tier Tribunal was right to reject HMRC's secondary argument.

Disposal

67. For the reasons set out above, we allow HMRC's appeal.

MRS JUSTICE ROSE

JUDGE HOWARD NOWLAN

TRIBUNAL JUDGES

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