TC01734

Appeal number: TC/2010/3195

Corporation tax – lead case - loan relationships – whether profit accruing on loan notes assigned for shares issued at a premium is a taxable profit – profits capitalised and transferred to share premium account – application of s 84(2)(a) FA 1996 – application of para 12, Sch 9 FA 1996

FIRST-TIER TRIBUNAL

TAX

VOCALSPRUCE LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE ROGER BERNER
JUDGE HOWARD NOWLAN

Sitting in public at 45 Bedford Square, London WC1 on 15 and 17 November 2011

Jonathan Peacock QC and Michael Ripley, instructed by PwC Legal, for the Appellant

Julian Ghosh QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is the appeal of Vocalspruce Limited ("the Appellant") against a notice of amendment issued on 11 December 2009 by HMRC ("the Respondents") in relation to the corporation tax return of the Appellant for the accounting period ended on 31 December 2004. The effect of the amendment was to increase the taxable profits of the Appellant by £3,674,561.

2. As we will describe, this case is a lead case under rule 18 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. A number of related cases, with common or related issues of fact and law, have been stood behind this appeal.

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 Finance Act 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 contend that the Appellant has not received any "amounts 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.

6. The Appellant was represented by Jonathan Peacock QC and Michael Ripley. Julian Ghosh QC appeared for the Respondents.

Lead case

7. As mentioned earlier, this case is a lead case. It has common or related issues with a number of related cases, which have been stayed. Subject to a right to apply to the Tribunal for a direction to the contrary, the parties to the related cases are bound by this decision in respect of the common or related issues.

8. We need not recite the common or related issues of fact, as that will be apparent from our description of the facts of this case. However, we set out here the common

or related issues of law, as we shall need to return to those when summarising our conclusions. The common or related issues of law are:

(1) Whether the profit arising from the loan note and appropriated to pay up the issue premium on the shares, was "required to be transferred to the share premium account" within the meaning of FA 1996, s 84(2)(a).

(2) Whether the amounts which are required to be transferred to share premium account are within the meaning of "profits or gains and losses" for the purposes of FA 1996, s 84(1)(a).

(3) Whether the amounts taken to the share premium account are to be brought into account for the purposes of calculating tax under the loan relationship rules and are not, therefore, subject to tax.

(4) Whether FA 1996, Sch 9, para 12 applies in the present case, and, if so, excludes the "share premium" profit arising to the Appellant from the scope of s 84(2)(a).

9. It will be apparent from this that the first three issues essentially arise out of the dispute as to the meaning and effect of s 84(2)(a); the fourth issue is as to the application of para 12, Sch 9.

The facts

10. We had a helpful statement of agreed facts, which we reproduce below, and we also had reports from expert witnesses as to accountancy called by each of the parties, and a joint experts' report which those witnesses helpfully provided. Each of those accountancy experts, Mr Andy Simmonds of Deloitte LLP for the Appellant and Mr David Henworth, an advisory accountant within HMRC, for the Respondents, also gave oral evidence under cross-examination.

Statement of agreed facts

> 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**
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> 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") in the following amounts:
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> > a. Brixton Northfields (Wembley) Holdings Limited (formerly known as Stylescore Limited), with a face value ("Principal Amount") of £35,483,871 and purchased for the issue price of £33,000,000;

b. Brixton Northfields 1 Limited, with a Principal Amount of £6,892,473 and purchased for the issue price of £6,410,000;

c. Brixton Northfields 2 Limited, with a Principal Amount of £548,387 and purchased for the issue price of £510,000;

d. Brixton Northfields 3 Limited, with a Principal Amount of £4,021,505 and purchased for the issue price of £3,740,000;

e. Brixton Northfields 4 Limited, with a Principal Amount of £3,924,731 and purchased for the issue price of £3,650,000; and

f. Brixton Northfields 5 Limited, with a Principal Amount of £4,505,376 and purchased for the issue price of £4,190,000.

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 £55,376,344 (clause 2.2). Accordingly, each share would be paid up £1 as to nominal value and £0.071 as to premium (clause 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.
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> 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.

11. We were very helpfully taken through a sample of the documents to demonstrate the documentary basis for the facts as agreed. These included the corporate resolutions from which there is little material to record by way of further findings of fact. We would however mention the board minutes of the Appellant in relation to the board meetings referred to at para 11 of the statement of agreed facts, which in each case recorded that the directors had noted that the company had positive distributable reserves, including in particular that none of the investments or other assets held by the company were impaired, and that no provisions were required to be made in respect of the profits arising on the loan notes, and accordingly that all of the amount capitalised represented a realised profit.

12. We should also note, by way of clarification, that the reason why there was a difference between the aggregate issue price of the loan notes (£51,500,000) and the

nominal amount of the shares issued by the Appellant under the subscription agreement (£51,701,782) is that in the period between the date of issue of the loan notes and the date of the share subscription the value of the loan notes had increased, having regard to accruals, by the amount of £201,782.

Joint statement of accountancy experts

13. The accountancy experts, Mr Simmonds and Mr Henworth, very helpfully provided a joint report. As regards matters of expert opinion relevant to this case, there was no dispute between the experts. We shall come on to one or two points that arose during cross-examination of each of them, but we set out here a summary of the matters of expert opinion on which they agreed.

(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 (sic) 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. (This is not strictly a matter of accountancy opinion, but is not disputed.)

(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. This appears to be the accounting which has been adopted by the Appellant although full disclosure of the reserves movements as required by Companies Act 1985, Sch 4, Part III, para 46 was not included and the accounts anticipate the final transfer which was not approved by the board until after the year end.

(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 (FRS3 "Reporting Financial Performance") 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, £3,674,561, from the profit and loss account to the share premium account was required by the articles of association (see above). The accounting treatment of that transfer as a movement in shareholders' funds was in accordance with UK GAAP.

(c) In the opinion of Mr Henworth, and in accordance with the company law assumptions provided to Mr Simmonds, the share premium of £3,674,561 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. We should clarify one point from this summary. Although the experts refer to the recognition of interest income, it will be apparent from the agreed facts that the loan notes in question 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.

15. There are only a few additional points to record arising out of the cross-examinations of the experts.

16. Mr Simmonds was asked whether, on a straightforward direct subscription by an investor for shares at a premium, the amount would go straight to share premium account, and not be carried first to any other reserve. Mr Simmonds said that within the bookkeeping system there would often be instances where cash would be received for a public subscription before the shares were allotted, and the amount might then be posted to a holding account, which could be called a subscription account or an allotment account. Once the shares were allotted, the transfer would be made to share premium and the share capital. But in a case where a known subscriber simply subscribed for shares at a premium, Mr Simmonds confirmed that the premium amount would go directly to share premium. This would apply whether the subscription was for cash or on a capitalisation of a debt.

17. Mr Simmonds clarified the joint report conclusion that UK GAAP required the transfers from profit and loss account to the share premium account to be reflected as movements in shareholders' funds. The accrual of income was correctly accounted for as part of the profit and loss account. That was on account of the fact that this would affect the amounts of assets and liabilities that were stated in the balance sheet. The resultant aggregate amount accounted for in the profit and loss account would

then be the amount of the profit and loss reserve. The transfer from that reserve to another reserve, namely share premium account, would not affect the assets and liabilities, and so would not itself be a profit and loss account movement.

18. Mr Simmonds also confirmed that if the Appellant had not appropriated the accrued profit on the loan notes and capitalised it in the way it was obliged to do, the balance of the profit and loss account would have been carried as a balancing figure to the profit and loss reserve.

19. Mr Henworth's report expressed opinions on the accounting treatment of the borrowing companies, and the parent company. As the tax positions of those companies were not in issue in this appeal, we took no account of those opinions. The report also contained a number of assertions of opinion on fact and law that were outside the scope of accountancy expertise. A number of instances of this were put to Mr Henworth in cross-examination. We need not record them; it suffices for us to say that in relation to any questions of fact and law that were a matter for determination by the tribunal we have paid no regard to the expressions of opinion by Mr Henworth.

The law

20. This case is concerned with the tax treatment of loan relationships. At the material time, the relevant provisions were contained in Chapter II of Part IV of the Finance Act 1996. Those provisions were themselves amended after the time relevant to this appeal; we set out the relevant provisions as in force at the material time.

21. Section 80 FA 1996 sets out the basic position that 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 Chapter II. The loan notes evidence loan relationships in this case. The Appellant was, following the assignment, a creditor in respect of the loan notes, and accordingly its loan relationship was a creditor relationship (FA 1996, s 103(1)).

22. Section 82 describes the method of bringing amounts into account for tax. Sub-section (1) provides:

> "(1) For the purposes of corporation tax—
>
> (a) the profits and gains arising from the loan relationships 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."

23. The tax position is thus ascertained by reference to credits and debits as provided for by Chapter II. It is s 84 that sets out the basic rule, and which is material to the first of the issues we have to consider. So far as material it 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 relationships 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.

…

(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)."

24. Section 84 contains the basic rule. Sub-section (7), however, directs attention to Sch 9, and the special provisions that can apply. One such provision is that in para 12, which contains special computational rules for certain transactions between group companies. So far as material, para 12 provides:

"(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,

(b) a series of transactions having the same effect as a related transaction between two companies each of which—

> (i) has been a member of the same group at any time in the course of that series of transactions, and
>
> (ii) is within the charge to corporation tax in respect of the related 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.”

25. Company law imposes requirements on the issue of shares at a premium. Prior to s 56 of the Companies Act 1948 having effect, and apart from any provision in the articles of association, there was no legal objection to a company making a distribution out of share premium by way of dividend. The change in law by s 56 effectively assimilated share premium to share capital. For present purposes the rule is found in s 130 of the Companies Act 1985:

> “(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 an account called ‘the share premium account’.
>
> (2) The share premium account may be applied by the company in paying up unissued shares to be allotted to members as fully paid bonus shares, or in writing off –
>
> (a) the company’s preliminary expenses; or
>
> (b) the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company,
>
> or in providing for the premium payable on redemption of debentures of the company.
>
> (3) Subject to this, 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.
>
> (4) Sections 131 and 132 below give relief from the requirements of this section, and in those sections references to the issuing company are to the company issuing shares as above mentioned.”

26. It was common ground that neither s 131 nor s 132 apply.

27. Although, prompted by questions from the Tribunal, there was some discussion on the applicability of s 130 in the circumstances of the share issue and capitalisation of share premium in this case, the Respondents did not seek to argue that s 130 does not apply. We are therefore not required to make any findings in that respect. We are content to assume that the transfer to share premium account was either a function of the obligations under the subscription agreement and the articles of association and board resolutions of the Appellant, or a function of those obligations together with s 130. Either way, it is common ground that the applicability or otherwise of s 130 itself is not determinative of this appeal.

Discussion

28. We turn first to consider the rival submissions on s 84(2)(a). If we find for the Respondents on that question, that will determine the appeal, and the Respondents will not need to rely on para 12, Sch 9.

Section 84(2)(a)

29. Put shortly, what the Appellant contends is that the transactions clearly fall within the plain words of s 84(2)(a): the profits arising on the loan notes were required to be transferred to share premium account. As such, it is said, s 84(2)(a) provides a statutory injunction to remove such amounts from the scope of tax. Mr Peacock submitted that s 84(2)(a) encompasses all profits that are required to be transferred to share premium account. No distinction is drawn between one type of share premium and another, nor between any accounting treatment and another; nor does it ask how or why it is that an amount falls to be transferred to share premium account. The only question is: “Have you been required to transfer any amount?” It is the end result that matters.

30. Mr Ghosh submitted that s 84(2)(a) is looking at a requirement for the transfer to share premium account only at the time that the relevant amount arises as a profit on a loan relationship. Accordingly, in this case the profits as they accrued were required to be transferred to profit and loss account. There was at that time no requirement to transfer to share premium account; the profit remained in the profit and loss account until a movement on reserves was required when the Appellant appropriated and capitalised the profit to share premium. Mr Ghosh argued that it was not the end result that matters. The fact that there is a present obligation to do something in the future with the profits does not mean that there is no obligation, when the profit accrues, to transfer that profit to the profit and loss account, nor that there is a requirement at that time to transfer to share premium account.

31. There was no argument that the transactions should be analysed on the basis that they were concerned with tax avoidance. Nor did we receive any evidence on whether the transactions were for commercial purposes. We make no findings in that respect. We are here concerned purely with a question of statutory construction.

32. It was common ground that we should construe the relevant provisions purposively. Both parties agreed that the starting point is the guidance given by the House of Lords in *Barclays Mercantile Business Finance Limited v Mawson* [2005] STC 1 (HL) at para 36:

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

Here there is no dispute on the nature and effect of the transactions. The only question for us is the purposive construction of the statutory provisions.

33. The parties agreed that the wording of s 84(2)(a) reflected, in its reference to "transferred to share premium account", the similar wording in s 130. It is evident that the draftsman of s 84(2)(a) had s 130 in mind when constructing the exclusion from what would otherwise be profits, gains or losses arising to a company from its loan relationships. We need therefore to consider why it was that such an exclusion was considered to be required.

34. Mr Peacock referred us to a number of case law authorities on the pre-1948 company law position of share premium, before s 56 of the Companies Act 1948 (now s 130 CA 1985) had assimilated share premium to share capital. The question was whether share premium was available for distribution by way of dividend. In *Drown v Gaumont-British Picture Corporation Ltd* [1937] 2 All ER 609, it was held in the High Court that the part of a reserve fund that consisted of monies paid by way of premium on the issue of shares was generally available for dividend purposes. In a case which considered the post-1948 position, *Re Duff's Settlement* [1951] Ch 721, Harman J held that the effect of s 56 was that money paid out of share premium account is to be treated as capital and not as income. This conclusion was confirmed by the Court of Appeal [1951] Ch 923.

35. In the High Court, at page 724, referring to *Drown*, Harman J remarked that before the 1948 Act the sums received by companies as premiums on the allotment of shares ranked as profits available for payment of a dividend. He goes further (at p 727), confirming that, even after the 1948 Act, share premium "represents a profit in the sense that the company got more for its shares than their nominal value" albeit not, after s 56, a distributable profit.

36. On this basis Mr Peacock developed his argument that in 1996 the draftsman was alive to the fact that, notwithstanding that s 130 would make a profit non-distributable, a transfer to share premium account would not of itself prevent a profit arising, and that if that profit was from a loan relationship or related transaction, it would have to be excluded so as to make it not taxable in the hands of the recipient. Mr Peacock submitted that one could infer that as a matter of policy it had been determined that if something was added to the share capital of the company, albeit through the mechanism of the share premium account, and by virtue of that became non-distributable, that should be something that was not charged to tax in the hands of the recipient.

37. Mr Ghosh argued in this respect that the company law authorities were not to do with whether the share premium is a taxable profit in the hands of the company which books the amount to share premium account. Instead, the cases were concerned with the quality of a dividend in the hands of the recipient. We accept, of course, that the cases had nothing to do with taxation of profits of the company. But they do demonstrate the fact that, even after the assimilation of share premium to share capital, a share premium is itself a profit, albeit one that is not distributable, and can be reduced only in the same way as share capital. The important point, we consider, is that share premium could represent a profit, and that the draftsman evidently considered that there were circumstances in which such a profit ought not to be taxable under the loan relationships code. The legislative purpose of s 84(2)(a) was to eliminate the charge to tax in those circumstances.

38. What we need to consider, therefore, is the circumstances in which s 84(2)(a), properly construed, does have that effect. The argument of Mr Ghosh proceeds on the basis that a profit once identified and carried, according to GAAP, to profit and loss account is a taxable profit, and that a transfer of that profit to share premium account, even pursuant to an obligation to do so that exists at the time of the profit accrual does not exclude that profit from the ambit of s 84(1)(a).

39. Mr Peacock points to the language of s 84(2)(a), and in particular the use of “transferred”, importing the term used in s 130 CA 1985. Mr Peacock argued that this connoted a transfer from one place to another, and must at the least include a transfer from one reserve to another. He submitted that there could be no basis for concluding that where the draftsman talks of “transferred” he means only a direct credit to share premium account.

40. Mr Ghosh on the other hand argued that, in this context, “transferred” means nothing more than a movement, in the same way as one might have on a direct subscription for shares or on the issue of shares at a premium on the extinguishment of a debt, when a transfer to share premium account is required.

41. We do not consider that the use of the term “transferred” in the context of a requirement that share premium be taken to share premium account is determinative. It is clear that the term can encompass all means whereby share premium is credited to share premium account. A share premium may be required to be credited to share premium account without first being credited to any other account or reserve, or, as in this case, it might first be required to be credited to another account or reserve, such as the profit and loss account or reserve, and then transferred, by a movement on reserves to share premium account. But the mere use of the term “transferred” does not lead to the conclusion that all such transfers to share premium account must fall within the ambit of s 84(2)(a).

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 such as suspense accounts on certain share

subscriptions, in which an amount paid as a share premium might temporarily be held prior to the premium being transferred directly to share premium account, 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.

43. We consider that this construction is supported by the context in which s 84(2)(a) falls to be construed, and by its discernable purpose.

44. Firstly, s 84(2)(a) must be considered along with s 84(2)(b). Mr Peacock drew our attention to the fact that (b) uses the language of profits, gains or losses being "carried to or sustained by" any other reserve. Although this can be contrasted with the use of "transferred" in (a), we do not, for the reasons we have given, consider that this indicates anything other than that the draftsman had s 130 CA 1985 in mind when drafting (a). We ourselves note, on the other hand, that whereas (b) refers to "profits, gains or losses", (a) refers only to "amounts". We consider that this is a strong indication that s 84(2)(a) is confined to cases where there is no pre-existing profit etc that has been required to be carried to any other reserve, and that it accordingly encompasses only cases where the premium has been transferred directly to share premium account.

45. A clear contrast is drawn in s 84(2) (and this is in our view emphasised by the use of the conjunction "but") between cases where an amount is transferred to share premium account and cases where profits, gains or losses are carried to or sustained by other reserves. In our view the scheme of s 84(2), taken as a whole, is to ensure that only amounts which would not otherwise for any reason be profits, gains or losses, but which are transferred to share premium account, are excluded from being profits, gains or losses within s 84(1)(a). Amounts which are profits, gains or losses carried to or sustained by any other reserve are within s 84(1)(a), and are not taken out of the meaning of that expression by subsequently being transferred to share premium account, even if the company is obliged to make that transfer.

46. It follows therefore that we agree with the submissions of Mr Ghosh. The time at which both s 84(2)(a) and (b) operate is, in our view, the time when the profit accrues. That is the material time at which the taxability of an amount must be determined. In this case the profit accrued to profit and loss account, and at that time the profit fell to be taken into account. We do not accept Mr Peacock's submission that s 84(2)(a) looks to the end result. 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.

47. The reference in s 84(2)(a) must, in our view, be construed so as to mean a present requirement to transfer at the time the profit accrues. It does not, in our judgment, encompass an obligation which exists, but as regards which the company will be required to make the transfer only at some time in the future (which may be very shortly afterwards). There can be no requirement to make the transfer unless and

until the capitalisation has taken place. The requirement to transfer to share premium account does not arise until a premium is contributed, by subscription or capitalisation or otherwise. It does not matter whether the company is obliged contractually or under its articles to effect the capitalisation. That merely amounts to a present obligation which, when satisfied, will at that stage give rise to the requirement to transfer an amount to share premium account. Until then the requirement to transfer to share premium account is not a present requirement.

48. In our judgement this analysis accords with what we perceive to be the purpose of s 84(2)(a). We regard the evident purpose of that provision to be to take out of account for tax on loan relationships an amount which would be a profit only by virtue of its being a premium on the issue of shares, and not for any other reason. As we have described, under company law, despite the assimilation effect of s 130 CA 1985, a share premium, in the words of Harman J in *Re Duff's Settlement*, represents a profit in the sense that the company gets more for its shares than their nominal value. One can readily appreciate why that possible outcome was something that Parliament would not be seeking to tax, even if the "profit" that was represented by the premium arose from a loan relationship. 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, in our view, 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.

49. Perhaps the paradigm example of the application of s 84(2)(a) is the case of the extinguishment of a debt of £100 in exchange for the issue of 10 £1 shares. In such a case a creditor has effectively subscribed for the shares at a premium of £90. That premium must be transferred to share premium account. In company law terms, the £90 represents a profit. The company has received value, in the form of debt release, of £100 in consideration for an issue of shares of £10. Without more, that profit on the debtor relationship of the company could be regarded for the purposes of s 84(1) as a profit arising on the company's loan relationship. Unless excluded, that profit could be represented by a credit to be brought into account to corporation tax. Section 84(2)(a) prevents that consequence. It does so because the only reason why the amount of £90 could be a profit is because it is a premium. Nothing else in respect of that loan relationship has given rise to any profit accrual. If there had been some other accrual or recognition of profit for accounting purposes, s 84(2)(a) would not apply merely because that profit had to be transferred, even under a pre-existing obligation, to share premium account.

50. Mr Peacock argued that this construction would be to narrow the meaning and scope of s 84(2)(a). He argued that the section expressly applied to "any" amounts required to be transferred to share premium account, and that there was no principled basis upon which those words could be given a narrower construction so as to create separate sub-categories of share premium which do or do not qualify for relief. We

do not consider that the construction we have placed on s 84(2)(a) is aptly described as a narrow construction; in our view it is a principled and purposive construction. We do not regard the use of the word “any” as militating against a purposive construction which recognises that the section is looking at those amounts, and that transfer, when considering whether they are or are not to be regarded as profits, gains or losses arising to the company. The use of the word “any” has no significance in this context; it does not, in our view, extend the scope to any amounts that are profits otherwise than by reason of being share premiums.

51. We base our conclusion purely on the construction of s 84(2)(a) itself. In particular, whilst we recognise that in many respects the loan relationships code does provide for symmetry between the tax treatment of debtors and creditors to loan relationships, this is not a universal rule, and has not provided an aid to construction in this case, even on a contextual basis. The fact that the Appellant’s submissions in this case, if correct, would have given rise to an asymmetry in the treatment of the borrowing companies (which obtained a corporation tax deduction for the accruing borrowing cost) as against the Appellant, as creditor, which would not have been taxed on the corresponding accrual of profit, has not been material to our decision.

52. Our conclusion, therefore, is that s 84(2)(a) does not have the effect of removing the accrued profits on the loan notes from tax. That is enough to dispose of the appeal, but in case this appeal goes further, and in light of the submissions we have received, we turn now to the issue of the effect, if any, of para 12, Sch 9 FA 1996.

Para 12, Sch 9 FA 1996

53. Were we to have decided that the Appellant was right on s 84(2)(a), the Respondents argued that para 12, Sch 9 operates to exclude the “share premium” profit arising to the Appellant from the scope of s 84(2)(a).

54. We will consider this contention by looking first at the wording of para 12, focussing in particular on para 12(2); we will then outline Mr Ghosh’s contentions, and Mr Peacock’s response; and then give and explain our decision.

55. Paragraph 12 makes provision for certain special computational rules for groups of companies. There was no dispute between the parties that the conditions for its applicability in this case were satisfied. The assignment of the loan notes from the parent company to the Appellant was a “related transaction” between companies in the same group as a result of which the Appellant directly replaced the parent company as a party to the loan relationship.

56. The dispute centred on the extent and effect of the disregard provisions of para 12(2). Although we have set out that sub-paragraph above, it is convenient to remind ourselves of its wording;

> “(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."

57. Paragraph 12(2) contains two possible statutory fictions. The first is that, subject to the exception in sub-paragraph (ii), the related transaction must be disregarded. The second is that, subject to the same exception, the transferor company (here the parent company) and the transferee company (the Appellant) are the same company.

58. The purpose and effect of para 12(2) in the normal situation of an intra-group transfer of a loan relationship are relatively straightforward. Should the assignment itself be effected at a price that would ordinarily occasion debits and credits, the assignment and those debits and credits are to be disregarded. Only the assignment is ignored, however. The accrual of interest, or profit on a discounted security (depending on the nature of the loan relationship) on the assigned loan relationship are not ignored, and they are allocated to the assignor and assignee in accordance with the normal basis of recognition of those items.

59. In this case, therefore, prior to addressing Mr Ghosh's contentions, para 12(2) would have little effect. The parent company assignor had already recognised the accrued profit on the loan notes prior to the assignment. The assignment was made at a price that precisely reflected the accrued profit at the point of the assignment. The price paid on the assignment itself would be ignored, but the parent company accounted for an equivalent accrued profit, and the amount of profit to be accrued in the assignee was reduced by a corresponding amount. In those circumstances, on the assumption that the Appellant had succeeded on its s 84(2) argument, the assignee would be arguing that its accrual of profit on the loan notes would be excluded from tax.

60. Mr Ghosh's contention, however, was that the assignment was a bilateral transaction. If one disregarded the assignment, one should also disregard the share issue, because that was itself merely part of the consideration for the assignment, along with the inherently connected terms in relation to paying up the premium on the issued shares by crediting later loan relationship profits to share premium account. One did not disregard the later accruals because the loan notes conferred that profit, quite apart from the assignment transaction, in other words quite apart from the "related transaction". But when one had to disregard the share issue and the credit to share premium account, the Appellant's argument in this case that the accruals in its profit and loss account should not be taxed because of a transfer to share premium account would cease to fly, because one would be disregarding the feature that the profit was later applied in paying up the premium on the shares, and thus the credit to share premium account.

61. Mr Ghosh then submitted that this result would neatly achieve the purpose of para 12, namely the objective of ensuring that the quality of the debits and credits in respect of the loan relationship itself would remain unchanged, notwithstanding the intra-group transaction. He also observed that a feature that confirmed that it was coherent that the share issue be disregarded was that the fiction of treating the parent company and the Appellant as a single company (other than for the purpose of accruing the profits on the loan relationship itself) the notion of issuing shares to the issuer was unintelligible. Disregarding the share issue thus avoided that absurdity.

62. In response, Mr Peacock contended that Mr Ghosh was over-extending the purpose of para 12. The first statutory fiction clearly required one to disregard the assignment of the loan notes, but to extend the fiction to negate the share issue and the related credits to share premium account was unwarranted. Mr Peacock referred to the guidance recently summarised by the Supreme Court in *DCC Holdings (UK) Limited v Revenue and Customs Commissioners* [2010] UKSC 58; [2011] STC 326, to which we shall revert, and argued that:

(a) the “related transaction” was simply the assignment of the loan notes, and there was no occasion to ignore the share issue;

(b) concluding that the share issue should not be disregarded, and implicitly that the second statutory fiction (of treating the two companies as one) did not apply in relation to a share issue that was unaffected by para 12, led to the coherent result that the shares were still issued by one company to another; and

(c) the Respondents’ contention was purportedly affecting the quality of credits that were not meant to be affected by para 12, which was inconsistent with the purpose of the paragraph of dealing essentially with the treatment of the related transaction alone.

63. Our decision in relation to whether Mr Ghosh is right to say that para 12 would undermine the Appellant’s case, were the Appellant to have succeeded on the s 84(2) issue is as follows.

64. Since this issue relates largely to identifying the extent of the effect of statutory deeming provisions, it is we think appropriate first to summarise the principles of construction of deeming provisions or statutory fictions recently articulated by Lord Walker in *DCC Holdings* (at paras 37 – 39):

(1) The normal principles of construction apply, but it must be recognised that, by its very nature, a deeming provision involves artificial assumptions. It will frequently be difficult or unrealistic to expect the legislature to be able satisfactorily to prescribe the precise limit to the circumstances in which, or the extent to which, the artificial assumptions are to be made.

(2) A court is entitled and bound to ascertain for what purposes and between what persons the statutory fiction is to be resorted to.

(3) The words of a deeming provision should be given their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the

purpose of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction.

(4) Because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so.

65. We consider that the effect of para 12 can readily be ascertained by construing the words used and by giving them their ordinary and natural meaning. But we should approach the construction of the paragraph with due regard to its evident purpose. 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.

66. Indeed, para 12 itself contains a clear delineation of the statutory fictions: they each expressly do not apply in identifying the company required to bring into account any debit or credit not relating to the related transaction. So whereas the related transaction, namely the assignment, and so the consideration which is part of that related transaction, whether in cash or shares or otherwise, would fall to be disregarded and thus not give rise to loan relationship profits or losses on the related transaction itself, it is evident from para 12(2)(a)(ii) that nothing in para 12 is intended to affect the accrual of profit on the loan notes. That accrual derives from the loan notes themselves, and is not occasioned by the disregarded "related transaction". It then seems to us that there is nothing in para 12 to lead to a requirement to disregard anything in relation to credits and debits that arise from the accruals on the loan notes, including the circumstances in which s 84(2)(a) might apply to those credits to which we should, and must, have regard. 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.

67. Mr Ghosh argued that the credit to share premium account did relate to the assignment, and so the disregard and the single company fiction were not excluded by para 12(2)(a)(ii). He submitted that this was because the undertakings to carry out the various transactions that resulted in the transfer to share premium account was part of the related transaction, namely the assignment of the loan notes. The assignment should be ignored, with the consequence that the issue of shares and the transfer to share premium should be ignored.

68. To the extent that Mr Ghosh can be taken to be arguing that the reference to credit in para 12(2)(a)(ii) can include the credit to share premium account, we reject

that submission. That credit, or transfer, is not of the nature of the credit or debit to which (ii) is directed. We agree with Mr Peacock that the reference to credits and debits in (ii) is confined to the statutory credits and debits postulated by s 82 FA 1996, and cannot encompass some other credit such as that which arises on a transfer to share premium account.

69. The credits in question, and those which accordingly are not subject to the statutory fictions, are the credits that represent profits in the profit and loss account of the Appellant. The assignment of the loan notes cannot be ignored for this purpose, and it follows in our view that the assignment and everything else that flowed from it, including the capitalisation of profits and the transfer of those profits to share premium account, are also not disregarded for the purpose of applying any relieving provision that might affect such profits. That would include, as in this case, were we to have found that s 84(2)(a) applied as the Appellant argued, the exclusion of amounts transferred to from profit and loss reserve to share premium account from being profits and credits for tax purposes.

70. Finally we consider Mr Ghosh's submission that para 12(2)(a)(ii) would not operate in any intelligible fashion if the quality of the credits, and the nature and tax treatment of any "profit", was changed by the fact of the related transaction, namely the assignment. This was on the footing that the effect of para 12(2)(a)(ii) is to require there to be an allocation of credits arising on the loan notes as between the parent company. Mr Ghosh argued that the very purpose of para 12 in this respect is to preserve the tax treatment of the loan relationship which is the subject of the related transaction, both before and after that transaction, except to allocate the debits or credits, as the case may be, between the parties to the related transaction.

71. We do not accept that what we consider to be the proper analysis of para 12 gives rise to any incoherence of the nature suggested by Mr Ghosh. The statutory disregard of the related transaction and the deemed single company fiction do not apply to credits or debits that are not related to the related transaction. There is nothing incoherent in identifying as between the transferor company and the transferee company to what extent each of those individual companies is required to bring those credits and debits into account, and then applying the normal rules of computation, including any exclusion by virtue of s 84(2)(a) separately in the case of each individual company. That, it seems to us, is the correct approach on a plain reading of para 12.

72. On the assumption, therefore, that the effect of s 84(2)(a) is to take the accruals of profit on the loan notes outside of the meaning of profit for loan relationships purposes, we conclude that para 12 would not deprive the profit accrued on the loan notes of the exclusion afforded by s 84(2)(a).

Summary of conclusions

73. We have concluded:

(1) Section 84(2)(a) FA 1996 does not have the effect of removing the accrued profits on the loan notes from tax under the loan relationships rules. The Appellant is accordingly liable to corporation tax on those profits.

(2) If we had decided that s 84(2)(a) did remove the accrued profits from tax, that result would not have been prevented by application of para 12, Sch 9 FA 1996.

Decision

74. For the reasons we have given, we dismiss this appeal.

Lead case issues

75. We set out here our formal responses to the lead case common or related issues of law. These must of course be read in conjunction with our decision in the lead case.

(1) Whether the profit arising from the loan note and appropriated to pay up the issue premium on the shares, was "required to be transferred to the share premium account" within the meaning of FA 1996, s 84(2)(a). There was an obligation to transfer the profit arising from the loan note and appropriated to pay up the issue premium. However, that obligation, and that transfer, did not prevent the profit that had accrued to profit and loss account from being within the meaning of "profits, gains and losses" in s 84(1).

(2) Whether the amounts which are required to be transferred to share premium account are within the meaning of "profits or gains and losses" for the purposes of FA 1996, s 84(1)(a). Yes. Those amounts were the profits accrued and accounted for in the company's profit and loss account. Those are within the meaning of "profits, gains and losses" in s 84(1), and are not excluded from being within that meaning by being required to be transferred to share premium account.

(3) Whether the amounts taken to the share premium account are to be brought into account for the purposes of calculating tax under the loan relationship rules and are not, therefore, subject to tax. The amounts taken to share premium account are not by virtue of s 84(2)(a) excluded from being profits within s 84(1). Accordingly, the accrued profits on the loan notes are subject to tax as profits arising to the company on its loan relationships.

(4) Whether FA 1996, Sch 9, para 12 applies in the present case, and, if so, excludes the "share premium" profit arising to the Appellant from the scope of s 84(2)(a). The conditions for the application of para 12 were not disputed. Paragraph 12 does not, however, have the effect of excluding the "share premium" profit from the scope of s 84(2)(a), if applicable.

Application for permission to appeal

This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

ROGER BERNER
HOWARD NOWLAN

TRIBUNAL JUDGES
RELEASE DATE: 21 December 2011