[2015] UKUT 0418 (TCC)

Appeal number: FTC/64/2014

CAPITAL GAINS TAX – section 38(1)(b) Taxation of Chargeable Gains Act 1992 – whether expenditure incurred "on" an asset and "reflected in the state or nature of the asset at the time of disposal" – whether expenditure incurred "in establishing, preserving or defending … title to, or to a right over, the asset"

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS — **Appellants**

- and -

JULIAN BLACKWELL — **Respondent**

TRIBUNAL: MR JUSTICE NEWEY
JUDGE CHARLES HELLIER

Sitting in public at the Rolls Building, London on 6 and 7 July 2015

Michael Jones, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Kevin Prosser QC and Charles Bradley, instructed by Shipleys LLP, for the Respondents

DECISION

1. This appeal relates to the effect of section 38(1)(b) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), which specifies the expenditure a taxpayer may deduct in computing his capital gains.

2. In 2006 Mr Blackwell paid £17.5 million to be released from certain obligations he had undertaken in 2003 in relation to his shares in Blackwell Publishing (Holdings) Limited ("BP Holdings"). Shortly after making that payment he disposed of those shares. He sought a deduction for that sum under section 38(1)(b) in computing his capital gain on the disposal of the shares. HMRC refused to allow the deduction. Mr Blackwell appealed to the First-tier Tribunal ("the FTT") (Judge Richard Barlow and Mr Duncan McBride), which allowed his appeal. HMRC now appeal against that decision ("the Decision").

The facts

3. There is no dispute about the primary facts. They are to be found in paragraphs 4 to 23 of the Decision. We take the following summary in large part from the skeleton argument of Mr Kevin Prosser QC and Mr Charles Bradley, who appeared for Mr Blackwell.

4. Mr Blackwell held class A (and other) shares in BP Holdings such as would enable him to veto a special resolution, including one to approve or facilitate a takeover of the company. In 2003, following an unsuccessful takeover attempt by Taylor & Francis Group plc ("Taylor & Francis"), Mr Blackwell entered into an agreement ("the 2003 agreement") with Taylor & Francis to do and not to do certain things connected with his A shares in return for £1 million.

5. In 2006 John Wiley & Sons Inc ("Wiley") made an offer for BP Holdings for a much higher sum than Taylor & Francis had offered in 2003.

6. Mr Blackwell wished to accept Wiley's offer, but he was advised by his solicitors that the only way to avoid the risk of litigation was not to take any step in respect of the offer.

7. Taylor & Francis offered to release Mr Blackwell from the 2003 agreement if he paid them £25 million.

8. Mr Blackwell decided that it was necessary to make that payment in order to allow the Wiley deal to go through. He believed that the payment would enable the Wiley bid to be accepted.

9. On 17 November 2006 Mr Blackwell entered into a new agreement ("the 2006 agreement") with Taylor & Francis whereby he was released from his undertakings under the 2003 agreement. In return he paid Taylor & Francis £25 million of which

Wiley provided £7.5 million and he provided £17.5 million. The deduction was sought for the £17.5 million.

10. The FTT found that Mr Blackwell held a rational and well founded belief that the 2003 agreement amounted to an impediment to his acting freely to vote his shares as he would have wished when the Wiley bid came to his attention: the threat of litigation, whether in the form of an attempt to obtain an injunction or otherwise, could well have had a detrimental effect on the prospect of a successful acceptance of the take over or at least have delayed it. The FTT considered that it was easy to see that the price of the shares could have been affected or even that the deal could have failed altogether.

Section 38(1)(b) TCGA 1992

11. This section provides:

> "(1) Except as otherwise expressly provided, the sums allowable as a deduction from the consideration in the computation of the gain accruing to a person on the disposal of assets shall be restricted to–
>
> (a) [acquisition costs]
>
> (b) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or to a right over, the asset, and
>
> (c) [incidental costs]"

12. Section 38(1)(b) may be said to contain two limbs. The first ("limb 1") relates to expenditure on the asset reflected in the state or nature of the asset. The second ("limb 2") relates to the establishment, preservation or defence of title to, or to a right over, the asset.

The Decision

13. The FTT addressed three issues in the context of limb 1 of section 38(1)(b):

(1) Was the £17.5 million expenditure "on the asset"?

The FTT held that it was "in the sense that it was incurred in respect of [the] shares". HMRC appeal against this conclusion;

(2) Was the expenditure incurred wholly and exclusively "for the purpose of enhancing the value of the asset"?

The FTT held that it was. Although the £17.5 million was paid to release Mr Blackwell from his obligations under the 2003 agreement, the FTT found that "Mr Blackwell did believe that the payment would enhance the value of his shares because that would enable the Wiley bid to be accepted which was considerably higher than the Taylor & Francis bid." In the FTT's view, the fact that the value enhancement was not the proximate effect of the payment did not prevent the purpose of the payment being the enhancement of the value of the shares. There is no appeal against this conclusion; and

(3) Was the expenditure "reflected in the state or nature of the asset at the time of disposal"?

The FTT held that, looking at the situation realistically, the "state", if not the nature, of Mr Blackwell's shares changed when he became free to vote them as he wished without the risk of litigation and, hence, that the £17.5 million expenditure satisfied this test. HMRC appeal against this conclusion.

14. Having concluded that limb 1 of section 38(1)(b) was satisfied, the FTT allowed Mr Blackwell's appeal without giving consideration to limb 2. Before us, Mr Prosser argued that a deduction was also permissible under limb 2.

Limb 1

The arguments in brief

15. In outline, the contrasting contentions of the parties are these:

(1) Mr Michael Jones (who appeared for HMRC) argues that the asset disposed of by Mr Blackwell was his shares and that the rights and obligations comprising that asset were unaffected by the 2003 and 2006 agreements. According to HMRC, the expenditure of £17.5 million was neither "on" the asset nor reflected in the state or nature of that asset at disposal;

(2) Mr Prosser argues that the obligations undertaken in the 2003 agreement affected the rights which were available to Mr Blackwell and that the £17.5 million payment was therefore on, or concerned with, those rights and made a change for the better in the state or nature of the rights in Mr Blackwell's hands.

The restrictions imposed by the 2003 agreement

16. The 2003 agreement defined an "Offer" as a takeover offer from Taylor & Francis which was either recommended by the board of BP Holdings or was as good as (or in some cases better than) any other takeover offer. Under the agreement, Mr Blackwell undertook in clause 2.1(c) to assent his shares to such an Offer.

17. In clause 2.3 of the agreement, Mr Blackwell undertook to vote his shares against resolutions which might prejudice Taylor & Francis's prospects of acquiring BP Holdings.

18. Clause 2.6 of the agreement provided that Taylor & Francis should not be entitled to seek specific performance of these obligations and that no interest in his shares should pass to Taylor & Francis.

19. Subject to this, clause 4.1 of the agreement provided that damages might not be an adequate remedy and that an equitable remedy might be the only adequate remedy for a breach of the agreement.

20. In clause 2.1(d) of the agreement, Mr Blackwell gave three undertakings to which the bar on specific performance did not apply (and to which clause 4.1 was applicable):

(1) not to dispose of his shares;

(2) not to solicit, encourage, accept or agree to accept any other offer for his shares;

(3) not to do or permit anything which might impede the acceptance of an Offer.

21. By clause 14 of the agreement, all these undertakings would terminate if a takeover offer was made by a third party and Taylor & Francis did not, within six weeks, make an equally good or better offer.

Case law

22. In well constructed and appealing arguments, Mr Prosser and Mr Jones referred us to a number of authorities. We start by considering these although unfortunately they provide only limited specific assistance.

23. In *Aberdeen Construction Group Ltd v IRC* (1978) 52 TC 281, the taxpayer had paid £114,000 for shares in, and lent £500,000 to, another company. It later sold the shares under an agreement whose obligations were conditional upon its waiving its loans. The purchaser agreed to pay £250,000.

24. In the Court of Session, the taxpayer contended that the making of the loans and their waiver constituted allowable expenditure within the predecessor of section 38(1)(b). It was submitted that the words "state or nature" must be applicable to incorporeal property and were wide enough to include every circumstance which could affect its value.

25. This argument was rejected. Lord Emslie said (290 C-D):

> "…by no reasonable stretch of the imagination is it possible to classify the making of the loans or their waiver as expenditure wholly and exclusively incurred 'on' the shares and I find it impossible to say that either were reflected in the state or nature of the shares which were sold. The waiver of the loans may well have enhanced their value but what [section 38(1)(b)] is looking for is, as a result of the relevant expenditure, an identifiable change for the better in the state or nature of the asset, and this must be a change distinct from the enhancement of value."

26. Lord Johnston similarly said that the relevant expenditure was neither "on" the shares nor reflected in their state or nature at the time of their disposal (293). Lord

Avonside said that when the loan was waived the shares "remained in their state or nature unchanged" (294).

27. Mr Prosser says that Mr Blackwell's case is different. His payment may have increased the value of the shares but that was not relevant; what was relevant (Mr Prosser argues) was that the payment changed the rights which Mr Blackwell could exercise, and that was a change for the better.

28. We agree that the case before us is distinguishable. We accept that section 38 requires that the expenditure must result in an identifiable change for the better in the state or nature of the asset. We agree with Mr Jones that the Court of Session's decision makes clear that section 38(1)(b) requires more than expenditure "in respect of" shares. The judgments do not, however, help to identify the asset with which the section is concerned.

29. When the *Aberdeen* case reached the House of Lords, the argument in relation to section 38(1)(b) was not pursued. The effect of their Lordships' judgments was that the £250,000 purchase price should be apportioned between the shares and the waiver of the loans. Lord Wilberforce set out a guiding principle which he said must underlie the interpretation of the capital gains tax legislation (which, at the time, was mainly to be found in the Finance Act 1965):

> "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 court should hesitate before accepting results which are paradoxical and contrary to business sense" (296f-g).

30. The business reality was that the taxpayer's investment in the company was sold for £250,000 and it made a loss of £364,000 (i.e. £114,000 plus £500,000 less £250,000). But Lord Wilberforce said (296-297):

> "It is clear however that the capital gains tax legislation prevents the matter being looked at in so simple a manner as this because it imposes a tax on the disposal of 'assets' ... [s]o it is necessary to consider separately each asset disposed of in the light of rules which apply to that asset",

thus highlighting the importance of determining the asset to which the legislation applies.

31. Lord Wilberforce returned to what he had said in *Aberdeen* in *WT Ramsay Ltd v IRC* [1982] AC 300, where he said (326):

> "The capital gains tax was created to operate in the real world, not that of make-belief ... [I]t is a tax on gains …, it is not a tax on arithmetical differences. To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, there is not such a loss (or gain) as the legislation is dealing with, is in my opinion well and indeed essentially within the judicial function."

32. Mr Prosser relies on Lord Wilberforce's guiding principle. He says that on normal business principles Mr Blackwell's gain was reduced by £17.5 million.

33. Lord Wilberforce's speech in *Aberdeen* indicates the importance of identifying the asset at issue. Mr Jones relies on *Welton v Saffery* [1897] AC 299, *White v Bristol Aeroplane Co Ltd* [1953] 1 Ch 65, and *Unilever (UK) Holdings Ltd v Smith* (2002) 76 TC 300 as showing that an asset which comprises shares is unaffected by agreements made in relation to them by shareholders. He draws a distinction between the rights attaching to the shares (the asset) and the enjoyment of those shares.

34. *Welton v Saffery* concerned a liquidator's claim against a shareholder to whom shares had been issued at a discount in contravention of the provisions of the relevant Companies Act. It was argued on the shareholder's behalf that because the articles authorised the issue of shares at a discount there was a contract between the shareholders which limited the shareholder's obligation to contribute in the winding up. The House of Lords held that the statute forbade the company to release a shareholder from the obligation to pay unpaid amounts and that the shareholder was liable. In the course of his speech, Lord Davey said (331):

> "Of course, individual shareholders may deal with their own interests by contract in such a way as they think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, or an exceptio personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders."

35. This passage was quoted by Lord Jauncey in *Russell v Northern Bank Development Corp Ltd* [1992] 1 WLR 588, where it was held that a provision in a shareholders' agreement to which the company was a party could take effect only as a personal contract and could not restrict the company's powers to amend its articles.

36. Mr Jones relied upon Lord Davey's dictum in *Welton* in support of the proposition that the asset held by Mr Blackwell was unaffected by the 2003 agreement. But we note that it provides such support only if the "asset" for the purposes of section 38(1)(b) is to be regarded as the rights of the shares under the company's articles.

37. *White v Bristol Aeroplane* concerned the proper interpretation of the articles of a company which provided that a class of shareholders had a right to an extraordinary general meeting to consider any action which "affected" the rights of the class. The company had proposed to issue shares whose issue would change the proportion of the voting rights held by this class of shareholders without varying the rights attached to their shares. Evershed MR accepted that a right could be "affected" without being varied (77) and drew a distinction (at the foot of 74) between affecting the rights and affecting the enjoyment of the rights. He said (at page 76):

> "Without going into too much detail, I cannot make these articles consistent with the view that any variation which in any manner touches or affects the

> value of the preference stock, or the character or enjoyment of any of their privileges, is within the contemplation of [the relevant article].

38. This was therefore a case about the meaning of "affected" as it appeared in those articles. It is of limited assistance with the identification of the "asset" to which section 38 applies or the determination of the state or nature of that asset.

39. Following *White v Bristol Aeroplane*, a distinction was made in the *Unilever* case between an alteration to the enjoyment of rights attaching to shares and an alteration in the rights themselves. In that case the taxpayer, who held ordinary shares, had paid a sum to the holders of preference shares whose shares had been cancelled under a scheme of arrangement. If the cancellation had taken place as part of a reorganisation within section 126 TCGA 1992 then that sum could have been consideration for the "new holding" which arose from the reorganisation. The Court of Appeal held that there was no reorganisation. In so finding Jonathan Parker LJ concluded that there was no variation or alteration of the rights attaching to the retained shares. In the course of his comments on this issue, he referred to *White v Bristol Aeroplane* and the distinction there made between rights and the enjoyment of rights, but he said (at [57]) that the distinction was not in point because the issue was whether the relevant rights had been "altered (ie varied)", and at [75] found that the expression "rights attached to the shares" in section 126 referred to the rights incident to a share viewed as a transferable item of property and did not refer to or embrace the rights between members of the company inter se.

40. We agree with Mr Prosser that this is of little help in addressing the application of section 38(1)(b) for it is only if the state or nature of the asset is equated with the rights attaching to the shares that the distinctions drawn in these cases are relevant.

41. *Gray's Timber Products Ltd v Revenue and Customs Commissioners* [2010] UKSC 4, [2010] STC 782 concerned the market value of shares acquired under a subscription agreement which granted the subscriber a disproportionately high share of the proceeds of any takeover of the company. The issue arose under the employment related securities code, but the definition of market value was taken from section 272 TCGA 1992 which provided that:

> "In this Act 'market value' in relation to any assets means the price those assets might reasonably be expected to fetch on a sale on the open market."

In determining that market value the question was what a hypothetical purchaser would pay a hypothetical vendor.

42. Lord Walker (at [25]) noted the importance of identifying precisely the property to be valued. That requirement gave rise to the first controversy in the case: whether the relevant shares were to be valued as shares simply having the rights in the articles (so that the extra rights were "extrinsic" to the shares), or as shares having additional rights by virtue of the subscription agreement (so that those rights were "intrinsic"); the second controversy was whether, if the rights were intrinsic, that affected the amount which would be paid by the hypothetical purchaser.

43. Lord Walker referred to *Russell v Northern Bank* but he was not convinced that the employment related securities code drew a coherent distinction between intrinsic and extrinsic rights ([37]) and he concluded that, even if the rights in question had been intrinsic to the shares, they would have been of no value to a potential purchaser since they were personal to the subscriber and would not avail him. Lord Hope said that the terms on which the shares were issued were personal to the shareholder and were of no interest to a potential purchaser ([51]). It was the terms subject to which the purchaser would take and hold the shares that must be considered ([52]).

44. Mr Prosser says that *Gray's* concerned market value. In the determination of market value, what the purchaser would hold was relevant; in this appeal, in contrast, we are concerned with the state or nature of what Mr Blackwell held: that (submits Mr Prosser) is a different test and what was extrinsic or intrinsic was not relevant because one has to have regard to how the asset operated in the hands of Mr Blackwell.

45. In *Garner v Pounds* [2000] STC 420, the taxpayer granted an option for £399,750 to M to acquire land, and agreed with M to use its best endeavours to obtain the release of restrictive covenants over the land. The exercise of the option was not dependent upon the removal of the restrictive covenants. If the restrictive covenants were not removed and the option not exercised, the £399,750 was repayable. The taxpayer obtained the release of the restrictive covenants on the payment of £90,000. The grant of the option was the disposal of an asset (the option) for the purposes of the TCGA 1992 and the taxpayer sought to deduct the £90,000 under section 38(1)(b) in computing its gain on the disposal of the option.

46. Lord Jauncey (with whom the other members of the House of Lords agreed) held that:

> (i) The purchase price could not be apportioned between the grant of the option and the obligation to obtain the release of the restrictive covenants. Referring to Lord Wilberforce's speech in *Aberdeen* he said (425f-h) that important as commercial reality may be, it could not be invoked to alter the unambiguous terms of an agreement negotiated at arm's length which made no apportionment of the price between the option and the obtaining of the release from the restrictive covenants;
>
> (ii) The payment of £90,000 for the obligation to remove the restrictive covenants (which was accepted as expenditure) could not be said to be reflected in the state or nature of the option (the asset disposed of) at the date of disposal. He said (426j to 427k) that section 38(1)(b):
>
> "presupposes that the asset is in existence when the expenditure is incurred. This would cover the situation where after acquisition <u>an asset is transformed or improved with the result that it fetches a higher price on subsequent disposal</u>. ... Since the option only came into existence at the date of the agreement I do not see how a contemporaneous obligation could be said to qualify as expenditure to which para (b) applies" (underlining added); and

(iii) This need not produce a "black hole of £90,000". If M had exercised the option the taxpayer "would have had strong grounds for claiming that the £90,000 was deductible" in determining the gain on the disposal of the land.

47. Mr Prosser refers to Lord Jauncey's citation of Lord Wilberforce's speech in *Aberdeen* and his acknowledgement of the importance of commercial reality. Mr Jones says if Mr Prosser is right then the £90,000 would have been held to have been deductible from the option price since that reflected the commercial reality, and that was a result which Lord Jauncey denied.

48. We find some assistance in this case. Although the decision is not focused on the meaning of the "state or nature" of an asset, and depends on the fact that the state or nature of the option when disposed of could not reflect the later removal of the restrictive covenants, or the contemporaneous obligation to remove the restrictive covenants, it makes clear the constraints imposed by the scheme of the Act on the obtaining of a result which accords with business sense. We also note Lord Jauncey's emphasis in the words we have underlined on the transforming of the asset so that it fetches a higher price. His speech provides, too, an example of a change - the removal of restrictive covenants - which could on a later disposal of the asset be reflected in its state or nature.

49. In *Schofield v HMRC* [2012] EWCA Civ 927, [2012] STC 2019 a taxpayer bought two options (a put and a call) from, and sold two options (a put and a call) to, a bank, in a single transaction. The terms of the options were such that any gain or loss made by the taxpayer on the exercise or closing out of one of the options would be matched by a loss or gain to the taxpayer on the exercise or closing out of another of the options; the precise nature of each option was intended to ensure that any loss made by the taxpayer before he became non-resident was allowable but any gain was exempt from capital gains tax.

50. The FTT had found that the arrangements constituted a series of interdependent and linked transactions bereft of commercial purpose with a guaranteed outcome arising from a preordained path from which there was no prospect of deviation. It had concluded that there was no real loss suffered by the taxpayer and no allowable loss.

51. Before the Court of Appeal, Mr Schofield, relying in part on *Aberdeen*, argued that the FTT was wrong to fail to recognise the separate nature of each option. HMRC argued that the transaction to which the TCGA 1992 must apply was the aggregate of all four options - each constituent having been set up to be destroyed by others with the consequence that there was no asset.

52. Sir Andrew Morritt C found that the factual conclusions of the FTT meant that it would be wrong to adopt the step-by-step approach advocated by Mr Schofield. The *Ramsay* doctrine applied. That principle was not a special doctrine of revenue law for striking down tax avoidance schemes but a general principle of purposive and contextual construction for all legislation:

> "Where the *Ramsay* principle does apply the conclusion may be expressed in a number of different ways; for the purposes of ss 1 and 2, TCGA no asset, and no disposal, no loss or all three. Counsel for HMRC contended that the relevant transaction was the four options together and such a transaction does not constitute a disposal to which ss 1 and 2 TCGA, apply. This accords with the conclusion of Lord Fraser in *Ramsay* itself ..., and I am content to accept it" ([39]).

53. Hallett LJ said:

> "[43] The relevant transaction here is plainly the scheme as a whole: namely a series of interdependent and linked transactions with a guaranteed outcome. Under the scheme as a whole, the options were created merely to be destroyed. They were self cancelling. Thus, for capital gains purposes, there was no asset and no disposal."

54. Mr Prosser says that the *Ramsay* principle applies to Mr Blackwell's transaction. That principle was sufficient in *Schofield* to conclude that there was no asset: it must (so Mr Prosser maintains) be amply sufficient to conclude that the state or nature of Mr Blackwell's asset was changed by the 2006 payment. Realistically viewed Mr Blackwell's rights were restricted, purposively construed the legislation was concerned with the asset in the hands of the taxpayer.

55. We accept that the *Ramsay* principle is one of universal application, not restricted to tax avoidance. The principle has two interacting limbs. The facts must be considered realistically, and the legislation construed purposively; although consideration of one informs that of the other. The ultimate question is whether the words of the statute were intended to apply to a particular transaction. Even if Mr Blackwell's ability to exercise the rights in his shares was limited by the 2003 agreement the question must be whether the "assets" to which section 38 applies are, as Mr Prosser puts it, the asset in the taxpayer's hands rather than the asset a purchaser would acquire from him.

56. *Schofield* does not help with that question. While the Court of Appeal may have held that a series of interdependent, self cancelling options was not an asset, that was not because it regarded the statute as applying to the options in Mr Schofield's hands, but because it looked at them together as the single transaction by which they were created and as which they functioned and concluded that was not an asset within the meaning of the statute. Looking at the legislation, the almost instinctive reaction of the reader is, "Of course Parliament did not enact all these provisions to tax the individual elements of a self cancelling transaction". In other circumstances the legislation may not elicit such an, almost coarse, response, and a more painstaking investigation may be required to ascertain what the legislation intended and how it may apply to a particular set of transactions. It is not a necessary consequence of the Court of Appeal's judgment that the asset with which the legislation is concerned is "the asset as it operated in the taxpayer's hands".

57. Mr Prosser relies on the approach taken by Lightman J in *Inland Revenue Commissioners v John Lewis Properties plc* [2001] STC 1118. There the taxpayer

sold future rentals arising from leases granted out of land owned by it. Lightman J held that the interest disposed of was an interest in land and thus that there was a part disposal of the land for the purposes of TCGA 1992. He then went on to consider whether, if he was wrong, and the assignment was not the sale of an interest in land but of contractual rights, there was a part disposal on the grounds that a capital sum had been "derived" from the superior interest. This latter requirement related to section 22 TCGA 1992 which provided that:

> "(1)... there is for the purposes of this Act a disposal of assets by their owner where any capital sum is derived from assets notwithstanding that no asset is acquired by the person paying the capital sum and this subsection applies in particular to –
>
> (a) [compensation]
>
> (b) [insurance]
>
> (c) capital sums received in return for forfeiture or surrender of rights, or for refraining from exercising rights, and
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> (d) capital sums received in consideration for use or exploitation of assets."

58. Lightman J said that it was would be necessary to identify from which asset the price was derived:

> "[49] …In the circumstances I can deal with this question very shortly. JLP say that it was the underlying properties; the Revenue say it was JLP's contractual rights to the rents assigned. It is common ground that this question must be approached as a matter of business reality (see *Aberdeen* ...). The answer is that the disposals reduced the value of the property in the hands of JLP; JLP did not own the properties unaffected and unimpaired, even if (because the rights sold not constitute an interest in land) the purchaser would acquire the properties unaffected and unimpaired…."

59. Lightman J's decision does not bear the weight which Mr Prosser would like to put on it. The decision was not that the "asset" to which the TCGA 1992 applied would have changed, but that, because its value in JLP's hands had changed, the capital sum should be treated as derived from the land. The change in its value was a touchstone for the derivation or source of the capital sum and not an indication of the nature or state of the asset for the purposes of TCGA 1992.

60. Finally in the review of the authorities cited to us we should turn to *Trustees of the FD Fenton Will Trusts v HMRC* [2007] STC (SCD) 281. In this case, the Special Commissioners held that a capital contribution - a gift - made to a company by its shareholder affected the value of the shareholder's shares but was not reflected in their state or nature on disposal. They found, at [23], that "state or nature" must be something other than merely the value of the asset otherwise the phrase would add nothing to the preceding words of the section.

61. In its decision the FTT criticised *Fenton* because in places the decision of the Special Commissioners had referred to "state *and* nature" rather than "state *or* nature". However, it seems to us that this criticism was unfair. The Special Commissioners' reasoning did not depend on a cumulative requirement reflected in "state *and* nature". The references were slips. We agree with their conclusions. But its reasoning does not help us address the question of whether Mr Prosser is right that the focus should be "on the asset as it operated in the taxpayer's hands".

62. Mr Jones says that if Mr Blackwell had not entered into the 2006 agreement but had acted in contravention of the agreement and become liable to damages, there could be no argument that the damages were deductible within section 38. There was therefore no reason for the amount paid to avoid those damages being deductible. We do not find this persuasive: the two transactions are too different to expect similar tax treatment; the damages would not have been paid for the purpose of enhancing the value of the asset.

Expenditure "on" the asset

63. The FTT held that the question whether the £17.5 million payment can be said to have been expenditure "on" the asset was really bound up with the other two questions mentioned in paragraph 13 above. It held that "on", being a normal word, should be given a normal meaning, and in the context of the legislation it considered that the expenditure was "on" the shares in the sense that it was incurred in respect of the shares.

64. HMRC say that for the expenditure to be "on" the shares it must "affect" the shares and have the shares as its object. Mr Prosser says that "on" may have a wider meaning.

65. Mr Prosser and Mr Jones advanced two rival Shorter Oxford English Dictionary definitions of "on", Mr Jones relying on definition 16:

> "In the direction of, so as to face; towards; so as to affect or have as its object";

and Mr Prosser on definition 20:

> "In reference to, with respect to, as to; concerning about".

66. It seems to us that this adds nothing to the debate, for the words which follow "on" in section 38(1)(b), namely:

> "being expenditure reflected in the state or nature of the asset"

either indicate the first meaning or, if Mr Prosser is correct, mean that it is only expenditure which affects or will affect the asset, or has as its object the asset, that can be brought into account.

67. Whatever else, it is clear in this appeal that if the relevant expenditure was reflected in the state or nature of the asset at the time of disposal it must have been expenditure "on" the asset.

Discussion

68. We acknowledge that the result for which HMRC contend appears somewhat unfair: (i) Mr Blackwell would be taxed on a profit which exceeds his commercial profit, (ii) the £1 million he received under the 2003 agreement was, Mr Jones agreed, a capital sum derived from an asset (see section 22 TCGA 1992 above) and gave rise to a capital gain which was not cancelled when the 2003 agreement was undone, and (iii) the effect of sections 21(2) and 42 TCGA 1992 would have been that his base cost would have been reduced by the 2003 payment so that an even larger gain arose in 2006.

69. Indeed if Mr Blackwell had repeated the 2003 and 2006 transactions a number of times paying and receiving £1 million on each occasion he would be no better or worse off in cash terms but would suffer increasing amounts of tax on each receipt. Thus it might be said that there is here an element of double taxation.

70. By contrast, if (to compare with the *John Lewis Properties* case) JLP had disposed of part of its freehold after the expiry of the leases, it would have had a reduced base cost to set against the proceeds of that disposal but would have had retained the benefit of the earlier capital sum; Mr Blackwell had in effect repaid the sum received but was still disadvantaged by a lower base cost.

71. On the other hand, it is not completely clear that the application of normal business principles would have led to the conclusion that Mr Blackwell's profit *on his disposal of the shares* was reduced by the sum he paid under the 2006 agreement. It might possibly be said that the activity of holding and dealing with the shares had suffered a reduction in its profit although the gain he made on the disposal of the shares was unaffected.

72. Mr Prosser's argument is that the words "state or nature of the asset" do not refer to a juristic concept, but are ordinary language. As such, they are particularly susceptible to a broad commercial approach. Thus one should focus, not on the intrinsic legal quality of an item, but on how it operates in the taxpayer's hands. That is an argument about the proper purposive construction of the Act, and requires to be assessed against the scheme of the Act.

73. Mr Prosser gives the example of a freehold owner, X, whose freehold is occupied by Y. X pays Y to give up his right of occupation. Mr Prosser says that it would be paradoxical if the payment were deductible only if Y's right were a lease or other interest in land and not if it was a pure contractual licence. That result he says is avoided by focussing on the asset in the hands of the taxpayer rather than the intrinsic legal quality of the asset. The state or nature of X's interest changes because he becomes entitled to vacant possession.

74. We agree that it would be paradoxical if the deductibility of expenditure on the removal of a right of occupation which would have affected a purchaser of the land depended upon whether the right of occupation was a licence or a lease. But if Y's licence was such that it automatically came to an end on X's sale of the land or was

otherwise such that it would not affect a purchaser's enjoyment of the land, it does not seem anomalous that the payment should not be deductible because it would not have been for the purpose of enhancing the value of the land. What to our minds the example suggests is that the asset to which the Act applies is the bundle of rights and obligations which would pass to a purchaser.

75. Mr Prosser says that a focus on what may pass to an acquirer gives rise to anomalies. Suppose the articles of a company say that while X is a shareholder some of the normal rights are limited. X makes a payment to remove that restriction. What thereafter would pass to an acquirer are rights which in his hands are the same as if the sum had not been paid, yet the intrinsic rights of the shares have clearly been changed. That analysis, however, ignores the fact that, if the sum had not been paid, the shares would have remained shares which lost rights if they fell into X's hands: a focus on what the acquirer gets does not prevent the recognition of limitations on the rights acquired.

76. For the following reasons we conclude that in the context of the scheme of the TCGA 1992 as a whole the words "state or nature of the asset" do not have the meaning for which Mr Prosser contends:

(1) Section 38 restricts the allowable expenditure. As Mr Jones said, the words "shall be restricted to" indicate that not all expenditure associated with an asset will be deductible. Thus it is possible that the scheme of the Act has the effect that expenditure which would on normal business principles be regarded as reducing a gain is not allowable;

(2) We should hesitate before accepting a result which appears unfair or contrary to business sense, but must recognise that the legislation may require such a result;

(3) It is not completely clear that the application of business sense would lead to the conclusion that the gain on the sale of the shares was reduced by the £17.5 million;

(4) The *Ramsay* principle requires a realistic view of the facts and a purposive approach to the legislation;

(5) A realistic view of the facts recognises that the 2003 and 2006 agreements affected the ability of Mr Blackwell to deal with his asset, but it does not on its own require the asset referred to in section 38 to be treated as modified by those agreements;

(6) Section 38(1)(b) requires the identification of an asset. A purposive construction of "asset" or "state or nature of the asset" is required. That is not the same as a business sense approach because it also needs to have regard to the purpose of the structure and provisions of the Act. If there has been some change in an asset, a broad business sense approach may assist in deciding whether that change is really in the state or nature of the asset, but first it is necessary to identify the asset;

(7) Mr Blackwell's shares were a bundle of intangible rights (*Borland's Trustee v Steel Brothers & Co Ltd* [1901] 1 Ch 279) potentially affected by the 2003 agreement. The state or nature of an intangible asset can be determined only by reference to the rights and obligations comprising that asset;

(8) The Act is concerned with gains and losses on *disposals* of assets. More specifically, section 38 refers to the asset "at the time of the disposal", not immediately prior to disposal. This points towards a notion of "asset" which is concerned with what is disposed of rather than what was held. Not all disposals are to another person – the abandonment of an asset is an example – but very many disposals will be;

(9) The requirement that the expenditure be for the purpose of enhancing the value of the asset points towards expenditure which is reflected in the consideration for the disposal of the asset. Whilst "value" is used rather than "market value", it suggests an objective test relating to qualities of the asset which would cause a third party to pay more or less for it, rather than a test which looks to the value of the asset to the holder;

(10) Lord Jauncey's comment in *Garner v Pounds* that section 38(1)(b) envisages a situation in which an asset is transformed or improved with the result that it fetches a higher price on a subsequent disposal invites the identification of a transaction in which a lower price would have been received. There is implicit in this a comparison between a notional disposal before the change and the disposal to be taxed. That suggests that what is to be compared is what the acquirer would have acquired on that earlier disposal, rather than what the owner held immediately before it. That indicates that it is only rights and obligations which would be transferred which comprise the asset;

(11) Section 21 states that "all forms of property" are to be "assets" for the purposes of the TCGA 1992. This indicates that the word means the same in section 272(1) (dealing with valuation) as it does in section 38. Section 272 does not differentiate between what a disponor holds and what a purchaser would acquire - what is required is an assessment of what a hypothetical purchaser would pay for "the asset". Value is determined by what would be achieved on an open market sale of the assets. That presupposes that a purchaser will acquire what is sold and points to a meaning of "asset" which is the same in the hands of the notional purchaser as it is in the hands of the notional seller. It suggests, in other words, that section 38(1)(b) is concerned with the rights and obligations which are acquired, not those which operate exclusively on the vendor.

77. We conclude that the asset to which section 38(1)(b) applies is not the asset as it operates in the vendor's hands, but the bundle of rights and obligations which would be acquired by a purchaser. On this basis, the £17.5 million payment cannot be reflected in the state or nature of the asset unless the 2003 agreement would have affected a purchaser of the shares.

78. Mr Prosser did not develop any argument to the effect that, had it not been for the 2006 agreement, the 2003 agreement could have been enforced against someone

who had bought Mr Blackwell's shares. In any case, we cannot see how that would have been possible. The normal rule is that a contract binds only the parties to it (see e.g. Chitty on Contracts, 31st ed., at [18-134]). That principle may be inapplicable if the contract in question gives rise to a proprietary interest, as a specifically enforceable contract can do (see e.g. Megarry & Wade, "The Law of Real Property", 8th ed., at [15-052] and [15-061]). While, however, specific performance will often be available to enforce a contract for the sale of shares in a private company (such as BP Holdings), the 2003 agreement stated in terms that Taylor & Fisher should not be entitled to specific performance of Mr Blackwell's obligations under clauses 2.1(c) and 2.3 of the agreement and was not to have an interest in the shares. That being so, there can, as it seems to us, have been no question of enforcing the 2003 agreement against a purchaser of the shares. Cases such as *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175 (for example, at 1250-1254), *Ashburn Anstalt v Arnold* [1989] Ch 1 (for example, at 22 and 25-26) and *Chaudhary v Yavuz* [2011] EWCA Civ 1314, [2013] Ch 249 confirm that contractual rights do not bind third parties in the absence of a proprietary interest.

79. In the circumstances, it seems to us that the asset that Mr Blackwell sold was not changed by the 2006 agreement. Since it was unchanged, its state or nature could not have altered. In finding that the 2006 agreement changed the state of Mr Blackwell's shares, the FTT therefore made an error of law.

80. In short, we consider that at the time of their disposal the state or nature of Mr Blackwell's shares did not reflect the money paid under the 2006 agreement.

Limb 2: establishing, preserving or defending title to, or to a right over, the asset

81. Mr Prosser accepts that limb 2 is legalistic: it refers to a "right" and title; but (says Mr Prosser) the right need not be intrinsic to the asset since the section refers to a right "over" the asset. As a result of the 2003 agreement, Mr Blackwell did not have the right as against Taylor & Francis to vote his shares as he wished or to dispose of them as he pleased. He acquired such rights by virtue of the 2006 agreement. They were rights "over" the asset.

82. Mr Jones says Mr Blackwell had absolute legal title to the shares and was in no need of establishing, preserving or defending it. He adopts a dictum of Goff J in *Alison v Murray* [1975] STC 524. In that case Mrs Murray paid an insurance premium as a condition for the making of a variation to a trust as a result of which she would acquire an absolute interest in part of a trust fund in place of her contingent interest. One issue was whether the expenditure on the premium qualified as expenditure under what is now the second limb of section 38(1)(b). Goff J said:

> "The word 'establishing' must be read in the context of [section 38(1)(b)] as a whole, and in particular the juxtaposition of the words 'establishing, preserving or defending his title to, or to a right over, the asset'. In paying the premium Mrs Murray was not 'establishing, preserving or defending' her title. She had her title to a contingent share, which was not challenged and was in no need of establishment, preservation or defence. What she was doing was not

‘establishing, preserving or defending’ her title to something greater, but acquiring that greater thing….”

83. Under the 2006 agreement it is clear that Mr Blackwell did not “preserve” or “defend” any right over his asset, and did not establish, preserve or defend his title; so did he “establish” a right over the shares?

84. Paragraph (b) must be read in the context of section 38. Section 38(1)(a) deals with the expenditure on the acquisition of an asset: the establishing of a right over an asset must mean something different from acquiring such a right. Establishing in that context must mean making good or proving and may extend to actions to clarify the existence of a right, but it cannot extend to acquiring a right. Thus if Mr Blackwell acquired a right over the shares under the 2006 agreement no deduction is available as a result of limb 2.

85. There is a difficulty in the drafting of limb 2. It speaks of a right over the asset rather than a right which is part of the asset. A right over an asset would normally be seen as an asset separate from the primary asset. But the section is concerned with the deductible expenditure on the disposal of the primary asset. That indicates that by a right over the asset the draftsman does not mean a right separate from the asset but something which is or becomes part of the primary asset.

86. Did Mr Blackwell establish any rights in his asset? We agree with Mr Jones that he did not. The 2006 agreement enabled Mr Blackwell to exercise rights relating to his shares, it did not create or establish such rights. The “asset” remained the same.

87. We conclude that under the 2006 agreement Mr Blackwell did not establish, preserve or defend any right over his asset.

The result

88. We allow the appeal.

Mr Justice Newey **Judge Charles Hellier**

JUDGES OF THE UPPER TRIBUNAL

Decision released: 13 August 2015