Neutral Citation Number: [2016] EWCA Civ 809

Case No: A3/2014/3399

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
Mr Justice Simon and Judge Greg Sinfield
[2014] UKUT 0344 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 4 August 2016

Before :

THE CHANCELLOR OF THE HIGH COURT
LORD JUSTICE PATTEN
and
LORD JUSTICE SALES

- -

Between :

ANDREW CHAPPELL	**Appellant**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondents**

- -
- -

David Ewart QC and **Edward Waldegrave** (instructed by **GRM Law Solicitors**) for the **Appellant**
David Goy QC and **Aparna Nathan** (instructed by **The General Counsel and Solicitor to HM Revenue and Customs**) for the **Respondents**

Hearing date : 12 July 2016

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Approved Judgment

Lord Justice Patten :

Introduction

1. This is an appeal by the taxpayer, Mr Chappell, against an amendment made to his self-assessment tax return for the year 2005-06. The purpose and effect of the amendment (made by a closure notice dated 1 November 2010) was to disallow a deduction from his total income for that year totalling £303,123. The effect of the deduction (if allowable) would have been to reduce Mr Chappell's total income from £553,321 to £250,198. On that basis he would have been entitled to claim a repayment of income tax of £131,039.48.

2. Mr Chappell's entitlement to make this deduction depends upon two payments of £4,164 and £298,969 (I have rounded up the sums) which he made to a company called Barsbury Limited ("Barsbury") being "manufactured overseas dividends ("MOD's") within the meaning of paragraph 4(1) of Schedule 23A to the Income and Corporation Taxes Act 1988 ("TA 1988"). If that is right then the payments fall to be treated as annual payments within s.349(1) TA 1988 as a result of the operation of regulation 2B of the Income Tax (Manufactured Overseas Dividends) Regulations 1993 SI 1993/2004 ("the 1993 Regulations").

3. The taxpayer claims that as annual payments they are deductible in full from his total income. The Commissioners' case in response to this was that the payments are not so deductible either because as annual payments they are not deductible unless paid with a deduction of tax (which in this case is excluded by regulation 2B(3)) or more fundamentally because on their true construction the provisions of paragraph 4(1) and regulation 2B have no application to the transaction under which the payments came to be made. This is because the contract for the payments was part of a purpose-made tax scheme composed of transactions which had no commercial or other purpose apart from the avoidance of tax.

4. The Commissioners succeeded on both these arguments before the First-tier Tribunal ("the FtT") (see [2013] UKFTT 098 (TC)) and on appeal before the Upper Tribunal ("the UT") (Simon J and Judge Greg Sinfield) (see [2014] UKUT 0344 (TCC)). But as I shall explain HMRC's two arguments involve very different constructions of the relevant statutory provisions which cannot both be right. By the end of the hearing Mr Goy QC had confirmed that the Commissioners wished to rely on the second of their two arguments which is founded on the line of authorities beginning with the decision of the House of Lords in *W. T. Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300, [1981] STC 174 (*"Ramsay"*). If that construction is wrong and the payments made by Mr Chappell do constitute MOD's and are deductible then the Commissioners contend that relief is only available to Mr Chappell in respect of higher rate tax as a result of the operation of s.3 TA 1988. The Commissioners failed in this argument before the FtT but succeeded in it on appeal to the UT. It is of course only of relevance if Mr Chappell succeeds in his appeal against the UT's construction of paragraph 4(1).

The statutory provisions

5. The references which follow are all to provisions of TA 1988 unless otherwise stated.

6. Section 736A provides:

> "736A. Manufactured dividends and interest.
>
> Schedule 23A to this Act shall have effect in relation to certain cases where under a contract or other arrangements for the transfer of shares or other securities a person is required to pay to the other party an amount representative of a dividend or payment of interest on the securities".

7. Paragraph 4(1) of Schedule 23A states:

> "This paragraph applies in any case where, under a contract or other arrangements for the transfer of overseas securities, one of the parties (the "overseas dividend manufacturer") is required to pay the other ("the recipient") an amount representative of an overseas dividend on the overseas securities; and in this Schedule the "manufactured overseas dividend" means any payment which the overseas dividend manufacturer makes in discharge of that requirement."

8. The critical terms in paragraph 4(1) are defined in paragraph 1(1) as follows:

> ""dividend manufacturer" has the meaning given by paragraph 2(1) below;
>
> "dividend manufacturing regulations" means regulations made by the Treasury under this Schedule;
>
> "interest manufacturer" has the meaning given by paragraph 3(1) below;
>
> "manufactured dividend", "manufactured interest" and "manufactured overseas dividend" shall be construed respectively in accordance with paragraphs 2, 3 and 4 below, as shall references to the gross amount thereof;
>
> "overseas dividend" means any interest, dividend or other annual payment payable in respect of any overseas securities;
>
> "overseas dividend manufacturer" has the meaning given by paragraph 4(1) below;
>
> "overseas securities" means--
>
> (a) shares, stock or other securities issued by a government or public or local authority of a territory outside the United Kingdom or by any other body of persons not resident in the United Kingdom; and
>
> (b) …

> "overseas tax" means tax under the law of a territory outside the United Kingdom;
>
> “overseas tax credit" means any such credit under the law of a territory outside the United Kingdom in respect of overseas tax as corresponds to a tax credit;
>
> "prescribed" means prescribed in dividend manufacturing regulations;
>
> …
>
> "securities" includes any loan stock or similar security;
>
> "transfer" includes any sale or other disposal;
>
> …
>
> “United Kingdom equities" means shares of any company resident in the United Kingdom;
>
> "United Kingdom securities" means securities of the government of the United Kingdom, of any public or local authority in the United Kingdom or of any company or other body resident in the United Kingdom or of any company or other body resident in the United Kingdom, but does not include … United Kingdom equities.”

9. Schedule 23A also contains (in paragraph 8(1)) a power to make regulations which:

> “may make provision for –
>
> (a) such … manufactured overseas dividends as may be prescribed,
>
> (aa) such persons who receive, or become entitled to receive, … manufactured overseas dividends as may be prescribed, or
>
> (b) such … overseas dividend manufacturers as may be prescribed,
>
> to be treated in prescribed circumstances otherwise than as mentioned in paragraph … 4 above for the purposes of such provisions of the Tax Acts as may be prescribed.
>
> …”

10. This power has been exercised in the form of the 1993 Regulations which adopt the defined terms used in Schedule 23A: see regulation 2(1). Regulation 2B provides:

> “(1) For the purposes of the provisions of the Tax Acts relating to the charge to tax under Schedule D, paragraph 4(2) and (3)

> of Schedule 23A shall not apply to a manufactured overseas dividend paid in the circumstances prescribed in paragraph (2).
>
> (2) The circumstances prescribed are where the manufactured overseas dividend is representative of an overseas dividend on an overseas security that represents a loan relationship.
>
> (3) Where the payer of a manufactured overseas dividend to which paragraph (2) applies is neither a company nor carrying on a trade in circumstances where the manufactured overseas dividend is taken into account in computing the profits of that trade, the manufactured overseas dividend shall be treated, for the purposes of the provisions of the Tax Acts relating to the charge to tax under schedule D and so far as the payer is concerned, as if the amount paid was an annual payment, within section 349(1) of the Taxes Act , but so that no amount is required to be deducted on account of income tax from the amount of the payment, or accounted for under section 350 of that Act.
>
> (4) Where the recipient of a manufactured overseas dividend to which paragraph (2) applies is neither a company nor carrying on a trade in circumstances where the manufactured overseas dividend is taken into account in computing the profits of that trade, the manufactured overseas dividend shall be treated, for the purposes of the provisions of the Tax Acts relating to the charge to tax under schedule D and so far as the recipient is concerned, as an overseas dividend of an amount equal to the amount of the manufactured overseas dividend received by him, but not so as to entitle the recipient to claim relief under Part XVIII of the Taxes Act in respect of any tax attributable to the manufactured overseas dividend received.
>
> (5) For the purposes of paragraph (2), an overseas security shall be taken to represent a loan relationship if a company holding that security would have a loan relationship within the meaning of section 81 of the Finance Act 1996.
>
> …"

11. As one can see from regulation 2B(1) and (2), the 1993 Regulations disapply the provisions of paragraph 4 of Schedule 23A in cases where the transfer of the overseas security and the payment of the MOD is made in the context of a loan relationship. In such cases the critical provisions are regulations 2B (3) and (4). Individuals who are not trading so as to be required to include the MOD's in their calculation of profits are allowed to treat the MOD's as annual payments under s.349(1) for the purposes of their own Schedule D self-assessment and are not obliged to deduct and account for tax on the amount of the payments. This statutory hypothesis which deems the MOD's annual payments therefore involves a variation of the position under s.349(1) itself which requires the annual payments to which it applies to be paid after deduction of tax and for the tax to be accounted for under s.350.

12. The recipient of the MOD (if not a trader) is taxed in accordance with regulation 2B(4) on the gross amount of the payment on the basis that the MOD is treated as an overseas dividend in an equal sum.

13. Some explanation of the types of commercial transactions which involve what is described as securities lending can be found in an introductory guide to the subject published in September 2010 by various bodies including the Association of British Insurers and the International Securities Lending Association. Both counsel agreed that it contains a helpful summary of typical transactions of this kind involving the transfer of securities on loan in return for collateral in the form of shares, bonds or cash. The lender is paid a monthly fee for the duration of the loan. In addition the borrower undertakes in the agreement to return the securities on demand within the standard market settlement period (3 days for UK equities) and to pay to the lender a sum equal to the amount of any dividends or interest which is received on the securities during the period of the loan.

14. Lending of this kind is usually carried out using a custodian of the security or a third party agent. The standard market terms are contained in agreements such as the Global Master Security Lending Agreement ("GMSLA"). The guide states that lenders are typically large-scale investors such as pension funds and insurance companies and that the borrowers are typically large financial institutions such as investment banks and broker dealers who will often act on behalf of hedge funds. Securities are borrowed on those terms for various reasons including to facilitate market making and other trading activities such as hedging and short selling. In return the existence of a market for securities lending provides investors such as pension funds with a valuable source of additional income.

The facts

15. The securities lending involved in this case was a long way from the commercial transactions I have just described. The facts are set out in detail in the decision of the FtT but for the purposes of this appeal I can adopt the summary of those findings which appears in the decision of the Upper Tribunal:

> "8. On 29 July 2005, Mr Chappell entered into a ' Global Master Securities Lending Agreement ' (the 'GMSLA') with a company called Barsbury Limited ('Barsbury'). Under the terms of the GMSLA , securities could be lent by Barsbury to Mr Chappell, secured against 'collateral'. The terms of each loan of securities were to be agreed before the loan was made. The GMSLA provided that, where interest or dividends were paid in respect of securities which had been loaned to him, Mr Chappell was required to pay a corresponding amount to Barsbury.
>
> 9. On 29 July 2005, Mr Chappell and Barsbury both signed a letter (the 'Stock Loan Letter') from Mr Chappell to Barsbury setting out the terms of a loan of securities under the GMSLA . Under the terms of the Stock Loan Letter, Mr Chappell borrowed from Barsbury loan notes (the "Loan Notes") issued by a company called Santi Crescent Limited ('SCL'). The

nominal value of the borrowed Loan Notes was £6,377,280. The Loan Notes were to be transferred to Mr Chappell on 29 July 2005 and were to be returned to Barsbury on 9 August 2005 (or earlier if Mr Chappell so chose).

10. The Loan Notes were governed by a 'Loan Note Instrument' issued by SCL on 29 July 2005 (the 'Loan Note Instrument'). The Loan Note Instrument provided that SCL would pay interest in respect of the Loan Notes at a rate of about 4.8% per annum. Interest was to be calculated on a daily basis, and was to be paid by SCL as follows:

(1) on 2 August 2005, interest was payable in arrears in respect of the period from 29 July 2005 to 2 August 2005;

(2) on 4 August 2005, interest was payable in arrears and in advance in respect of the period from 3 August 2005 to 27 July 2006;

(3) on 28 July 2006, interest was due in respect of that day only; and

(4) on 27 July 2007 (which was the day before the Loan Notes' 'Final Redemption Date'), interest was payable in arrears in respect of the period from 29 July 2006 to 27 July 2007.

11. On 1 August 2005, Mr Chappell sold the Loan Notes to a company called Berry Lane Limited ('BLL'), by a 'Loan Note Sale Agreement' signed on that day. BLL paid Mr Chappell £6,373,804 for the Loan Notes.

12. On 2 August 2005, interest was due from SCL in respect of the Loan Notes, for the period from 29 July 2005 to 2 August 2005. This amounted to £4,164 (rounded to the nearest £1). As required by the GMSLA , Mr Chappell made an equivalent payment (i.e. of £4,164) to Barsbury. This is one of the two payments in respect of which Mr Chappell seeks a deduction from his income.

13. On 4 August 2005, interest was due from SCL in respect of the Loan Notes, for the period from 3 August 2005 to 27 July 2006. This amounted to £298,959 (rounded to the nearest £1). As required by the GMSLA , Mr Chappell made an equivalent payment (i.e. of £298,959) to Barsbury. This is the second payment in respect of which Mr Chappell seeks a deduction from his income.

14. On 5 August 2005, Mr Chappell purchased SCL Loan Notes with a nominal value of £6,377,280 from a company called Qintar Limited ('QL'), by a 'Loan Note Sale Agreement'

> signed on that day. Mr Chappell paid QL £6,073,588 for these Loan Notes.
>
> 15. On 5 August 2005, Mr Chappell transferred the Loan Notes which he had acquired from QL to Barsbury, in repayment of the loan made under the Stock Loan Letter.

16. A number of points merit further elaboration. The transactions were carried out as part of a tax scheme promoted by Dominion Fiduciary Services Group. Apart from the payment of £18,000 to cover the fees and other costs involved in the scheme, Mr Chappell expected to incur no other expenses. The sum of £6.377m paid to SCL in return for the loan notes was provided by a loan from Société Générale Bank and Trust ("SGBT") in Luxembourg which was arranged through SG Hambros Bank & Trust (Jersey) Limited ("SGH") using a company called Brecknock which was set up as part of the scheme. SGH also acted as custodian of the loan notes for Mr Chappell and organised a letter of credit in favour of Barsbury as payment for the issue and transfer of the notes.

17. Brecknock, SCL and Barsbury opened accounts with SGBT and the £6.377m was credited to Brecknock's account and was then transferred to Barsbury in order to subscribe for the loan notes. SCL then deposited the subscription monies into Brecknock's account with SGBT which was in due course used to repay the bank loan.

18. The £6.373m paid by BLL for the loan notes on 1 August was credited to Mr Chappell's account at SGH against which the payments of £4,164 and £298,959 were debited.

19. The purchase price of the loan notes sold to Mr Chappell by QL for £6.037m was also debited to the SGH account. The loan notes themselves were credited to Mr Chappell's custody account and then used to repay the loan of the notes made to him by Barsbury. As the FtT found, the SGBT loan monies therefore flowed in a circle on the same day by way of entries in the books of SGBT and the sale of the loan notes by Mr Chappell to BLL, the payment of the £303,123 to Barsbury and the purchase of the loan notes from QL were all funded out of the same SGH account in amounts which cancelled each other out.

20. SCL which provided the loan notes that on Mr Chappell's case constitute the overseas securities for the purpose of Schedule 23A and regulation 2B is or was a BVI company with a share capital of £1 and redeemable loan notes of £1.5bn. It did not carry on a trade and its only purpose was to service this and other similar tax schemes. It therefore had no assets out of which it could repay its borrowings if called upon to do so and the loan stock was effectively worthless and certainly untradeable other than as part of the tax scheme arrangements.

21. Mr Chappell has never sought to present the scheme transactions as anything other than the series of circular payments which are described in the decision of the FtT. Mr Ewart QC accepts that the component transactions had no commercial purpose and were designed to produce deductible payments that qualified as MOD's under the 1993 Regulations. But HMRC did not seek to attack the scheme transactions as a sham and the issue therefore is whether the two payments of £4,164 and £298,959 fall

to be treated as MOD's within the meaning of paragraphs 4(1) of Schedule 23A. If on the proper construction of paragraph 4(1) they were not MOD's then it follows that Mr Chappell was not the payer of a MOD in respect of a loan relationship or at all. In that event neither regulation 2B(3) nor paragraph 4(1) have any application to the payments in question and being one-off contractual payments they are not deductible from his total income.

The construction of paragraph 4(1)/regulation 2B

22. The most obvious purpose (or at least one obvious purpose) of the borrower of the overseas securities being able to treat the MOD's as deductible annual payments under regulation 2B(3) is to prevent the borrower from being taxed on the dividends or interest he receives during the period of the loan. The lender of the securities is treated for tax purposes under regulation 2B(4) as having received an overseas dividend which would be taxable under s.402 of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005") but even apart from regulation 2B(4) the MOD's would have been taxable in the lender's hands under s.687 of ITTOIA 2005 as income not otherwise charged. The only way of avoiding the charge would be for the lender (as in this case) to be non-resident.

23. HMRC's first argument that the MOD's, although deemed to be annual payments within s.349(1) TA 1988, were not deductible from Mr Chappell's total income because of the express removal (in regulation 2B(3)) of any obligation on the part of the borrower to deduct tax ran into the difficulty that on this construction of the legislation regulations 2B(3) and (4) serve no purpose. The lender would continue to be taxable on the MOD's under s.687 ITTOIA 2005 and the borrower would incur a charge to tax on the dividends he received whilst in possession of the securities. Regulations 2B(3) and (4) would be completely otiose.

24. Although it is undoubtedly an established principle that annual payments are not generally deductible from the payer's income unless payable under deduction and retention of tax (see *Commissioners for Inland Revenue v Frere* (1964) 42 TC 125) the rule must yield to the particular legislation under which the annual payment arises. In this case the concluding words of regulation 2B(3) remove the obligation to deduct tax but in my view that cannot have been intended to remove the borrower's right to deduct the annual payment from total income. Otherwise, as I have said, the deeming of the MOD's to be annual payments serves no purpose.

25. Mr Goy drew our attention to the fact that paragraph 4(2) TA 1988 has been amended by the Finance Act 2004 to make it clear that the treatment of MOD's under paragraph 4 as annual payments within s.349(1) is no longer to be determinative of whether they are deductible. That suggests to me that without the amendment the MOD's would be deductible. But we are not concerned on this appeal with the treatment of the MOD's under paragraph 4. In the case of securities lending, their tax treatment is governed by regulation 2B which has remained unchanged in this respect.

26. Although the point is now conceded, the Upper Tribunal was wrong in my view to treat regulation 2B(3) as subject to the principle set out in *Frere*. The regulation was intended to give the borrower tax relief on the overseas dividends (as defined) which he receives. The question therefore is whether that tax treatment was intended to

apply to taxpayers in Mr Chappell's position who only enter into the loan arrangements as part of a scheme to avoid tax.

Ramsay

27. The decision in *Ramsay* and the conjoined appeal of *Eilbeck* (*Inspector of Taxes*) *v Rawling* [1980] STC 192 concerned two schemes designed to produce an allowable loss which could be set against the chargeable gains of the taxpayer arising (in *Ramsay*) from the disposal of a farm and (in *Rawling*) from the disposal of some shares. Each of the schemes involved an elaborate series of transactions created solely for the purpose of producing the allowable capital losses. In his speech Lord Wilberforce set out what he described as the significant features of schemes of this character:

> "First, it is the clear and stated intention that once started each scheme shall proceed through the various steps to the end; they are not intended to be arrested halfway (cf *Chinn v Collins* (*Inspector of Taxes*) [1981] 1 All ER 189, p 1, ante). This intention may be expressed either as a firm contractual obligation (it was so in *Rawling*) or as in *Ramsay* as an expectation without contractual force.
>
> Second, although sums of money, sometimes considerable, are supposed to be involved in individual transactions, the taxpayer does not have to put his hand in his pocket (cf *Inland Revenue Comrs v Plummer* [1979] 3 All ER 775, [1980] AC 896, [1979] STC 793, and *Chinn v Collins* (*Inspector of Taxes*)). The money is provided by means of a loan from a finance house which is firmly secured by a charge on any asset the taxpayer may appear to have, and which is automatically repaid at the end of the operation. In some cases one may doubt whether, in any real sense, any money existed at all. It seems very doubtful whether any real money was involved in *Rawling*: but facts as to this matter are for the commissioners to find. I will assume that in some sense money did pass as expressed in respect of each transaction in each of the instant cases. Finally, in each of the present cases it is candidly, if inevitably, admitted that the whole and only purpose of each scheme was the avoidance of tax."

28. The success of the schemes considered in *Ramsay* and *Rawling* depended upon treating each component transaction as having both legal and tax consequences. The Revenue's argument was that they should be treated for tax purposes as a nullity, producing neither a gain nor a loss. Much of the argument in *Ramsay* and the cases which followed concentrated on the transactional structure of the scheme and on whether the intermediate transactions could be regarded as independent or merely steps in a single composite transaction designed to produce particular tax consequences. One can see this in the part of Lord Wilberforce's speech where he discusses the proper approach of the courts to the analysis of scheme transactions:

> "Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of *Inland Revenue Comrs v Duke of Westminster* [1936] AC 1, 19 Tax Cas 490. This is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded. For this there is authority in the law relating to income tax and capital gains tax: see *Chinn v Collins* (*Inspector of Taxes*) and *Inland Revenue Comrs v Plummer.*
>
> For the commissioners considering a particular case it is wrong, and an unnecessary self-limitation, to regard themselves as precluded by their own finding that documents or transactions are not 'shams' from considering what, as evidenced by the documents themselves or by the manifested intentions of the parties, the relevant transaction is. They are not, under the *Duke of Westminster* doctrine or any other authority, bound to consider individually each separate step in a composite transaction intended to be carried through as a whole. This is particularly the case where (as in *Rawling*) it is proved that there was an accepted obligation once a scheme is set in motion, to carry it through its successive steps. It may be so where (as in *Ramsay* or in *Black Nominees Ltd v Nicol* (*Inspector of Taxes*) [1975] STC 372, 50 Tax Cas 229) there is an expectation that it will be so carried through, and no likelihood in practice that it will not. In such cases (which may vary in emphasis) the commissioners should find the facts and then decide as a matter (reviewable) of law whether what is in issue is a composite transaction or a number of independent transactions."

29. It is, however, clear from his speech that the question of how the tax legislation applies to the scheme transactions and with what effect is essentially one of statutory construction:

> "The capital gains tax was created to operate in the real world, not that of make-belief. As I said in *Aberdeen Construction Group Ltd v Inland Revenue Comrs* [1978] 1 All ER 962,

> [1978] AC 885, [1978] STC 127, it is a tax on gains (or I might have added gains less losses), 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, 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."

30. A useful and extremely interesting description of how the *Ramsay* principle or approach to construction has developed through the case law can be found in the judgment of Lord Millett NPJ in the decision of the Hong Kong Court of Final Appeal in *Collector of Stamp Revenue v Arrowtown Assets Limited* [2003] HKCFA 46. The structural approach I have described led to controversy in cases like *Furniss v Dawson* [1984] STC 153 as to whether *Ramsay* applied in cases where the scheme transactions were more linear in nature as opposed to the circular, self-cancelling type of transactions which existed in *Ramsay* itself. Lord Brightman went so far as to say that for *Ramsay* to apply:

> "… there must be a pre-ordained series of transactions; or if one likes one single composite transaction… Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax—not "no business effect". If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes."

31. This approach has given way in recent decisions to a much broader, less formalistic approach to the analysis of the scheme. In *Barclays Mercantile Business Finance Limited v Mawson* [2005] STC 1 Lord Nicholls (at [32]) referred to the decision in *Ramsay* in these terms:

> "The essence of the new approach was to give a statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straightjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found."

32. He approved the statement of Ribeiro PJ in *Arrowtown* at [35] that:

> "[T]he driving principle in the Ramsay line of cases continues to involve a general rule of statutory construction and an

> unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."

33. The effect of these authorities was recently summarised by Lord Reed JSC in *UBS AG and Deutsche Bank Group Services (UK) Limited v HMRC* [2016] UKSC 13 at [64]-[68]:

> "64. This approach has proved to be particularly important in relation to tax avoidance schemes as a result of two factors identified in *Barclays Mercantile* at para 34. First, "tax is generally imposed by reference to economic activities or transactions which exist, as Lord Wilberforce said, 'in the real world'". Secondly, tax avoidance schemes commonly include "elements which have been inserted without any business or commercial purpose but are intended to have the effect of removing the transaction from the scope of the charge". In other words, as Carnwath LJ said in the Court of Appeal in *Barclays Mercantile*, [2002] EWCA Civ 1853; [2003] STC 66, para 66, taxing statutes generally "draw their life-blood from real world transactions with real world economic effects". Where an enactment is of that character, and a transaction, or an element of a composite transaction, has no purpose other than tax avoidance, it can usually be said, as Carnwath LJ stated, that "to allow tax treatment to be governed by transactions which have no real world purpose of any kind is inconsistent with that fundamental characteristic". Accordingly, as Ribeiro PJ said in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46; (2003) 6 ITLR 454, para 35, where schemes involve intermediate transactions inserted for the sole purpose of tax avoidance, it is quite likely that a purposive interpretation will result in such steps being disregarded for fiscal purposes. But not always.
>
> 65. As was noted in *Barclays Mercantile* at para 35, there have been a number of cases since *Ramsay* in which it was decided that elements inserted into a transaction without any business or commercial purpose did not prevent the composite transaction from falling within a charge to tax, or bring it within an exemption from tax, as the case might be. Examples include *Inland Revenue Comrs v Burmah Oil Co Ltd* 1982 SC (HL) 114, *Furniss v Dawson* [1984] AC 474, *Carreras Group Ltd v Stamp Comr* [2004] UKPC 16; [2004] STC 1377, *Inland Revenue Comrs v Scottish Provident Institution* and *Tower M Cashback LLP 1 v Revenue and Customs Comrs* [2011] UKSC 19; [2011] 2 AC 457. In each case the court considered the overall effect of the composite transaction, and concluded that, on the true construction of the relevant statute, the elements which had been inserted without any purpose other than tax

> avoidance were of no significance. But it all depends on the construction of the provision in question. Some enactments, properly construed, confer relief from taxation even where the transaction in question forms part of a wider arrangement undertaken solely for the purpose of obtaining the relief. The point is illustrated by the decisions in *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6; [2003] 1 AC 311 and *Barclays Mercantile* itself.
>
> 66. The position was summarised by Ribeiro PJ in *Arrowtown Assets*, para 35, in a passage cited in *Barclays Mercantile*:
>
>> "The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."
>
> 67. References to "reality" should not, however, be misunderstood. In the first place, the approach described in *Barclays Mercantile* and the earlier cases in this line of authority has nothing to do with the concept of a sham, as explained in *Snook.* On the contrary, as Lord Steyn observed in *McGuckian* at p 1001, tax avoidance is the spur to executing genuine documents and entering into genuine arrangements.
>
> 68. Secondly, it might be said that transactions must always be viewed realistically, if the alternative is to view them unrealistically. The point is that the facts must be analysed in the light of the statutory provision being applied. If a fact is of no relevance to the application of the statute, then it can be disregarded for that purpose. If, as in *Ramsay*, the relevant fact is the overall economic outcome of a series of commercially linked transactions, then that is the fact upon which it is necessary to focus. If, on the other hand, the legislation requires the court to focus on a specific transaction, as in *MacNiven* and *Barclays Mercantile,* then other transactions, although related, are unlikely to have any bearing on its application."

34. The argument on this appeal has concentrated on whether the provisions of paragraph 4 of Schedule 23A and regulation 2B(3) fall to be construed and treated like those in *MacNiven* so as to confer tax relief even though the transaction in question forms part of a scheme which was designed solely for the purpose of obtaining that relief and has no wider or other commercial justification. If that is not the right construction of the legislation then Mr Ewart accepts that there were no MOD's payable under a loan relationship of the kind to which regulation 2B(2) was intended to apply and the scheme will therefore fail.

35. In *MacNiven* the question was whether a property investment company (Westmoreland) was entitled to deduct from its taxable profits certain tax losses which had accrued from various unsuccessful investments made during the 1970's. Westmoreland was owned by a pension scheme and used as the vehicle for the pension scheme's own investments. As of 1988, after the sale of its realisable assets,

it owed the pension scheme trustees some £70m including £40m of accrued interest. Although it had no means of discharging these liabilities from its own assets, the existence of its tax losses, which could be set-off against future profits, made the company a valuable and saleable asset. But under s.338TA 1988 the £40m worth of interest only became deductible once it was paid. In order therefore to maximise Westmoreland's deductible losses, the pension scheme trustees lent the company the money which it needed in order to pay the interest. Westmoreland then paid the interest to the trustees net of tax and accounted to HMRC for the tax deducted. The pension scheme, being tax exempt, was then able to recover the tax deducted and to sell Westmoreland for £2m with the benefit of its tax losses including in respect of the accrued interest.

36. HMRC refused to allow the interest payments made to the trustees to be deducted against profits on the ground that they were not "charges on income" within the meaning of s.338(1). Charges on income are defined in s.338(2) as "payments of any description mentioned in subsection (3) below". Subsection (3) provides that "payments" include "(a) any yearly interest".

37. The argument in the House of Lords centred on whether the £40m of interest paid to the trustees by Westmoreland was a "payment" of this description within the meaning of s.338(2). The argument for the Commissioners, based on *Ramsay*, was that Westmoreland had not made a payment of interest in this case because it had used money provided by the pension scheme in order to make the payment and would not otherwise have been able to discharge the liability. Properly analysed, the transaction was therefore self-cancelling and would never have been contemplated or taken place but for the trustees' wish to obtain the tax advantage and so make Westmoreland saleable. The House of Lords held that there had been a payment within the meaning of s.338(2). Lord Nicholls said:

> "13. My Lords, I confess that during the course of this appeal I have followed the same road to Damascus as Peter Gibson LJ. Like him, my initial view, which remained unchanged for some time, was that a payment comprising a circular flow of cash between borrower and lender, made for no commercial purpose other than gaining a tax advantage, would not constitute payment within the meaning of section 338. Eventually, I have found myself compelled to reach the contrary conclusion. My reasons are as follows.
>
> …
>
> 15. I must elaborate a little. In the ordinary case the source from which a debtor obtains the money he uses in paying his debt is immaterial for the purpose of section 338. It matters not whether the debtor used cash in hand, sold assets to raise the money, or borrowed money for the purpose. Does it make a difference when the payment is made with money borrowed for the purpose from the very person to whom the arrears of interest are owed? In principle, I think not. Leaving aside sham transactions, a debt may be discharged and replaced with another even when the only persons involved are the debtor and

> the creditor. Once that is accepted, as I think it must be, I do not see it can matter that there was no business purpose other than gaining a tax advantage. A genuine discharge of a genuine debt cannot cease to qualify as a payment for the purpose of section 338 by reason only that it was made solely to secure a tax advantage. There is nothing in the language or context of section 338 to suggest that the purpose for which a payment of interest is made is material.
>
> 16. This is not surprising. Payments of interest, other than interest on a bank loan, have the advantageous tax consequence of constituting charges on income. But, hand in hand with this, they have the consequence that tax must be deducted from the payment and paid to the Inland Revenue. In the ordinary course, therefore, an exchange of cheques between creditor and debtor does not give rise to a tax advantage. The tax benefit of being able to treat the payment as a charge on income is offset by the obligation to account to the Inland Revenue for tax on the payment. This being so, there is no basis on which Parliament can be taken to have intended that payment in section 338 should bear some special meaning which would exclude the case where the interest debt is satisfied with money borrowed for the purpose from the creditor."

Lord Hoffmann said:

> "67. My Lords, payment of a debt such as interest ordinarily means an act, such as the transfer of money, which discharges the debt. It is accepted that in this case the interest debt was indeed discharged. So why did this not count as payment for the purposes of the Act? One of the difficulties which I have with the argument for the Crown is that I find the alternative concept of payment for which it contends completely elusive. It is easy to understand a commercial sense of a loss which treats as irrelevant the fact that one part of a composite transaction produced a loss which was never intended to be more than momentary and theoretical. But what is the commercial concept of payment of a debt which treats as irrelevant the fact that the debt has been discharged? Mr McCall does not contend that payment must involve a negative cash flow which is not compensated by a cash flow in the opposite direction. He accepts, for example, that many commercial refinancing operations discharge old debts and create new ones without any cash flow either way. Nor is there any apparent policy to be found in section 338 which would require a negative cash flow. Otherwise, why should bank interest be deductible without any payment at all? As I have already said, the only apparent reason for the insistence on payment of yearly interest is that payment gives rise to an obligation to deduct tax. In the present case, WIL complied with that obligation. The Crown's real complaint

> is that the scheme, as an exempt fund, was able to reclaim the tax. But this cannot be remedied by giving the word "paid" a different meaning in the case of a payment to an exempt lender. The word must mean the same, whatever the status of the lender."

38. Mr Ewart seeks to draw an analogy with this interpretation of the word "payment" in s.338(2). The critical feature, he says, of the legislation relating to the taxation of MOD's in Schedule 23A and the 1993 Regulations is that Parliament has provided a complete code which not only gives tax relief to the borrower or transferee of the overseas securities but concomitantly also imposes a tax charge on the MOD's in the hands of the payee. The case, he says, is therefore different from, for example, *UBS* where the issue was whether the bank could take advantage of the special tax regime for "restricted securities" under Part 7 of the Income Tax (Earnings and Pensions) Act 2003 which was created to encourage share ownership by employees in the company for which they worked. UBS had attempted to set up a scheme to reduce income tax on bankers' bonuses under which companies were set up solely for the purpose of the scheme in order to issue what were said to be restricted securities which were allotted to selected employees in lieu of a cash bonus. Once the conditions for the tax exemption had occurred, the shares were redeemable by the employees for cash. The companies were then liquidated. As Lord Reed said at [77]:

> "Approaching the matter initially at a general level, the fact that Chapter 2 was introduced partly for the purpose of forestalling tax avoidance schemes self-evidently makes it difficult to attribute to Parliament an intention that it should apply to schemes which were carefully crafted to fall within its scope, purely for the purpose of tax avoidance. Furthermore, it is difficult to accept that Parliament can have intended to encourage by exemption from taxation the award of shares to employees, where the award of the shares has no purpose whatsoever other than the obtaining of the exemption itself: a matter which is reflected in the fact that the shares are in a company which was brought into existence merely for the purposes of the tax avoidance scheme, undertakes no activity beyond its participation in the scheme, and is liquidated upon the termination of the scheme. The encouragement of such schemes, unlike the encouragement of employee share ownership generally, or share incentive schemes in particular, would have no rational purpose, and would indeed be positively contrary to rationality, bearing in mind the general aims of income tax statutes."

39. Mr Ewart's argument seems to me to depend upon two propositions. The first is that the legislation on MOD's creates a complete code under which tax is actually imposed on the MOD's in the hands of the payee in return, so to speak, for the payer being relieved of tax on the dividends and interest he receives from the overseas securities. The second is that this justifies giving to the words "a contract … for the transfer of overseas securities" in paragraph 4(1) an essentially literal construction

unaffected by the context in which the transaction has come into existence. The result of applying this construction to paragraph 4(1) and regulation 2B is not, on this argument, to deprive the Revenue of tax on the MOD's and there is therefore no reason for giving the words used a purposive construction which robs Mr Chappell of the regulation 2B(3) exemption to which he is entitled as part of the code.

40. I do not find these points persuasive. *MacNiven* was not a case involving a tax scheme as such. The tax losses suffered by Westmoreland had been incurred as part of its ordinary business activities. They were real liabilities arising from real commercial transactions. The only question was whether the company could still obtain the available tax relief on the interest it owed if it funded the payment of the interest by a loan from the creditor. The decision of the House of Lords was no more than that, in order to be a payment under s.338(2), the source of the payment was irrelevant. This is hardly surprising given that the losses had arisen from Westmoreland's ordinary trading activities and that tax relief was statutorily available in respect of those losses subject only to the payment of the interest. There was therefore nothing inherently objectionable in the owner of the debtor company funding its interest payments in order for the company to obtain the tax relief to which it was otherwise entitled. This was not a case (like *UBS*) where the relief was claimed in reliance on transactions which had no commercial purpose and had only been entered into in order to obtain the relief. As I have said, the losses were incurred in the ordinary course of Westmoreland's investment business.

41. Lord Hoffmann expressed the view that "payment" was a legal concept which by its very nature was not susceptible to anything but a literal interpretation and application: see [69]. But he was I think alone in resorting to this level of abstraction. Lord Nicholls (at [15]) could see no policy reason for excluding payments on a purposive basis even where the only purpose of the loan made to the debtor by the creditor was to enable the debtor to obtain the benefit of the tax relief:

> "16. This is not surprising. Payments of interest, other than interest on a bank loan, have the advantageous tax consequence of constituting charges on income. But, hand in hand with this, they have the consequence that tax must be deducted from the payment and paid to the Inland Revenue. In the ordinary course, therefore, an exchange of cheques between creditor and debtor does not give rise to a tax advantage. The tax benefit of being able to treat the payment as a charge on income is offset by the obligation to account to the Inland Revenue for tax on the payment. This being so, there is no basis on which Parliament can be taken to have intended that payment in section 338 should bear some special meaning which would exclude the case where the interest debt is satisfied with money borrowed for the purpose from the creditor."

42. We are not concerned on this appeal with the concept of a payment, legal or otherwise, but with whether the loan transaction in this case was the type of contract contemplated by regulation 2B. Of more relevance to the issues on this appeal therefore is the approach of Lord Hope who said (at [79]):

> "The Special Commissioners found as a fact that the loans which were made by the Scheme to WIL were real loans. It is clear that, but for the loans, WIL could not have afforded to pay the interest which it owed to the Scheme. Nevertheless the fact is that the loans were made and the interest was paid. WIL's claim is therefore based upon transactions which have been found by the Special Commissioners to be genuine. There was no step that falls to be ignored because it was artificial. It cannot be said that there was no business or commercial reason for the interest to be paid. The payment reduced the amount of WIL's accrued liability to pay interest. It was received as interest in the hands of the payee. WIL's obligation to pay interest to that extent was discharged. Nothing was inserted into the transaction to make it appear to be different from what it was. It was a payment of yearly interest which was paid out of the company's profits for the relevant accounting period."

43. Lord Hutton also stressed the real-world nature of the interest obligations that were being discharged:

> "95. The Special Commissioners found [1997] STC 1103, 1116G that:
>
> > "all the loans made to the taxpayer company from 1980 onwards were real loans and the taxpayer company used them for real purposes, viz the discharge of real earlier outstanding loans and the payment of real accrued interest…. "
>
> Therefore by undertaking to pay the interest Westmoreland had incurred the economic burden which Parliament intended should give rise to the allowances given by section 338, and I consider that Westmoreland was entitled to take steps to obtain the advantage which Parliament gave to it in respect of that burden. As Lord Templeman said in *Ensign Tankers (Leasing) Ltd v Stokes* at page 676D: "the taxpayer is entitled to any reduction in tax which Parliament has attached to each transaction."
>
> This was not a case, as in *Inland Revenue Commissioners v McGuckian*, where a tax payer was on the point of incurring a tax liability and took an artificial step to avoid the liability: rather this was a case where Westmoreland had incurred a genuine loss for tax purposes and then took a step to enable it to claim the tax allowance for that loss. Accordingly I am in respectful agreement with Peter Gibson LJ ([1998] STC 1131, 1143B) that:
>
> > "In the present case the accrued interest liability was real and always possessed the potentiality of being converted into a charge on income by payment. What occurred was

> the crystallisation of the tax loss through payment of the accrued interest."”

44. The decision in *MacNiven* does not therefore in my view assist Mr Chappell in the present case. I also disagree with Mr Ewart in relation to his analysis of Schedule 23A and the 1993 Regulations as creating a complete tax code which is designed only to avoid double taxation on the MOD’s and which does not therefore have to be given some purposive or restricted meaning in order to exclude tax avoidance. The 1993 Regulations (like paragraph 4 in relation to transfers) create a special tax exemption for loan arrangements in relation to overseas securities under which there is only one charge to tax on the MOD’s in the hands of the lender and the borrower obtains tax relief on the dividends or interest he receives during the period of the loan. The parties are treated in fiscal terms as if the loan had never been made. But for this legislation the lender would, as described earlier, have been taxable on the payments made by the borrower and the borrower would have been taxable on the dividends. There is therefore no change in the position of the lender in economic and fiscal terms. The significant aspect of regulation 2B(3) is the relief which it gives to the borrower in being able to avoid a tax charge on the dividends or interest from the securities and this is clearly intended to benefit the parties to real-world, commercial transactions involving the lending of marketable securities and not to transactions which lack those characteristics and whose only purpose is to obtain tax relief. The position seems to me to be exactly analogous to that in *UBS* and, for the same reasons, I would dismiss Mr Chappell’s appeal under ground 1.

Ground 3

45. If my Lords are agreed that the appeal should be dismissed on ground 1 then this point does not arise for decision but, having heard argument on it, I propose to give brief reasons why I disagree with the conclusions of the UT on this issue.

46. Shortly stated, the contention of HMRC is that even if Mr Chappell is otherwise entitled to relief under regulation 2B(3) that relief is limited to higher rate tax relief by virtue of the operation of s.3 TA 1988. This provides:

> “Where a person is required to be assessed and charged with income tax in respect of any property, profits or gains out of which he makes any payment in respect of –
>
> (a) any annuity or other annual payment (not being interest); or
>
> (b) any royalty or other sum in respect of the user of a patent;
>
> he shall, in respect of so much of the property, profits or gains as is equal to the payment and may be deducted in computing his total income, be charged at the basic rate.”

47. If s.3 applies to the MOD’s then Mr Chappell will be liable for basic rate tax on the amount of his taxable income used to make the payments and any relief which he will obtain by being able to deduct the MOD’s from his own taxable income will therefore be limited to higher rate tax. For this reason, Mr Ewart submits that the argument is wrong and that s.3 has no application to a payment within regulation 2B(3) because

the MOD is treated as an annual payment under s.349(1) TA 1988 which covers annual payments "not payable or not wholly payable out of profits or gains brought into charge to income tax". In the case of such payments, the payer is obliged to deduct basic rate tax from the payment and to account for the tax to the Revenue under s.350(1). Where the annual payment is made out of profits or gains charged with income tax then s.348(1) applies. Tax is charged on the payer's profits without distinguishing the annual payment (s.348(1)(a)) but the payer is entitled to deduct and retain basic rate tax out of the annual payment.

48. The FtT took the view that s.3 had no application to annual payments covered by s.349 including in the present case where the MOD's were deemed to be payments under s.349 even though they were in fact paid out of Mr Chappell's taxable income. The UT disagreed. They accepted Mr Goy's argument that s.3 applies to any annual payment that is made either wholly or in part out of taxable profits. This can include a payment under s.349 to the extent it is paid out of such profits which in this case Mr Chappell's was. After referring to ss.349 and 350, they said:

> "73. The effect of those provisions is that, to the extent that annual payments are made out of profits or gains chargeable to income tax, the payer is entitled to deduct tax from a payment and retain the tax deducted. We consider that the fact that similar consequences follow under section 349 and section 350 in relation to payments made out of profits or gains chargeable to tax as follow when section 348 applies, indicates that section 3 should also apply to annual payments within section 349 made out of profits or gains chargeable to income tax. Although the FTT may be correct in stating, at [268], that the usual sort of payment within section 349 is one made other than out of profits or gains chargeable to income tax, that does not mean that, where a payment within section 349 is made out of such profits or gains, section 3 should not apply.
>
> 74. In our view, the fact that regulation 2B(3) removes the requirement to deduct and account for tax under sections 349 and 350 does not lead to the conclusion that section 3 does not apply to payments that fall within section 349 by virtue of regulation 2B of the Regulations. We consider that the words of section 3 are clear. On its terms, section 3 applies where a person makes an annual payment out of any property, profits or gains in respect of which he is required to be assessed and charged with income tax. We cannot discern any purpose in section 3 which would lead us to interpret it so as to limit its operation to annual payments subject to deduction of tax at source. Nor can we find such a purpose in sections 348, 349 and 350."

49. My own view is that the UT is right about the first part of the argument but wrong about the second. I accept that the rationale behind ss.349 and 350 is to require the payer who is not making the annual payment out of taxed income to deduct and account for basic rate tax on the payment on account of the payee's own tax liability and that the requirement to account for the tax so deducted has no application to any

part of the payment which is made out of taxable income. I therefore accept Mr Goy's submission that s.3 can apply to a s.349 case to the extent that taxable income is used to make the payment so as to ensure that the amount of the annual payment (in respect of which tax has been retained by the payer and not accounted for under s.350) has borne tax as part of the payer's income.

50. But the parity of treatment described in [73] of the UT's decision depends upon the payer being entitled to retain out of the annual payment (whether under s.348 or s.350(1)) the amount of the tax deduction which is referable to his own taxed income. Otherwise s.3 will operate to impose a double charge to tax on the payer which is the exact opposite of what both sides accept it was intended to achieve. In the present case, regulation 2B(3) removes the obligation to deduct and account for tax under s.350 from the notional s.349(1) payment and in my view that requires payments falling within regulation 2B(3) to be treated as s.349 annual payments not made out of taxable profits. Regulation 2B(3) should therefore be construed as excluding the operation of s.3 in cases to which the regulation applies. This is also, I think, consistent in its result with HMRC's acceptance that regulation 2B(3) should not be read as removing the borrower's right to deduct the annual payment from his total income because of the exclusion of the obligation to deduct basic rate tax.

Conclusions

51. I would dismiss Mr Chappell's appeal for the reasons I have given in relation to the construction of paragraph 4 and regulation 2B.

Lord Justice Sales :

52. I agree.

The Chancellor of the High Court :

53. I agree also.