Neutral Citation Number: [2014] EWCA Civ 1302

Case No: A3/2013/2375

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM UPPER TRIBUNAL (TAX & CHANCERY CHAMBER)
MRS JUSTICE PROUDMAN & JUDGE SADLER
TC/2010/3195

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 30/10/2014

Before :

LORD JUSTICE GROSS
LORD JUSTICE LEWISON
and
LORD JUSTICE UNDERHILL

- -

Between :

Vocalspruce Limited	**Appellant**
- and -	
The Commissioners for HMRC	**Respondent**

- -
- -

Jonathan Peacock QC and Michael Ripley (instructed by **PricewaterhouseCoopers Legal LLP**) for the **Appellant**
Julian Ghosh QC and Ms Barbara Belgrano (instructed by **HMRC Solicitors Office**) for the **Respondent**

Hearing date: 1st July 2014

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Approved Judgment

Lord Justice Gross:

INTRODUCTION

1. The "loan relationship" code found in Chapter II of the Finance Act 1996 ("FA 1996") deals with the taxation of corporate debt. Profits, gains and losses of a company in respect of its loan relationships are brought into account for the purposes of corporation tax in accordance with this Chapter. The question in the present case goes to the scope of s.84(2)(a) of the FA 1996 which excludes from the profits, gains and losses thus taken into account, "… any amounts required to be transferred to the company's share premium account".

2. Vocalspruce Limited ("the Appellant") appeals against the decision of the Upper Tribunal ("the UT Decision" and the "UT" respectively) released on the 19th June, 2013, upholding the decision of the First-Tier Tribunal ("the FTT Decision" and the "FTT" respectively) released on the 21st December, 2011, in favour of The Commissioners for Her Majesty's Revenue and Customs ("HMRC").

3. The dispute arises out of a marketed tax scheme; if successful, the scheme would remove the accrued profit on loan notes from a charge to corporation tax pursuant to the provisions of s.84(2)(a).

4. Both the FTT and the UT held that the scheme was not successful, as a matter of the true construction of that sub-section ("Issue (I)"). This conclusion was sufficient to dispose of the matter. However, had it failed on Issue (I), HMRC had a second string to its bow: namely, that the "related transaction" provisions contained in para. 12 of Schedule 9 to the FA 1996 excluded the profits in question from the scope of s.84(2)(a) ("Issue (II)"). That contention failed; both the FTT and the UT held that, had HMRC not succeeded on Issue (I), it would not have been assisted by the related transaction provisions.

5. The Appellant appeals on Issue (I). If the Appellant succeeds on Issue (I), HMRC contends, by way of Respondent's Notice, that it is entitled to succeed on its alternative case under Issue (II).

6. The case was described to us as a "lead case", in the sense that a number of other corporate groups are said to be in a similar position to the Appellant. Any such importance is, however, historical only; the relevant legislation has since been radically amended.

7. Although, as foreshadowed, this case concerned a tax scheme, HMRC advanced no contention that it involved tax avoidance. Issues (I) and (II) thus turned on statutory construction.

8. There was no dispute before us as to:

   i) The facts;

   ii) The accountancy position;

   iii) The relevant provisions of company law.

9. We were most grateful to Mr. Peacock QC, for the Appellant and Mr. Ghosh QC, for HMRC, for their excellent submissions.

THE FACTS

10. In the absence of any relevant dispute, the facts may be taken from the helpful summary contained in the FTT Decision. As there explained (at [1]), the Appellant appealed against the notice of amendment issued on 11th December, 2009 by HMRC, in relation to its corporation tax return for the accounting period ended on 31st December, 2004. The effect of the amendment had been to increase the taxable profit of the Appellant by £3,674, 561.

11. In a nutshell (at [3] – [5]):

> " 3. The dispute arises in relation to certain intra-group financing arrangements and transactions. In essence, the parent company, Brixton plc, subscribed for zero coupon loan notes ('the loan notes') in a number of group companies. Those loan notes were then transferred to the Appellant for shares issued with a nominal value equal to the then value of the loan notes, but also at a premium, on terms that the premium would be paid up by capitalising profits arising on the loan notes and appropriating those sums to the Appellant's share premium account.
>
> 4. The Appellant claims that the credit that would otherwise be brought into account for corporation tax purposes on the accrual of profits on the loan notes under the loan relationships rules in the …[FA 1996]… is not brought into account because the transactions fall within s.84(2)(a) of that Act. In essence, the Appellant says that the profits on the loan notes were required to be transferred to the share premium account, and that as such the effect of s.84(2)(a) is to remove such amounts from the scope of tax.
>
> 5. The Respondents [i.e., HMRC] contend that the Appellant has not received 'any amount required to be transferred' to its share premium account within the meaning of s.84(2)(a). The Respondents also say, but it applies only if they are wrong on the first point, that para. 12, Sch 9 FA 1996 applies to disregard the transfer by the Appellant of profits on the loan notes to share premium account. "

12. As recorded by the FTT (at [10]), a statement of agreed facts and a joint experts' report as to accountancy, provided the following summary:

> "1. The Appellant is a UK-resident company, incorporated in England and Wales and at all material times was a subsidiary of Brixton plc, a publicly-quoted company.
>
> **The Loan Notes**

2. On 18 December 2003, Brixton plc subscribed for zero coupon loan notes (‘the Loan Notes’) issued by each of the following companies (‘the Borrowers’)….[each Borrower being a subsidiary of Brixton plc]…..

3.The aggregate Principal Amount of the Loan Notes was £55,376,343, payable on 17 December 2004. Each of the Loan Notes was issued at a 7% discount to the Principal Amount with the discount representing a commercial return on the funds advanced. The total issue price paid by Brixton plc for the Loan Notes was £51,500,000.

The Share Subscription Agreement

4. On 5 January 2004 Brixton plc entered into an agreement with the Appellant (‘the Share Subscription Agreement’) for the subscription of 51,701,782 ordinary £1 shares (‘the Shares’) issued by the Appellant.

5. Under the Share Subscription Agreement the parties agreed that the aggregate subscription price for the Shares would be £55,376,644 (clause 2.2). Accordingly, each share would be paid up £1 as to nominal value and £0.071 as to premium (cl. 3.1).

6. The parties agreed that, in payment up of the nominal value of the Shares, Brixton plc would assign the Loan Notes to the Appellant (clause 3.2).

7. In addition, the parties agreed that in payment up of the premium on the Shares the Appellant’s directors would ‘resolve to capitalise all and any realised profits arising’ on the Loan Notes and ‘appropriate the sum resolved to be capitalised to the share premium account’ (clause 3.3). Brixton plc also undertook to pay any unpaid premium, in the event that the amounts available from the Loan Notes were insufficient, within 5 days of it being called by the directors of the Appellant (clause 3.5).

Written Resolutions of the Appellant

8. On 5 January 2004 by ordinary resolution the Appellant increased its share capital from £1,000 to £51,702,782 by the [creation of] 51,701, 782 ordinary shares of £1 each ranking *pari passu* with the existing ordinary shares of £1 each.

9. On 5 January 2004 by special resolution the Appellant amended its articles of association by the insertion of Article 4 which required the directors to:

a. capitalise all and any realised profits arising on the Loan Notes whether accrued or received, within 30 days following 31 December 2004; and

b. appropriate the capitalised sum to the share premium account of the Appellant and apply such sum towards paying up the unpaid premium in respect of the Shares.

10. On 27 July 2004 by special resolution the Appellant amended Article 4 of its articles of association to require the directors to 'appropriate the sums to be capitalised to the share premium account' and the application of such amounts towards the unpaid premium of the Shares, within 15 days of each of the following dates: 31 July 2004, 30 August 2004, 30 September 2004, 31 October 2004, 30 November 2004 and 31 December 2004.

11. At meetings of the board of directors on 12 August 2004, 2 September 2004, 1 October 2004, 1 November 2004, 1 December 2004 and 4 January 2005, the Appellant's Directors passed resolutions in accordance with Article 4 of its articles of association.

Accounting treatment

12. As the date for payment of the Loan Notes approached, the profits arising were incrementally realised and posted to the profit and loss account. The Appellant transferred them to the share premium account."

13. The FTT further summarised (at [13]) the joint statement of the accountancy experts:

" *(1) Accounting recognition of the loan notes receivable and shares issued*

(a) There was no share premium to recognise in the financial statements of the Appellant on issue of the ordinary shares because the premium was not called or paid at the date of issue.

(b) The initial recognition by the Appellant in its balance sheet of assets (the loan notes) with a value of £51,701,782 was in accordance with UK GAAP.

(2) Accounting recognition of the accruals on the loan notes

(a) The Appellant applied an accruals approach as an accounting policy (recognising the interest …income as it was earned) to reflect the increase in the carrying amount of the loan notes as profit accrued on the original loan principal.

> (b) Further, UK GAAP requires that profits realised at the balance sheet date should be included in the profit and loss account.
>
> (c) The profit of £3,674,561 arising on the loan notes was a realised profit in the Appellant's profit and loss account for the period ended 31 December 2004 in accordance with UK GAAP.
>
> *(3) Accounting recognition of the transfers to share premium account*
>
> (a) The directors' appropriation of the transfer of £3,674,561 from the profit and loss account to the share premium account was undertaken in accordance with the articles of association…..
>
> (b) UK GAAP required those transfers to be reflected as movements in shareholders' funds (that is, a movement in reserves) because this was the effect of this part of the transaction……
>
> (c) In the opinion of the experts, the accounting treatment of the transfer as a movement in shareholders' funds is in accordance with UK GAAP.
>
> *(4) Accounting basis for the transfer to share premium account*
>
> (a) Initially recording the income from the loan notes in the profit and loss account was in accordance with UK GAAP ….which required that the income on the loan notes was first recognised in the profit and loss account.
>
> (b) The transfer of the amount equal to the income on the loan notes, £3,674,651, from the profit and loss account to the share premium account was required by the articles of association….The accounting treatment of that transfer as a movement in shareholders' funds was in accordance with UK GAAP.
>
> (c) ……the share premium of £3,674,651 on the shares was equal to the profit which accrued on the loan notes after their assignment to the Appellant.
>
> (d) There is no alternative accounting treatment."

14. The FTT went on to clarify (at [14]) that the notes in question ("the loan notes") were "zero coupon, or discounted, securities". There was no interest coupon.

> " The profit arose by an accrual of the increase in value of the security from its issue price (or, in the case of the Appellant, its acquisition value) as the loan notes approached maturity. "

THE LEGAL FRAMEWORK

15. *(1) The loan relationship code in the FA 1996:* Insofar as relevant, the statutory provisions are as follows:

" CHAPTER II

LOAN RELATIONSHIPS

80. Taxation of loan relationships

(1) For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter.

……

81. Meaning of "loan relationship" etc.

(1) Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever –

(a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects any money debt; and

(b) that debt is one arising from a transaction for the lending of money;

and references to a loan relationship and to a company's being a party to a loan relationship shall be construed accordingly.

……

82. Method of bringing amounts into account

(1) For the purposes of corporation tax –

(a) the profits and gains arising from the loan relationship of a company, and

(b) any deficit on a company's loan relationships,

shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter.

……

84. Debits and credits brought into account

(1) The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, in accordance with an authorised accounting method and when taken together, fairly represent, for the accounting period in question –

(a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions;

(b) all interest under the company's loan relationships and all charges and expenses incurred by the company under or for the purpose of its loan relationships and related transactions.

(2) The reference in subsection (1) above to the profits, gains and losses arising to a company –

(a) does not include a reference to any amounts required to be transferred to the company's share premium account; but

(b) does include a reference to any profits, gains or losses which, in accordance with [generally accepted accounting practice] are carried to or sustained by any other reserve maintained by the company.

…….

(5) [In this Chapter] 'related transaction', in relation to a loan relationship, means any disposal or acquisition (in whole or in part) of rights or liabilities under that relationship.

(6) The cases where there shall be taken [for the purposes of subsection (5) above] to be a disposal and acquisition of rights or liabilities under a loan relationship shall include those where such rights or liabilities are transferred or extinguished by any sale, gift, exchange, surrender, redemption or release.

(7) This section has effect subject to Schedule 9 to this Act (which contains provision disallowing certain debits and credits for the purposes of this Chapter and making assumptions about how an authorised accounting method is to be applied in certain cases).

……

SCHEDULE 9

LOAN RELATIONSHIPS: SPECIAL COMPUTATIONAL PROVISIONS

12. (1)…. this paragraph applies where, as a result of –

> [(a) a related transaction between two companies that are –
>
> (i) members of the same group, and
>
> (ii) within the charge to corporation tax in respect of that transaction,
>
> ……]
>
> one of those companies ('the transferee company') directly or indirectly replaces the other ('the transferor company') as a party to a loan relationship.
>
> (2) The credits and debits to be brought into account for the purposes of this Chapter in the case of the two companies shall be determined as follows –
>
> (a) the transaction, or series of transactions, by virtue of which the replacement takes place shall be disregarded except –
>
> ……
>
> (ii) for the purpose of identifying the company in whose case any debit or credit not relating to that transaction, or those transactions, is to be brought into account; and
>
> (b) the transferor company and the transferee company shall be deemed (except for those purposes) to be the same company. "

16. *(2) Company law:* As already observed, s.84(2)(a), FA 1996, furnishes an exception in respect of the share premium account as contrasted with the general scheme for bringing debits and credits into account under Chapter II. Accordingly, it is next convenient to say something as to the share premium account.

17. Prior to the Companies Act 1948 ("CA 1948"), the general position in company law was that funds consisting of moneys paid by way of premiums on shares ranked as profits and were available for distribution as dividends: *Drown v G- B Picture Corporation Ltd* [1937] 2 All ER 609; *In re Duff's Settlement* [1951] 1 Ch 721, esp. at p.724.

18. S.56(1) of the CA 1948 provided as follows:

> " Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called 'the share premium account' and the provisions of this Act relating to the reduction of the share capital of a company shall….apply as if the share premium account were paid up share capital of the company. "

As held by Harman J in *In re Duff's Settlement (supra)*, at p.727, the effect of s.56 was that funds consisting of share premiums were no longer available for the payment

of dividends or for distribution as profits. The funds indeed represented a profit, in that the company received more for its shares than their nominal value; however, as Harman J underlined (*ibid*) "….this is not *distributable* profit….". Thus, as the UT Decision observed (at [10] and [26]), the legislation had effectively assimilated share premium to share capital (for this purpose) with the attendant restrictions limiting reduction of share capital, while leaving unaffected the inherent nature of the premium as a profit.

19. Though somewhat differently worded, s.130 of the Companies Act 1985 ("CA 1985") – the applicable legislation for the present case - is to the same effect as s.56, CA 1948. So far as relevant, s.130 is in these terms:

> " (1) If a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to the 'share premium account'. "

Subject to the exceptions, immaterial for present purposes, contained in sub-section (2), s.130 continues as follows:

> " (3)……the provisions of this Act relating to the reduction of a company's share capital apply as if the share premium account were part of its paid up share capital. "

20. Against this background, it is plain that the draftsman of s.84(2)(a), FA 1996 intended that in some circumstances the non-distributable profit contained in a share premium account ought not to be taxable. The questions explored on this appeal inquire as to the nature of those circumstances and, therefore, the scope of s.84(2)(a).

21. I turn to the principal Issues.

ISSUE (I): THE TRUE CONSTRUCTION OF S.84(2)(a)

22. *(1) The Decisions below:* The essence of the *FTT's* reasoning on this Issue was as follows:

> " 42. In our view, the effect of s.84(2)(a) is limited to excluding profits that arise only by reason of the relevant amount being a share premium, and accordingly being required to be transferred to share premium account. It does not exclude profits that accrue to, and are carried to, any other account or reserve. Accounts that are purely internal administrative accounts……can be disregarded. On the other hand, a profit that is credited to profit and loss account is not excluded from the meaning of 'profits, gains and losses' in s.84(1) by a subsequent transfer to share premium account, even if there is an obligation to make such a transfer at the time the profit accrues. "

The FTT considered (at [43]) that this construction was supported by the context, by s.84(2)(a)'s "discernible purpose" and by the wording of s.84(2) as a whole. The

relevant time was when the profit accrued (at [46]). S.84(2)(a) did not look to the end result.

> " 46. ….Once a profit has accrued and been credited to profit and loss account, we do not consider that a subsequent transfer to share premium account even under a pre-existing obligation, can de-nature such a profit, so that it becomes non-taxable."

23. As to the purpose of s.84(2)(a), having regard to the position in company law, it was (at [48]):

> " ….to take out of account for tax on loan relationships an amount which would not be a profit only by virtue of its being a premium on the issue of shares, and not for any other reason….. But the mere transfer to share premium account of a profit that has otherwise arisen on a loan relationship, and which has been accounted for under GAAP as such, cannot….have been within the intendment and purpose of the exclusion under s.84(2)(a). And this remains the case even if there are pre-existing obligations at the time that profit accrues that will result in that profit being transferred to share premium account. Furthermore, we do not accept that the intention was to exclude a profit because it became non-distributable. The intention was to exclude a profit that arose purely because it was a premium; such a profit would, by virtue of s.130 CA 1985, at no time be distributable. "

24. The "paradigm example" (at [49]) of the application of s.84(2)(a) was the extinguishment of a debt in exchange for the issue of shares, on terms involving subscription at a premium. S.84(2)(a) prevented that profit (in the amount of the premium) being treated as a credit and brought into account for the purposes of corporation tax.

25. The *UT* began its analysis with a consideration of the purpose of s.84(2)(a) in light of the position in company law (at [26]). It went on to note (at [27]) that "…the important point, in the context of the loan relationship rules, is that the amount of the profit comprising the premium bears little or no relationship to any profit inherently arising from the terms of the loan relationship itself, or even arising from the dealing in the loan relationship...". It was for this reason "…that it is excluded from the profits to be treated as a credit for loan relationship purposes and so excluded from the tax charge…." – as, by contrast, s.84 looked to the quantum of profits, gains and losses arising from loan relationships.

26. It followed that (at [28]):

> " …s.84(2)(a) relates to those circumstances where the amount required to be transferred to share premium account is the profit arising by reason of the shares being issued at a premium, and it is that profit, so arising, which is excepted from the profits and gains giving rise to credits to be brought into the tax

> charge. This was the conclusion of the …[FTT]…and we agree."

The arrangements in the present case did not accord with the circumstances to which s.84(2)(a) was directed. The UT thus agreed with HMRC (at [30]):

> " …that the profit arising to the Appellant from its loan relationship (the loan notes) arises in its capacity as creditor (it having taken an assignment from PLC of the creditor rights), not in its capacity as the issuer of shares at a premium ….."

27. In accordance with the requirements of UK GAAP the profit (£3,674,561) arising on the loan notes was credited as a realised profit to the Appellant's profit and loss account for the accounting period in question. That, the UT considered (at [31]), fully dealt with "….the profit arising to the Appellant from its loan relationship, within the terms of s.84(1)(a)..". As a separate exercise (*ibid*):

> " ….and separately accounted for, once the directors of the Appellant had resolved to capitalise the profit realised on the loan notes, that sum, £3,674,561, was transferred from profit and loss account to share premium account, being accounted for as a movement in shareholders' funds. Those steps, and the accounting entries by which they were recognised in the Appellant's books, were distinct from the realisation of the profit from the loan relationship and the accounting entries by which that realisation of profit was recognised…. "

28. The same distinction between, on the one hand, the Appellant's realisation of the profit as a creditor on the loan relationship and, on the other, the capitalisation of the profit and its transfer to share premium account pursuant to a different relationship giving rise to no profit for the Appellant, was reiterated by the UT later (at [34]). As to the argument that on transfer of the capitalised profit to share premium account there ought to be a corresponding debit to the profit and loss account, the UT held (at [35]) that such a transfer:

> " …..was not a loss of the Appellant, and certainly not a loss arising from a loan relationship or a related transaction. No debit therefore arises."

29. There was, the UT concluded (at [35]), no "discernible rationale" for the Appellant's proposed construction of s.84(2)(a). In this regard, the UT posited (*inter alia*) that an identical transaction but with the loan notes interest-bearing rather than issued at a deep discount would not, on any view, have been within s.84(2)(a) – yet the inability to distribute the realised profit by way of dividend would have been the same.

30. *(2) The rival cases:* For the *Appellant*, Mr. Peacock's submission was that the words of s.84(2)(a) meant what they said; they spoke of "any amounts" required to be transferred, not "some" amounts. The draftsman focused only on sums credited to the share premium account; not whether they were credited directly or indirectly or on the capacity of the party crediting them. It was the end result which mattered. S.84(2)(a) was designed to reflect s.130, CA 1985; once shares were subscribed for at a

premium, s.130 applied; it was neither here nor there that, on the facts, s.130 was only applicable because of contractual agreements classifying the sums in question as a premium – all the more so as the requirement to capitalise existed from the outset. There was only one profit here; that profit was required to be transferred to the share premium account. It mattered not that the sums in question reached the share premium account via the profit and loss account; for s.84(2)(a) to apply, the amounts had to otherwise to constitute a profit under s.84(1)(a). In any event, insofar as the focus was on the credit in the profit and loss account, it was necessary to take into account the *debit* to that account when the funds were transferred to the share premium account. Although a debt-equity swap involving the subscription of shares at a premium was within s.84(2)(a), it was not the only circumstance which came within the sub-section and was not a good guide to its ambit. The purpose of the sub-section was to shield profit in the share premium account from corporation tax because it was not distributable by way of divided; however, on a subsequent disposal, there would be a liability to Capital Gains Tax.

31. For *HMRC,* Mr. Ghosh submitted that the loan notes (or loan relationship) and the assignment of the loan notes by Brixton plc ("Brixton") to the Appellant were separate and are to be dealt with separately. The appropriation of moneys to the Appellant's share premium account arose under the assignment agreement, not under the loan notes. Once the Appellant's profit on the loan notes had been booked to its profit and loss account – in accordance with an authorised accounting method (not in dispute here) – the loan relationship code found in Chapter II of the FA 1996 was spent. That profit was taxable; the subsequent transfer to share premium account – separate dealing with that profit – did not allow it to escape tax. While s.84(2)(a) of the FA 1996 would have shielded any profit arising under the assignment agreement from taxation, there was no such profit here. As expressed in Mr. Ghosh's written skeleton argument:

> " ….share premium profit is simply irrelevant to the loan relationship code…. Chapter II does not tax profits on the issue of shares. It taxes profits on loan relationships. Here, there is a profit in the profit and loss account. The obligation to transfer the profit to share premium account is not part of the loan relationship computation. It is merely a 'dealing in' the profit (like using it to make a distribution) to satisfy a condition imposed on it qua assignee."

Mr. Ghosh accepted (indeed averred) that s.84(2)(a) qualified s.84(1)(a): it excluded an amount otherwise taxable under s.84(1)(a). Although HMRC did not advance any case based on tax avoidance, these were very odd, meaningless transactions. S.84(2)(a) did not extend to sums "ultimately" required to be transferred to share premium account. The draftsman could not have intended to make the payment of corporation tax optional. The FTT and UT had rightly rejected the Appellant's case. No error of law had been demonstrated. The Appellant's case on Issue (I) was to be rejected and the appeal dismissed.

32. *(3) Discussion:* This issue concerns the true scope of s.84(2)(a) as a matter of construction. The starting point must be the language of the sub-section. Here, at first blush, there is considerable force in Mr. Peacock's submissions. S.84(2)(a) speaks of "any amounts" – not "some" amounts – "required" to be transferred to the share

premium account. Further, s.84(2)(a) says nothing, expressly, as to the capacity in which the Appellant may have been acting, or as to how the Appellant came to be required to transfer those amounts to its share premium account. That the amounts in question were or may otherwise have constituted taxable profits may not advance the argument - in that s.84(2)(a) is only applicable to sums which would or may otherwise have been taxable under s.84(1)(a). Still further, this is a taxing statute, to be interpreted strictly, at least absent any suggestion of avoidance, disclaimed here by HMRC.

33. The consequences, however, of the Appellant's construction are striking – calling at once into question whether, even approached strictly, such a construction can have been the legislature's intention. There is no doubt that s.130, CA 1985 applies where shares are issued at a premium, with the consequence in company law (as already described) that those sums represent a profit but are otherwise subject to the restrictions limiting the reduction of share capital. In the present case, however, the "requirement" to transfer the amounts in question to the Appellant's share premium account arose solely by reason of the – elaborate – contractual arrangements, otherwise meaningless, entered into by the Appellant, Brixton and the other group companies in order to create the very requirement in question: see the terms of the Share Subscription Agreement, the Appellant's written resolutions and the amendments to its Articles of Association, summarised above in the statement of agreed facts. There is an element of "bootstraps" here. Further, <u>if</u> s.84(2)(a) assists the Appellant, it would do so only because of contractual arrangements designed to bring the Appellant within its scope. This appears to be some distance from a straightforward case for the application of s.84(2)(a), *viz.,* to take out of account for corporation tax purposes sums which would only otherwise constitute taxable profits by reason of being a premium on the issue of shares. Moreover, the effect of the Appellant's arrangements, if successful, is to render the payment of corporation tax optional. While it must be acknowledged, as Mr. Peacock correctly submitted, that the Appellant would be liable to Capital Gains Tax on a subsequent disposal of the shares, the Appellant's construction of s.84(2)(a) would nonetheless have produced a (doubtless) valuable deferral of tax.

34. For my part, I would be reluctant to accede to such a construction unless driven to it. I do not think I am. Instead, as it seems to me, the key to unravelling the puzzle presented by this Issue lies in a careful focus on the transactions in question.

35. As is common ground, the Appellant's profit of £3,674,561 on the loan notes was credited in accordance with an authorised accounting method (UK GAAP) to its profit and loss account and was a realised profit in that account for the period ending 31 December 2004. As such, that profit was taxable pursuant to s.84(1)(a), FA 1996. In my view, the code found in Chapter II of the FA 1996 was, thereupon, spent. The Appellant's subsequent dealing in that profit by transferring it to the share premium account is neither here nor there and certainly does not result in that profit ceasing to be taxable. I accept Mr. Ghosh's submission that the taxability of a credit is not to be "retested" every time an amount is transferred from one reserve to another. Nor does that transfer, from profit and loss account to share premium account, constitute a loss to the Appellant, still less a loss arising from a loan relationship or related transaction. In agreement with the UT, I cannot see that a debit arises cancelling (so to speak) the profit earlier booked; the realised profit in the profit and loss account does not cease

to be such. The subsequent transfer is no more and no less than a mode of dealing with a realised profit.

36. Pursuing the analysis, the Appellant's obligation to capitalise and transfer its profit to the share premium account arose under a separate (though related) transaction – and in its capacity as assignee rather than as creditor under the loan notes. Had the Appellant realised a profit as assignee, that profit would have been protected by the language of s.84 (1) and (2), which, in combination, extends to "related transactions"; but the Appellant did not realise any profit as assignee.

37. Pausing here, s.84(2)(a) talks, notably, of "…any amounts required to be transferred to the company's share premium account" not "any amounts *[ultimately]* required to be transferred…". As it seems to me, the Appellant's construction hinges on reading the word "*ultimately"* into the sub-section; indeed, Mr. Peacock's submissions emphasised the end result rather than the means or route by which the amounts were required to be transferred. I respectfully disagree. I do not think that the sub-section is to be read as if the word "*ultimately*" was read in. Nor am I able to accept that s.84(2)(a) focuses only on the end result, however achieved. Were it otherwise, s.84(2)(a), as drafted, would be open-ended in temporal terms, a startling consequence given the impact of the Appellant's construction on the obligation to pay corporation tax.

38. Pulling the threads together, the choice lies between a literal construction of s.84(2)(a) and a more restrictive construction, informed by the context, in particular that provided by the provisions of company law as to share premium accounts and also Chapter II of the FA 1996 as a whole. Despite Mr. Peacock's attractive submissions I am persuaded that the literal construction, focussed essentially on the end result however achieved, cannot be right and cannot properly reflect the legislature's intent. It is simply too open-ended. It is one thing to address the "mischief" of share premium constituting a profit but not a distributable profit; it is quite another to grant *carte blanche* to a company to render the payment of corporation tax optional. In my judgment, therefore, the FTT and UT were right to treat s.84(2)(a) as taking out of account for tax on loan relationships, in the FTT's words (at [42]), "….profits that arise only by reason of the relevant amount being a share premium…".

39. For completeness:

    i) While I agree with the FTT that the capitalisation of debt on terms involving the subscription for shares at a premium serves as an obvious example for the application of s.84(2)(a), I do not see the need to characterise it as the "paradigm" example. Conversely, I do not think that the construction of the section which I favour unduly restricts its sphere of operation.

    ii) On the analysis which I have adopted, it is neither here nor there that the contractual arrangements structured by the Appellant (and others) contained an obligation from the outset that capitalised profits should be transferred to the share premium account.

40. It follows that I would dismiss the appeal on Issue (I). I have, however, had the benefit of reading the judgments of Lewison and Underhill LJJ in draft and

understand, with respect, that My Lords take a different view on Issue (I). Accordingly, I turn to Issue (II).

ISSUE (II): THE RELATED TRANSACTION PROVISIONS

41. *(1) Overview:* Issue (II) only arises by way of HMRC's alternative case on the footing, as the majority has concluded, that it failed on Issue (I). The premise for Issue (II) is accordingly that the Appellant's profit of £3,674,561 would otherwise be shielded from corporation tax on the true construction of s.84(2)(a), FA 1996.

42. The relevant provisions of s.84 (5) – (7) and para. 12 of Schedule 9 to the FA 1996 have already been set out. Various matters are common ground:

   i) the assignment of the loan notes by Brixton to the Appellant was a "related transaction" within s.84(5);

   ii) the Appellant replaced Brixton as a party to a loan relationship;

   iii) the related transaction was one within a "group" of companies for the purposes of para. 12(1) of Schedule 9.

43. As earlier foreshadowed, the Appellant would have succeeded before both the FTT and UT had this Issue arisen for decision. Summarising the FTT's conclusion, the UT put it (at [41]) as follows:

> " ….if the terms of the assignment would otherwise occasion loan relationship profits and losses that effect should be disregarded, but that was the limit of the statutory disregard. Accordingly, it was held that any debits or credits arising on the assignment (in fact there were none) would be ignored so that they would not be taken into account for tax purposes. "

44. The Appellant's case, before the Tribunals below and us, was that this conclusion correctly encapsulated the limit of the statutory fiction. HMRC, however, submitted, here and below, that the Appellant's agreement to capitalise the profits arising on the loan notes and transfer them to the share premium account should also be disregarded. Further, the "single company fiction" (para. 12(2)(b)), deeming the Appellant and Brixton to be the same company, rendered it "…unintelligible to treat shares issued by the Appellant to …[Brixton]… and any resulting 'share premium' as being relevant for the purposes of Section 84(2)(a)….".

45. Issue (II) therefore goes to the scope of the deeming provisions contained in para. 12 of Schedule 9.

46. *(2) The Decisions below:* Understandably (given its decision on Issue (I)), the UT dealt with this Issue almost summarily and did not advance the reasoning of the FTT. Accordingly, I concentrate on the FTT Decision.

47. The FTT alluded (at [57]) to the two "possible" statutory fictions in para. 12(2): first, that subject to the exception in para. 12(2)(ii), the related transaction must be disregarded; the second and subject to the same exception, that Brixton and the

Appellant are the same company. The words of para. 12 were to be given their ordinary and natural meaning, with due regard to its evident purpose (at [65]). Thus:

> " When para. 12 requires one to disregard the related transaction, it is important to note that the paragraph, in common with the entire body of the relevant legislation, is wholly directed to calculating loan relationship profits and losses. It is therefore central to the purpose of para. 12 that if the terms of the assignment would otherwise occasion loan relationship profits and losses, it is that effect that should be disregarded. That is the extent and the limit of the statutory fictions. "

Nothing in para. 12(2)(a)(ii) was intended to affect the accrual of profit on the loan notes (at [66]):

> " We are essentially directed to disregard the related transaction and to regard the Appellant and its parent company as one company when dealing with the credits and debits that would otherwise flow from that transaction; but required not to extend the disregard or the single company fiction so as to modify the treatment of the credits and debits that do not relate to that transaction."

48. Finally, the FTT (at [71]) did not accept that what it considered to be the proper analysis of para. 12 gave rise to any "incoherence" of the nature submitted by HMRC. There was nothing incoherent in identifying as between Brixton and the Appellant to what extent each was required to bring credits and debits – unrelated to the related transaction – into account and then applying the normal rules of computation (including any s.84(2)(a) exclusion) separately in the case of each individual company.

49. *(3) Discussion:* With respect to the FTT and UT Decisions and Mr. Peacock's submissions, Issue (II), as it seems to me, admits of a short answer. I agree with the FTT so far as it distinguishes between the credits and debits relating to the related transaction and the credits and debits relating to the loan relationship but which do not relate to the related transaction. It is at the next step, however, where I part company with the FTT's reasoning. As para. 12 provides, the "transaction, or series of transactions" comprising the "related transaction" are to be disregarded when assessing the "credits and debits" to be brought into account for the purposes of Chapter II. In my judgment, the "transaction" or "series of transactions" must be considered as a whole; it cannot be correct to look at a part only of any such transaction/s. It follows that the assignment to the Appellant cannot be considered (and disregarded) without likewise considering (and disregarding) the Appellant's agreement to capitalise the profits and transfer them to its share premium account. On this relatively straightforward and simple ground, I prefer HMRC's submissions to those of the Appellant. If right thus far, then the only credit not disregarded is that relating to the loan notes and credited to the Appellant's profit and loss account; on that footing, the foundation for any claim to invoke s.84(2)(a) disappears.

50. I am fortified in my conclusion when regard is had to the second fiction found in para. 12, namely that Brixton and the Appellant shall be deemed to be the same company. In this regard, I accept the submissions of Mr. Ghosh: if the Appellant and Brixton are to be regarded as the same company, it is unintelligible to treat shares issued by the Appellant to Brixton plc and any resulting share premium as relevant for the purposes of s.84(2)(a).

51. Accordingly, the UT has erred in law and HMRC's alternative case succeeds. On this ground too, I would dismiss the appeal.

52. For completeness, I have not overlooked Mr. Peacock's submission that HMRC's approach gave rise to capricious and anomalous results. With respect, I am not persuaded that it does. First, I accept that the stated legislative purpose of the para. 12 fictions was to enable "…debt to be moved around a group without tax obstacles….": see, the *Explanatory Notes* to para.11, Schedule 8 to the Finance Bill 1996 (the forerunner of para. 12). That purpose is not, however, determinative as to the scope of the deeming provisions of para. 12 in the context of the particular transaction/s here in question. Secondly, the fact that s.84(2)(a) may not apply to intra-group transactions even if applicable to identical transactions between unconnected companies, seems unremarkable, reflecting the reality of group companies constituting a commercial entity. Thirdly, it is perhaps unsurprising that the benefit of the para. 12 fictions (the movement of debt around a group of companies without tax obstacles) is restricted to UK group members "within the charge to corporation tax in respect of that transaction" (para. 12(1)(a)(ii)); that being so, it is or may be unavoidable that the availability of s.84(2)(a) may differ depending on whether both group companies are or are not UK taxpayers.

Lord Justice Lewison:

53. I have had the benefit of reading the judgment of Gross LJ in draft. I agree with him that the appeal should be dismissed, but I have reached that conclusion by a different route. Let me explain.

54. A share premium is a price that exceeds the nominal value of the share. It is received wisdom that an amount paid to a company by way of share premium is a profit in the hands of the company: *Drown v Gaumont-British Picture Corporation Ltd* [1937] 2 All ER 609. However, ever since the passing of section 56 of the Companies Act 1948 where a company issues shares at a premium a sum equal to the amount or value of the premium must be transferred to an account called the share premium account. Once transferred, the share premium account is treated as paid up share capital. This means that it cannot be distributed to the members of the company except by means of an authorised reduction in capital. At the time of the events with which we are concerned, the legislation to this effect was to be found in section 130 of the Companies Act 1985. It is now to be found in section 610 of the Companies Act 2006.

55. Whether a company issues shares at a premium will depend on the terms of the subscription agreement. In other words it depends on the terms of the bargain between

the issuing company and the subscriber. If the agreed terms include the payment of a share premium then section 130 (now section 610) applies; and the company must transfer the amount or value of the premium to the share premium account.

56. Chapter II of the Finance Act 1996 introduces the code relating to loan relationships. Section 82 provides that the profits and gains arising from the loan relationships of a company are to be computed in accordance with that section, using the credits and debits given by the following provisions of Chapter II. Section 84 relevantly provides:

> "(1)The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, in accordance with an authorised accounting method and when taken together, fairly represent, for the accounting period in question—
>
> (a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions; and
>
> (b) all interest under the company's loan relationship and all charges and expenses incurred by the company under or for the purposes of its loan relationships and related transactions.
>
> (2) The reference in subsection (1) above to the profits, gains and losses arising to a company—
>
> (a) does not include a reference to any amounts required to be transferred to the company's share premium account; but
>
> (b) does include a reference to any profits, gains or losses which, in accordance with generally accepted accounting practice, are carried to or sustained by any other reserve maintained by the company."

57. A "related transaction" is defined by section 84 (5) as follows:

> ".. "related transaction", in relation to a loan relationship, means any disposal or acquisition (in whole or in part) of rights or liabilities under that relationship."

58. Thus the first instruction in section 84 (1) (a) is to find the sums which fairly represent *all* profits and gains which arise from *both* loan relationships and related transactions. If something is not such a profit, then it does not fall within section 84 (1) (a) at all. But it will fall within section 84 (1) (a) if it is either a profit arising from a loan relationship or a profit arising from a related transaction. Mr Ghosh QC submitted that loan relationships on the one hand, and related transactions on the other, were to be separately considered. However, I can see no warrant in the words of the section for that conclusion. On the contrary both loan relationships and related transactions are dealt with in the same subsection; the inquiry is as to all profits from both, and the

sums in question are to be taken together. The second instruction in section 84 (1) (a) is to disregard interest. That is because it is separately dealt with by section 84 (1) (b).

59. We are told, however, by section 84 (2) (a) that the reference to profits and gains does not include "any amounts required to be transferred to the company's share premium account". Plainly, this sub-section is connected with the obligation created by section 130, and reflective of its wording. It is inherent in this sub-section that, but for its operation, the amount in question would be a profit or gain arising either from a loan relationship or from a related transaction. The sub-section does not distinguish between amounts required to be transferred to a share premium account because of the terms upon which the loan relationship was created and amounts required to be so transferred because of the terms of a related transaction. I agree with Mr Peacock QC that the sole inquiry posed by the sub-section is whether the amount is required to be transferred to the share premium account. It is not concerned with why. It is also clear that in order for an amount to fall within section 84 (2) (a) it must be both a gain arising out of a loan relationship or related transaction and also a share premium. I cannot therefore agree with Mr Ghosh that a gain made in the capacity of creditor somehow falls outside section 84 (2) (a). Section 84 as a whole is concerned with profits made in the capacity of creditor; so section 84 (2) (a) must have been intended to exclude some profits made in that capacity. I also agree with Mr Peacock that:

i) The sub-section focuses on the obligation (or requirement) to transfer the amount to the share premium account, rather than the timing of the actual transfer.

ii) The use of the verb "transferred" recognises that the amount may be transferred from one internal company account to another, with the consequence that its temporary appearance in the profit and loss account does not prevent the application of section 84 (2) (a).

iii) The profit in the present case was the realisation of the discount from the nominal value of the loan notes. As the FTT put it the "profit arose by an accrual of the increase in value of the security from its issue price … as the loan notes approached maturity". But there never was a time at which Vocalspruce was both entitled to the value of that gain but not required to transfer it to the share premium account. In other words the gain was a gain arising out of the loan relationship, but it was a gain that Vocalspruce was required to transfer to the share premium account. That obligation arose because of the combination of the terms of the share issue and section 130.

60. On a straightforward reading of section 84 (2) (a), therefore, the amount required to be transferred to the share premium account is not within the expression "profits or gains" arising from either the loan relationship or the related transaction. Unlike Gross LJ I do not consider that Mr Peacock's submission entails writing words into the statute. It is, as he says, the literal or (as I have called it the straightforward) reading of the statute. In respectful disagreement with Gross LJ I consider, therefore, that both the First Tier Tribunal and the Upper Tribunal were wrong on this point.

61. That leads to the second issue. It is common ground that because this was an inter-group transaction under which Vocalspruce replaced Brixton plc as creditor under the

loan relationship, Schedule 9 para 12 of the Finance Act 1996 applied. That paragraph states:

> "(1) Subject to paragraph 15 below, this paragraph applies where, as a result of:
>
> (a) a related transaction between two companies that are—
>
> (i) members of the same group, and
>
> (ii) within the charge to corporation tax in respect of that transaction, …
>
> one of those companies ("the transferee company") directly or indirectly replaces the other ("the transferor company") as a party to a loan relationship.
>
> (2) The credits and debits to be brought into account for the purposes of this Chapter in the case of the two companies shall be determined as follows—
>
> (a) the transaction, or series of transactions, by virtue of which the replacement takes place shall be disregarded except for the purpose of identifying the company in whose case any debit or credit not relating to that transaction, or those transactions, is to be brought into account; and
>
> (b) the transferor company and the transferee company shall be deemed (except for that purpose) to be the same company."

62. The question that arises is: what is to be disregarded? Mr Peacock said that because paragraph 12 (1) refers to a "related transaction" and a related transaction is narrowly defined as the acquisition of rights under the loan relationship, all that is required to be disregarded is the fact of Vocalspruce's replacement of Brixton plc. There is no warrant for disregarding the share issue, or its terms, even though the issue of the shares was the consideration for the acquisition.

63. I cannot accept this argument. The term defined is a related *transaction*; and the defined term may itself colour the meaning of the definition. A transaction is (at least) a bilateral arrangement. It makes no sense to disregard *part* of the transaction, when the statute clearly requires the whole transaction to be disregarded, except for very limited purposes. Moreover, paragraph 12 (2) says in terms that the "the transaction, or series of transactions, by virtue of which the replacement takes place" must be disregarded, except for limited purposes. In addition it is a well-known method of interpreting deeming provisions that one must treat as real the inevitable consequences flowing from the deemed state of affairs: *DCC Holdings Ltd v HMRC* [2010] UKSC 58, [2011] 1 WLR 44 at [38]. If the acquisition by Vocalspruce had not taken place, the inevitable consequence would have been that the shares would not have been issued for a premium, and there would have been no requirement to transfer anything to the share premium account. The rights under the loan relationship would have remained with Brixton plc, which was under no obligation to transfer any

amount to a share premium account, and that company would have been liable to pay tax on the gain. Thus there is nothing, in this deemed state of affairs, for section 84 (2) (a) to bite on. I regard this conclusion as supported by the obvious policy of paragraph 12, namely to ignore inter-company transactions. This may work for or against a corporate group, depending on what kind of transactions are in play.

Accordingly, in agreement with Gross LJ, I consider that both tribunals were wrong on this point too. The consequence of my disagreement with the tribunals on both points means, however, that this appeal must be dismissed.

Lord Justice Underhill

64. I agree that this appeal should be dismissed but, like Lewison LJ, I do so because I think that the FTT and the UT were wrong on Issue (II) rather than because I think they were right on Issue (I). So far as Issue (II) is concerned, I do not need to add anything to what Gross and Lewison LJJ have said. As for Issue (I), in view of the difference between My Lords I should give my reasons in my own words, but I can do so very briefly.

65. No-one disputes that the amounts with which we are concerned in this case were required by section 130(1) of the 1985 Act to be transferred to Vocalspruce's share premium account. It would seem necessarily to follow that they are caught by section 84(2)(a) of the 1996 Act, whose wording precisely – and evidently deliberately – tracks that of section 130(1). That language is perfectly clear, and in my view it leaves no room for distinguishing between different kinds of situation in which section 130(1) might apply, depending on how the premiums in question arose. It may well be that the draftsman did not foresee the kind of use to which section 84(2)(a) has been put in the present case; but that cannot justify introducing the qualifications to the plain statutory language for which HMRC contends. I do not think I need say more, but I should make clear that I agree with Lewison LJ's fuller analysis and in particular with the three numbered points made at the end of para. [59].